

# ***China's Financial Transition at a Crossroads***

**DRAFT MANUSCRIPT**

## CHAPTER 1

# China's Financial Markets: An Overview

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## INTRODUCTION

This chapter provides an historical overview of the development of Chinese capital markets since the onset of the reform period. This important subject has attracted the attention of some of the best scholars working on China over the last 20 years. There is a vast literature for the reader to learn from and build upon. No attempt will be made here to be complete or comprehensive in covering even the major English-language contributions to this literature, much less the enormous volume of work published by mainland Chinese scholars in Chinese.

Instead, the goal is to provide the reader with a basic understanding of the key economic, regulatory, and market developments that have shaped the evolution of China's financial markets up to the present. Whereas the other chapters in this volume focus to a significant extent on China's financial future, one must begin with a clear understanding of the recent past. Given the space constraints, the coverage will necessarily be selective, focusing primarily on banks and equity markets.

In presenting this material, three main themes will be repeatedly emphasized. The first is the centrality of the state in the intermediation of

In writing this historical overview, I have benefited immensely from reading the careful book-length studies of Stephen Green (2003), Yasheng Huang (2003), Nicholas Lardy (1998, 2002), Kellee Tsai (2002), and Carl Walter and Fraser Howie (2003). I have also learned a great deal from discussions with Michael Destefano, Fred Hu, Wei Jiang, Jack Langlois, Nicholas Lardy, David Li, Shan Li, Xiaobo Lu, Neng Wang, and Shang-Jin Wei. Any errors or inaccuracies are solely my responsibility. Renminbi figures are converted to dollars at the market exchange rates prevailing in March 2006, and may therefore differ from the conversions that appear in the original sources.

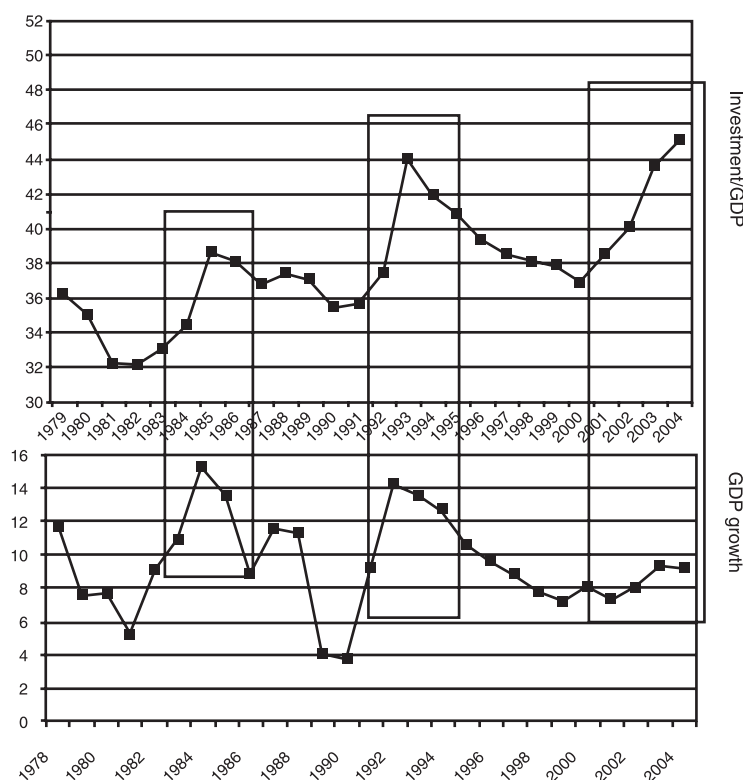
capital in the Chinese economy, which has persisted to the present day.<sup>1</sup> Chinese financial markets are dominated by banks, and the banking sector has been and continues to be dominated by state-owned banks, which, until very recently, have concentrated their lending on state-owned enterprises (SOEs). The equity markets have largely consisted of state-owned firms in which the state and its agents have retained a controlling, usually majority, interest. China's dynamic non-state sector, especially its private firms, has been heavily discriminated against in the allocation of capital. Bond markets are dominated by issues of Chinese government bonds, and the right to issue fixed income securities has been tightly restricted.

This situation contrasts sharply with the general trajectory of Chinese economic reform since 1978.<sup>2</sup> At the dawn of the reform period, the prices of nearly all goods and services were set administratively; by the mid-1990s, more than 94 percent of all prices were set by the market. Foreign trade in the late 1970s was highly restricted and monopolized by 12 state-owned trading companies; by the late 1990s, foreign-invested enterprises accounted for more than 55 percent of China's imports and exports, and gross values of import and export flows were equivalent to 75 percent of gross domestic product (GDP). Industrial output was dominated by SOEs in 1978; this fraction has fallen substantially. Chinese labor "markets" were once characterized by lifetime employment, administratively set wages, strictly limited interfirm and geographic mobility, and a cradle-to-grave intrafirm welfare state. Today, Chinese labor markets function much more freely. China's dynamic private firms can increasingly compete freely in the product market and the labor market—but access to capital, while it is improving, remains restricted. The increasing reliance on the market mechanism that is such a visible and striking feature of other aspects of modern Chinese economic life is much less evident in the financial sector.

The second related theme is that reform of Chinese financial markets has been inextricably bound up with the state's efforts to reform and improve the efficiency of its SOEs, while retaining a large degree of ultimate control over them. When this goal proved elusive in the 1990s, the government accepted the need to downsize and privatize a large component of the SOE sector, but the state has consistently reaffirmed, at least rhetorically, its commitment to control the "commanding heights" of the economy by continuing to support (and direct) the largest and most important SOEs, including the most important components of the financial sector.

From a Western perspective, the goal of retaining ultimate state control may conflict with the goal of pursuing maximum efficiency. This conflict may continue to limit the success of ongoing government efforts to improve the functioning of the country's capital markets.

The third main theme is the context of macroeconomic instability in which Chinese financial markets have evolved.<sup>3</sup> This can be illustrated by figure I.1. The top graph shows the investment to GDP ratio since the early years of the reform period. The bottom graph shows real GDP growth according to the official statistics, which have been the subject of some criticism in recent years. Although real GDP growth has remained consistently positive throughout this period, the growth rate has experienced pronounced fluctuations that are closely related to rapid increases in investment relative to GDP.



**Figure I.1** China's Investment-Driven Growth Cycles

Sources: Goldstein and Lardy (2004); National Bureau of Statistics.

China has already been through two investment-driven boom-and-bust cycles. The first, in the 1980s, was generated by an investment boom that led to serious macroeconomic imbalances, including rapid inflation, as well as the creation of excess capacity across a range of industrial sectors. The state had to sharply curtail bank lending, bringing investment back down to a sustainable level, but the result was a pronounced slowdown in macroeconomic growth. The second cycle came in the early 1990s. Deng Xiao-Ping's endorsement of continued economic reform during his famous "journey to the South"<sup>4</sup> touched off another investment boom even more dramatic than the one in the mid-1980s, financed principally by rapidly expanding bank loans. Once again, macroeconomic imbalances, including accelerating inflation, quickly became evident, and the authorities had to curtail bank lending, using a mix of sharp interest rate increases and administrative controls on the volume of lending. In the aftermath of this austerity regime, GDP growth slowed markedly and signs of excess capacity began to appear. Thomas Rawski (2001) has suggested that the combined effects of this slowdown, together with the onset of the Asian financial crisis in 1997, actually caused growth in the period from 1998 through 2000 to decline to considerably lower levels than the official GDP statistics suggest. Goldstein and Lardy (2004) estimate that roughly 40 percent of the loans extended during the early 1990s investment boom became nonperforming in the period of slower growth that followed.

The Chinese economy entered its third investment-driven boom in the early years of the current decade. Starting in 2002, bank lending and fixed asset investment began growing sharply relative to GDP. By 2004, the investment/GDP ratio had reached roughly 50 percent, an all-time high in recent decades.<sup>5</sup> Despite a slowdown in fixed asset investment growth in 2004, the ratio of fixed asset investment to GDP for 2005 remained close to 50 percent.<sup>6</sup> Over the past three years, real GDP growth has accelerated in response to the surge in investment, albeit to a lesser extent than in the past.<sup>7</sup> As in earlier investment-driven booms, government officials have decried the creation of excess capacity, particularly in certain industrial sectors, and the authorities have imposed stringent limits on lending and investment. While there is no sign yet of any significant deceleration in real GDP growth, some concern has arisen that economic growth will decelerate over the next several years, as the overhang of excess investment is slowly absorbed.<sup>8</sup>

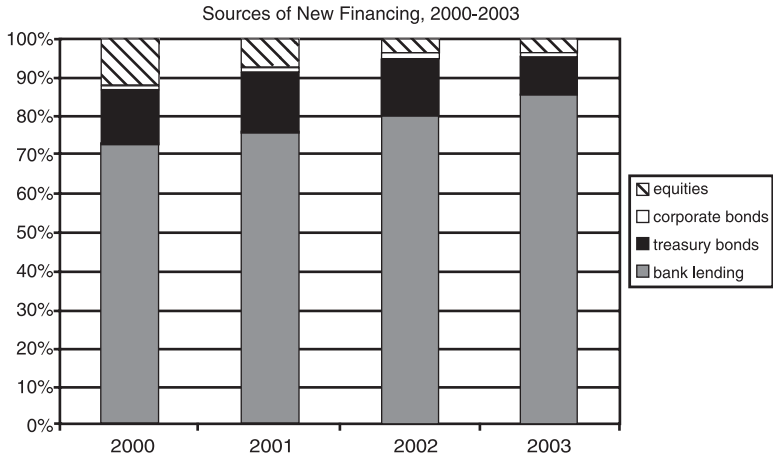
A number of market observers have pointed out, correctly, that the current investment boom has been financed, to a greater extent than in the past, by enterprises' own retained earnings. Net external financing, most of it through bank loans, has only accounted for about 30 percent of enterprise investment in the current cycle, as opposed to 40–60 percent of investment in the investment boom of the 1990s. As a consequence, the inevitable slowdown may pose less of a risk to the banking system than the slowdown of the mid- to late 1990s.<sup>9</sup> That being said, even proponents of this view concede that the current investment rate is likely to be unsustainably high, and enterprises that have overextended themselves may be unable to pay off their bank loans. This will probably trigger another substantial increase in the level of nonperforming loans (NPLs) in the banking system.<sup>10</sup> A slowdown in corporate earnings and aggregate demand may complicate efforts to improve the functioning of the equity market. This macroeconomic context is critical as one considers the trajectory of financial reform over the next few years.

#### CHINA'S BANKING SYSTEM

Chinese financial markets are dominated by banks to an extent that stands out even in Asia, with its history of bank-dominated financial markets. Chinese domestic equity and bond markets continue to play a relatively small role in the intermediation of financial capital to businesses in contemporary China. In 2003, lending by Chinese banks, as measured by total growth in loans outstanding, totaled 2.99 trillion renminbi (RMB). The total amount of funds raised on domestic capital markets, not including Chinese treasury debt or financial policy bonds, was less than 116 billion RMB—that is, *less than 4 percent of the increase in loans outstanding*. The sum of initial public offerings, secondary offerings, rights issues, and the sale of convertible bonds on domestic equity markets amounted to less than 82 billion RMB. Net funds raised by nonfinancial corporations through corporate bonds issuance was less than 34 billion RMB.<sup>11</sup>

Most other East Asian economies have traditionally had bank-dominated financial systems, but in many of those countries, the role of banks, at least in relative terms, has shrunk as domestic capital markets have developed and expanded. There is no sign of such a general trend in China, as can be seen in figure 1.2.<sup>12</sup>

For this reason, any discussion of Chinese financial markets, their history, and their evolution, will have to begin with a discussion of the banking



**Figure 1.2** Sources of New Funds

Source: People's Bank of China.

system. I will begin by briefly reviewing the structural transformation of the Chinese banking system from a Soviet-style monobank on the eve of the reform period to the present.

FROM MONOBANK TO A BANKING SYSTEM —  
REFORMS OF THE 1980S

In the early years of the People's Republic of China (PRC), the private and quasi-private banks of the Republican era were either closed down or folded into state-owned financial institutions. By the dawn of the reform period, in 1978, China nominally possessed three separate state-owned banks, but in reality there was only one: the People's Bank of China (PBOC), which simultaneously served as the chief lending institution and the nation's central bank.<sup>13</sup> The PBOC regulated the money supply, set interest rates, managed the PRC's foreign exchange, and supervised the rest of the financial system. In addition, through a nationwide network of over 15,000 branches, subbranches, and offices, it controlled roughly 80 percent of all deposits and was the source of over 90 percent of all loans by financial institutions.<sup>14</sup>

The Bank of China (BOC) was effectively a subsidiary of the PBOC and specialized in handling foreign exchange transactions, working closely

with the state-owned trading companies. The China Construction Bank (CCB), created by the PRC in 1954, operated as a branch of the Ministry of Finance, disbursing funds to approved investment projects that were part of the state economic plan; the funds came from the state budget. In reality, it was not a bank at all. There was a network of rural credit cooperatives, but their primary purpose was to mobilize rural savings—they did relatively little lending.<sup>15</sup>

In fact, the pre-reform banking system did relatively little lending in a modern economic sense. Household savings was very low relative to GDP. National savings were high but came primarily from the operating surplus of the state-owned industrial sector. This surplus was reinvested primarily through state budget allocations rather than lending per se. It is perhaps only a slight exaggeration to conclude that in the pre-reform era China lacked not only capital markets but also a banking system.<sup>16</sup>

Starting in 1979, the monobank began to evolve into a banking system with an increasingly complex and heterogeneous set of institutions. The Agricultural Bank of China (ABC) was reestablished with a mandate to focus on deposit and lending activity in rural areas, as part of the government's broad strategy to improve the agricultural sector. In the same year, the State Council brought the Bank of China out from under the authority of the PBOC and expanded its business scope in order to support China's rapidly expanding trade and foreign investment. Finally, the Construction Bank was elevated to similar status and allowed to take deposits and engage in lending activity rather than simply disbursing government funds.<sup>17</sup>

In 1983, the council decided to convert the PBOC into a central bank more on the lines of international standards. Over the next two years, the PBOC began to take on these normal central banking functions. However, the policy directives of the PBOC were subject to approval by the State Council—the PBOC has not had, nor does it have today, the kind of legally mandated independence granted to the U.S. Federal Reserve, the Bank of England, or the Bank of Japan.<sup>18</sup>

The former commercial banking functions of the PBOC, including its vast network of offices and its enormous loan portfolio, were transformed into an independent lending entity, the Industrial and Commercial Bank of China (ICBC), which upon establishment in 1984 was (and remains) the single largest bank on the mainland. Together, the big four state-owned banks—the BOC, the ABC, the ICBC, and the CCB—continue



to dominate China's financial system, accounting for 55 percent of all assets in the financial system as of the end of 2003 and roughly half of all new lending in recent years.<sup>19</sup>

As these institutions were taking shape, revolutionary changes and rapid growth in the rural Chinese economy, mostly reflecting the rapid de-collectivization of agriculture, led to an explosion of household savings. In the absence of alternatives, much of this flow of new savings found its way into the banking system. Income growth and high savings rates persisted throughout the 1980s, providing the nascent banks with an ample supply of new funds.<sup>20</sup> Bank deposits grew nearly 25 percent per year from 1985 to 1990.<sup>21</sup>

#### INCREASING COMPETITION AND COMPLEXITY

In the early years of the reform era, the big four operated with mandates that were, for the most part, nonoverlapping. The BOC managed transactions associated with foreign trade, the ABC concentrated its activity in rural areas, the ICBC lent to state-owned industrial enterprises, and the CCB financed new infrastructure and other investment projects. However, starting in the mid-1980s, the boundaries of their business models began to blur, new financial institutions arose, and competition began to increase. For example, the Bank of China lost its monopoly on foreign currency transactions as other state-owned banks moved into this market.<sup>22</sup>

Perhaps more significantly, there were two main waves of new bank creation, the first occurring in the mid- to late 1980s and the second in the early to mid-1990s. These gave birth to banks that today account for about 14 percent of all bank assets. These banks are legally organized as shareholding companies, and many are listed on China's A-share domestic stock market. The composition of shareholders reflects multiple entities, including foreign financial institutions. In most cases, however, a majority or plurality of outstanding shares are held by government entities, including SOEs, and governmental authorities continue to exercise considerable influence over senior executive appointments and other high-level decisions.<sup>23</sup> Yet these institutions were generally not subject to the sort of policy-lending directives that distorted much of the lending of the big four through the late 1990s.<sup>24</sup>

On the other hand, direct competition with the big four has been limited inasmuch as these banks collectively possess much smaller branch networks than their big four rivals. The PBOC has to approve the establishment

of new bank branches. By year-end 1994, the central bank had allowed the non-state banks to set up 130 branches, 98 subbranches, and 724 offices below subbranch level. In contrast, the big four possessed 138,081 offices below the subbranch level.<sup>25</sup> It seems clear that the pace of reform reflected the government's desire to retain direct control over capital allocation by ensuring the continued dominance of the financial institutions it directly supervised.<sup>26</sup>

Starting in the mid-1980s, there was also a proliferation of nonbank financial institutions, including leasing companies, trust and investment companies, and the internal financial arms of major state-owned conglomerate groups.<sup>27</sup> Urban credit cooperatives predated this period, but began their rapid expansion then. In the 1990s, mergers of these cooperatives in over one hundred cities created what has become the third tier of the modern banking system: city commercial banks. These institutions collectively accounted for about 5 percent of financial system assets by mid-year 2005.<sup>28</sup>

Despite the emergence of an increasingly wide range of players, the big four retained their dominance of financial assets and lending throughout the reform period, and their share of both remained as high as 70 percent as late as the mid-1990s. Furthermore, the business model consisted of taking deposits from households and lending to SOEs. At the end of 1995, the outstanding borrowing of SOEs from banks was 83 percent of all loans outstanding. Consumer credit remained very underdeveloped, and direct lending by state banks to private firms remained extremely limited.<sup>29</sup>

The concentration of lending in the state-owned sector reflected, in part, the degree to which the big four were constrained in their lending decisions by the policy directives of government at various levels. Official statistics do not provide clear indicators of the fraction of loans that were made on the basis of policy directives rather than commercial considerations, but estimates run as high as 40 percent for the banking sector as a whole.<sup>30</sup> More qualitative assessments suggest that 70 percent of the lending made by the big four to SOEs was "policy-based," with little consideration for commercial merit.<sup>31</sup> Through the mid-1990s, the big four were also constrained to follow annual credit quotas from the State Planning Commission that dictated the aggregate level of total lending and the geographic breakdown across provinces.<sup>32</sup>

This led to a distinctive pattern in the geographic distribution of Chinese bank lending that is clearly evident in the official statistics. Provinces

in which SOEs accounted for a particularly large share of industrial output, such as Jilin, Inner Mongolia, and Heilongjiang provinces, were characterized by high “loan-to-deposit” ratios. Bank deposits grew rapidly in coastal provinces where private firms, foreign-funded enterprises, and township and village enterprises (TVEs) were expanding their share of industrial output. However, branch banks in these provinces were not constrained by high lending quotas, because of the limited amount of SOE activity. Instead, these banks tended to place a large portion of their funds on deposit with the central bank. The central bank then re-lent these funds to branch banks in the provinces in which SOEs tended to dominate local industrial activity, which were thus characterized by a high ratio of loans to deposits. The central bank also engaged in lending through its own branches in those provinces. Regression analysis by Boyreau-Debray and Wei (2005) suggests that official policy allocated capital away from the country's most productive regions and toward some of its least productive regions.<sup>33</sup>

Defenders of China's economic record have suggested a political rationale for this pattern of capital allocation and for the relatively slow pace of reform in China's financial sector more generally.<sup>34</sup> While economically inefficient on the face of it, preferential allocation of capital to SOEs might have been politically necessary in order to maintain broad-based support within the system for continuing economic reform. Had the SOE sector been forced to shrink too quickly or change too drastically, the momentum of reform might have been drastically undermined.<sup>35</sup> The truth of this assertion is obviously difficult to assess—we do not observe the counterfactual world in which a different pattern of allocation of capital obtained. Nevertheless, it is reasonable to think that pressure to compensate vested interests was an important factor in explaining the pattern of allocation of bank lending.

In addition to mandated credit quotas, the banks had to contend with regulated interest rates on both deposits and loans. Official interest rates appear to have been consistently set far below market-clearing rates. This is particularly evident during the periods of high inflation that occurred in the late 1980s and early to mid-1990s. The rate of increase in producer prices for industrial goods peaked in 1989 at 19 percent and again in 1993 at a scalding 24 percent, which far outstripped the nominal interest rate on working capital loans of 11.34 percent and 10.98 percent, respectively.<sup>36</sup> Strongly negative real interest rates exacerbated excess demand for capital and arguably induced excess investment on the part of firms with access

to bank loans. The degree to which official rates deviate from a hypothetical market-clearing rate is less clear outside of these inflationary periods, but indirect evidence is provided by press accounts of the many illegal private banks that have sprung up throughout China to provide financing to the private entrepreneurs that were largely excluded from the formal financial system until the late 1990s. Tsai (2002) cites Chinese press accounts of interest rates in the informal financial sector running 30 to 100 percent higher than the official bank rate.<sup>37</sup>

Chinese commentators have pointed to a political explanation for the persistence of financial repression in China in the 1980s and 1990s. Li (2001) and Bai et al. (1999, 2001) have argued that these policies amounted to a flat tax on bank deposits and that, given the institutional constraints of the government's taxation system during the reform period, a partial reliance on this tax was actually optimal.<sup>38</sup> At the same time, these authors acknowledge the longer-run costs of financial repression and the need to move to a more market-directed financial system.

Political interference in the operations of the major banks was not limited to the lending quota and interest rate regulation that favored borrowers. Until the PBOC began to aggressively reassert control over its vast network of local offices in the mid-1990s, the provincial branches of the PBOC tended to be more responsive to the political directions of provincial governments than they were to the PBOC central headquarters in Beijing. This reflected the political realities of the appointment process—selection of the top officials in provincial PBOC branches was controlled by provincial party officials, not the central office of the PBOC. Because the local representatives of the agent of the state charged with overseeing the banking system tended to follow the dictates of local officials, it is not surprising that the provincial branches of the big four banks tended to do the same. The organizational structure of the PBOC was reformed in the mid-1990s at the instigation of Zhu Rong-Ji, with the aim of reasserting central control.<sup>39</sup> The goal appears to have been largely successful, but local government influence over lending decisions continues to affect the efficiency of banking in China.<sup>40</sup>

The final dimension of government interference was confiscatory taxation of the banks. China's largest banks have been required to pay significant taxes on their gross income. Through the end of 1996, China's major lending institutions were compelled to pay the central government taxes equal to 5.5 percent of gross income as well as additional business income taxes on their operating income. Lardy (1998) has shown that this was

equivalent to a business income tax rate of 73–84 percent in the mid-1990s for the largest banks. Perhaps it is not surprising that about one-sixth of central government revenue in the mid-1990s came from taxes on the big four banks. In the late 1990s, business income taxes on banks were reduced, but the tax on gross income was increased to 8 percent. This has been reduced since then, but taxes on gross income remain a significant barrier to profitable bank operations.<sup>41</sup>

The Ministry of Finance's disproportionate reliance on tax revenue from the banks in the 1990s created some interesting conflicts of interest from a regulatory perspective. The ministry has been reluctant to allow banks to make provisions for NPLs that would have the impact of reducing operating income and, thus, revenue for the state. As increasingly effective revenue collection and continuing economic growth allowed government revenues to increase substantially faster than GDP, the fiscal rationale for this kind of policy began to ebb.<sup>42</sup>

Over the course of the late 1980s and early to mid-1990s, the combined impact of these interventions took their toll on the health of the Chinese banking system as a whole and the big four banks in particular. Bank capital shrank as a fraction of assets, NPLs accumulated in the system at an increasing rate, and the margin on corporate lending diminished. By the mid-1990s, it was becoming increasingly clear that major reform of the financial system was required. The central government began to accept the fact that SOE reform had not succeeded, and the consensus at senior levels shifted in favor of privatizing and downsizing firms in that sector.<sup>43</sup> Press accounts suggest that the early stages of the East Asian economic crisis unfolding in neighboring countries helped convince the senior leadership that quick, decisive action was needed.

But it was also clear that bank reform could not take place in a vacuum. It had to be integrated with further reform of the state-owned sector. The dilemma facing the central government in the mid-1990s can be easily summarized. Despite rapid growth in the non-state economy, the government still relied heavily on the state sector for tax revenues; it relied on the investments of state firms to meet its industrial policy and development objectives; and it relied on state firms to provide what welfare state existed in Chinese cities.<sup>44</sup> Keeping the state sector alive in a liberalizing, marketizing, increasingly competitive economy required increasing infusions of capital from the banks, and this was the ultimate source of the banks' problems. Cutting off the state-owned firms without developing alternative sources of revenue, however, could precipitate a fiscal crisis, and cutting

off state firms without first creating some kind of social safety net for the workers that would be inevitably displaced would invite social chaos. All of these nettlesome problems had to be tackled at once.

#### FROM POLICY-LENDING TO A COMMERCIAL CREDIT CULTURE—REFORMS SINCE 1994

Even before the shock of the Asian financial crisis, major steps toward reform were already being undertaken. We can divide these reforms into those directly focused on the banking sector and complementary reforms that we will only note briefly, referring the reader to more comprehensive treatments elsewhere in the literature. We will deal with the latter reforms first.

The central government instituted fundamental tax reform in the mid-1990s, making a value-added tax (VAT) the centerpiece of central government revenue collection. It took several years for the state revenue authority to effectively implement this system, but starting in the late 1990s, government revenue began growing as a percentage of GDP, after falling for the first 12 years of the reform era. This provided the government with a steadily increasing degree of financial independence from the SOE sector.<sup>45</sup>

Next, the government began taking steps to create a safety net in urban China that was increasingly independent of the SOE sector. Perhaps the most important component of this safety net is something that is not normally associated with those in the West: housing. Even in the late 1990s, a huge fraction of residential housing units in Chinese cities were owned by SOEs and provided to SOE employees at highly subsidized rates. Over the latter half of the 1990s, the urban housing stock was progressively privatized, and an active urban real estate market began to develop.

This allowed the state to take a harder line with chronically loss-making SOEs. Huge numbers of them were either shut down or forcibly converted into other categories of enterprises, with the state largely leaving them to their own devices.<sup>46</sup> Manufacturing employment in the state-owned sector fell by two-thirds over the course of the late 1990s.<sup>47</sup> Unofficial estimates of employment in the Northeastern provinces especially dependent on the SOE sector skyrocketed.

At roughly the same time that the government was cutting down the size of the state sector, it was taking important and expensive steps to strengthen the banking system, particularly the big four. First, the state

created three new financial institutions that would henceforth be responsible for making loans in support of the state's policy objectives: the Agricultural Development Bank, the China Development Bank, and the Export-Import Bank. In principle, these institutions would pursue the "policy-lending" objectives of the government, allowing the state-owned commercial banks to refocus their lending on purely commercial lines.<sup>48</sup>

Second, the central government recapitalized the state-owned commercial banks. In 1998, the government injected RMB 270 billion (\$34 billion) into the four major banks, directly boosting their capital reserves. Then, the government established four asset management companies (AMCs), each of which was paired with a major bank. The AMCs took RMB 1.4 trillion (\$175 billion) in NPLs off the books of the four largest banks and an additional RMB 100 billion off the books of the China Development Bank.<sup>49</sup> The banks received interest-bearing bonds from the AMCs equal to the *face value* of the transferred loans (about 20 percent of their gross loan book), substantially strengthening their balance sheets.

Third, the banks were forced to adopt more stringent accounting standards, which made it progressively harder for them to conceal their bad loans. Starting in 1998, banks were no longer allowed to accrue unpaid interest on outstanding loans and count it as income.<sup>50</sup> At the same time, the formal lending quota system was abolished, providing the banks with more freedom in their allocation of capital. Senior bank managers were put on notice that a reduction in the NPLs to asset ratio was absolutely necessary, and they were encouraged to pursue aggressive targets for this reduction.<sup>51</sup> Banks were allowed, and even encouraged, to lend to consumers on a large scale. Some shareholding banks were allowed to undertake initial public offerings (IPOs), and the government made it clear that it intended to sell a stake in the stronger major banks when conditions were appropriate.

#### THE MIXED SUCCESS OF BANKING REFORM

In the period immediately following this bank reform through 2002, a number of positive signs emerged suggesting that attempts to instill a more commercially-oriented credit culture in the banking system were bearing fruit. First, the big four banks collectively made a major effort at internal reorganization, which included closing surplus and unprofitable branches; by 2002, they had collectively closed more than a third of their offices. Second, measured NPLs in the banking system declined, even as more stringent reporting requirements, at least on the part of the four

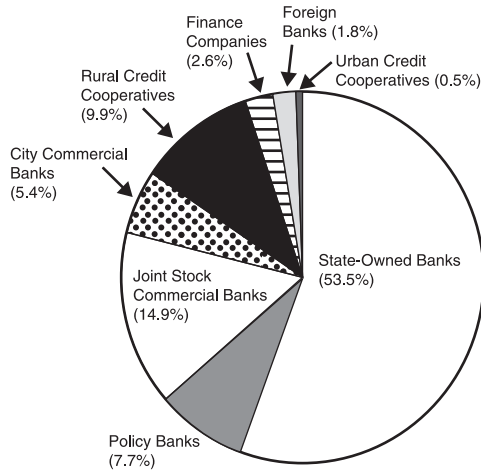
major banks, were adopted. Third, the number of loans grew at a moderate pace, suggesting that the rapid, indiscriminant lending of the mid-1990s had been replaced by a greater degree of prudence. During the investment boom from 1992 through 1994, the growth in the stock of outstanding loans relative to GDP rose from about 12.5 percent in 1989 to a peak of 19 percent in 1993. From 1998 to 2001, this measure increased at a steady pace of about 15 percent or less, well below the extreme levels of the investment boom years. Fourth, there was a dramatic increase in lending to households, mostly to finance mortgages and auto purchases. The share of new lending to households increased from 1.1 percent in 1998 to an average of 20.2 percent from 1999 through 2002.<sup>52</sup> This implies that the share of lending to SOEs fell substantially.

Other economic indicators suggested that the allocation of capital became more efficient in the aftermath of these reforms. Throughout the 1990s, it was well known that the banking system was propping up SOE production of goods for which there was little demand. One could see evidence of this in the national accounts. In modern national accounting systems, inventory unsold at the end of the year is technically counted as investment, and its value is added to the GDP aggregate. However, in most industrialized economies, firms take care not to produce goods that customers will not buy, and unsold inventories usually account for less than 1 percent of GDP. From 1992 to 1997, unsold inventories accounted for 5.3 percent of Chinese GDP, on average, providing powerful evidence of the wasteful allocation of capital in China. From 1998 to 2003, this dropped to about 1 percent.<sup>53</sup>

#### TWO STEPS FORWARD, ONE STEP BACK

From the perspective of early 2006, it is apparent that while much progress has been made, much work remains in terms of reforming China's banks. First, it seems clear that the creation of the policy banks has not completely eliminated the burden of policy-lending from the state-owned commercial banks. Consider the way that the policy banks are funded: these institutions issue long-term bonds that are mostly purchased, on terms favorable to them, by the state-owned commercial banks. The level of issuance has increased sharply over recent years.<sup>54</sup> The banks clearly believe that policy bank bonds are backed by the state and that there is no meaningful risk of policy bank bond default, but the simple fact is that policy-lending continues to use the financial resources of the state-owned banks, albeit indirectly.





**Figure 1.3** Composition of the Banking Sector in 2004

Source: OECD Economic Surveys—China (2005). Note that this graph reports the distribution of assets within banks and finance companies only. Assets in insurance companies and fund management and securities companies are excluded. Trust and investment companies are counted together with finance companies.

Figure 1.3 illustrates the distribution of assets in the banking system across organizational categories. By 2004, the big four banks' collective share of banking sector assets had declined to 53.5 percent from levels of greater than 70 percent in the mid-1990s. But the policy banks accounted for another 7.7 percent of banking sector assets, suggesting that the total fraction of banking system resources controlled by institutions under direct state control remained above 60 percent.

Second, political factors likely continue to influence the lending of the state-owned banks. An interesting perspective on this was provided by a widely cited interview in *Caijing* Magazine given in April 2005 by Guo Shuping, recently appointed chairman of China Construction Bank, and Xie Ping, the head of Central Huijin Investment, which now holds shares in CCB on behalf of the state since the bank's conversion to a shareholding enterprise. Both individuals called for a reduction in the role of Communist Party committees in the operations of financial institutions. Mr. Guo acknowledged that the Party Committee had dominated bank governance to the point of debating individual loan decisions under his predecessor, whereas the board of directors, which was vested by CCB's corporate charter with ultimate authority, had played almost

no role. Mr. Xie criticized the almost total control over senior appointments maintained by the party's organization department. Mr. Guo suggested that the conflict between the board and the Communist Party Committee would be eliminated under his stewardship. In addition to being chairman, he is also the party secretary, and he comes to CCB after serving as a senior administrator with the foreign exchange regulatory agency.<sup>55</sup>

Influence over senior appointments extends to the "joint-stock" banks in the second tier, as illustrated by a 2003 interview Ma Weihua, then CEO of Shenzhen-based China Merchants Bank (CMB), gave in the *China Economic Quarterly*. Mr. Ma was a graduate of the Communist Party School, a 20-year veteran of government service, and was head of a provincial branch of the PBOC before coming to CMB. At the time of the interview, he was also a delegate to the National People's Congress.<sup>56</sup>

Third, the lending restraint shown by the banks in the immediate post-reform period broke down in late 2002, helping power the investment surge depicted in figure 1.1. In 2003, the stock of loans outstanding expanded by nearly RMB 3 trillion. The increase in loans outstanding relative to GDP rose to 25 percent, well above the previous peak in the investment boom from 1993 through 1994. PBOC governor Zhou Xiaochuan and China Banking Regulatory Commission (CBRC) Chairman Liu Mingkang began trying to slow the growth rate of lending as early as mid-2003, and growth in lending has come down over the course of 2004 and 2005. Inflationary pressures that appeared to be building in the economy are moderating. Consumer Price Index (CPI) inflation has fallen substantially from its high of 5 percent in mid-2004, and the corporate goods price index has fallen from a high of over 9 percent to a roughly 5 percent rate of annual increase. However, the level of lending has reached such stratospheric levels that the investment to GDP ratio remains extremely high by historical standards.<sup>57</sup>

The manner in which lending growth was curtailed also suggests that reform has had its limits. In modern market economies, central banks will typically respond to a lending boom by raising the cost of capital, leaving it to the private market to sort out which projects to fund as the cost of funds increases. Interest rates were increased 27 basis points in late 2004, but this left short-term lending rates—at roughly 5.6 percent—lower in real terms than they had been in 2002. By late 2004, the corporate goods price index was increasing at more than 9 percent per year.<sup>58</sup> In other words, real interest rates were negative, just as they became in the

lending boom from 1992 through 1994. Instead of substantially raising interest rates, the authorities sought to bring lending under control by simply ordering banks to stop lending, particularly to certain industrial sectors, regardless of the underlying quality of investment projects a particular bank might be considering. In terms of preventing inflationary pressures from building, this has evidently worked. On the other hand, government direction of lending by administrative fiat is not supposed to be the direction in which China's increasingly market-driven financial system is heading.

As of early 2006, growth remains robust, and it is as yet quite hard to determine what fraction of loans extended during the lending boom may become nonperforming. PBOC statistics suggest that growth in lending during the credit boom from 2002 through 2004 was concentrated not in the largest state banks, but in the other segments of the banking system, including the joint-stock commercial banks. Some warning signals have emerged in the financial press. In February 2004, China Minsheng Banking Corporation was hit with a fraud scandal. By June, China's bank regulator was publicly warning of deterioration in the solvency of the second tier of the banking sector.<sup>59</sup> Shenzhen Development Bank, effectively acquired by American private equity firm Newbridge Capital Management in a landmark deal in 2004, was criticized for deficiencies in risk management and bad loan accounting.<sup>60</sup> Rapid growth in loan portfolios—50 percent per year at the height of the credit boom—has generated the risk of a new flood of bad loans that could emerge as the economy slows.<sup>61</sup> In October 2004, sources at the China Banking Regulatory Commission indicated that the default rate on more than U.S. \$23 billion worth of auto loans extended since 2002 already exceeds 50 percent.<sup>62</sup>

The fourth point of caution in the efficacy of bank reform is the asset management companies themselves. As noted, the four state-owned asset management companies purchased RMB 1.4 trillion of NPLs from the state-owned banks at face value. This purchase was financed by the issuance of RMB 820 billion in bonds and the assumption of roughly RMB 600 billion in existing central bank loans to the state-owned banks. The AMCs do not issue regular periodic reports on their financial position, so it has been difficult to determine the extent to which their recoveries on NPLs have been in excess of their costs.<sup>63</sup> As Lardy (2004) suggests, this recovery rate, net of operating costs, is probably less than 10 percent of the face value of the loans. The transfer of NPLs from the balance sheets of the state-owned banks was clearly necessary, but these calculations

suggest that the ultimate cost to the Chinese taxpayer will be quite high.

The regulatory authorities are clearly aware of these issues, and efforts at reform have accelerated over the last two years. The locus of reform effort shifted with the creation of the CBRC in 2003; this commission took over the role of bank regulation that had been the responsibility of the PBOC. In December, CBRC Chairman Liu Minkang announced that the big four banks were now free to seek foreign “strategic shareholders”—something that had only been allowed in the lower tiers of the banking system. The CBRC also pushed through a regulatory change allowing banks to issue subordinated debt in order to strengthen their capital base.

In early 2004, the CBRC issued a new set of capital adequacy standards that will apply to all segments of the banking system, except for policy banks and rural credit cooperatives. These regulations require all commercial banks to meet an 8 percent capital adequacy ratio by January 1, 2007. Banks are also required to change the risk-weighting of their assets in a way that eliminates most of the discounting of risk that had been applied to loans to SOEs. By 2006, banks must have set aside provisions equal to 80 percent of their nonperforming loans, using a five-tier classification scheme that is much closer to international standards than the traditional four-tier system.<sup>64</sup> The stronger banks have been aggressively writing off NPLs, and nearly all major banks are seeking to raise capital through equity issues, sales of stakes to “strategic investors,” and issues of subordinated debt. Industry observers also expect that this new regulatory regime will force banks to be much more selective in lending—expansion of assets can only take place when capital also grows.

The CBRC has also proactively sought to fundamentally reform China's largest banks, starting with the relatively healthier BOC and CCB. Both banks have been pushed to institute sweeping reforms of internal management, restructure the credit approval process, and make major investments in new IT systems. The Bank of China received a U.S. \$22.5 billion capital injection from the government in December 2003 and was allowed to transfer another U.S. \$19 billion of NPLs to Cinda Asset Management Company in June 2004 at a price that was probably higher than the fair value of the loans. In August 2004, the BOC became a shareholding company under Chinese law. CCB also received a U.S. \$22.5 billion capital injection in December 2003 and sold roughly U.S. \$17 billion in NPLs to Cinda Asset Management in June 2004. In September 2004, it

became a shareholding company. In recognition of the improvement in financial health engendered by these changes, Standard & Poor's raised the bond ratings of BOC and CCB to investment grade.<sup>65</sup> Both banks have issued large amounts of subordinated debt to strengthen their capital bases, and both received substantial investments by foreign financial institutions in the banks prior to their international IPOs. CCB sold stakes to Bank of America, and Temasek, the investment arm of the government of Singapore. Bank of China received substantial investments from the Royal Bank of Scotland, Merrill Lynch, Temasek, and the Li Ka-Shing Foundation.<sup>66</sup> Global equity markets appear to have provided a strong endorsement to the government's reform strategy: CCB raised U.S. \$9.2 billion in its November 2005 IPO, successfully selling new shares at the top of the indicative price range.

Despite this market success, recent news stories suggest that the ongoing management reforms at the large state-owned banks remain a work in progress.<sup>67</sup> A BOC subbranch manager in Harbin fled the country after stealing as much as \$125 million in customer accounts at the end of 2004. This was followed by the announcement in April 2005 that the Beijing branch had lost \$81 million in a major mortgage fraud.<sup>68</sup> These scandals followed the dismissal of the CEO of BOC's Hong Kong branch for approving loans to individuals later convicted of securities fraud.<sup>69</sup> A much larger scandal, involving a scheme to steal nearly \$1 billion from the Industrial and Commercial Bank of China, emerged in January 2005, amid government announcements that nearly 80 officials, including senior ICBC executives, were involved in the plot.<sup>70</sup>

Presuming that ongoing management reform and the influence of foreign "strategic investors" do succeed in fundamentally altering the way the state-owned banks work, it will still require an enormous injection of capital from the state to bring the much weaker ICBC and ABC up to the levels of financial health that the government has helped BOC and CCB obtain over the last two years. Standard & Poor's has estimated that it could take up to U.S. \$197 billion to clean up these two financial institutions.<sup>71</sup> This makes no allowance for bad debt elsewhere in the financial system. Analysts believe that there are extremely high levels of NPLs in the rural credit cooperatives and that these would constitute an additional burden to the state.<sup>72</sup>

China is in the fortunate position, however, of having rapid economic growth, steadily rising revenues relative to GDP, abundant foreign exchange reserves, and a relatively modest ratio of government debt to GDP.

It seems clear that China has the financial resources to clean up its banking system, and the current reform effort has taken a number of important steps in the right direction.<sup>73</sup> The institutional foundations of a sustainable, more market-driven banking system appear to be taking shape in China today. But we are not there yet.

## EQUITY, DEBT, AND INSURANCE MARKETS

### THE DEBATE OVER EQUITY MARKETS IN THE 1980S

Long before the central government formally established the current equity exchanges in Shanghai and Shenzhen in the early 1990s, there was widespread small-scale experimentation with equity issuance and trading. This history is described at length by Walter and Howie (2003). Agricultural collective enterprises began issuing financial instruments referred to as shares, although they were actually something more like a fixed income security. In the interests of promoting development and growth in a countryside that had been starved of investment for decades, the government formally approved this practice. Perhaps not surprisingly, enterprising factory managers, public officials, and private entrepreneurs began informally financing their ventures through issuance of equity shares. A Shanghai-based factory called Shanghai Feile Acoustics is given credit as being the first Chinese enterprise to issue common stock-like securities to the general public, back in 1984, long before the establishment of a national legal framework governing securities issuance or a formal, legally sanctioned stock exchange. While large numbers of share-issuing enterprises had sprung up by the mid-1980s, this phenomenon remained a spontaneous, small-scale response to the general problem of capital scarcity and excess demand for investment funds. At that time, the development of an organized equity market in China was not a major focus for the central government.<sup>74</sup>

That was about to change. At the same time that China's equity finance pioneers were experimenting with share issuance, a debate was growing within the Chinese government as to the future path of SOE reform. Reformers were beginning to advocate the "corporatization" of SOEs as the ultimate—indeed the only—solution to the problems of China's SOEs. In a strikingly radical and prescient internal government policy paper in 1983, two young government economists suggested that SOEs be reorganized as joint-stock corporations and that a substantial equity stake be sold to outside investors, including foreigners. This proposal

was publicly circulated in 1985 as a front-page essay in the nation's most widely circulated economics newspaper, *Jingji Ribao*.<sup>75</sup>

The authors, Wu Jiaxiang, a 30-year-old official in the Theory Department of the Central Department of Propaganda, and Jin Linzuo, a 27-year-old official in the State Commission for Economic Structure Reform, began their argument by emphasizing the inefficiency of the allocation of capital in China. Central planners controlled much of this allocation, but they were simply unable to determine which firms could use these resources most efficiently, and there was no effective way in contemporary China for the private savings of households to fund especially productive firms.

Wu and Jin argued that these inefficiencies were made even more intractable by the absence of well-defined property rights that separated the firm from the state. Investment decisions were necessarily clouded by bureaucratic and political objectives that compromised their economic efficiency. Government-appointed managers identified more strongly with the ministries they came from than the firms they governed. The authors laid out a plan for solving this problem by legally separating firms from the state—one that appears to have served as an inspiration for the later “privatization” of SOEs.

In the initial step, the firms' assets would be evaluated and shares would be issued to the supervising agency or, as was often the case, multiple supervising agencies. Ownership of shares would empower the governmental bodies that had supervised the firm in the past to appoint representatives to a board of directors, which, in turn, would appoint professional managers—not government cadres—to run the company on behalf of its shareholders. Eventually, Wu and Jin advocated that the shares held by the governing agencies be transferred to state holding companies, which would manage the firms according to purely commercial criteria. This second stage would sever the political connection between regulating agency and private firm that might otherwise distort the actions of both firm and agency. At the same time, the majority stakes held by the state holding companies would preserve state ownership and ultimate state control.

The final stage would allow large SOEs to issue shares to private investors on domestic and international stock exchanges. This would allow productive, progressive SOEs to attract sufficient capital from private investors to enable them to emerge as world-class competitors. Clearly, however, issuance of shares on domestic exchanges would have other desirable

effects. The constant scrutiny provided by the equity market would monitor firm managers more effectively than the government ever could. Equity prices would be a constant, objective reflection of the effectiveness of firm management, and their movements over time would help steer capital to the most productive firms.

#### EXPLOSIVE GROWTH OF EQUITY MARKETS IN THE 1990S

While central government officials were debating the theoretical merits of selling shares in state companies to the public, the practice of doing so was gathering momentum and increasing public interest, thanks to the entrepreneurial effort of local governments. In 1986, the Shenzhen government established a set of local regulations known as the Shenzhen Provisions, which provided a legal basis for the corporatization of local SOEs and other entities. Five SOEs offered shares to the public in 1987, including the Shenzhen Development Bank (SDB).<sup>76</sup> Generally, these initial offerings were poorly subscribed, owing in part to the lack of general understanding about just what stocks were. The SDB raised public interest significantly a year after its IPO, when it paid its first dividend. The SDB was quite generous to its investors, and the market value of its shares soared on the informal over-the-counter exchanges. Suddenly, Chinese investors had (re)discovered the truth that stocks can appreciate dramatically. Almost overnight, public interest in equity offerings soared.<sup>77</sup> What had begun as a modest experiment was now becoming a national obsession, at least in Southern China.

The events of June 1989 raised questions in the minds of many conservative government officials about the wisdom of establishing stock exchanges, but frenetic black market trading in equity shares constituted a powerful argument in favor of establishing formal exchanges that would bring this activity under stricter government control.<sup>78</sup> This pragmatic realization combined with unceasing efforts on the part of the governments of Shanghai (where Zhu Rongji had become mayor in 1988) and Shenzhen to obtain government approval for their exchanges. In fact, the Shenzhen exchange actually began operations before formal government approval had been obtained. The Shanghai exchange formally opened first, in December 1990; the Shenzhen exchange was approved in July 1991.<sup>79</sup>

The early years of the exchanges were quite dynamic, though chaotic. First, the official stock exchanges coexisted in the early years with



unauthorized trading in regional over-the-counter markets as well as two electronic exchanges, loosely modeled on the NASDAQ, which focused primarily on government bond trading but also engaged in the trading of shares. Second, the regulatory environment was marked by the absence of legal foundations for much of what was going on in the market, and there was uncertainty and ambiguity about which branch of the government was responsible for regulating it.

In 1992, after Deng's Southern Excursion, the State Committee for the Reform of Economic Structure (SCRES) issued the "Standard Opinion," which first set forth national guidelines for reorganizing state-owned companies as joint-stock enterprises that could list shares.<sup>80</sup> The Company Law was not issued until 1994, and, as Walter and Howie (2003) emphasize, it was less connected to the reality of Chinese equity markets than the Standard Opinion that it supposedly superseded. The reforms that converted the PBOC into the nation's central bank had also given it formal authority over the securities markets, but the evident need for a separate securities market regulator, along the lines of the American Securities Exchange Commission, led to the establishment of the China Securities Regulatory Commission (CSRC) in 1992. However, it took more than five years for the CSRC to acquire the resources and regulatory clout that would allow it to fulfill its mandate to effectively regulate China's securities markets. The matter was effectively settled by the 1999 implementation of the long-awaited Securities Law, which elevated the CSRC to ministerial status.<sup>81</sup>

As has been the case throughout China's reform period, market developments forged ahead of the regulatory regime that was supposedly governing the market. The absence of a clear legal basis for equity transactions did not prevent retail investors from wanting to earn quick profits. Memberships on the exchanges surged as eager newcomers piled into the market. Enthusiasm turned violent on August 10, 1992, when hundreds of thousands of would-be investors piled into Shenzhen to subscribe to a new listing. On the day of the offering, the official subscription forms ran out with suspicious speed, leading the frustrated investors to conclude that the subscription process had been corrupted by local PBOC officials. Violent riots broke out in the afternoon and evening. Order was quickly restored, but this event led directly to the establishment of the CSRC.<sup>82</sup>

The entrepreneurial spirit of Chinese managers (and that of their hired foreign investment bankers) was also on full display in October 1992, when

Brilliance China Automotive became the first Chinese company to list on the New York Stock Exchange (NYSE)—something for which there was no established legal basis at the time.<sup>83</sup> Zhao Xiyu, chairman of Jinbei Automotive, was seeking to corner the Chinese market on luxury mini-buses, using technology acquired from Toyota. To finance his ambitious plans, he effectively sold an interest in his firm to a Bermuda-based holding company, Brilliance Automotive. Together with local and national politicians, who were brought into the deal, Mr. Zhao retained control of the Chinese enterprise through a nonprofit onshore Chinese foundation. The Bermuda holding company listed shares on the NYSE.<sup>84</sup> The company made its debut on the New York markets at a time when investor interest in China was surging and American investors had almost no avenues to buy into the “mainland China growth story.” A billion dollars’ worth of orders were placed for the \$80 million share offering.<sup>85</sup> Brilliance’s stock rose 117 percent within three months of listing. The unsanctioned experiment became a smashing success, prompting praise from none other than China’s president, Jiang Zemin.<sup>86</sup> This success started a gold rush, as SOEs from around China sought to tap into global equity markets, which, in turn, were eager to increase their exposure to the world’s fastest-growing economy.

Although some Chinese firms continued to use variations on the indirect, offshore structure pioneered by Brilliance Automotive, the Chinese government had already been negotiating with the Stock Exchange of Hong Kong regarding the possibility of listing Chinese SOEs. This more direct, officially sanctioned avenue to global markets was given its trial run in June 1993, when Tsingtao Beer undertook its Hong Kong IPO.<sup>87</sup> As with the Brilliance case, the success of this experiment did much to convince government officials that vast amounts of money could be raised by allowing Chinese SOEs to tap global equity markets. This triggered a burst of additional listings.

From their establishment in late 1990 through 1993, the domestic equity exchanges enjoyed robust demand from investors and rapidly rising equity prices. A sharp drop in the markets occurred following the August 10, 1992 riot in Shenzhen, but demand came roaring back a few months later. These sharp fluctuations reflected, in part, the underdeveloped state of the market. In 1992, there were only 40 listed stocks, so volatility was understandably high. The strong demand reflected, in part, the sizzling economic growth rates being recorded in mainland China in the early 1990s. Real GDP growth rates peaked at 14 percent in 1992 and declined

only slightly in 1993. Unfortunately, the sharp acceleration in GDP growth triggered a burst of inflation. Consumer prices were rising slowly at rates in the low single digits in 1991. By 1993, the CPI was rising at 15 percent per year, and this accelerated in 1994 to nearly 25 percent per year. Fearing a hyperinflation and the social unrest this could trigger, the government began firmly applying the brakes in late 1993. Interest rates were sharply increased—the RMB deposit rate was quickly brought up to double-digit rates—and quantitative restrictions on new lending were firmly imposed throughout the economy. During this period of retrenchment, the government sought to limit IPOs and secondary stock offerings.

The harsh medicine worked, but it caused equity markets to drop sharply. Domestic equity indices collapsed, hit by both high interest rates and a slowing economy. The shares of Chinese companies listed in Hong Kong also fell as these internationally listed SOEs struggled with the domestic economic slowdown. By 1996, inflation had dropped back down into the single digits and the economy appeared to be stabilizing at lower rates of growth that were still extremely high by international standards. The central bank began reducing interest rates sharply, and this clearly helped boost demand for equities. The domestic markets enjoyed a spectacular surge in 1996. In addition, 218 companies listed shares on the domestic exchanges (as compared to 36 in 1995), and overseas listings also picked up.<sup>88</sup> In the run-up to the retrocession of Hong Kong to mainland sovereignty in mid-1997, there was also a sharp increase in unofficial overseas listings through offshore holding companies—the so-called Red Chip issues. Market observers have suggested that the final stages of this rally were marked by speculative excesses and that the government was actually seeking to slow the rate of price increase even in 1996.<sup>89</sup>

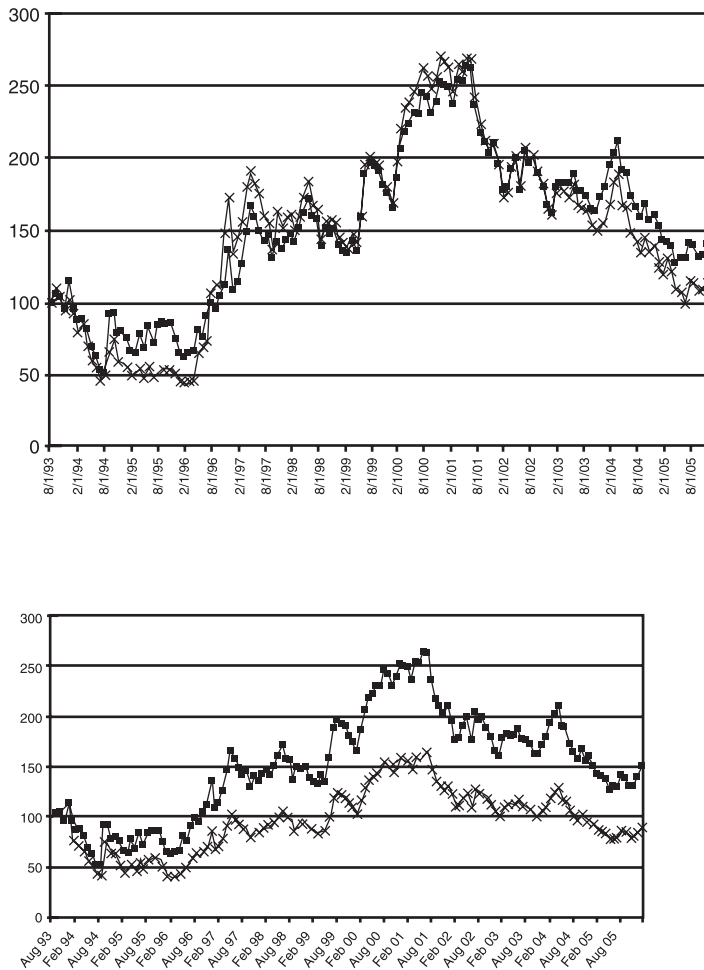
In any case, the market soon had to confront the onset of the Asian financial crisis in mid-1997. The Hong Kong economy and equity markets were strongly affected by this crisis, and Western investors' interest in Asian equities dropped off sharply, all of which had a rapid chilling effect on the official or unofficial use of Hong Kong to tap international equity markets. Indices of the stocks of Hong Kong-listed Chinese companies and indices of the unofficial Red Chip companies fell dramatically in late 1997. As the severity of the crisis became increasingly evident, the Chinese government responded by sharply cutting interest rates and substantially increasing deficit spending to stimulate economic growth. This action appears to have helped boost the equity markets,

but issuance of new shares in both domestic and overseas markets dropped off sharply yet again.<sup>90</sup>

Exactly how well the Chinese economy performed in the aftermath of the Asian financial crisis has been the subject of a highly charged debate within the ranks of economists who follow the Chinese economy. As already noted, Thomas Rawski (2001) has argued that the official statistics in this period may substantially overstate true economic growth. He claims that there may have even been a brief period of negative GDP growth in the wake of the crisis. Other China experts dispute these claims, but a consensus has emerged that official GDP statistics probably overstate real growth in the immediate aftermath of the crisis. The official statistics suggest that GDP, retail sales, investment, and prices stopped declining in 1999 and began to stage a modest turnaround. To the extent that this reflects reality, it may provide the macroeconomic backdrop for the sharp run-up in equity markets from 1999 through 2001. China's listed companies tend to be concentrated in the more trade-dependent coastal provinces, and their local demand conditions were probably more robust than those of the overall economy. In any case, China's equity markets ended the century with a bang, enjoying robust appreciation from 1999 through 2001. Ten years after their establishment, the equity markets appeared to be a real success story for the regime. Over ten years, share issuance had raised \$129 billion for over 1,400 companies, and the total market capitalization of China's exchanges, *as conventionally measured*, made its equity markets the second largest in Asia after Japan.<sup>91</sup>

#### DECLINE SINCE 2001—WHY HAS THE MARKET FAILED TO REFLECT THE DYNAMISM OF THE ECONOMY?

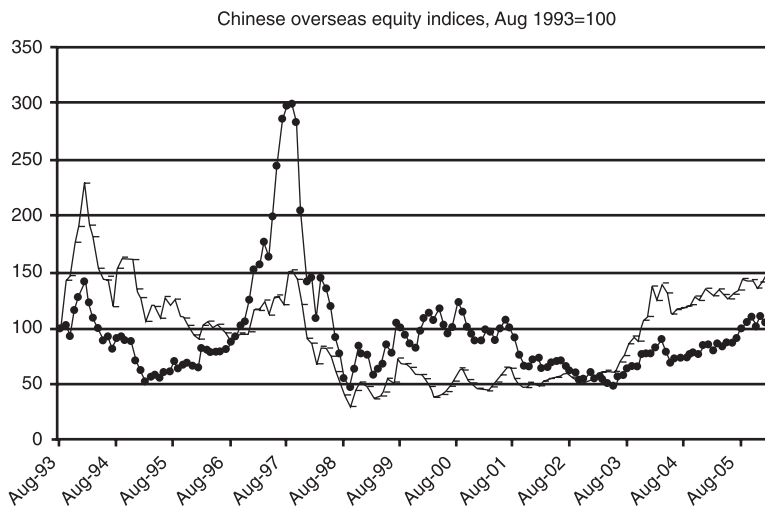
Equity markets have declined fairly steadily since mid-2001. In 2003 and again in 2004, China's domestic equity markets were the world's most poorly performing major equity markets by a wide margin. The inexorable decline appeared to pause in 2005, and equity markets actually enjoyed a modest boost at the end of the year. Nevertheless, as of early 2006, Chinese equity markets had lost about half of their 2001 value, in spite of a sharp acceleration in real GDP growth. Figure 1.4 tracks equity prices on China's domestic (A-share) exchanges from August 1993 through early 2006. The top segment of the figure shows the indices in nominal terms, rebased so that August 1993 levels are equal to 100. The bottom graph tracks the Shanghai A-share index over time in both nominal and real terms, adjusting for



**Figure 1.4** Domestic Equity Markets in Decline

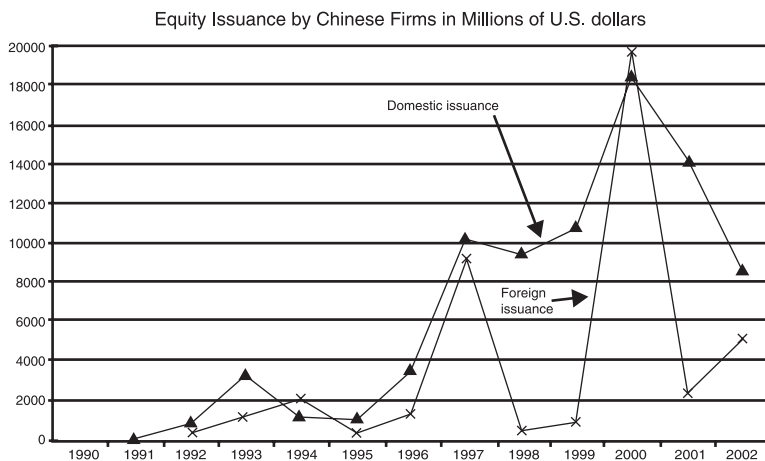
Sources: Shanghai and Shenzhen Stock Exchanges; National Bureau of Statistics.

inflation as measured by the CPI. The downturn since 2001 has been so severe that real returns in the Shanghai market since 1993 have been slightly negative. Total market capitalization has dropped even as hundreds of new firms have listed on the Shenzhen and Shanghai exchanges. Figure 1.5 tracks trends in equity issuance. Not surprisingly, equity issuance expands sharply in bull markets and contracts in bear markets. The volatility of overseas issuance is particularly pronounced.



**Figure 1.5** Hong Kong China–Linked and Red Chip Equity Indices, August 1993=100

Source: Hong Kong Stock Exchange.



**Figure 1.6** Equity Issuance by Chinese Firms

Source: Walter and Howie (2003).

The poor performance of China's equity markets contrasts sharply with the country's rapid economic growth. While China specialists may have suspected that the official GDP statistics overstated growth in the aftermath of the Asian financial crisis, most experts now believe that, if anything, official GDP statistics have understated real growth in recent years. If the official statistics are to be believed, the Chinese economy has expanded by more than 40 percent since 2001, and foreign direct investment (FDI) has soared, demonstrating the multinational corporations' intense interest in China's dynamic marketplace.

Why have China's equity markets failed to reflect the dynamism of the economy? First, access to public equity markets has been limited to the least dynamic sector of the economy: SOEs. Second, the state and state-controlled entities retain a majority stake in most publicly traded firms. These shares can be transferred under certain circumstances, but they are not traded in the marketplace. This vast overhang of nontraded shares continues to plague the market, and dealing with it constitutes one of the most serious challenges facing market regulators. Finally, the various arms of the state continue to interfere in the operations of many listed companies—a level of interference legally justified by the continuing high level of state ownership. This interference degrades the efficiency of investment decisions. The bottom line is that the ultimate separation of politics and enterprise management envisaged by Wu and Jin more than twenty years ago remains an elusive goal.

For most of their history, the official stock exchanges only allowed SOEs to list shares. The most dynamic sectors of the Chinese economy—private firms and the local subsidiaries of foreign multinationals—have been deliberately excluded from these markets, with a small number of exceptions. Allowing private firms and the local branches of foreign multinationals to compete freely for capital in the equity markets would dramatically reduce the amount of money local investors would willingly invest in the IPOs of SOEs. It would also probably lead to a sharp decline in the market capitalizations of existing SOEs, as investors would shift away from the incumbent firms, many of which have performed quite poorly, to the newly listing private organizations. The high price/earnings ratios sustained in Chinese equity markets through 2001 largely reflected the limited investment choices available to domestic Chinese investors.

This brings us to the second point. The Chinese state faces a unique conflict of interest in that it is simultaneously the market regulator and

the largest holder of equity. The 1992 Standard Opinion promulgated by SCRES laid out several classes of shares that were limited in terms of who could own them. First were the state shares, which for all intents and purposes have been nontradable and nontransferable. Second were legal person shares, which could not be held by individuals or traded directly on equity exchanges. These shares could be held by an organization with “legal person” status under Chinese law. This includes SOEs and other state-affiliated organizations; a large portion of legal person shares have historically been held by such organizations, but this status is not limited to them. Private domestic firms and even the Chinese subsidiaries of foreign firms can acquire this status and therefore hold these shares. The Standard Opinion allowed for the transfer of legal person shares subject to the approval of the exchange on which the underlying firm trades.

As of year-end 2005, roughly 70 percent of the shares in listed firms on China's domestic exchanges were either state shares or legal person shares. A large fraction of shares in the legal person shares category were held by organizations that were direct or indirect branches of the state.<sup>92</sup> The state, directly or indirectly, has retained a controlling interest in most firms via shares that could not be bought or sold in the marketplace. As historians of the market in China emphasize, this was deliberate: the state did not want to surrender control of its enterprises when shares were listed. Thus, as of year-end 2005, the tradable segment of the market was limited to about 30 percent of the shares. This tradable segment was itself divided into two distinct share classes—A shares that were still restricted to Chinese nationals and B shares that (until 2001) were restricted to foreign nationals. H shares, which were listed on overseas exchanges, constituted a third class of shares, but one entirely separate from China's domestic securities markets, in which Chinese citizens themselves could not generally invest due to China's capital controls.<sup>93</sup> While Chinese law indicated that these shares conferred equal rights and benefits on the holders, a casual inspection of share price data for listed companies indicated that, in 2002, H shares traded at a 42 to 88 percent discount relative to A shares in the same company.<sup>94</sup> While investment in B shares was prohibited for Chinese nationals, B shares typically traded at a roughly 80 percent discount to A shares in the same firm. After Chinese nationals were allowed to purchase these shares, the discount narrowed to 50 percent, but a discount remains even today.<sup>95</sup>

This raises fundamental questions of market valuation. There is no one answer to the question, what is a Chinese company worth—much less,



what is the Chinese stock market worth? The typical answer quoted in the financial press takes the A-share market price and multiplies that by total shares outstanding, including the nontradable shares held by the state and by legal persons. This calculation, undertaken for the entire market, implied that China had the second largest equity market in Asia after Japan at year-end 2002, before the steep declines of 2003 and 2004 took their toll. However, if one valued only outstanding A shares at the A-share price (implicitly assigning a value of zero to other share classes), the market capitalization at the end of 2002 (before the steep market declines of 2003 and 2004) was only slightly larger than that of Malaysia.<sup>96</sup> Valuing all outstanding shares at the H-share price would yield yet a different value. For at least some of the reformers who argued for the establishment of equity markets, equity prices were meant to serve as a summary statistic of the performance of the firm, guiding capital to the most productive, best managed enterprises. Equity prices do not—and cannot—play this critical signaling role in the segmented markets of contemporary China. Correcting the current situation would seem to require the unification of these markets along with a dramatic increase in the “free float.” This, in turn, would require the sell-off of a large component of the state’s current direct and indirect shareholdings, which are locked up in nontradable state and legal person shares.<sup>97</sup>

In increasing numbers of cases illegal person shares have exchanged hands, including cases in which legal person shares pass from an (often cash-strapped) state-affiliated organization to a private firm, allowing private interests to acquire effective control of a listed enterprise. At least 200 listed firms were believed to have been transferred to private control through these asset transfers as early as year-end 2003.<sup>98</sup> A transfer of legal person shares allowed Newbridge Capital, an American private equity firm, to implement its landmark acquisition of effective control over Shenzhen Development Bank.<sup>99</sup> However, these asset transfers take place without reference to the stock price on the A-share or B-share market. Often, the valuation of the legal person shares are made based on calculations of net asset value, and suggest a valuation that is only a fraction of that implied by the A-share market.<sup>100</sup> In the vast majority of cases, it appears that China’s equity markets provide no input whatsoever into the prices at which these asset trades take place.

The fact that these asset trades are taking place at such a large discount to A-share prices illustrates another stark challenge confronting the regulators: the pressure for the state and its various arms and affiliated organizations

to sell off their shareholdings. As the state has slowly come to terms with an increasingly important role for the private sector, it has become increasingly willing to sell off at least part of its stake in all but the most “essential” enterprises.<sup>101</sup> If it could do so at the price/earnings ratios that have historically prevailed in the A-share market, the potential windfall for the state would be enormous. Many of the financial challenges looming ahead, such as the recapitalization of the banking system and the looming pensions crisis, would pose much less of a challenge to the treasury if the state could simply sell off a chunk of its titanic equity portfolio.

Rumors that the state was planning such a sell-off to help shore up pension financing in 2001 helped end the bull market. Whenever this idea has resurfaced in policy debates, the market has dropped further. Knowledgeable observers suggest that one of the major factors behind the steady decline in equity prices since 2001 has been the market's anticipation that the state will eventually sell off a substantial portion of its holdings.

The major equity market development of 2005 was the government's push for listed firms to come up with a way of transforming illiquid state and legal person shares into fully tradable A-shares. In the final quarter of 2005, at least 130 of the firms listed in Shanghai or Shenzhen had received formal approval from the government for these share transfer schemes.<sup>102</sup> Another 100 or so companies were waiting for approval, and many market participants expect that over the course of 2006 as many as 300 companies, collectively accounting for more than 60 percent of total domestic equity market capitalization, will go through with these transfers. The general pattern is already well established. To compensate existing A-shareholders for the price impact of putting previously nontraded shares on the market, the largest holders of state and legal person shares gift a portion of their shares to the existing A-shareholders. Generally, three bonus shares are provided for every 10 shares held. Occasionally, free puts or call warrants are transferred to existing shareholders in addition to or in place of new shares. The National Social Security Fund has admitted that it used large amounts of public funds to support the markets while the first set of firms undertook these share transfers. Financial support provided by the People's Bank of China to securities firms may have also played a role in supporting the market. Although it is unclear what role outright public support of the market has played, the equity markets have appeared to react fairly well to the implementation of this plan, even if the market capitalizations of some of the reforming firms have fallen. Additional price supports come from the restrictions placed on the erstwhile

state and legal person shareholders. While they will now have a liquid asset, they are explicitly forbidden from dumping it on the market. They cannot sell more than 10 percent of the total share capital of the company over the next three years. The CSRC has also promised to limit domestic IPOs until a large enough number of sufficiently large companies have implemented their share transfer schemes. So far, the market appears to be reacting to these announcements with equanimity. In fact, domestic equity indices have enjoyed a modest boost.

This reform is a major step forward, and the oft-criticized Shang Fulin, chairman of the CSRC, deserves much credit for seeing it through. Once the majority of shares are tradable, the prospects for efficiency-enhancing mergers and acquisitions activity, consolidation, asset trading, and even the emergence of a limited market for corporate control would appear to be far more realistic. The functioning of the market could improve considerably.

Prospects will brighten further if the authorities relax their control over the access of currently unlisted private firms to the public equity markets. Even in a market in which most shares are tradable, investor appetite for a collection of poorly run SOEs is likely to be limited. The best way to bring more capital into the equity markets is to improve the quality of the firms on offer—but allowing private firms and foreign subsidiaries to list domestically would limit demand for the incumbent SOEs even further. Clearly, the state and its various branches want an opportunity to unwind their massive shareholdings first, before they improve the menu of options for Chinese individual investors.

The final barrier to improvement of the equity markets has to do with the pervasive influence of the state and its various arms in the investment decisions and other activities of leading enterprises in pillar industries. While the state is increasingly willing to divest itself of equity holdings in nonessential industries, even at the cost of a basic loss of control, it is not yet willing to let its national champions evolve without state “guidance.” The Communist Party retains its control over senior executive appointments in the most important enterprises, depriving the corporate boards of one of their most important functions. These firms generally have party committees that vet—and sometimes reverse—the most important decisions of senior managers and the corporate board itself. It is hard to imagine the party relinquishing control of senior appointments or resisting the urge to meddle in major decisions. The separation of government and firm remains elusive for China’s state-designated national champions.

In China's first ten years of operating equity markets, it would have been hard not to declare them a success. Despite deep-seated structural problems that, from a Western perspective, impaired their functioning as efficient asset markets, they nevertheless managed to raise large amounts of capital and provide reasonable returns to domestic investors. Over the last five years, as China's equity markets have steadily lost value in spite of a strong economy, and as the problems cloaked by share appreciation have increasingly come to fore, one might be tempted to declare the experiment a failure. The state's attempt to have its cake and eat it too would appear to have ended as most such attempts inevitably end. The state's efforts to ensure its control have also shielded firms from the consequences of their own underperformance, undermining investor demand. Equity prices have failed to play the role of improving capital allocation.

That judgment, too, may prove to be premature. China's falling equity indices have proved to be a public embarrassment for the regime, generating increasing pressure for fundamental reform of the system. Individual firms may be shielded from the consequences of their actions by state ownership, but the weaknesses of the fundamental approach to equity markets have been ruthlessly exposed. Although China's brokerages and auditing firms have failed to adequately inform investors, muckraking journals like *Caijing* have doggedly exposed these shortcomings. With the public encouragement of the CSRC, individual Chinese shareholders are now seeking redress by filing lawsuits in Chinese courts. By embarking on the path of *partial* privatization and being forced to confront its resounding failure, the regime may yet be compelled to move much further down the path to true privatization—a road that once would have been politically unthinkable.

#### BOND AND INSURANCE MARKETS

Whereas equity markets have gone through impressive cycles of boom and bust in China over the last 15 years, corporate bond markets have remained heavily suppressed, at least until very recently. The market for Chinese government bonds (CGBs) has grown substantially over the 1990s, as the central government stopped borrowing directly from the central bank and began borrowing from the financial system. The central government enthusiastically used fiscal pump-priming to jumpstart economic growth in the latter half of the 1990s, and it continues to run deficits today, even in the face of near double-digit growth. The accumulation

of large quantities of government debt in the financial system has led to pressure for partial deregulation of the government bond market, as it has in other Asian countries. As this happens, it reinforces the liquidity of the government bond market.

In striking contrast, issuance of corporate bonds remained well below the levels achieved in 1992 for more than a decade thereafter.<sup>103</sup> Many barriers to the further development of this market remain, the most important including laws that could protect the rights of arm's-length creditors. As China's banks and asset management companies have discovered, the *de jure* legal right to force a debtor into bankruptcy does not translate into a *de facto* right to acquire control over the debtor's assets.<sup>104</sup> The problems these organizations have encountered are likely to be magnified for private bondholders. After all, the largest banks and the asset management companies are SOEs; their acquisition of control over another SOE do not pose the same political challenge that would arise if a small group of private bondholders required control over the enterprise. The shaky finances of large numbers of SOEs imply that this scenario is all too plausible. A regime that has resisted true privatization in the equity markets may hesitate to embrace a back door to true privatization in the bond markets. In the absence of such legal protections, bonds acquire some of the risks of equities without their commensurate rewards.

A robust bond market would pose problems for the Chinese financial system along other dimensions. Until recently, commercial lending rates have been tightly regulated in China. A bond market would have undermined interest rate controls, since the effective interest rate is set by the marginal investor, not the state. The People's Bank of China partially deregulated commercial interest rates in late 2004. Commercial banks are now, in principle, free to charge rates higher than the rate set by the PBOC, but they have little practical experience in pricing risk into their lending rates.

Bond and equity market liberalization in Japan in the 1980s led to a rapid disintermediation of the banking sector. Blue-chip manufacturers were able to bypass commercial banks and go to domestic or foreign bond (or equity) markets to obtain the cheapest possible financing. As loan demand dropped but deposits continued to grow with the economy, Japanese banks found themselves with a loan portfolio that was increasingly concentrated in riskier sectors of the economy, such as real estate development. When the real estate downturn came, it essentially bankrupted

what had been a healthy, profitable, and reasonably well-capitalized banking system.

It would be possible, if not exactly easy, to imagine a scenario in which robust bond markets and more functional equity markets pose the same threat to China's big four banks. Even in the absence of effective competition from the capital markets and in the presence of a rapidly growing economy, China's large banks have struggled to make profitable loans. One could envision a bond market-led disintermediation that simultaneously deprived the banks of their richest depositors and their most credit-worthy corporate lending customers, leaving them with a portfolio full of NPLs and declining liquidity. A well-functioning bond market would also pose a threat to Chinese equity markets as they currently exist. From a retail investor's perspective, Chinese equity markets are extremely risky but have delivered meager returns over protracted periods. A functioning bond market that offered predictable returns well above the current (extremely low) RMB deposit rate would be heartily welcomed, and many investors might choose to allocate some of their equity holdings to bonds. These lessons have not been lost on financial market regulators, lending impetus to a "go slow" approach to bond market development.<sup>105</sup> It is telling that the one group of firms that have been given permission to issue bonds on a large scale in recent years are state-owned and joint-stock banks, insurance companies, and securities firms, seeking to issue subordinated debt in order to shore up their capital adequacy. For nonfinancial corporations, the right to issue bonds remains tightly restricted.

Unfortunately, the absence of a functioning bond market has enormous costs. Bond markets spread credit risk out among a large body of diversified investors. The current alternative in China—a high concentration of corporate lending and loan risk, in a small number of banks that all have the implicit backing of the state—carries costs that are becoming increasingly obvious. The absence of a functioning corporate bond market also deprives investors of a broad class of assets that can help them meet their own investment needs. American and European financial institutions have been almost endlessly inventive in their ability to create new bond-related and bond-like securities. The wealth of investment choices in these markets contrasts sharply with that of contemporary China, in which retail investors can place their funds into banks whose deposit rates have sometimes fallen below the rate of inflation, into secure, but low-yielding government debt, into highly risky (but underperforming) equity

markets, or into real estate. It is easy to understand why, in this context, residential real estate investment has grown so rapidly that the government has felt compelled to take steps to deflate what many fear to be an emerging real estate bubble in cities like Shanghai.<sup>106</sup>

Households are not the only agents in the economy that suffer from this limited range of financial instruments. The insurance industry in China is growing rapidly as households increasingly look to the markets to provide the security once guaranteed by the work unit and, behind that, the state. Insurance companies profit by investing policyholder premiums effectively in order to build a level of wealth sufficient to meet their obligations to policyholders under a wide range of circumstances. This traditional business model is dramatically undermined in the Chinese context by the limited range of financial assets on offer. Locked out of the booming residential real estate market, at least officially, by prudential regulations, insurance companies are in some ways in an even less enviable position than households.<sup>107</sup>

The same could be said of China's pension system, such as it is. The demographic challenges confronting Western countries are by now well-known. The aging baby boom generation born after World War II will be replaced by a much less numerous cohort, placing strain on public sector pay-as-you-go pension systems owing to the declining ratio of workers to retirees. China's challenges in this regard are even more striking. Because of the stringent birth control policies adopted under Deng Xiao-Ping, China's population will age with breathtaking speed. By 2025, according to projections of the United Nations Development Programme (UNDP), China's median age will be higher than America's (39 for China versus 37.6 for the United States), and its population will be aging more rapidly than that of the United States.<sup>108</sup> China is not alone in this regard—the East Asian tigers and Japan will be in a similar position. The challenge for China 20 years hence is that it will have the age profile of a highly developed country but the income level of a developing country. In 2025, 13.4 percent of China's population will be 65 or older. When Japan crossed the 13.4 percent threshold, its per capita GDP was well over \$20,000 per year. Even with robust economic growth, it is unlikely that China's per capita income will reach equivalent levels in real terms over the next 20 years.<sup>109</sup> Japan grew rich before it grew old. In China, the risk is that the country will, in the evocative phrase of Hong Kong pension expert Stuart Leckie (2005), "grow old before it gets rich."

While the pessimists' prognosis may not come about, the need to build wealth over the next generation lends some urgency to the debate in China



over broadening and improving Chinese capital markets. In the pre-reform period, urban workers received a pension equal to 80 percent of their salary, and retirement age was set at a relatively early age, reflecting the short life expectancies that existed in the first decades of the People's Republic.<sup>110</sup> Over the course of the 1980s and 1990s, state-owned firms were increasingly squeezed by price reform and intensifying competition with the non-state sector. Some state firms found themselves with more pensioners than current employees and began to effectively default on their pension payments; the old system was clearly not sustainable. In 1997, the State Council formally adopted a three-pillar model consisting of a state pension funded by employer contributions that would provide a guaranteed benefit of only 20 percent of local average earnings, mandatory individual accounts (in which individuals contribute 8 percent and employers 3 percent), and optional private pensions for citizens who wished to invest more on their own, funded by individual contributions. Unfortunately, the state system is undermined by the unwillingness or inability of financially strapped firms to actually make their mandatory contributions. The individual account system has been subverted by provincial governments raiding these funds to pay current retirees. And all legs of the system have been constrained by regulations that require pension fund assets to be invested in low-return asset classes such as bank deposits and government bonds, generating returns of 2 to 3 percent per year.<sup>111</sup>

The traditional "pension system" in Chinese society has been the family, and even today an ethos of filial duty to care for aging parents remains reasonably well embedded in mainland culture. By 2025, however, nearly 300 million Chinese will be over 60, suggesting something approaching a one-to-one ratio between elderly parents and the children obliged to support them. A sizable fraction of this elderly population will have no living son on whom to rely for support.<sup>112</sup> A large fraction of the elderly population will therefore have to work, but herein lies another problem: much of the work available to these individuals is likely to be more physically taxing than it would be in richer countries, and some of these elderly workers may be poorly suited to these jobs.<sup>113</sup>

#### FOREIGN EXCHANGE AND CAPITAL CONTROLS

Prior to reform, the regime maintained an overvalued exchange rate in order to subsidize the import of capital goods that could not be produced domestically. Overvaluation led to excess demand for foreign exchange,



necessitating an extensive system of rigid controls. Key elements of this control system included a 100 percent surrender requirement for exporters, tight limitations on the rights of individuals to hold foreign currency, and strict controls on the inflow or outflow of foreign capital.

Over the course of the reform period, all of these restrictions were relaxed. The official exchange rate was devalued in stages, from an official exchange rate of RMB 1.5 to the dollar in 1981 to 8.7 in 1994. Following a modest appreciation, the exchange rate was effectively fixed at RMB 8.3 to the dollar in 1995. The International Monetary Fund (IMF) estimates that the Chinese currency lost about 70 percent of its value against the dollar in real terms over this period, substantially enhancing the international competitiveness of China-based export operations. In addition to substantial real devaluation, Chinese exporters have been allowed to retain part of their foreign exchange earnings, individuals have been allowed to hold foreign exchange, and capital outflow requirements have been relaxed.<sup>114</sup>

By the mid-1990s, China was able to inform the IMF that it was in compliance with the conditions for current account convertibility. At the same time, however, the country maintained what were, in principle, tight controls on capital account transactions. The experience of the Asian financial crisis and the increasing official awareness that China's own banking system was fragile led top officials to conclude that maintaining these restrictions was essential until China's financial system could be substantially strengthened.

The general caution China's government has shown toward capital account transactions has not applied to FDI. Since the beginning of the reform period, China has shown increasing openness to foreign firms seeking to set up subsidiaries in the country. This pro-FDI stance has been extended to official encouragement (even government subsidization) of outward FDI by leading Chinese companies. Recent data suggest that the increasingly extensive international linkages forged by multinational corporations have helped open up a back door for unauthorized capital account transactions. In other words, regardless of official regulations, China already has an increasingly open capital account, albeit one that is only open to certain classes of investors. To the extent that the current structure of capital controls exists in order to buffer the economy from the instability of global capital markets, that buffering effect has already been somewhat compromised.

Barry Naughton has recently pointed out that the relative stability of FDI, as measured by actual capital deployment, and the current account

surplus contrast sharply with pronounced volatility in other elements of aggregate statistics on China's balance of payments. Over the past eight years, from 1996 to 2004, these "other capital flows" have swung from a low of minus 8 percent of GDP to a positive 5 percent of GDP.<sup>115</sup> The level of change is reminiscent of the dramatic swings in capital flows seen in other Asian countries that had more officially open capital account regimes. These flows, especially the large and variable "errors and omissions" component, no doubt reflect unsanctioned capital movements. Money left the country on an enormous scale during the Asian financial crisis, and money returned on an equally enormous scale in the context of a domestic macroeconomic and real estate boom, as well as speculation about currency revaluation. China's outsized levels of exports and imports, relative to GDP, and the huge fraction of both that are mediated by multinationals, provide ample scope for the under- or overinvoicing of trade flows and related profit remittances. The capital mobility genie may be out of the bottle already.

#### THE CHALLENGES AHEAD

As part of its accession agreement to the World Trade Organization (WTO), China agreed to implement significant changes in its financial system, including "national treatment" of foreign financial firms in a number of product areas. Given the importance of banks in China's financial system, we will begin with an overview of the WTO-mandated liberalizations in that sector. Although foreign banks initially operated under a host of restrictions on the geographic scope of their operations, the customers they could transact with, and the types of business they could engage in, these restrictions have been progressively relaxed in line with gradual convergence to national treatment over five years mandated by the accession agreement. The principal restriction remaining on the operations of foreign banks is the requirement that they limit their RMB deposits to 50 percent of their foreign currency deposits. This limits their ability to engage in retail banking services on a large scale. This restriction is to be phased out over the course of the current year, at which point foreign banks will be subject only to the same rules and regulations that Chinese banks must follow. Given the many obvious advantages of foreign banks—particularly the absence of large levels of NPLs and superior financial technology—one might imagine that this liberalization would subject Chinese banks to an important source of new competition.<sup>116</sup>

Many experts, however, believe that expansion of the foreign banks is likely to be gradual for a number of reasons. Since foreign banks will be subject to China's international capital controls, it will not be possible to take Chinese deposits and invest or loan them offshore, eliminating one potential source of foreigners' comparative advantage. Furthermore, foreign banks will be subject to the same regulations that limit the ability of Chinese banks to directly engage in asset management, securities, or investment banking activities. While there appears to be some movement away from this segmentation of the financial markets, this shift is progressing slowly. Given these constraints, foreign banks will only want to grow their RMB deposit base as fast as they can find creditworthy firms and consumers to whom they can loan these funds.<sup>117</sup> In an environment characterized by extremely rapid change, highly imperfect information on the creditworthiness of borrowers, and the absence of a legal framework that gives a creditor the ability to foreclose the assets of a delinquent borrower, it is likely that foreign banks will wish to proceed with caution in building up their China businesses. The good news is that an immediate rush of deposits from domestic to foreign banks that could threaten the liquidity of the domestic banking system seems unlikely. The bad news is that the limited scale of foreign banking operations for the foreseeable future implies that the threat of competition from foreigners will also remain limited.

The insurance sector is also being opened up, and many of the important steps have already been taken. Foreign participation in life insurance is limited to 50 percent ownership in Sino-foreign joint ventures, but foreign insurance firms are already able to take majority positions in non-life insurance companies and operate anywhere in China.<sup>118</sup> Unfortunately, foreign insurers operating in China will be subject to the same capital controls, investment limitations, and rate regulations as domestic firms, which place stringent limits on their choices of assets in which to invest premium income. Until recently, Chinese insurers were largely limited to investing their funds in bank deposits, government debt, and a narrow range of other debt instruments. Approval to invest in domestic equity markets was only granted in 2005. In August 2004, Chinese insurers were allowed to invest a portion of their foreign exchange holdings in overseas debt markets, dramatically broadening the choice of assets but strictly limiting the amount of capital that could be invested offshore. In June 2005, insurers were allowed to invest, albeit in a very limited way, in overseas equities. For the time being, this investment is limited to the overseas shares of Chinese companies.<sup>119</sup>

Foreign entrants also have to contend with large, successful domestic incumbents that have built up massive sales forces, long-established branches, and popular products. Two well-known incumbents, China Life Insurance Company and Ping An Insurance Group, control more than 75 percent of the market for life insurance. The top four domestic firms controlled 95 percent of the market in life and non-life insurance at the end of 2003.<sup>120</sup> The incumbent firms have traditionally focused on the pursuit of market share rather than profitability. As in the commercial and retail banking sector, it is unlikely that foreigners will displace these dominant incumbents in the immediate future. On the other hand, the ability of foreign firms to offer group, health, pension, and corporate annuity products to sophisticated consumers and progressive firms creates a real zone of opportunity for leading firms with well-established China operations, such as AIG. Non-life insurance has been traditionally dominated by automobile insurance, but demand for other non-life insurance products is expected to accelerate as the market grows.

The leading Chinese firms have weak capital structures, by international standards. Prior to 1999, the firms sold life insurance policies that guaranteed high rates of return. When interest rates dropped sharply over the next several years, this created a serious problem of negative spreads. The firms' aggressive pursuit of market share has generated risks, and it is believed that non-life insurers particularly under-reserve given the risks they face.<sup>121</sup> As a consequence of more stringent oversight by the regulatory authorities, Chinese firms are seeking to shore up their capital bases through equity and subordinated bond issuance.

The rest of the financial services sector is expected to remain relatively closed, even after the phasing-in of all WTO-mandated liberalizations. For the indefinite future, foreign asset management companies will be restricted to minority positions in joint ventures, and foreign securities brokers and underwriters will be limited to one-third equity positions in joint ventures.<sup>122</sup> This has not prevented Goldman Sachs from acquiring de facto control of Goldman Sachs Gao Hua Securities Company with the option of raising its 33 percent stake, but it is unclear how many similar opportunities will exist in the immediate future.<sup>123</sup> On the one hand, this will give domestic companies opportunities to build skills and market positions in advance of any further opening. On the other hand, the competitive pressures foreign participants could exert will remain limited for the foreseeable future.

The securities industry in China could probably use this pressure, as domestic securities firms have been subject to withering criticism in the

domestic and foreign press over the past few years.<sup>124</sup> Hu Shuli, of *Caijing* Magazine, offered the following perspective in 2003: “China has 131 brokerage firms, almost all of which are state-owned and most of their financial circumstances are not at all clear. . . . It is widely known that many securities firms are technically insolvent and depend for their survival on the unauthorized appropriation of clients’ deposits, trust bonds, and other assets held in trust.”<sup>125</sup> The government has tacitly admitted the truth of this situation by launching a two-year program of extending official loans and, in some cases, emergency cash injections, to bail out the brokerage firms. Like China’s weak banks and insurance companies, brokerages are also being given the right to raise capital through bond issuance.<sup>126</sup>

### CONCLUSION

As with other aspects of its economy, the transformation of China’s financial markets over the course of the reform period has been breathtaking. In the late 1970s, China did not even have a banking system in the Western sense of the word. The legal framework that could undergird a modern financial system did not exist, nor were there regulatory agencies with the capacity to supervise such a system. Even the vocabulary needed to talk about such a system would have been alien to the Chinese entrepreneurs and officials who, in the decades since, have created China’s financial system. Over the space of a quarter century, China has managed to build financial markets that, for all of their flaws, have still managed to function effectively enough to power one of economic history’s great development successes. As Americans have been reminded by their own recent financial history, no country has a perfect capital market. Any assessment of the Chinese financial system has to begin by acknowledging the immense progress that has been made.

Only when one compares the speed and nature of reform of financial markets in China to the reform of other sectors of the economy does progress appear to be slow. As noted at the beginning of this chapter, a hallmark of the Chinese reform process has been the steady growth in importance of non-state actors and the increasing reliance on the market mechanism as a means of allocating resources. Whether one looks at Chinese industrial product markets, the determination of goods prices, or China’s expanding foreign trade, one sees a rapid and pronounced relative decline of the role of the state and its enterprises as producer, price setter, and trader. In contrast, China’s bank-dominated financial system remains dominated by enterprises under direct

state control: the state-owned banks and policy banks collectively account for around 60 percent of banking system assets, even in 2005. Furthermore, even the banks that are least directly tied to the state in an organizational sense are still subject to its influence. Formal credit quotas have been replaced by what the PBOC calls “moral suasion to guide credit structure optimization.”<sup>127</sup> The role of foreign firms—so visible and important throughout the modern Chinese economy in other sectors—remains quite limited and narrowly circumscribed in the financial sector, with little prospects for immediate change. Discrimination against private firms in the credit market persists, even as access to consumer credit has improved enormously.

The dominant hand of the state extends to Chinese equity markets. State control continues despite the “backdoor privatizations,” in which a limited number of cash-strapped SOEs and other affiliates of the state sell their legal person shares. The domestic exchanges are dominated by these SOEs in which the state and its affiliated organizations retain a controlling—and often majority—stake. The access of firms to the primary equity markets remains tightly controlled and largely limited to SOEs. Party control of personnel appointments at key firms continues to obscure the boundaries between enterprises and the government, and interference in firm management by internal Communist Party committees remains pervasive. This general state of affairs extends to Chinese insurance companies and brokerages. Although China’s WTO commitments require a substantial liberalization of this sector, financial markets will remain far more closed to foreigners and far more dominated by centrally controlled SOEs than is true of, say, international trade, where foreign-invested enterprises have become the dominant players and all indigenous firms now have trading rights. Bond issuance is largely limited to the government, its agencies, and the financial institutions it is attempting to strengthen; nonfinancial firms’ lack of access to bond finance perpetuates their dependence on the banking sector.

Given the still-dominant role of SOEs in this sector, the pace and nature of reform remains closely tied to the government’s strategy for reforming SOEs. Fortunately, this appears to be entering a new phase, opening up the prospects for an acceleration in the reform process that could allow for a serious diminution of the state’s role.

Of the many critical factors that have enabled this shift in the reform process, one of the most important has been the ability of the regulatory agencies and the statutes they operate under to, in a sense, finally begin to catch up to market developments by the end of the 1990s. While the

government played too large a role in Chinese financial markets, it consistently played too small a part as regulator, rule creator, and rule enforcer.<sup>128</sup> It was only at the end of the 1990s that the CSRC emerged as an agency with the technical expertise, legal authority, and political clout necessary to actually start bringing Chinese securities markets under control. The Securities Law itself was only passed in 1999. The China Banking Regulatory Commission (CBRC), which has emerged as the principal regulator of the banking system, was not created until 2003. It also took time for a generation of technocrats who really understood how capital markets work in the West to rise up into positions of power sufficiently strong to effect change in policy. While Chinese law lacks important elements that fully developed capital markets will need, the regulatory framework is now largely in place, and the key agencies are led by knowledgeable individuals who have a much clearer understanding of the necessary reforms ahead.

Under the influence of these leaders, the state has formally endorsed the notion that it will seek to retain a direct controlling interest in a relatively small number of firms. In March 2003, 196 huge enterprise groups supervised by the central government were placed under the ownership of the recently created State-owned Asset Supervision and Administration Commission (SASAC).<sup>129</sup> This organization will be the holding company originally envisaged by Wu and Jin back in the early 1980s; it will hold shares in these key enterprises on behalf of the state, but it will also provide a degree of separation of the firm from the regulating agencies.<sup>130</sup> These firms represent, in the government's view, the "commanding heights" of the industrial economy. Collectively, they accounted for more than half of state-owned assets at the end of 2002. True privatization of these key enterprises is not being considered, even if stakes in them are eventually sold. The government's priority with these firms will be to maximize efficiency, while retaining ultimate state control. As we have seen, history suggests that the government can pursue one or the other of these goals but not both.<sup>131</sup>

But for the remaining 159,000 state-owned and state-controlled enterprises in existence at the end of 2002, the state has accepted that it will eventually relinquish both formal ownership and actual control. Although the word "privatization" (*siyoubhua*) does not show up in government documents, it seems clear that this will be the fate for the vast majority of smaller SOEs that have not yet been privatized or liquidated. The sell-off of these state assets to private interests promises to be one of the critical events in the history of Chinese capital markets.



The critical stage in this process will be the sale of currently nontradable legal person and state shares. As noted earlier, these shares constituted more than 70 percent of the total equity in mainland companies at the end of 2005. The government's clear willingness to press forward in its efforts to convert these into tradable shares, with the eventual goal of unwinding its shareholding in "nonessential" enterprises, has been the most significant equity market development of 2005. Indeed, it represents one of the most significant steps forward since the founding of China's domestic exchanges. The process of unwinding state shareholdings is likely to take some time; during that interval, state asset sales will take priority over the need for private firms to get access to public markets.

The less positive development is that the key enterprises over which the state will seek to retain ownership and control are collectively very large, accounting for just below 50 percent of the state's total assets. Notably, they will include the four largest banks. While the government seeks to sell significant stakes in the big four prior to IPO to foreign "strategic investors," and while it clearly plans to float shares on foreign exchanges, it is equally clear that the government has no intention of truly privatizing the banks. The party will retain control over executive appointments, and, for this reason alone, government policy priorities will get weighted heavily relative to shareholder value maximization. The government wishes to turn these enterprises into "national champions" that can compete globally. The realization of these ambitions is likely to require enormous amounts of capital. Because the government will retain control of the largest banks, it can ensure that these "champions" get the capital they need, even at the cost of crowding out private firms and limiting the returns the banks receive from their commercial lending business.

The commitment to the state-owned sector has narrowed considerably in scope, but it has not died. As long as designated "national champions" exist in which the government holds a majority interest, it will be difficult for the state to act as a neutral arbiter in maintaining a level playing field. Under China's WTO commitments, it will be difficult to keep out foreign competition in many industries—financial services being a notable exception. Foreign firms are likely to be able to compete with the state-owned national champions even if the latter have preferential access to subsidized capital. As usual, it will be the Chinese private sector that will pay the cost for the government's enduring commitment to maintain ownership and control of the commanding heights. This may continue to constrain the efficiency of capital allocation in the coming years.



### POSTSCRIPT

Since this chapter was completed in March 2006, Chinese equity markets have appreciated by over 100 percent. The major indices have now surpassed their previous highs. This strong performance reflects, in part, the market reaction to the reform of state and legal person shareholding detailed in this chapter. These reforms have been implemented more quickly and more smoothly than expected. It also reflects the impact of faster than expected growth on corporate earnings over the last few years. The basic fact of the Chinese financial system is that it has a large stock of savings highly concentrated in low-yielding bank accounts and government bonds. The (re)emergence of China's equity market as an alternative investment offering the promise of high returns has clearly driven a substantial—though still limited—reallocation of savings into the equity markets, driving stock prices sharply higher. Robust share price appreciation has done much to shore up the portfolios of Chinese financial institutions that invest in the market. The challenges facing Chinese insurance companies and pension funds appear less daunting than they did in the early spring of 2006.

However, the recent public and private statements of government officials reflect the worry that the market has come too far, too fast. This author shares that concern. The potential for yet another boom-and-bust cycle in Chinese equity markets clearly exists. While China's financial market regulators clearly deserve the credit given to them in this chapter for accelerating the pace of market reform, serious issues remain. Corporate governance in China remains a work in progress. While state and legal person shares have been made tradable, they are being sold to private investors at a slow pace. The commitment to state ownership and control of the “commanding heights” of Chinese industry noted in this chapter has been regularly reiterated, even as reform has continued. It seems likely, given the problems that still exist, that Chinese financial markets will continue to offer a less than perfect reflection of the acknowledged dynamism of the economy for some time to come.

### NOTES

1. A large fraction of corporate investment is financed out by retained earnings, such that one needs to make a distinction between the government's control over the intermediation of capital—which is still substantial—and the government's control over investment, which is considerably smaller.

2. This striking contrast has been emphasized by many other observers, including Lardy (2004).

3. By the unfortunate standards of many developing countries, of course, China's macroeconomic trajectory has been relatively stable in that sharp declines in real output and an outright collapse of the financial system have been avoided.

4. Deng Xiao-Ping's famous southern tour in 1992 marked a turning point in China's direction toward economic development. Deng visited Guangzhou, Shenzhen, Zhuhai, and Shanghai, and generated strong support for his reformist agenda and the importance of economic construction and openness.

5. The figure provides the ratio of total fixed asset investment to GDP, in RMB terms. The official estimate of capital formation as a percentage of GDP for 2004 is slightly lower, at 44 percent. At the end of 2005, Chinese statistical authorities announced major revisions of their estimates of the size of the Chinese economy and of the growth rates the economy has achieved over the last decade. The statistics cited in this chapter refer to the pre-revision estimates, unless otherwise indicated. The revision in GDP does not allow us to estimate by what percentage investment may also have been underestimated; revised investment/GDP ratio is therefore difficult to compute.

6. These estimates come from the *China Economic Quarterly* and are based on data published by the National Bureau of Statistics.

7. However, there is widespread speculation that real economic growth may actually *exceed* the official statistics, in contrast to the situation in the late 1990s.

8. See Goldstein and Lardy (2004).

9. Dr. Louis Kuijs, senior economist in the Beijing Office of the World Bank, has been an articulate proponent of this view. See his detailed discussion in the *China Economic Quarterly* Q3 (2005).

10. A leading official of the China Banking Regulatory Commission was quoted in the *China Economic Quarterly* Q4 (2005) as stating that he expected firms with outstanding loans equivalent to nearly RMB 200 billion to declare bankruptcy within three years.

11. The numbers in this paragraph are taken from Lardy (2004: 97–98).

12. I thank Barry Naughton for bringing these numbers to my attention.

13. See Dipchand, Zhang, and Ma (1994: 7–8).

14. Lardy (1998: 60–61).

15. See Dipchand, Zhang, and Ma (1994: 7–8, 19–20); and Lardy (1998: 60–61).

16. Lardy (1998: 60–61).

17. Dipchand, Zhang, and Ma (1994: 20–21).

18. Lardy (1998: 63).

19. Dipchand, Zhang, and Ma (1994: 22–25); Lardy (1998: 63).

20. See Naughton (1995) for a detailed treatment of this reform and its financial consequences.

21. Dipchand, Zhang, and Ma (1994: 29).

22. Lardy (1998: 64–65).

23. Lardy (1998: 65–76); Lardy (2004: 99). Minsheng Bank and Shenzhen Development Bank are two banks widely considered to be “private,” in that nongovernmental entities own a majority of shares.

24. Lardy (1998: 66).
25. Lardy (1998: 124–25). This enormous difference in the retail presence of the first and second tiers of the banking system has persisted to the present day, and has helped ensure continued dominance of the big four throughout the 1990s and into the current decade.
26. I would like to thank David Li for pointing out how leading government figures, such as Chen Yun, made the case for continuing state control of the financial sector.
27. Dipchand, Zhang, and Ma (1994: 29–30).
28. Statistics are taken from the Web site of the China Banking Regulatory Commission, “Total Assets and Liabilities as of June 30, 2005,” <http://www.cbrc.gov.cn/english>.
29. Lardy (1998: 81–83).
30. See Lardy (1998: 86).
31. See Dipchand, Zhang, and Ma (1994: 41).
32. The formal annual credit quota was abolished in 1998, but the PBOC has continued to provide “guidance” to the banks on their lending activities.
33. See Boyreau-Debray and Wei (2005: 4–5, 16–19); Lardy (1998: 83–90).
34. See Lau, Qian, and Roland (2000) for a formal presentation of this argument.
35. I would like to thank David Li for stressing this point in conversations with the author.
36. Lardy (1998: 90).
37. Tsai (2002: 58).
38. Lardy has called this point into question as well as the earlier assertion that it was necessary to “compensate the losers” from financial reform through distortions in capital markets. Lardy suggests that the systematic underpricing of capital led to inappropriately capital-intensive production in SOEs. A more market-oriented system would have allowed for similar rates of growth with less foregone consumption and a higher rate of employment creation. See Lardy (1998: 184–86).
39. Brandt and Zhu, in their contribution to this volume, point out that recentralization of the financial sector actually limited the share of lending going to the non-state sector.
40. Lardy (1998: 90–91).
41. Lardy (1998: 170–72).
42. See Langlois (2001a: 1, 4–9).
43. Lardy (2002) shows that SOE profitability fell steadily throughout the 1990s.
44. See Naughton (1996: 287–95) for a detailed discussion of the triangular relationship between the state, the banks, and SOEs as of the mid-1990s. See Steinfeld (1998: 137–43) for a fascinating account of the array of welfare activities and social services provided by large SOEs in the steel industry to their workers.
45. See Naughton (1996: 291). Evidence of growing revenues is provided by recent issues of the *China Statistical Yearbook*. Government revenues grew from about 12 percent of GDP to roughly 17 percent over the last decade.
46. Some 14,000 firms were converted to joint-stock companies, which accounted for some of the measured reduction in the SOE workforce. The degree to which these enterprises were truly “reformed” may be called into question. Studwell (2003)

suggests that at least some of these firms probably continued to have preferential access to capital and to engage in inefficient production. He estimates that another 30,000 SOEs were sold to private parties or liquidated. However, there is little debate that a significant downsizing of the SOE sector occurred from 1999 to 2001.

47. See National Bureau of Statistics, *China Statistical Yearbook* (2000: 126) and *China Statistical Abstract* (date?: 39).

48. Strictly speaking, the creation of the three policy banks preceded the most significant steps in SOE reform by a few years. The banks were created in 1994. See Lardy (1998: 176–80).

49. Standard & Poor's (2004).

50. See Lardy (2004: 101–2).

51. See Harner (2004: 42).

52. Many of the statistics in this paragraph are taken from Lardy (2004: 101–4).

53. See Kroeber (2004: 39).

54. Lardy (2004: 107).

55. See MacGregor (2005).

56. See “Best in Class: China Merchants Bank,” *China Economic Quarterly* Q3 (2003).

57. Goldstein and Lardy (2004).

58. Goldstein and Lardy (2004).

59. See Kyne (2004).

60. See Sender (2004).

61. See Kyne (2004).

62. This allegation has been reported in a number of press outlets, including Studwell (2004) in the *Financial Times*.

63. Lardy (2004: 107–8).

64. This paragraph and the preceding one draw upon Harner (2004: 42–45).

65. Given the history of Standard & Poor's highly public criticism of the health of the Chinese banking sector over the last decade, this is significant.

66. The Industrial and Commercial Bank of China, though clearly not as far along in its “clean-up” process, has received substantial investments from Goldman Sachs and Allianz capital.

67. Bank executives associated with the big four banks have pointed out to me in private conversations the challenges involved in changing lending behavior throughout their far-flung networks of branches. One executive noted that more than one-third of the provincial heads in his bank did not have a college degree, much less training in modern credit-scoring methods. Some Chinese commentators, such as David Li, have suggested that the scale of the big four is so great that reform is impossible unless they are broken up into smaller organizations. Personal conversations with government officials suggest that this is unlikely to happen.

68. See Browne (2005b).

69. See Associated Press (2005b).

70. See Browne (2005a).

71. Standard & Poor's (2005b). Assuming it does cost \$190 billion (\$197 billion at current exchange rates) and that recovery rates of the AMCs continue to be very low

net of operation costs, this would bring the cumulative cost of fixing the banking system to date to over U.S. \$500 billion.

72. The policy reports issued regularly by the PBOC make it clear that the rural credit cooperatives have been exempted from the tighter reporting, provisioning, and capital adequacy standards being imposed on the rest of the banking system. This fact implicitly suggests that compliance is simply infeasible given the accumulation of NPLs in this segment of the banking system.

73. See the fiscal sustainability calculations undertaken by Lardy (2004). He calculates a number of alternative scenarios regarding the size of the Chinese government's contingent liabilities related to NPLs in the banking system. Even in his worst-case scenario, the Chinese gross debt-to-GDP ratio never rises above 0.860, which is well below levels maintained today by advanced industrial countries such as Japan (1.4+). However, Lardy's calculations include no accounting for China's unfunded pension liabilities.

74. Walter and Howie (2003: 6).

75. This remarkable document was highlighted in the English-language literature by Steinfeld (1998: 132–37). The discussion in the following paragraphs closely follows Steinfeld's description.

76. Walter and Howie (2003: 24–25).

77. Walter and Howie (2003: 25).

78. Dipchand, Zhang, and Ma (1994: 161–63).

79. Walter and Howie (2003: 27–29).

80. Walter and Howie (2003: 72).

81. Walter and Howie (2003, 59–62).

82. Green (2003: 13–14).

83. The chief architect of the deal, Carl Walter, then with Credit Suisse First Boston, described the transaction as “an under-the-table deal, when there was no table.” See Studwell (2003: 78).

84. Studwell (2003: 78).

85. Studwell (2003: 73).

86. Unfortunately, the story of this firm did not have a brilliant ending. The Stock Exchange of Hong Kong and the NYSE suspended trading in Brilliance shares in 2002 after a leading executive, Yang Rong, was forcibly removed from office. See Green (2003: 59).

87. Green (2003: 58).

88. Walter and Howie (2003: 21, table 6.1).

89. Green (2003: 22–23).

90. See Walter and Howie (2003: 207–18).

91. Green (2003: 26–28). Conventional measures assign the value implied by A-share prices to all the outstanding shares of Chinese listed firms, ignoring the reality that H shares and B shares have historically traded at a significant discount to the A-share prices, and that state and legal person shares have often changed hands at valuations implying an even steeper discount.

92. Green (2003: 119–21; 2004).

93. The “H” refers to Hong Kong, the foreign stock exchange most favored by Chinese firms seeking an overseas listing. However, like many others in the

literature, I use the term *H shares* to refer to the shares listed on any foreign stock exchange.

94. Walter and Howie (2003: 178–80). This discount has narrowed substantially in the last few years, but it still remains.

95. Green (2003: 55).

96. Walter and Howie (2003: 188–89).

97. This basic point has been eloquently stressed by Walter and Howie (2003: 175–206), which is the source from which the statistics in this paragraph are taken.

98. Green (2004).

99. See Sender (2003).

100. Walter and Howie (2003: 184–86).

101. Green (2004).

102. See Areddy (2005a).

103. Chinese banks were allowed to issue subordinated debt in order to strengthen their capital and meet government standards for capital adequacy. This touched off a sharp increase in subordinated bond issues in 2004. However, this does not appear to indicate a shift in policy regarding the issuance of bonds by nonfinancial corporations.

104. Reinforcing this point, Chinese commentators have pointed out that one reason for the slow pace of financial reform in China is the reliance of financial markets on these kinds of legal institutional foundations, which remain quite weak in China. I thank David Li for pointing this out to me.

105. Initial experiments in commercial paper issuance, allowed by the government, have been enthusiastically embraced by the market. However, press coverage has stressed the potential threat this financial instrument could pose to bank lending. See Areddy (2005b).

106. In June 2005, the central government required localities nationwide to levy a 5.5 percent tax on residential property sold less than two years after purchase. A number of restrictions were placed on real estate developers. This followed imposition of a similar tax in Shanghai, the country's hottest property market, in March. See Associated Press (2005a) and Areddy (2005c). As of March 2006, real estate market participants were noting price declines in some regions of metropolitan Shanghai on the order of 20 to 30 percent.

107. See Standard & Poor's (2004: 22). The government has taken a number of steps over the last three years to broaden the set of assets in which insurance companies can invest, but this remains a challenge for the industry.

108. See Eberstadt (2004: 9–10).

109. See Eberstadt (2004: 9).

110. See interview with Leckie (2005).

111. *China Economic Review*, 2005.

112. See Eberstadt (2004: 10).

113. See Eberstadt (2004: 10).

114. Branstetter and Lardy (forthcoming).

115. Dong Fu of the Federal Reserve Bank of Dallas has also called attention to these features of the data. See Fu (2000).

116. See Langlois (2001b) for a summary of the WTO-mandated liberalizations for the financial sector.

117. See Lardy (2002) for a detailed discussion of the likely evolution of the banking sector after WTO-mandated liberalizations are phased in.

118. See Langlois (2001a). The life insurance industry has been about three times as big, measured by annual premiums paid, as the non-life insurance industry. See Standard & Poor's (2004).

119. See Browne (2004) and De Ramos (2005).

120. See Standard & Poor's (2004).

121. Standard & Poor's (2004).

122. See Langlois (2001b).

123. Rumors in the market indicate that the quid pro quo for this investment was that Goldman Sachs had to spend \$60 million bailing out investors in an unrelated brokerage firm. See "A Marginalized Market," *Economist*, February 24, 2005.

124. The cover story of *Caijing* Magazine on October 5, 2000, stunned the markets by presenting incontrovertible evidence of stock price manipulation by 22 investment funds. Many other such exposes have followed in recent years. For a Western perspective, see Walter and Howie (2003: 139–74).

125. See Hu Shuli (2003).

126. See Areddy (2005a).

127. See China Monetary Policy Report, Quarter 2 (2004), official English translation, from the PBOC Web site.

128. This observation reflects the influence of the scholarship of Xiaobo Lu.

129. See Green (2004: 30–32).

130. A separate holding company, Central Huijin, will manage state shares in major financial institutions. This organization is headed by a former PBOC official, calling into question the true degree of separation between regulator and SOE.

131. See Clarke (2003: 27–30).

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## COMMENT

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One of the major political economic events in the last half of the twentieth century was the rapid economic growth in China. With a growth rate averaging roughly 9 percent annually, it is hardly disputable that China's economic growth has been the most remarkable world economic story in the last 20 years. However, reforms in the Chinese financial sector are far from a success. In fact, the financial sector has so lagged behind that some scholars suggest it is an "elephant mired in a swamp"—slowly moving ahead with great difficulty. Others call it the Achilles' heel of the Chinese reforms. If, for different reasons, there had been wavering and indecision on the need to speed up financial sector reforms, this is no longer the case. By the end of the 1990s, a consensus among Chinese policymakers had emerged that such reforms were imperative to the success of overall reforms. How have such successes been achieved? What lessons do the Chinese reforms—both in general and the financial sector in particular—offer? In this comment, I will offer some analysis of the Chinese financial market development in the larger context of reforms in China. The chapter by Lee Branstetter provides a comprehensive survey of the policy and institutional changes in the Chinese financial sector over the last two decades. His three main themes—the centrality of the state, the close relationship between financial and SOE reforms, and the changing macroeconomic environment of China's financial markets—provide a basis for my comments and analysis. I will draw upon his findings and arguments as well as other sources.

As part of the overall reforms in China, reforms in the financial sector have been characterized by the same traits and strategies as many other major reforms: state-led (rather than market-driven), gradualism (rather than "shock therapy"), and destatization (rather than outright privatization). As

an important part of the state sector and its main financing arm, Chinese banks and other financial institutions have been very closely tied to the SOE reforms, as Branstetter points out.

### GRADUALISM

Financial sector reforms in China have followed a similar pattern to other major reforms—a gradualist, trial-and-error approach that tackled easy problems first and constantly adjusted. By doing so, the government tried to advance the modernization of the financial sector, making it more competitive and efficient while avoiding unwanted social and economic instability. Consider the evolution and change of the banking system. As Branstetter cogently describes, it has taken more than two decades and several major institutional reforms—from monobank to emergence of commercial banks, from creation of a central bank to opening up to non-state banks—for China to develop its banking sector. The pace of reform has been cautious—“crossing the river on one stepping stone at a time” to use a famous phrase by the late Deng Xiaoping, the architect of the Chinese reform. Facing the potential competition from overseas and private banks (as China’s WTO commitment requires a further opening up of the financial market by the end of 2006), China has stepped up its financial market reform pace since 2001.

The development of the stock market is another illustration of how the attempt to balance economic reform and social stability often slowed down the pace of change. As Branstetter states, the equity market has seen volatility, chaos, and even violence, since its establishment in the early 1990s. In one case, in 2001 the government attempted to speed up the reform of the SOEs and the stock market by preparing to sell more holdings of the SOEs and other public institutions. Yet, to many individual stockholders this signaled the government’s reduction of support for those SOEs. As a result, the stock market slumped, and there was widespread uncertainty about the future. In less than nine months, the government decided to rescind its policy to reduce state shares. The government’s concerns were not just merely economic; they were also social and political. Individual stockholders, though relatively small in number, consisted of urban retirees whose livelihood depended much on the stock valuation. The dilemma that a reform regime often faces is how to balance the needs to drastically change existing inefficient institutions against the necessity to maintain stability and minimize consequential transition pains. In reforming

the financial sector, Chinese leaders have faced the same dilemma. From the beginning, the equity market has served a critical role: help reform the SOEs. Many measures and institutions were implemented as a result of reacting to these problems.

A typical but innovative strategy in the gradualist approach with regard to Chinese reforms, is the so-called dual-track (*shuanggui zhi*)—the coexistence of two types of institutions as a transitional measure.<sup>1</sup> As in many other reforms, financial reformers also adopted this deliberate strategy in developing China's equity market, that is, the coexistence of two kinds of shares: tradable shares that individual investors can buy, and nontradable rights that state-owned enterprises and other legal persons hold. As Branstetter observes, by the end of 2005, the tradables only accounted for 30 percent of the shares. In fact, this may well be the last dual-track item in existence in China. A series of new measures were taken to convert nontradable rights to tradable shares in 2005. As a buffer to absorb the shock effect, the government restricted the sale of nontradables to tradable shares and preset trading thresholds for nontradables to be traded. It is too early to see if these measures will be effective in smoothly converting all nontradable rights and reducing the state holding in the equity market. So far, they have been relatively well received by the market.

Gradualism is also reflected in another unique character of the Chinese institutional reforms—the establishment of formal institutions often precede rules and regulations. In the United States, for example, any major institutional change would require that legislative statutes, court rulings, or administrative regulatory changes be established first. These statutes and rules would provide legal and regulatory basis for the formal institutions to be established. This approach, often found in mature democratic regimes, tends to guarantee predictable and stable procedures, reducing uncertainty. But the approach also lacks flexibility and can make change more difficult. The Chinese-style reform approach, particularly in the first two decades of the reform, tended to be more flexible and easy to amend and adjust. But it also has serious downsides: when rules and regulations lag behind formal institutions, often uncertainty, distortion, and even chaos result, as Branstetter notes. Although rules and regulations can be revised and fine-tuned to adjust to new situations, their effectiveness can also be reduced and diluted owing to frequent changes. Thus, this “institution first, rules second” approach often negatively affects the development and capacity of regulatory agencies, including the

three major ones in the financial sector: the China Securities Regulatory Commission (CSRC), the China Banking Regulatory Commission (CBRC), and the China Insurance Regulatory Commission (CIRC). Fairly or unfairly, many blame the “regulatory lag” for problems in the Chinese financial sector. While Branstetter does refer to China’s financial regulatory bodies in his analysis, the development and function of the regulatory system deserve more attention.

### STATE-LED REFORMS

Unlike reforms in European and other Asian economies, where financial sector reforms have been driven mostly by financial crisis or private sector needs, China’s financial reforms have been undertaken by the state’s initiative. The state, though attempting to establish more viable financial markets and to make state-owned banks more competitive, led the way to withdraw itself from excessive control, intervention, and regulation. Not only did the state launch and regulate the financial markets, it has also been a major player in expanding the marketplace. Indeed, this point is similar to Branstetter’s theme of the centrality of the state in the intermediation of capital in the Chinese economy. But more than Branstetter, I would give the state greater credit for initiating and for trying to withdraw itself. I would also suggest that in the post–state-socialist transition, the state has inevitably led the reforms, owing to past dependency on the state (i.e., state socialism). To be sure, to say that the state has led the reforms by setting its goals, scopes, and pace does not mean that it is not also a source of problems. The dual role of player and referee, besides the piecemeal reforms typical of a gradualist approach, is blamed for investors’ lack of confidence in China’s financial markets, particularly the stock market. Many people are critical of the regulatory body, CSRC, for both having regulated too much (and thus stifling incentives for private firms and investors to be listed and invest in the stock market) and for having regulated too little and been ineffective in preventing widespread insider trading and manipulation of the market by large institutional stockholders. But in the process of transforming itself from an all-encompassing player-coach-referee in an uncompetitive game to a referee in a competitive game, the regulatory agencies are learning to function better.

State-led reforms reflect the reluctance of a regime determined not to give up all political and economic control, particularly with regard to important state-owned firms. Branstetter argues, correctly, that the state is

committed to controlling the “commanding heights,” including the most important components of the financial sector. Restructured banks will still face the challenge of governance. Many top officials continue to be appointed by the government. Branstetter sees the state’s attempt not to relinquish total control over leadership as likely to run into conflict with the market. I would highlight an additional possible scenario for future reforms. In the gradualist, de-statization framework, Chinese reforms first tackled problems and changed institutions with relatively concentrated social interests. Tight authoritarian rule afforded these early reforms some maneuvering room. As reforms touch upon more and more core institutions and interests, and the social interests become more diverse and fragmented, it will become increasingly difficult for any major reform measures to be deliberated and implemented.

#### DE-STATIZATION

Instead of large-scale privatization of the state sector, since the beginning of the reforms China has adopted a deliberate policy of reducing the share of the state sector in the overall economy by what some scholars call a “growing out of the plan” strategy—in other words, maintaining the core industrial enterprises in the hands of the state while allowing the non-state sector to grow. The two differing concepts, *feiguoyouhua* (de-statization) and *siyohua* (privatization), are not just semantics; rather, they reflect two different approaches to reforming a former state socialist economy. In China, the economy has been gradually de-statized without large-scale privatization of the state-owned firms over the last twenty some years. The financial sector is no exception, although it has moved at a much slower pace. The two may eventually converge once the state sector is no longer dominant in the economy and once the markets become more mature.

In banking reforms, the government has been determined to prevent large state-owned banks, particularly the big four, from failing. The four banks—the Bank of China (BOC), the China Construction Bank (CCB), the Industrial and Commerce Bank of China (ICBC), and the Agricultural Bank of China (ABC)—have received capital injections to restructure and prepare to receive foreign investments. They handle roughly 60 percent of all bank loans in China, a large portion of which have gone to SOEs. Chinese policymakers and scholars are debating whether the government should continue to inject capital to bail out state-owned banks.

Opponents argue that injecting further money into inefficient banks could create moral hazards, thus delaying and even distorting restructuring efforts. Advocates argue that the poor performance and high rate of NPLs<sup>2</sup> are caused by the state's own distortions and past institutional weaknesses. It is the government, they argue, that should take responsibility for helping the banks, and that only with the injection of public money can these banks survive and compete.

### CONCLUSION

In discussing the development and reforms of the financial sector in China, it is apparent that these reforms are part of overall economic transition strategy in the post-Mao era. However, the financial reforms have clearly lagged behind other reforms, in part owing to the approaches the Chinese leaders adopted—gradualism, state-led reform, and de-statization. The financial sector, which has been regarded as an important component of the state sector, took a long time to implement reforms. Lee Branstetter has provided a detailed and convincing overview of the process of financial reform. His most important observation is that [o]ver the space of a quarter of a century, China managed to build financial markets that—for all their flaws—have still managed to function effectively enough. . . . It is only when one compares the speed and nature of reform of financial markets in China to the reforms in other sectors of the economy that progress appears to be slow.”

When we assess the success or failure of the financial reforms in China, we must view them with historical and comparative perspectives. As Branstetter reminds us, China has come a long way from its monobank, single-source-of-capital days in a relatively short span of time. Building market institutions requires time. Transforming the old *and* building new economic institutions takes even more time. When we criticize China's financial regulatory system as weak and rudimentary, we should not forget that it has taken nearly a century for a country like the United States to build up and improve its financial regulatory system. In the meantime, there should be no denial that financial sector reforms have been slow and overly cautious, sometimes because of noneconomic considerations. The financial markets are likely to be a bottleneck for China's future growth. The era of easier reforms is over. Now at every step of the way, reform policies will face tremendous difficulties. Old approaches such as gradualism and de-statization have worked in the past, but they have also left behind

unintended consequences and may no longer work. Perhaps only by implementing more innovative and daring reform measures can China's financial sector, still dominated by state players, meet the challenges posed by the foreign competitors under WTO commitments, and more importantly, meet the challenges of financing China's continuing growth.

#### NOTES

1. The most illustrative example of this dual-track strategy is the price reform between the mid-1980s and the mid-1990s. In the beginning of this reform, the intention was to avoid high inflation and social unrest likely to be caused by a rapid lift of price control by the state. So the government allowed a noncontrolled, market-driven pricing mechanism to grow while maintaining the state-set pricing in more critical items. Eventually, all prices but a few strategic items were converted to a market-driven pricing mechanism. Although this measure resulted in successfully establishing market pricing without experiencing high inflation and social unrest in China, it also had some unintended consequences of causing widespread corruption and abuse by government officials.

2. One of the contentious points is the level of NPLs in the Chinese banks. As recently as May 11, 2006, the government criticized some estimates by overseas analysts as overly high. According to the official figures, the NPL rates at the big four are 5.41 percent (BOC), 3.84 percent (CCB), 4.69 percent (ICCB), and 2.37 percent (ABC) (see Xinhuanet.com, May 11, 2006).