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IN

CHINA

BANK REFORM IN CHINA

What It Means for the World

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INTRODUCTION

BANKING IN THE CONTEXT OF CHINA'S ECONOMIC REFORM



The world watches as China, formerly a closed and crippled state, steadily transforms itself into an economic powerhouse. The combination of sheer size and spectacular growth has China on course to become the world's largest economy by 2020. Opening up cautiously to international trade and foreign investment in the 1980s, China has rapidly emerged as the world's factory, out-competing other nations in low-cost production of manufactured exports of increasing sophistication — from textiles and toys to cameras, computers and cars. China today not only manufactures every conceivable gizmo, it now designs gizmos to come.

With the expansion of China's economic power, the extent and complexity of China's involvement with the rest of the world has likewise increased. China is the world's second-largest recipient of foreign direct investment (FDI), behind only the United States. Modern technology and management acumen accompanies the inflow of capital, moving China further up the learning curve of international business. More recently China has been involved in a significant amount of outward foreign direct investment. So far China has kept its sights mostly on foreign mining, oil and gas, sectors that are naturally important to Canada.

Global inflation has been kept in check by the double influence of China's production efficiency on product prices. For instance the 50% fall in the price-index of consumer electronics over the past 10 years and 40% drop in the price-index of textiles are directly attributable to China's exports. Meanwhile China has acquired a large hoard of financial paper issued by countries that buy China's low-cost goods.

China's foreign exchange reserves have topped US\$1 trillion. China's ability and willingness to accumulate this paper fortune has allowed industrial nations, including Canada, to enjoy non-inflationary consumption. US interest rates and interest rates related to US rates, such as those in Canada, have been lower than they

otherwise would have been over the past number of years because China is a major provider of credit. It is a curiosity in international finance that a country with per capita GDP of \$1,500 lends US\$1 trillion to the rest of the world.

China's voracious demand for industrial commodities — oil, copper, and nickel for example — explains much of the increase in traded commodities prices over the past 10 years, reversing a century-long decline. As a commodity exporter, Canada is enjoying the global commodities boom. The effects are also felt in the new-found strength of the Canadian currency, of course.

Within China, the nation-in-transition faces new economic and social challenges that include worsening income inequality, massive internal migration, a shattered "iron rice bowl," political corruption and a fragmented fiscal system that fails to facilitate the new relationship between the private sector and the state. Larger, angrier and more frequent demonstrations reflect a degree of social unrest that is especially troubling in a country that formally places "social harmony" above all else.

China, "the mysterious East," is a country of contradictions. It has the technical wherewithal to launch satellites yet in remote parts of the country life is virtually unchanged from centuries past. China seems forbidding and secretive, yet Beijing will host the international spectacle of the Olympics within less than two years. China seems intent on following its own agenda on economic dealings with the rest of the world, sometimes defiantly, yet it is now a full member of the World Trade Organization and has properly reclaimed the "China chairs" at the International Monetary Fund and the World Bank.

This monograph deals with banking and finance, a perplexing but increasingly crucial aspect of the made-in-China version of economic reform. For most of the

period of reform that is now approaching 30 years, China has moved steadily and successfully toward functioning markets — for agriculture, for goods for domestic consumption and export, for labour and for capital. All the while, however, China’s market-building program has had to contend with a financial sector with features of the old central planning regime. That bank-centric system continued as a state-run plan-financing mechanism with a bias toward state-owned enterprises (SOEs). China’s deliberate move to markets was not accompanied by similarly serious reform of the banking system. What does this imply for the importance of finance for the transition itself and, more important than the historical point, what would continued weakness and inefficiency in banking mean for the sustainability of China’s economic modernization? It could be ominous.

A disturbing recurrence in economic development, dubbed Goldsmith’s Law, relates financial fragility and economic instability. Goldsmith’s unsettling finding is that, in most cases, economic transition from heavy-handed statism to a decentralized market economy and a burst of extraordinary growth sooner or later comes crashing down in a financial crisis.¹ Weak financial institutions, inexperienced central banking, inefficient intermediation, volatility in monetary aggregates, lack of confidence and the spectre of capital flight combine to undermine and destroy hard-won economic gains. Inflation, soaring interest rates, mounting bad loans, internal runs on banks and external runs on the currency that torpedo the exchange rate — these make up a destructive turbulence that is the dark side of economic growth built on a shaky financial structure.

China may yet break Goldsmith’s Law. The boom-bust cycles have diminished in amplitude. Inflation is low. The currency is strong. Exports are booming. Tax revenue is rising. Meanwhile, as far as banking itself is concerned, China is engaged in a broad campaign of financial institution building, albeit relatively late in the reform program. It is intriguing to ask whether China has devised a template for transition that allows it to deal with a weak financial system without substantially compromising the forces for growth. A few uniquely Chinese factors may explain economic gains achieved without sophisticated finance.

First is the “population dividend” that China seems to be enjoying. People born in the 1950s and 1960s are the backbone of the Chinese economy. It has an exceptionally high ratio of young working people to retirees. The financial implication is an extraordinarily high national rate of “deposit” or savings that flow directly into the banking system. China’s savings rate is close to 45% of income.²

Second, the opening up of China to international trade and foreign investment has attracted huge inflows of FDI that augment internally generated investment. On average, over recent years 60% of FDI from Organization for Economic Cooperation and Development (OECD) nations to non-OECD nations has gone to China. Multinational corporations generally have well-honed financial relations with the global banking system and hence the production efficiency of foreign investment in China is unlikely to be compromised by weakness in its banking system.

Finally, China’s monetary policy seems to shrewdly compensate for structural problems in finance. The high savings ratio belies a disappointingly low rate of transfer of savings to investment, indicating that the banking system in China is woefully inept in its intermediation function. At the same time, China’s money “velocity” — a standard measure of the efficiency of money circulation, for instance from savings to investment — is exceptionally low. If velocity is low and pools of cash are stagnating, the compensating monetary policy is to inject more cash into the system. In fact in China “M2” (circulating cash plus bank demand deposits) is 150% of GDP which is extraordinarily high by international standards (in the US M2 is 70% of GDP).

Is a debilitating financial crisis in China a serious risk? To anticipate a more detailed response to this nagging question, my answer is that China’s remarkable economic advances are unlikely to end in financial conflagration. China has both the policy insight and the resources to allow it to act early and forcefully to any threat of financial instability. In global finance, a trillion dollars of foreign exchange buys a lot of strength and credibility. In short, the concern about banking in China is not the apocalyptic story. The problem is not that

banking is precarious but rather that it is inefficient and incapable of doing all that could reasonably be expected of banking in China's emerging complex industrial society. It will take some time to rid the system of the fundamental inefficiencies but the reform process is well underway. Meanwhile China suffers capital misallocation, poor risk management and weak linkages in macro-monetary mechanisms. Addressing the shortcomings could create enormous value for China's economy. The McKinsey Global Institute estimates that reforming China's financial system could boost GDP by more than US\$320 billion annually.³

The aim of this monograph is to outline the nature of banking in China and to provide an overview of the ongoing bank reform process. A key focus is the transition from the old banking structure to a new system appropriate for a market economy the likes of which are familiar in the West but not so familiar in the East. Indeed, there is some question as to whether Chinese banking is headed in a westerly direction. One of the great challenges in Asian bank reform — and one cannot be quite certain that China fully intends to confront it — is the need to reorient the political and social function of banking from traditions that date back at least to the imperialist Meiji Restoration in Japan. In the “Asian model” of banking as illustrated in Japan, South Korea and China, household savings are pooled in the banking system (the “savings” side of national finance) and then their use (the “investment” side) is determined by priorities set by the state plan. This long-standing view of banking could take a long time to fade. Nevertheless, in my account of reform, the Western view of the role of banking as intermediation between savers and *decentralized* borrowers/investors underlies the analysis, thus relying on the proposition that China is genuinely committed to market-driven and market-responsive banking.

Before grappling with the nitty-gritty of bank reform, including such topics as credit allocation, non-performing loans, recapitalization, regulation, supervision and risk management, I will briefly frame the reform process in uniquely Chinese philosophical terms. In institutional reform, social and political context is crucial.

THREE APHORISMS TO GUIDE REFORM



China is a one-political-party state. The ruling Communist Party can introduce sweeping changes in policy and social direction with remarkable speed and virtually no political resistance. That is certainly the case for the so-called “modern reforms” that, in little more than a generation, have transformed China from an isolated, starving nation to one that holds the world in awe of its newfound economic might.

Unlike in nations with parliamentary rule and formal oppositions that are expected to challenge policy initiatives of the government, policy positions of the Politburo in China arrive as diktats that, regardless of merit, are unchallenged by public debate. While we in the West may be uncomfortable with such autocratic governance, there is no denying that the arrangement allows matters of state to move quickly. However, the lack of an adversarial system of government prevents the one-party state from reassuring the nation of the aims and wisdom of policy. Even autocrats appreciate that public acceptance can be crucial for policy success. To mobilize support for broad-based initiatives, the central government in China often represents the intent and logic of policy in Confucian-like aphorisms offered as wise words from the leader. Three such sayings are especially useful for understanding the motivation, direction and design of China’s approach to reforming and restructuring its economy.

Back in 1978, when Deng Xiaoping set the process of economic reform in motion, he acknowledged that he had no definitive plan of how the job would be done. The objective was clear: to create national wealth and to reverse the poverty that was crushing China. Reform was surely needed. The issue was how to operationalize reform. In a phrase that perfectly captured the conundrum, Deng announced, “*We will cross the river by feeling for the stones.*”

Deng’s poetic commitment to cautious, flexible incrementalism has guided China’s reform over the

ensuing years. Major stones that provided solid footing include the sequential order of reform, beginning with the relatively simple step of allowing farmers to sell some of their crops for profit. Soon more and more items were priced in markets. Relaxed restrictions on labour mobility allowed workers to migrate from rural areas to the cities, from agriculture to industry. Industrial advances tapped the energy of township and village enterprises. Special economic zones were opened to international trade and foreign capital with anticipation of expansion of the liberalized areas. Then came the biggest industrial challenge of all — reform of the vast array of state-owned enterprise — which introduced complicating considerations of the social role of such industry.⁴ The tertiary sector (services, wholesaling and retailing) and financial sector reform were left for a later stage.

From the outset, the reform initiative faced the potentially crippling criticism of revisionism and a shift from socialism to Western-style capitalism. It took the failure of the Great Leap Forward and the Cultural Revolution, and subsequently the death of Mao and the rise of Deng, to resolve the ideological debate. Deng declared, “*It doesn’t matter whether the cat is black or white, as long as it catches mice.*” These choice words contrast Deng’s flexible pragmatism with the rigid, ideology-bound statism of Mao. The endorsement of the move toward a more efficient and productive economy removed the yoke of ideology from economic management. If markets work, let them do so.

Finally, as market-oriented reforms took root, the planners in government recognized an emerging distinction between goals that could be most effectively achieved by market liberalization versus what remained — in the industrial sphere — as the responsibility of the state. “*Grasp the large and release the small,*” they said. The idea is to retain and reform state ownership and control in large industry with high national

significance — such as infrastructure, heavy industry and banking — and to allow small disparate industry that flourishes with market flexibility and owner-initiative to be controlled and managed by private owners.

The three aphorisms — concerning ideology (“*black and white cats*”), process (“*crossing the river*”) and planning priorities (“*large and small*”) — turn up frequently in formal state documents, rousing speeches and, as here, in China-watchers’ accounts of the world’s most comprehensive and consequential economic experiment.



BANKING IN CHINA

– WHERE IT’S BEEN, WHERE IT IS, WHERE IT’S GOING



Banking reform is being carried out within the broader context of China’s transition from a planned economy to a market economy. This account of the reform process is necessarily selective, highlighting the objectives and the major milestones followed by an assessment of performance.

The key issues that are the concern here are:

- the three-stage evolution of the institutional structure of banking.
- the solution to the problem of non-performing loans.
- bank supervision, regulation and governance.
- banking in the broader context of China’s financial market development.

EVOLUTION OF THE INSTITUTIONAL STRUCTURE OF BANKING

Prior to opening up to the rest of the world, China’s banking system consisted of only one financial institution, the People’s Bank of China (PBC). What eventually came to be called the “first stage” of bank reform took root in the early 1980s with the creation of a two-tier system. The PBC became the central bank. The Industrial and Commercial Bank of China (ICBC) was carved out of the PBC and, together with the China Construction Bank (CCB), Bank of China (BOC) and the Agricultural Bank of China (ABC), the four so-called specialized banks became the second tier of the system. The Big Four banks were 100% state-owned as, for all practical purposes, they are to this day. In the early stage of reform the specialized banks were allowed very little scope to extend commercial or consumer credit.⁵

The second stage in developing a market-oriented banking system in China began in 1994 when the Big Four banks were relieved of their role in “policy lending” that characterized the banking regime in the era of

comprehensive central planning. That function was assigned to three “policy banks” under the direct jurisdiction of the State Council. The three policy banks are:

1. **Agricultural Development Bank of China (ADBC)** took over the policy lending role of the ABC. ADBC provides loans for the purchase, transport, marketing and reserves of selected agricultural products (grain, oil, cotton, meat, sugar, tobacco and wool) and loans for enterprises involved in processing. It takes deposits from publicly-owned entities and manages their international transactions.
2. **China Development Bank (CDB)** took over the policy lending role of the CCB and, to a lesser extent, the ICBC (inasmuch as the latter was never a major state-directed lender). The CDB is responsible for financing public-sector investment in support of national economic development and strategic structural readjustment.
3. **Export-Import Bank of China (EXIM)** took over the policy-lending role from the BOC, especially the trade financing function and inter-bank transactions. EXIM provides guarantees and concessional loans for firms involved in international trade and investment.

China’s policy banks fund themselves primarily through bond issues. They accept few deposits and those that they do accept are exclusively from state-owned institutions. The combined assets of the three policy banks have grown rapidly. They now comprise about 10% of total bank lending which bears evidence of the continued presence of state-directed commercial finance.

In 1995 the Commercial Bank Law was promulgated, recognizing the status of state-owned specialized banks as *commercial* banks operating according to market-based banking principles of capital-adequacy, prudence, profitability, risk recognition, liquidity and responsibility

for own profit and loss. Despite the law, government intervention — such as tight restrictions on banks' deposit and lending rates of interest — continued to constrain the fledgling commercial banks' discretion on business decisions.

While ostensibly pushing China's banking system to be market-driven and market-reliant, the second stage of the reform process continued to be bureaucratically managed from the top. At this point a proper banking regulatory agency had not been established. In 1997 the Central Committee of the Communist Party and the State Council held the first National Financial Operations Conference and introduced several important measures to accelerate the reforms.

First, the government issued RMB270 billion (US\$33 billion) in special government bonds to recapitalize the Big Four state-owned commercial banks. Second, new regulations abolished the credit quota policy (by which the commercial banks had quotas imposed on them concerning to whom and how much they could lend) and, instead, allowed banks to adopt asset-liability management. Finally, in a dramatic and significant step that marks the transition from the second to the third stage of banking reform, the central government transferred RMB1.4 trillion (US\$170 billion) in non-performing loans from the books of the state-owned commercial banks to new entities dubbed "asset management companies." I will return to the third stage of the reform process following a closer look at the non-performing loan problem and its resolution.

NON-PERFORMING LOANS – THE ROLE OF THE ASSET MANAGEMENT COMPANIES

Most non-performing loans in China's banking system are a carry-over from the era of central planning. Wholly state-owned banks represented the full extent of China's financial system. The banks served as cashiers to the Central Plan. Banks were passive conduits of finance

from the central government to state-owned enterprises, to ministries responsible for infrastructure and to lower-levels of government. Loans subsequently termed "nonperforming" in many cases were never expected to "perform" in the first place. In central planning, banks have no commercial mandate. Likewise, when economic policy in China was dictated from the centre, banks had no role as the institutional mechanism for credit-based monetary policy. Credit was expanded or squeezed by quotas, not by lowering or raising loan rates.

Even in the intermediate stages of economic reform, with bank reform considered to be less urgent than industrial and labour adjustment, banks continued to have non-performing loans imposed upon them. The banking system was caught between Marx and markets. On the one hand the balance sheets of the banks were burdened by loans that had no prospect of repayment. On the other hand, perhaps even more perilous for the success of market-based reform, China's banks had no commercial imperative, no history of profit-based banking, no "culture of credit" and — as state-owned institutions — no incentive to do anything about it. The solution, if there was one, had to come from above.

In dealing with the weight of non-performing loans that would otherwise hobble China's fledgling banking system and deprive the nation of a crucial facet of a market economy, the central response was characteristically decisive and, by most accounts, effective. The approach was to remove surgically the financial over-hang of the earlier era. Centrally funded "asset management companies" (AMCs) were established to purchase the non-performing loans (at face value) and deal with them in a more direct manner by selling them at deep discount to interested financial institutions, including foreign-owned buyers.

Four financial asset management companies were established, one for each of the state-owned commercial banks. The AMCs are:

- Great Wall: for the Agricultural Bank of China.
- Orient: for the Bank of China.
- Huarong: for the Industrial and Commercial Bank of China.
- Cinda: for the China Construction Bank.

AMCs remain under the supervision of the central bank with input from the State Securities Supervisory Committee and the Ministry of Finance. In many respects the AMCs are an arm of the state. Currently their major activity is debt-equity swaps that are selected by the State Economic and Trade Commission (SETC), not by the AMCs themselves. In this way the AMCs are a part of the central government's overall restructuring program for the state-owned sector.

The immediate mandate of the AMCs is to recover approximately RMB1 trillion (US\$121 billion) in banks' non-performing loans, the bulk of which can be attributed to inefficient state-owned enterprises. The longer-term aim of the AMCs is to rehabilitate loss-making large state-owned companies and eventually to liquidate their stakes by selling or listing the shares of the firms. However, whether the AMCs will be able to revive the firms and find a market for their shares remains to be seen.

The AMCs are crucial to the liberalization of the banking sector. By allowing the AMCs to handle the state-owned banks' debt burden that had accrued through government directed lending since the 1950s, the four banks are better positioned to adopt lending policies based on client creditworthiness. As non-performing loans were removed from the balance sheets of the commercial banks, the central bank also strengthened those balance sheets through recapitalization. Excising bad loans and injecting new equity-blood are fundamental features of the transition from China's old banking system to the new. There is still the challenge of instilling an effective commercial banking culture — the third stage of bank reform.

TURNING STATE-OWNED COMMERCIAL BANKS INTO JOINT-STOCK COMMERCIAL BANKS WITH THE STATE AS CONTROLLING SHAREHOLDER

The term "joint-stock restructuring" refers to financial

restructuring, reform of corporate governance and public listing of bank shares on stock markets both at home and abroad. In 2003 the CPC Central Committee and the State Council selected the BOC and CCB as the pilot banks in an exercise of establishing broader ownership of banking and concomitant change in the commercial banking culture. The intention was to carry out reform sequentially, beginning with those banks with fewer problems followed by differentiated policy packages for the others.⁶

With funding drawn from foreign currency reserves, BOC and CCB each received a fresh capital injection of US\$22.5 billion. The two banks used their new capital along with undistributed profits to write off RMB193 billion (US\$23 billion) of loan losses. The two banks sold RMB279 billion (US\$33.7 billion) of doubtful loans. Unlike the 1999 non-performing loan transfer at face value to the AMCs, this time the doubtful loans were sold in a bidding process involving the four AMCs. The accepted bid was by Cinda AMC with a recovery ratio of 31%, i.e., the questionable loans sold at a 69% discount to face value.

In late 2003 the Law on the People's Bank of China and the Commercial Banking Law was amended to establish the China Banking Regulatory Commission (CBRC) to oversee reform of regulation of banking. By this time China was addressing explicit World Trade Organization (WTO) commitments to financial sector reform to be implemented by the end of 2006. Regulations were invoked to permit and regulate foreign investment in China's banks. According to these regulations, a foreign investor may hold a stake of up to 20% in any one bank; total foreign ownership of any one bank is capped at 25%.

Further revisions to China's banking laws took effect in 2004. Changes to the Law on the People's Bank strengthened the central bank's responsibility for monetary policy and relieved it of responsibility for regulation of financial institutions. Revisions to the *Administrative Measures on the Supervision of the Banking Industry* assigned the newly formed CBRC responsibility for regulating all banks and other depository institutions and incorporated international norms for banking supervision to improve risk

management. In addition, changes to the Commercial Banking Law freed the Big Four from the requirement to provide loans to State Council-approved projects and permitted them to carry out commercial banking activities — such as trading government bonds, dealing in foreign exchange and offering credit card services.

BANK SUPERVISION, REGULATION AND GOVERNANCE

The features of good governance and management that China intends to instil in the banking system are standard fare in the banking world — for instance, well-defined capital adequacy and asset quality, reliable measures of credit worthiness of borrowers, sound risk-management methods and transparency in reporting. *What* China is developing is conventional in banking; *how* it is going about it is uniquely Chinese. For one thing, China set for itself a breathless agenda to have a properly functioning system of supervision, regulation and governance in place and operating. To devise and implement a market-oriented banking and financial system in the world's most populous nation in less than a generation is a huge and complex undertaking.

China's approach to the task is incremental and experimental as the BOC and CCB pilot projects illustrate. Equally important, China directly and indirectly draws on established knowledge and practice of banking in the rest of the world. It directly draws on the expertise of foreigners to assist in the development of modern accounting, information processing and risk management through technical assistance from institutions such as the International Monetary Fund and the Bank for International Settlements. China also uses its own resources to scan the globe for best practice in bank governance, management, regulation and supervision.⁷ China indirectly taps established best practice by opening up to foreign involvement in banking and finance.

The CBRC issued *Guidelines on Corporate Governance Reforms and Supervision of Bank of China and China Construction Bank*, putting forward requirements to secure the success of the pilot joint-reforms of the BOC and CCB. The BOC was transformed into BOC Limited, while CCB was split into two entities — China Jianyin Investment Company Limited (Jianyin Investment) and

China Construction Bank Corporation (CCB Co., Ltd). Both banks are expected to introduce domestic and foreign strategic investors to diversify their equity base and to adopt appropriate governance structures.

The CBRC also set out seven performance indicators for the two pilot banks benchmarked to the top 100 largest banks globally, *viz*,

The *net return on assets* (ROA) of the banks shall reach 0.6% by 2005 and further increased to the level required for an internationally competitive bank by 2007. The average net ROA of the world's top 100 banks was about 1% over the past 10 years.

To reinforce the effectiveness and to ensure the return of the capital injection, *net return on equity* (ROE) of the banks shall reach 11% by 2005 and further increase to 13% or above by 2007. The average net ROE of the world's top 100 banks was in the range of 12-14% over the past 10 years.

Starting from 2005 the *cost/income ratio* of the banks shall be controlled within the range of 35-45% each year which is the average level of the world's top 100 banks over the last 10 years.

As an explicit indicator of asset quality, the banks shall apply the five-category classification system to their non-credit assets and assessment of the quality of their entire asset portfolio while controlling the *non-performing assets ratio* within the range of 3-5%. The average non-performing assets ratio of the world's top 100 banks was within the range of 2-3% over the last 10 years.

With respect to operational prudence, the banks shall manage their capital strictly in accordance with the *Regulation Governing Capital Adequacy of Commercial Banks* (modelled on Basle II of the Bank for International Settlements) and their *capital adequacy ratio* shall be maintained at 8% or above at any point of time.

Each bank's lending to a single client shall be *no more than 10%* of its total capital.

The *non-performing loan provision coverage ratio* shall reach 60% for the Bank of China and 80% for China Construction Bank, which shall be further increased by the end of 2007. The average NPL provisioning

coverage ratio of the world's top 100 banks was about 100% over the last ten years.

As a set of explicit performance guidelines for the two pilot banks, these conventional indicators address the banks' credit risk, market risk, operational risk and liquidity risk.

Finally, there are the constructive influences on bank governance, management and performance that stem *inter alia* from public listing of bank shares on stock exchanges. The regulatory requirements imposed by exchanges create (usually high) minimum standards for capital adequacy, current performance, reporting and transparency. In addition, publicly listed banks are subject to exchange-set standards for the structure of corporate governance. The following initial public offerings (IPO) indicate that extent to which the formerly wholly state-owned Big Four commercial banks have come in a remarkably short time.

In 2005, CCB issued an IPO on the Hong Kong Stock Exchange, raising US\$8 billion in share capital. CCB is in a strategic partnership with the Bank of America which purchased 9% of the shares for US\$2.5 billion. Some 95% of IPO shares were sold to institutions.

Also in 2005, Bank of Communications issues an IPO on the Hong Kong Stock Exchange. London-based HSBC acquired 2.6% of the shares.

In 2006, BOC's US\$9.7 billion IPO on the Hong Kong Exchange was the largest issue on international markets in more than five years. Shares offered to institutional investors were oversubscribed by up to 20 times. Royal Bank of Scotland, Merrill Lynch, Temasek Holdings of Singapore and a group led by Li Ka-shing of Hong Kong took minority stakes in BOC.

Also in 2006, the once woefully troubled Industrial and Commercial Bank of China (ICBC) received approval for an IPO. ICBC plans to issue US\$14 billion in shares on international markets. The bank's newfound strength derives from US\$15 billion in recapitalization funds received from the government in 2005.

CHINA'S UNBALANCED FINANCIAL SYSTEM

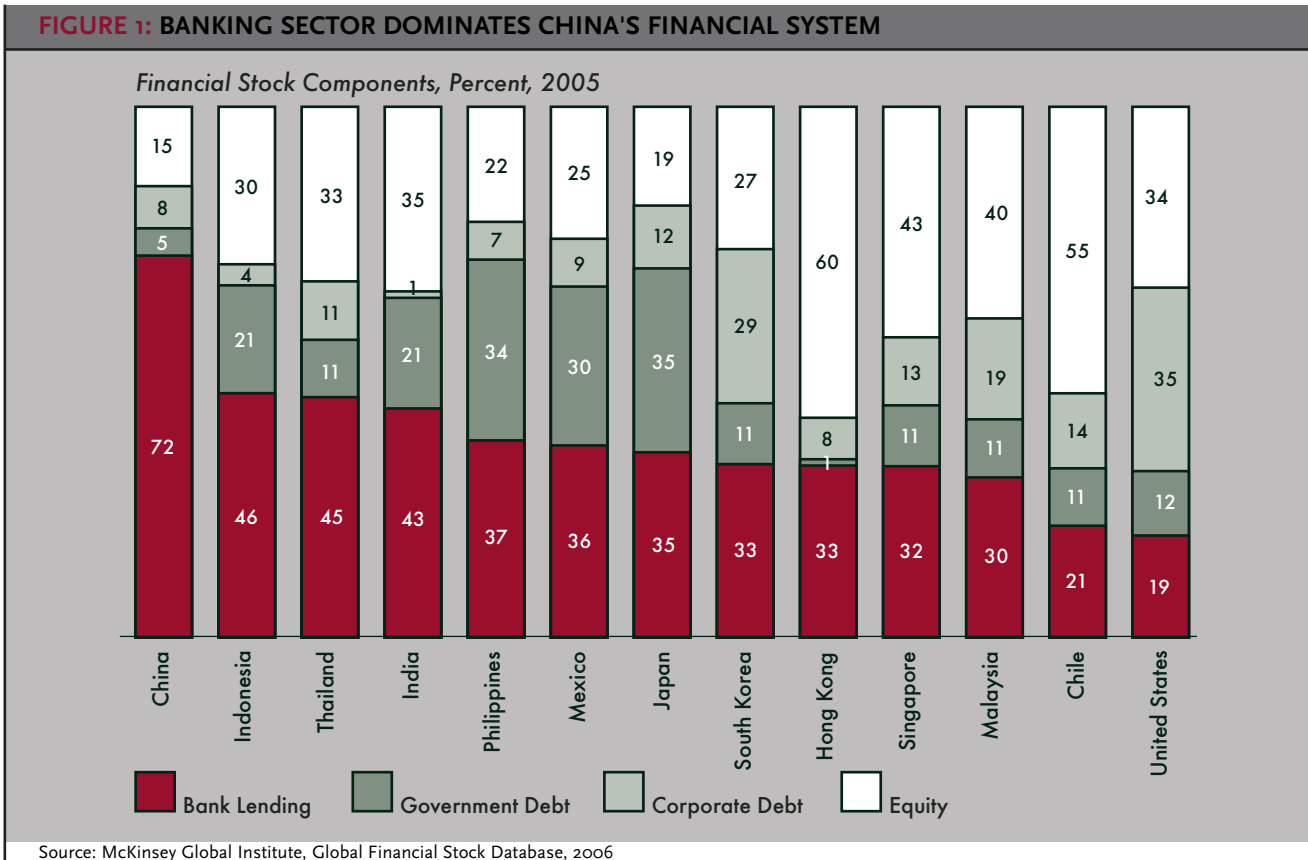


To this point I have presented an account of the evolution of banking reform in China that focuses largely on legal, regulatory and institutional developments in the move toward financial modernization. While the underlying message is that bank reform is important for China's aspiration to become a fully functioning market economy, it is imperative to realize – to have an empirical sense — of how important bank operations are in the Chinese system.

The most striking feature of the structure of China's financial system is the sheer dominance of banking. Figure 1 illustrates this point by means of comparison of the proportional shares of four major components in the financial system in China and in 12 other countries. Based on 2005 statistics, 72% of finance in China –

industrial plus consumer finance — is bank lending. No other country is even close to this figure. Since banking is proportionally big in China, the other components are accordingly small.

In the overall financial picture, government debt is proportionately much smaller in China than in most other countries. Government debt in advanced financial systems is useful as a source of liquidity and as the generator of “reference” interest rates used to price bonds. Non-bank corporate debt (bonds) in China is also relatively small. China's bond market, from investment bankers to bond rating agencies and trading institutions, is substantially undeveloped. Likewise, the 15% share in the form of equity is small by international standards.



The United States represents the other end of the spectrum although not necessarily a financial structure that China seeks to match. The US, of course, typifies a financial system that has depth, liquidity, effective regulation and technical sophistication. Whereas the US economy is about 50% larger than China's economy (US\$12 trillion versus US\$8 trillion), total finance in the US is ten times the total finance in China. Meanwhile bank lending in the US is only 19% of finance. Equity finance plays a substantially larger role in the US as it does in most English-speaking nations.

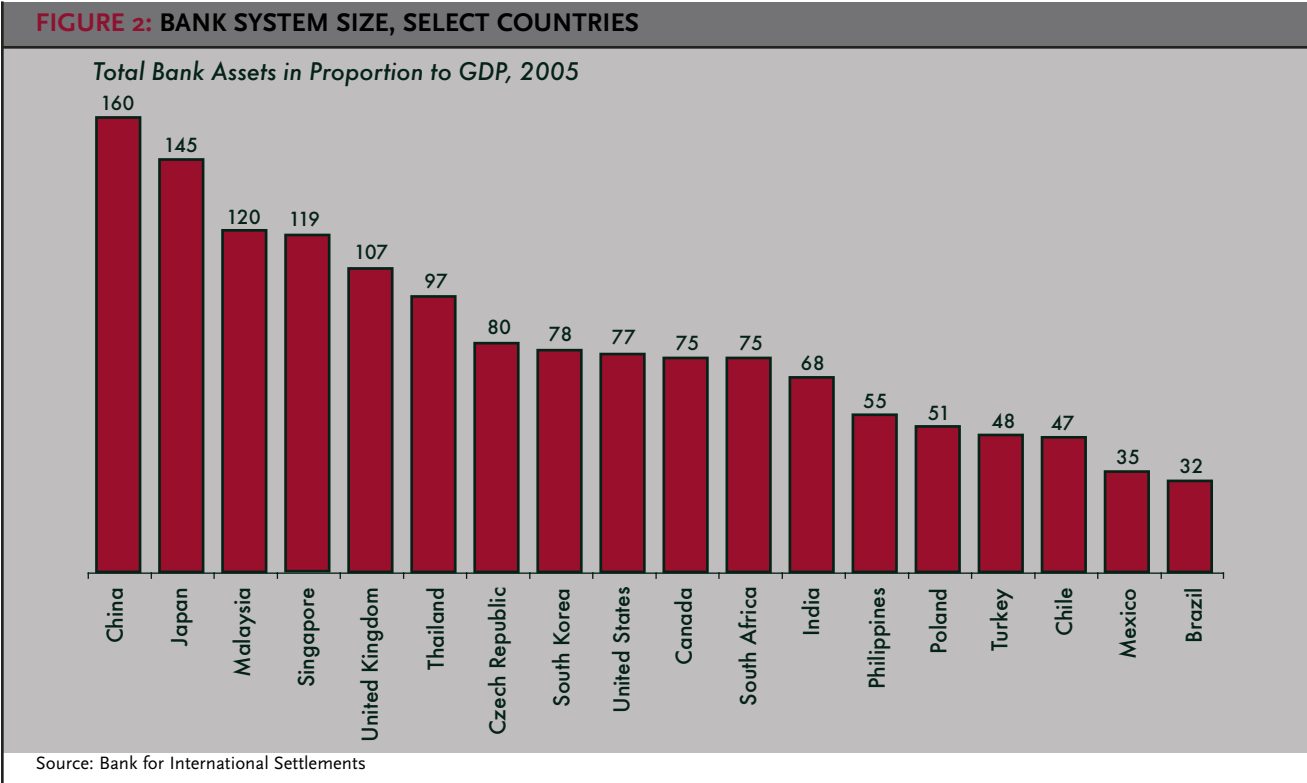
Figure 2 highlights the fact that the banking sector in China is large relative to the size of the economy, disproportionately so compared to other countries. Bank assets are 160% the size of China's GDP. In Canada, for example, the corresponding figure is 75%.

There are two primary reasons for the overwhelming size of the banking sector in China. First is the huge flow of savings from individuals that end up as bank deposits. The other factor is the even larger volume of corporate deposits. In the absence of a developed system of collateral, corporations in China are often obliged to keep cash on deposit as partial collateral for

loans. This in turn raises the deposits-to-loans ratio and reduces the efficiency of bank lending for industrial investment.

Some corporations also have excess capital that they keep in bank deposits because they cannot find attractive investment opportunities and because the alternative, paying out profits to shareholders, is not an established practice especially as many corporations are state-owned. In addition, some companies hold high levels of bank deposits because of lack of commercial paper and other debt securities to fund their liquidity needs and because payment system inefficiencies prevent large companies with many branches from optimizing cash management nationally.

Figure 3 shows the nascent development of China's financial structure over the period 1994, the year before the Commercial Bank Law was promulgated, until 2004. The column for each year presents each financial sector component – bank deposits, government debt, corporate debt and equity – as a percentage of China's nominal GDP in that year. The year-over-year growth in the sum of component figures is a useful and consistent times-series measure of financial depth. By this measure,



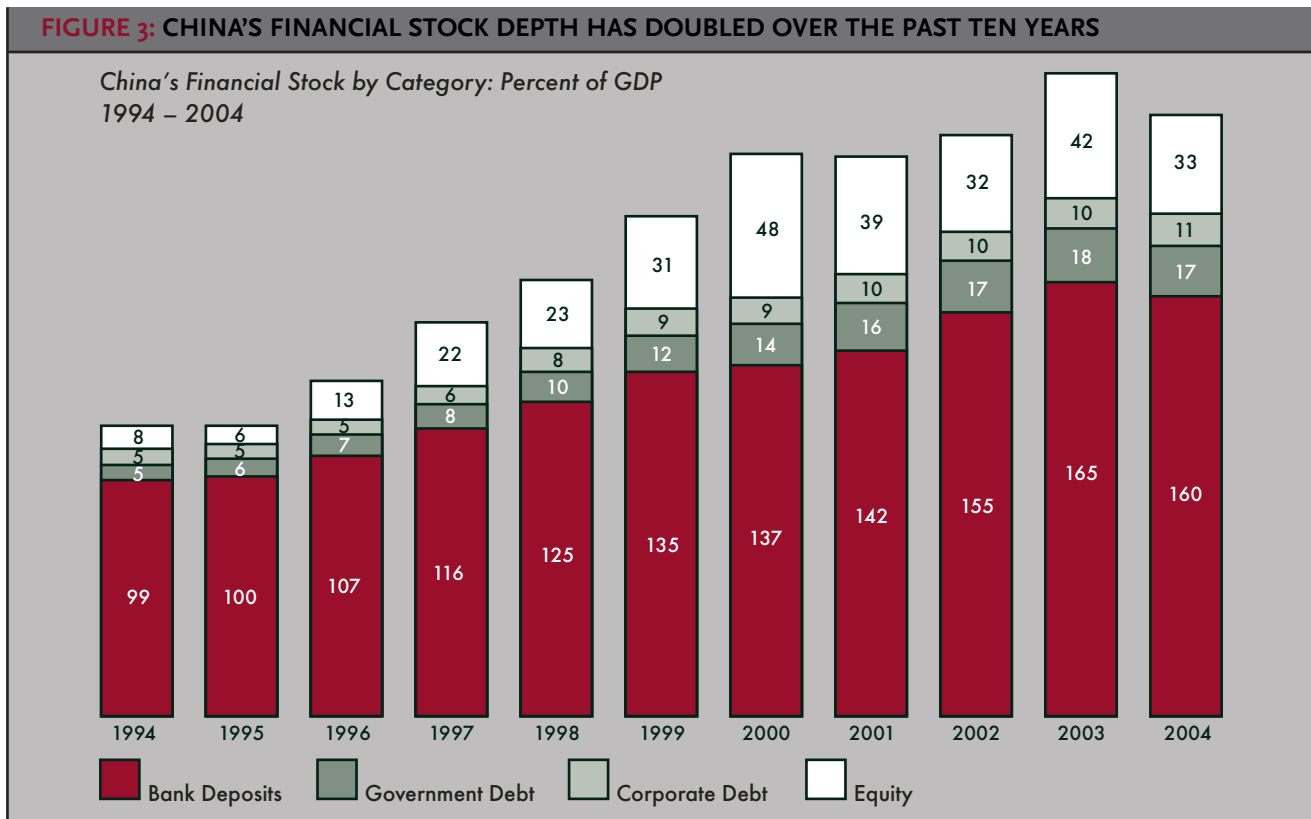
over the period China's financial depth doubled. While much of the increase in financial depth comes from the dominant bank sector, Figure 3 also indicates the emerging roles, absolute and relative, of both corporate debt and equity.

The most significant implication of the dominance of the banking sector in China's financial structure is, quite simply, the converse — that other modes of finance are undeveloped. Other modes include the bond market and stock or equities market. The economic attraction of securities markets is that they are more flexible and more financially innovative than bank lending. To the extent that the function of finance is to facilitate the flow of funds from savers to investors while at the same time allocating risk and putting a "price" on risk across the full spectrum from low-risk to high-risk, then informed, liquid securities markets have distinct operational advantages over banks.

However, disintermediation — from banking to securities markets — is a complex process of institution building along with the development of laws and regulations. In

financial sector reform China for now is directing most effort to bank reform with the development of securities markets playing a lesser role. Unfortunately such priorities have negative implications for incentives to develop the sorts of financial instruments and markets that are central to risk management, including futures and forwards, options and derivatives as well securitization and other forms of financial engineering. This, in turn, has implications for the cost of capital for industry and hence for economic growth.

The fact that China's financial structure is dominated by banking has important implications for whether China's financial system is likely to eventually emerge into a bank-centric model of industrial finance of the sort typically associated with Germany or Japan. Bank-centric finance is in contrast to the so-called Anglo-American model with its foundation in securities markets and a lesser role for banks. China seems to be flirting with an approach that is closer to the bank-centric system as I discuss in the following section. The issue is framed by comments of Zhou Xiaochuan, the Governor of the People's Bank of China.



Source: McKinsey Global Institute, Global Financial Stock Database, 2006

THE POLICY DEBATE ON “CROSS-SECTOR BANKING”



Among the unresolved structural issues in Chinese banking, a crucial current concern of the regulators is whether financial institutions ought, by force of banking law, to be required to keep various financial functions separate. Commercial banking, investment banking (securities) and insurance are the sorts of financial dealings that in the past have been rigidly kept separate in China. An alternative reform design could allow such operations to be housed under one roof or “integrated” within individual financial institutions. The Chinese refer to such integrated or comprehensive banking as “cross-sector banking.”⁸ In the West, the corresponding term is “universal banking.”

Canadians know this situation well, as we have examined and dismantled much of the three pillar structure — commercial banking, investment banking and trusts & insurance — that had characterized our financial system for years.⁹ The old institutional idea, reflecting a deep distrust of banking power, was to keep the three pillars separate. Today, every major Canadian chartered bank owns investment banking and securities divisions as well as credit card operations and foreign exchange desks.

In the US, the required separation of commercial banking and securities operations that had been in force until a few years ago, had its origins in the financial turmoil of the Great Depression. At that time, overzealous commercial bank involvement in stock market investment was considered to be a primary contributor to the financial crash of 1929. The view was that commercial banks took on too much risk with depositors’ money, often with a deposit-taking division buying shares issued by the securities underwriting division of the same bank. The famous Glass-Steagall Act (GSA) of 1933 put a stop to this. In later years, however, less institutionally-based explanations for the Great Depression evolved. Financial researchers and regulators came to the view that the GSA hindered the

emergence of competitive financial services that would otherwise create market discipline and foster financial innovation. The GSA was repealed in 1999.

In China in the late 1980s and early 1990s, a time that marked a relatively advanced stage in overall economic and industrial liberalization but early in the financial sector reform, the financial industry consisted of a small number of large banks, each of which conducted integrated operations. At the time, the financial industry was fraught with disorder. There were several underlying causes, including the absence of appropriate regulatory and supervisory legislation, weak and inexperienced bank management and the lack of internal control and accounting standards. In the early 1990s commercial banks were required to terminate their divisions involved in international transactions and credit card operations. The financial authorities felt that the pervasive disorder — for example unspecified losses, embezzlement and lack of transactional clarity — originated in non-traditional banking companies created by the commercial banks.¹⁰ Later in the decade, problems in the stock and bond markets such as rampant speculation and excessive volatility lead to the view, reminiscent of 1930s America, that it was dangerous and destabilizing for funds to flow from banks’ deposit-taking operations into the stock market.

Since financial disorder and risks were interpreted as caused or at least exacerbated by “cross-sector operations,” the different financial sectors were gradually segmented with the support of legislation. By 1993, 90 securities dealers were approved and 386 trust and investment institutions were in operation. Some 145 non-bank financial institutions had been licensed to carry out foreign exchange business. China appeared to be committed to establishing a set of clearly separate financial institutions, an arrangement that is the antithesis of functionally integrated “cross-sector” banking.

Times and attitudes are changing. The recent call by Zhou Xiaochuan to “switch to a new way of thinking and (to) steadily experiment with cross-sector operation in the financial industry” is appropriately cautious and circumspect yet cognizant of the merits of an alternative structure that allows financial institutions to exploit their natural economies of scope. Obviously influenced by the US repeal of the Glass-Steagall Act, Mr. Zhou points to numerous inherent advantages of “cross-sector” banking including incentives that financial institutions would have to develop strategies and processes to deal with their own non-performing loans and treasury risk. Above all, the knowledge-intensive business of banking and near-bank operations requires sophisticated talent that is most effectively and creatively employed in an expansive, inter-related context.

To bring effect to the considered shift from segmented to cross-sector banking in China, the 5th Plenum of the 16th CPC Central Committee formally proposed pilot projects in cross-sector financial structures. Relevant financial laws have been revised to leave room for such piloting efforts. This, of course, is feeling for the stones.

WHAT CHINA'S BANK AND FINANCIAL SECTOR REFORM MEANS FOR CANADA



Bank reform in China within the broader context of overall financial sector development provides promising opportunities for Canadian banks and other financial institutions. The openings for foreign financial institutions become better defined and more attractive as fundamental aspects of China's reform take deep root. To turn opportunity into reward, Canadian financial institutions must act strategically in line with unique advantages that stem from their Canadian base. Two particular aspects of finance — insurance and extensive retail branch-banking — are likely to offer the greatest potential for Canadian financial firms involved in China.

Several major Canadian financial firms have had a significant presence in China for some time. On the insurance side, Manulife established the first Sino-foreign joint venture life insurance company, Manulife-Sinochem Life Insurance, in 1996. Operations began in Shanghai and have since expanded into nine other urban locations. Manulife has 51% ownership of the company. As the first joint venture insurance company in China, Manulife-Sinochem has been a pioneer in the industry. Sinochem's understanding of the Chinese market together with Manulife's expertise in insurance have resulted in considerable development in agency networks, product design, market development and service effectiveness.

Recently lifted geographical restrictions for foreign insurers as part of China's commitment to the WTO have allowed Manulife-Sinochem to expand rapidly. For instance, the firm's Guangzhou licence has been converted into a province-wide licence for Guangdong (excluding Shenzhen), giving Manulife-Sinochem immediate access to a relatively wealthy market of almost 80 million people. In January 2005 the China Insurance Regulatory Commission authorized Manulife-Sinochem to expand its product portfolio to include group life, health and pension business, bringing the firm's business scope in line with domestic insurers.

Manulife-Sinochem is Canada's second largest employer operating in China, with more than 4,000 professionally trained staff and agents serving approximately 250,000 customers. As acknowledgment of its good corporate citizenship, Manulife-Sinochem has been designated the Official Life Insurance Partner of the Beijing 2008 Olympic Games.

Another Canadian insurance company, Sun Life Assurance, began business in China in 2002 in collaboration with the China Everbright Group, a conglomerate involved in banking, securities, insurance and investment management. Sun Life Everbright, based in Tianjin, has a 50:50 Sino-Canadian ownership split. Sun Life Everbright has developed innovative insurance products including term life, endowment, critical illness, personal accident plans and juvenile insurance. The creative synergies of the joint venture are illustrated by the recent announcement, prompted by the removal of geographical restrictions on financial operations, that China Everbright Bank would distribute Sun Life Everbright Financial products — in particular individual and group pension, health, and accident insurance — through the nationwide network of banks owned by China Everbright. This development may reflect the wisdom of Sun Life's choice of dancing partner in China since the Everbright Group is under the direct supervision and control of the policy-setting State Council.

Like the insurance companies, Canadian banks have made substantial strides toward finding a place in the Chinese market. The enticement is great — a pool of RMB32 trillion (C\$4.9 trillion) in household and commercial wealth and a rapidly growing demand for personal and corporate financial services. As I have shown, China's financial system is, and is likely to continue to be, bank-centric as opposed to a more decentralized securities-based system, an institutional tilt that plays to the strength of Canadian banks.

Among the major Canadian chartered banks, some demonstrate more China-commitment than others. The Bank of Montreal (BMO), for example, rightly considers itself to be blazing a trail in China. In 2006 BMO became the first Canadian bank to get permission to provide commercial banking services such as loans, deposits and trade finance in Beijing in Chinese currency, renminbi. It was also the first Canadian bank granted permission to sell derivative financial instruments such as futures and option contracts in China. BMO was the first foreign bank to buy into a Chinese fund-management firm, taking a 17% stake in Fullgoal Fund Management Co. Ltd. in 2003. BMO's share has grown to a 28% stake in the firm, which controls US\$3.4 billion in assets. BMO was also the first Canadian bank to underwrite a domestic bond in US dollars as well as the first Canadian institution to participate as a market-maker in China's foreign exchange market. Through the inter-bank China Foreign Exchange Trade System (CFETS), BMO is helping to lay the groundwork for trade and quote prices of eight so-called currency pairs, including dollar-sterling and euro-yen.

Scotiabank and the RBC Group (Royal Bank) are likewise reinforcing their presence in China by gaining permission to deal both in foreign currencies and renminbi. This has just become much easier. In December 2006, China had to fully honour its WTO commitments in banking and financial services, allowing Canadian banks, along with others in the international banking sector, to open branches as opposed to representative offices and to deal in a broad range of commercial, industrial and intrabank functions within China and between China and the rest of the world.

Regardless of the list of firsts and other milestones in the foreign foray into China's domestic banking, outsiders' involvement in general and the presence of Canadian banks in particular is relatively small when measured on the national scale of banking operations.

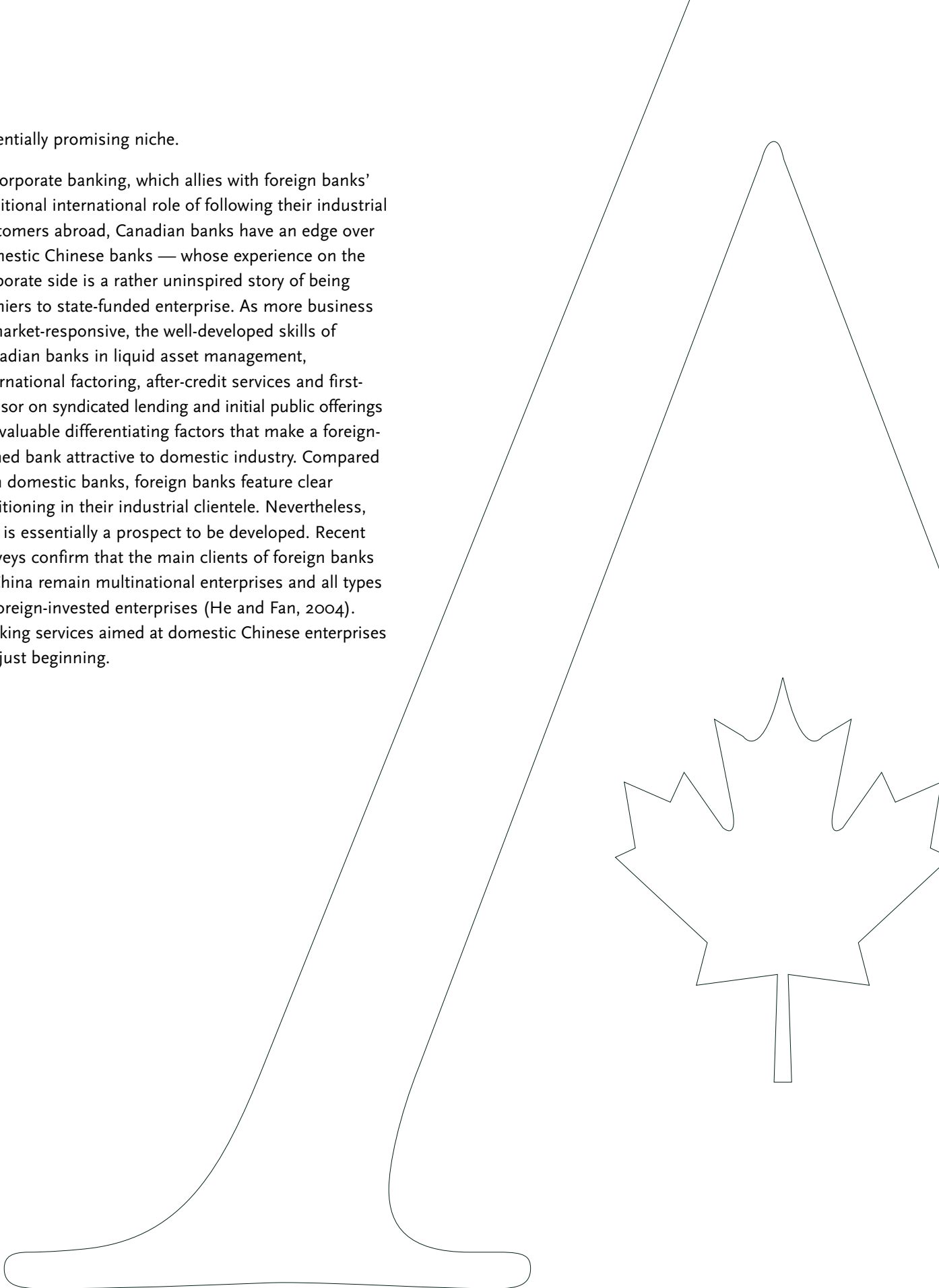
The reference points are the 90,000 branches of the Big Four banks plus 50,000 credit cooperative operations with combined employment of 1.4 million people. In comparison, there are no more than 250 branches of foreign banks in China. Of these, about 17 are Canadian. There is a long way to go.

Yet, these are early days in banking and financial sector development in China. For the time being at least, the China strategies of Canadian banks are about gaining position and building platforms from which to access what are likely to be massive opportunities in the inevitable financial deepening of China. Such points were underscored recently by Canada's Minister of Finance, Jim Flaherty, in remarks made following his trade mission to China.¹¹ Mr. Flaherty makes special mention of The Financial Sector Policy Dialogue, the ongoing consultative partnership on financial issues that China hosted for the Canadian delegation, as an example of our two nations working together to reduce regulatory barriers, to facilitate institutional innovation in and — in general — to foster a climate for financial development that contributes to overall economic growth and social welfare in China.

A number of specific opportunities in the emergence of commercial banking in China favour the fundamental style and *modus operandi* of Canadian banking. For example, the technology of extensive branch banking, to which Canadian banks have made significant up-front and back-office developments, is transferable operational technology of the sort that is sorely needed in China. On the retail side, Canadian banks' customer-considerate services, reliable credit screening, wealth management, Internet banking and credit card operations are likely to fit with the growth areas in China, especially in the urban areas where foreign banks naturally have a better fit. Such a marketing focus on high-end customers, who tend to be younger, better educated and less resistant to changing from old-line banking, fits a

potentially promising niche.

In corporate banking, which allies with foreign banks' traditional international role of following their industrial customers abroad, Canadian banks have an edge over domestic Chinese banks — whose experience on the corporate side is a rather uninspired story of being cashiers to state-funded enterprise. As more business is market-responsive, the well-developed skills of Canadian banks in liquid asset management, international factoring, after-credit services and first-advisor on syndicated lending and initial public offerings are valuable differentiating factors that make a foreign-owned bank attractive to domestic industry. Compared with domestic banks, foreign banks feature clear positioning in their industrial clientele. Nevertheless, this is essentially a prospect to be developed. Recent surveys confirm that the main clients of foreign banks in China remain multinational enterprises and all types of foreign-invested enterprises (He and Fan, 2004). Banking services aimed at domestic Chinese enterprises are just beginning.



WHAT CHINA'S BANK AND FINANCIAL SECTOR REFORM MEANS FOR THE WORLD



The subtitle of this monograph on China's banking reform, "*What it Means for the World*," is a crucial international concern. The success or otherwise of China's efforts to liberalize and modernize its financial institutions in line with a sweeping economic reform agenda — with its international ("Open Door") orientation — has profound global implications. The sheer size of China, with one-fifth of the world's population together with seemingly endless growth unleashed by its embrace of markets, means that what happens in China affects us all. "Let the dragon sleep," Napoleon famously remarked on China in 1803, "for when she awakes she will shake the world." China is decidedly awake and economic tremors are being felt around the globe.

In the most general terms, the world's interest in China reflects China's enormous size, its demonstrated potential and its ever-expanding economic linkages with the rest of the world, because:

- A closed, backward China was a loss to the world.
- A dynamic, growing China is an asset to the world.
- An unstable, insecure China would be a threat to the world.

The aim of China's reform was economic growth. The achievements can hardly be understated. In 25 years the reforms in China are responsible for lifting 400 million people out of poverty. While banking reform has been ongoing throughout the process, the complete adjustment to a fully functioning banking system will take some time. The most important economic and social consequences of China's banking and financial sector reform are:

- improved intermediation between savings and investment — the asset allocation issue. Indeed, the fundamental function of finance and financial institutions is to channel savings to their most

efficient use.

- enhanced effectiveness of monetary policy that operates through interest rates. This crucial macro-economic dimension of financial sector reform will enable China to rely more on monetary policy, and with greater effect, for stabilization.
- increased capacity to manage the internal-external balance involving trade surpluses and capital flows. While these are appropriately a later-stage concern in comprehensive economic reform, there is increasing urgency for China to relax its constraints on its capital account and currency. Efficiently functioning financial institutions are crucial.
- relief of pressure on financial institutions to carry out economic functions that are more appropriately done through the fiscal system. Financial institutions in China — especially banks — face almost confiscatory taxation. Especially in the intermediate stages of reform, banks were under substantial pressure to support inefficient state-owned enterprises (SOEs) since dismantling the SOEs would have caused social pain and dislocation.

Finance experts want to believe that a properly functioning banking system is crucial to balanced, market-driven growth. However, we know that for several years China has been able to generate substantial economic growth despite an under-developed, if not downright dysfunctional financial system. The reasons are fascinating but they are neither permanent nor recurring — for example the "demographic dividend" with its low ratio of workers-to-retirees, China's extraordinarily high rate of savings, shrewd monetary policy that compensated for inefficient intermediation, and massive inflows of foreign direct investment. To this list we might add the drastic devaluation of China's currency in 1994 that proved to be a contributing factor to the Asian financial crisis a couple of years later. China's devaluation caused a fall in Thailand's exports

— especially to Japan and the U.S. — and so raised the risk of Thailand’s indebtedness to both those countries. Capital flew from Thailand. Pressure on the baht was overwhelming. Meanwhile China enjoyed the classic benefits of currency devaluation — a sharp decline in inflation and explosive export-led growth.

It is reassuring to the theory of finance and transition economics, then, that through a combination of timely intervention and effective experimentation China has fared well, but also that continued balanced growth will require an increasingly sound financial system to achieve the four points above.

My discussion has dealt for the most part with the recent history of financial liberalization and banking reform through a period which, in the overall history of China, is a snap of the fingers. The Chinese are remarkably patient. In the famous response of Zhou Enlai, premier to both Mao and Deng and architect of the “four modernizations,” when asked what he thought of the influence of the French Revolution, “It is too soon to tell.”

Bank reform presents a unique and crucial challenge within China’s ambitious economic transition from central planning to a market economy. Banking is much more institutionally dependent than any comparable facet of reform. In this respect we have seen that China has been cautious and flexible in the process of developing laws, regulations, interventions and in setting the speed of implementation.

The international financial community is fond of citing the “collapse of communism” as a significant turning point in the evolution of today’s global economy.¹² Perhaps, but that seriously confuses the China case. In China, communism has not collapsed. China is currently very much under one-party rule. A market system is not a political system. Nevertheless, the implications of rising living standards within an increasingly market-oriented economy are overwhelmingly favourable to the world’s long-term interest in the development of a more pluralistic political system in China. As was true in the case of Taiwan from the 1950s onward, a rapidly modernizing economy is likely to generate growing pressure for

political change, away from one-party authoritarian rule. As Nicholas Lardy (2001), a respected American authority on China’s political economy puts it, “In Taiwan it took almost four decades of rapid economic growth between the time popular elections for county and city officials were introduced in 1950 and the time martial law was lifted and opposition parties legalized. Another decade elapsed before the first national popular election for president. Although China has been conducting popular elections at the village level for more than a decade, at least another decade or two of sustained economic growth probably will be required before a more pluralistic political system begins to emerge.” The world will watch with great attention.

APPENDIX 1: THE STRUCTURE OF CHINA'S BANKING SYSTEM¹³



The banking system in China consists of four types of institutions:

- wholly state-owned banks.
- commercial banks that are at least partially private.
- credit co-operatives.
- foreign banks.

1. Wholly state-owned banks: The central government is the owner. There are two distinct types of wholly state-owned banks — commercial banks and policy banks.

a) State-owned commercial banks: China has four state-owned commercial banks, commonly referred to as the Big Four. Each has an extensive branch-banking system throughout the nation. Together they consist of almost 90,000 branches with over one million employees. The Big Four are:

1. **Agricultural Bank of China (ABC).** Originally set up in 1949 to provide loans to agriculture and rural areas, ABC is now the second largest bank in China in terms of total assets behind the Industrial & Commercial Bank of China.
2. **Bank of China (BOC).** Founded in 1912, BOC is the oldest bank in China. Its traditional operations were exclusively international transactions such as foreign exchange services and extending trade credit. Until very recently, the BOC was 100% owned by the central government. In June 2006 the bank floated one of the largest initial public offerings (IPO) in history on the Hong Kong Stock Exchange, raising US\$9.7 billion. Various non-governmental and foreign investors and shareholders now have a stake of over 26% of BOC.
3. **China Construction Bank (CCB).** The CCB was set up in 1954 to specialise in the finance of construction and infrastructure projects, usually in the form of long-term loans. CCB was the principal credit conduit for the central government's five-year plans. Today the CCB holds about two-thirds of all household mortgages in China.
4. **Industrial & Commercial Bank of China (ICBC),** founded in 1984, manages more than 21,000 domestic branches and more than 100 overseas branches and offices serving more than 100 million individual clients and eight million corporate clients. ICBC oversees about a quarter of the total domestic assets owned by China's commercial banks.

All four state-owned banks moved away from their original operating mandates in 1994 when the government created the so-called policy banks to take over the Big Four's role in state-directed lending. The Big Four subsequently expanded their

portfolio of financial services especially in retail banking — including loans to private-sector industry, personal loans and credit card operations.

The recent initial public offering by the Bank of China is the first such move among the Big Four, but others are planned. This extension of bank ownership to non-government entities of course modifies the literal designation of wholly state-owned banks. Regardless, the presence and influence of the Big Four will continue to dominate the market. Together they account for 60% of the banking sector's total assets and a similar share of loans. A key concern is whether the legacy of “wholly state-ownership” will constrain the performance of these huge and powerful institutions as they move from Marx to markets.

b) State-owned policy banks: In a constructive and crucial change, in 1994 the Big Four banks were relieved of their role in centrally-planned “policy lending” that characterized the former banking regime. That function has been assigned to three “policy banks” under the direct jurisdiction of the State Council. The three policy banks are:

1. **Agricultural Development Bank of China (ADBC)** took over the policy lending role of the ABC. ADBC provides loans for the purchase, transport, marketing and reserves of selected agricultural products (grain, oil, cotton, meat, sugar, tobacco and wool) and loans for enterprises involved in processing. It takes deposits from publicly-owned entities and manages their international transactions.
2. **China Development Bank (CDB)** took over the policy lending role of the CCB and, to a lesser extent, the ICBC (which was never a major state-directed lender). The China Development Bank is responsible for financing public-sector investment in support of national economic development and strategic structural readjustment.
3. **Export-Import Bank of China (EXIM)** which primarily took over the policy-lending role from the BOC, especially the trade financing function and inter-bank transactions. EXIM provides guarantees and concessional loans for firms involved in international trade and investment.

China's policy banks fund themselves primarily through the issue of bonds. They accept few deposits, and exclusively from state-owned institutions. The combined assets of the three policy banks have grown rapidly and now comprise about 10% of the total banking sector which bears evidence of the continued presence of state-directed lending in the banking sector.

2. Commercial Banks (that are to some extent privately owned):

Commercial banks owned by states (other than the central government) as well as private investors represent a second tier of banking in China. There are currently 120 commercial banks that together account for 18% of the banking sector's assets. While not as prominent as the Big Four, the lesser commercial banks tend to be more focussed, flexible and innovative. They are generally more in touch with and responsive to local demands for commercial financial services.

Commercial banks are divided into two groups that reflect distinct origins.

a) Shareholding or joint-stock commercial banks: The incorporating law for such banks is the People's Republic of China Company Law. Most banks have relatively concentrated ownership structures with predominantly state-controlled shareholding. There are currently 11 shareholding banks. For the most part shareholding or joint-stock banks have emerged in the thriving urban areas along the east coast including Tianjin, Shanghai and Shenzhen. Leading banks include Bank of Communications, China Minsheng, China Everbright Bank, China Merchants Bank, Shanghai Pudong Development Bank and Shenzhen Development Bank. Foreign financial institutions with minority equity investments in these banks include the International Finance Corporation, the Asian Development Bank, HSBC, RBC, Scotiabank, GE Capital and Newbridge. The shareholding commercial banks are competitively expanding their branch networks throughout China.

b) City commercial banks: City commercial banks have evolved from urban credit unions. Because of their identity with and strong ties to their local setting, city commercial banks are effectively restricted from operating on a regional or national scale.

3. Credit co-operatives: The co-operatives typically provide credit to small and medium-sized enterprises and individuals. The co-operative sector is divided into urban and rural credit co-operatives. All told they number close to 50,000, accounting for approximately 11% of total banking-sector assets. The rural credit co-operatives were formerly supervised by the Agricultural Bank of China and then by the People's Bank of China. In 2003 the CBRC took over the supervisory functions for both urban and rural co-operatives. Due to their collective-ownership status, both types of credit co-operatives are subject to state-control and thus their loans are influenced by local policy considerations. Estimates of the level of non-performing loans at rural credit cooperatives run as high as 50% of total lending. There is a growing concern that rural credit co-operatives face the prospect of heavy losses as China's agricultural sector opens up under WTO requirements. Given the significance of the rural sector in China, with around 800

million people (almost two-thirds of the total population) living in rural areas, the government has been explicit about its intention to provide financial support for the rural credit co-operatives in need.

4. Foreign banks: A significant milestone in the financial liberalization process was China's accession to the WTO in late 2001. Under the terms of accession, China agreed to the full opening of the banking system to foreign affiliates by December 2006. Initially, foreign banks were only allowed to engage in foreign-currency transactions. As a second step, foreign banks were authorized to offer local currency services to foreign enterprises and individuals, albeit with geographical restrictions (starting with the more industrially advanced regions). Minimum capital requirements were high and prudential norms were tight in comparison with international standards. In 2003 the wholesale market in domestic currency (i.e., to Chinese enterprises) was opened to foreign banks for an expanded number of provinces. Finally, from the end of 2006, foreign banks were able to offer all banking services in local currency in all provinces and even to Chinese households. In addition, the Chinese authorities have recently announced measures to facilitate the entry of foreign affiliates, such as lifting the ban on opening more than one branch per year and reducing minimum set-up capital requirements for the establishment of a new branch. Since the signing of WTO in 2001, the number of foreign bank branches has increased from 157 to 192 in 2005, most of which are of Asian origin (mostly Taiwan, South Korea and Hong Kong). The number of representative offices also rose from 184 in 2001 to 223 in 2005.

Although WTO commitments do not deal directly with the acquisition by a foreign institution of a stake in a Chinese bank, Chinese authorities have increased the limit on a bank's foreign ownership from 15% to 20% of total capital for one single investor, and to 25% for the joint participation of all foreign investors. This is probably related to the need for fresh capital and highly qualified bank management. Twelve foreign banks have already taken stakes in Chinese banks but their participation is generally low.

APPENDIX 2: CHRONOLOGY OF FINANCIAL SECTOR DEVELOPMENTS AND BANKING REFORM, 1948 - 2006



DATE	MEASURE
1948	People's Bank of China (PBC) is established by newly formed People's Republic of China through consolidation of the former Hubei Bank, Beihai Bank and Xibei Peasant Bank.
1966-'76	Cultural Revolution. PBC is stripped of many functions.
1977	PBC regains sole responsibility for issuing currency and controlling money supply.
1978	Communist Party Congress, under Deng Xiaoping, approves "Open Door Policy" aimed at economic modernization. Measures include bank reform and securities markets development.
1979	Agricultural Bank of China (ABC) is split from PBC.
1979	Bank of China (BOC) established separately. State Administration of Exchange Control (SAEC, now SAFE) is separated from BOC and assigned to PBC.
1979-'82	Four Special Economic Zones (SEZs) created (Shenzhen, Zhuhai, Shantow, Xiamen), all "coastal cities." SEZs are given extraordinary freedom to engage in international trade and to receive foreign investment. Process is experimental.
1979	China Construction Bank is transformed from a department of the Ministry of Finance to a bank under the State Council.
1980	PRC assumes Chinese seats, vacant since 1949, at IMF and World Bank.
1980	China issues Treasury Bills - to be purchased by banks.
1981	China Investment Bank is created to lend funds borrowed from World Bank and later the Asian Development Bank (ADB).
1982	China begins to issue local enterprise bonds.
1983	State Council authorizes the creation of a central bank.
1984	14 additional cities opened to foreign investment.
1984	PBC is assigned role of China's central bank. The Industrial and Commercial Bank (ICB) is created to take over the PBC's remaining deposit-taking and lending functions.
1985	A few specialized banks are authorized to conduct foreign exchange transactions in three SEZs.
1986	China joins ADB.
1987	Treasury Bills begin trading in five major cities.
1987	SAEC approves 33 financial institutions for foreign exchange dealings. Total rises to 55 branch banks and 78 trust & investment companies.
1988	China implements Bankruptcy Law.
1988-'93	90 securities dealers approved; 386 trust & investment houses in operation.
1990	New approvals bring "open cities" (permitting foreign investment) total to 714. One third of provinces are "open."
1992	Number of branch banks licensed to deal in foreign exchange reaches 1,000. 145 non-bank financial institutions are also licensed for foreign exchange dealings.

DATE	MEASURE
1992	Banks given authority to write off loans of less than RMB500 million; larger amounts require approval of State Council.
1994	Three “policy banks” – Agricultural Development Bank (ADBC), China Development Bank (CDB) and China Export-Import Bank (CEIB) – created to free “big four” specialized banks from directed lending.
1994	Dual currency system – renminbi and foreign exchange certificates – unified. China devalues currency by 45% against US dollar. Inflation falls, export-led growth rises.
1995	Commercial Bank Law promulgated to define conditions for formation of commercial banking system and provide legal basis for transforming specialized state banks into state-owned commercial banks.
1995	Central Bank Law passed. PBC assigned additional functions to the central bank especially involving commercial credit expansion and money multiplier.
1996	Expansion of banks – previously only BOC – that can accept deposits and offer loans denominated in foreign currencies along with settlement of foreign trade transactions.
1996	First non state-owned commercial bank, Minsheng Bank, established.
1996	China establishes full convertibility of renminbi on Current Account of the Balance of Payments.
1997	Hong Kong transferred from British sovereignty to a Special Administrative Region of China. Transitional agreement stipulates two economic/financial systems to remain in place for 50 years.
1997-’98	Asian Financial Crisis triggered in Thailand with contagion to other countries. World watches China for reaction. PBC resists calls to devalue the renminbi.
1997	Government bond trading split between inter-bank market and stock markets following PBC decision to ban commercial bank trading on stock exchanges which was believed to be responsible for excessive speculation.
1997-’98	China cuts interest rates for macroeconomic expansion. Banks allowed greater flexibility to vary lending rates around administered level.
1998	Oversight of insurance and securities industries split off from the PBC to new regulatory agencies.
1998	PBC initiates credit allocation on basis of asset-management rather than quotas under a credit plan.
1998	China injects RMB270 billion in capital into state banks to strengthen balance sheets weakened by non-performing loans.
1999	PBC abolishes provincial and municipal branches and creates nine regional banks, each responsible for several provinces.
1999-00	Asset Management Companies (AMC) absorb RMB1.4 trillion of non-performing loans from SCBs and the CDB. The four AMCs and their corresponding commercial banks are: Xinda – CCB & CDB; Great Wall – ABC; Huarong – ICBC; Orient – BOC.
2001	China gains accession to WTO, agrees to allow foreign banks to conduct local-currency business without restrictions by 2007.
2002	Bank of China (Hong Kong), a subsidiary of BOC subject to Hong Kong bank regulation, issues initial public offering (IPO) on Hong Kong Stock Exchange. IPO is over-subscribed, raises US\$2.8 billion. Standard & Chartered Bank buys shares worth US\$50 million, a 2.6% stake in BOC (HK).
2003 (April)	China Banking Regulatory Commission (CBRC) created to oversee reform and regulation of the banking sector, allowing PBC to focus on monetary policy.
2003	Foreign-invested banks in eight selected cities – Shanghai, Shenzhen, Tianjin, Dalian, Jinan, Fuzhou, Chengdu and Chongqing – are authorized to initiate renminbi-based business.

DATE	MEASURE
2003	In unprecedented attempt at monetary management of macroeconomy, PBC increases reserve requirement by 1% to 7% for all commercial lenders thereby removing an estimated RMB150 billion (US\$18 billion) of liquidity from the banks.
2003 (Dec.)	In latest round of management of NPLs, US\$45 billion from PBC's foreign exchange reserves transferred to BOC and CCB.
2003 (Dec.)	6th Session of Standing Committee of 10th National People's Congress adopts Law of the PRC on National Banking Regulation and Supervision.
2003-04	Huarong AMC auctions RMB22.5 billion of NPL assets. Winning bidders include Citigroup, JPMorgan, Goldman Sachs, UBS, Morgan Stanley and Lehman Brothers.
2004 (March)	CBRC issues guidelines for IPOs by BOC and CCB.
2004 (April)	PBC imposes additional mandatory reserve requirement on commercial banks – from 7 to 7.5%. Reserve requirement for poorly performing banks raised from 7.5 to 8%.
2004 (May)	PBC announces plans to issue bonds to remove RMB200 billion (US\$24 billion) in non-performing loans from balance sheets of the BOC and CCB.
2005 (April)	ICBC US\$15 billion in recapitalization funds from government.
2005 (April)	PBC and CRBC set administrative rules for securitization of credit assets.
2005 (May)	PBC sets administrative rules for forward bond transactions in national inter-bank bond market.
2005 (June)	PBC announces administrative rules for issuance of financial bonds in national inter-bank bond market “to promote the development of the bond market, regulate the issuance of financial bonds and safeguard the lawful rights of the investors.”
2005	China revalues by renminbi 2.1% against US dollar, announces that external value of the currency will be managed against an unspecified basket of currencies.
2005	Bank of Communications issues IPO on Hong Kong Stock Exchange. London-based HSBC acquires 2.6% of the shares.
2005	CCB issues an IPO on the Hong Kong Stock Exchange, raising US\$8 billion in share capital. CCB is in a strategic partnership with Bank of America which purchased 9% of the shares for US\$2.5 billion. 95% of IPO shares are sold to institutions.
2005 (Dec.)	CBRC reports that 173 foreign banks from 40 countries and regions have set up 238 representative offices in 23 cities in China. Total assets of foreign banks in China amounted to US\$84.5 billion or approximately 2% of the total banking assets in China.
2006	ICBC receives approval for an IPO. Plan is to issue US\$14 billion in bank shares on international markets.
2006	BOC issues IPO on Hong Kong Stock Exchange, raising US\$9.7 billion.
2006	ICBC issues IPO on Hong Kong Stock Exchange, raising US\$21.9 billion.
2006	China opens financial markets and banking as agreed under WTO protocols. Lifts all geographic restrictions on banking services provided by foreign banks to foreign and domestic companies and individuals.

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NOTES

- ¹ Goldsmith (1969). Institutional reformists would like to think that Goldsmith's "law" is there to be defied. The impressively stable experience of South Korea seems a case in point.
- ² The shattering of the "iron rice bowl" — i.e., dismantling the cradle-to-grave social welfare system — gives further impetus to personal saving in China. In addition, people with increasing incomes tend to save more. China's 45% savings rate compares with the US rate of 0.2%!
- ³ McKinsey (2006).
- ⁴ A tentative move forward followed by retreat — "*feeling for the stones*" — is illustrated by the reversal of an aggressive plan in the early 1990s to dismantle state-owned enterprise. The plan was reconsidered because of the heavy social costs of disruption that arose. The authorities came to realize that, for example, a creaky, inefficient steel mill was also the centre of a complex social system — a company town — that provided not only employment but also housing, schooling, hospitals and social security.
- ⁵ An authoritative account of banking in China through the early to mid-stages is Lardy (1998). A review of developments in the later years is Shiyu et al (2006). Huang et al (2005) provide a compendium of finance-focused research.
- ⁶ The two state-owned commercial banks that were not selected for the joint-stock restructuring project were the Investment and Commercial Bank (ICBC) and the Agricultural Bank (ABC). While the ICBC is the largest of the state-owned commercial banks in China and the ABC has the largest branch network in China, these banks have created additional complexity for reforms. Both far exceeded the two pilot banks in terms of both asset size and non-performing loan burden. Both are considered to be inferior in terms of internal management and controls. In addition, the reform of the ICBC is dependent to a large extent on the reform of state-owned enterprises. The reform of the ABC is a part of the overall reform of the financial system in rural China.
- ⁷ In the reform process, China's authorities are keen to cooperate with and selectively draw lessons on policy and administration from foreign experts. See for example Brean (1998) on the effectiveness of the learning process in the area of tax reform which called on China to adopt structural change as sweeping as in the case of banking.
- ⁸ See, for example, the text of a recent speech by Zhou Xiaochuan, Governor of the People's Bank of China, "Switch to a New Way of Thinking and Steadily Experiment with Cross-sector Operation in the Financial Industry," delivered to the BoCom-HSBC Forum, Beijing, 15 June 2006. Posted on the Bank for International Settlements website, <www.bis.org/review/ro6o8o4b.pdf>.
- ⁹ See Brean (2003) on Canadian banking structure. Interestingly in the context, arrangements in the West that keep commercial banking operations rigidly separate from investment banking within the same financial institution are referred to as "Chinese walls."
- ¹⁰ In retrospect, many commercial banks in China remain convinced that a separate credit card company to run the business was the appropriate approach. The current Governor of the People's Bank of China appears to concur. (ibid).
- ¹¹ January 19, 2007 speech by the Hon. Jim Flaherty, Minister of Finance for Canada, to the Canada China Business Council, Beijing.
- ¹² See, for example, "An Historical Overview: 10 Events that Shaped the IMF," *IMF unFocus*, September 2006.
- ¹³ This account of the structure of China's financial sector draws from Deutsche Bank Research (2004): *China's Financial Sector: Institutional Framework and Main Challenges*, and Garcia-Herrero et al (2005), (Banco de España Report).

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