

PART III

FINANCIAL FAULT LINES

**CHINA'S FRAGILE FINANCIAL SYSTEM AND THE
STATE-OWNED ENTERPRISES**

This chapter seeks to identify the major problems in China's financial system that could escalate to a financial crisis and stifle economic growth in the next decade.¹ As will be shown below, the ailing state-owned enterprises (SOEs) lie at the center of China's financial problems. China's major banks themselves are SOEs. For these reasons, we discuss briefly the economic consequences of the lack of progress in enterprise reform, particularly its impact on the financial system.

China's financial system has undergone dramatic changes in the past two decades. Of particular interest are the changes in its organizational structure. By the year 2000, the mono-bank system of the pre-reform era had developed into a multilevel system with a central bank, 18 commercial banks, and a variety of financial institutions.² There are also rudimentary financial markets dealing in various financial instruments. A set of laws defining the specific functions of these institutions has been promulgated. In addition, the system is

¹The discussion here is limited to the domestic aspects of the financial system.

²The People's Bank of China (PBC) is the central bank. The state banks include four state-owned commercial banks: the Bank of China (BOC), the Industrial and Commercial Bank of China (ICBC), the Construction Bank of China (CBC), and the Agricultural Bank of China (ABC). There are also three state-owned policy banks: the State Development Bank, the Agricultural Development Bank, and the Export-Import Bank. For brief information on the 11 nonstate banks, see Almanac, 2001, pp. 32–48. Other financial institutions include urban and rural credit cooperatives or banks, investment trusts, financial companies, insurance companies, brokerage houses, and stock exchanges. A number of foreign banks have branches in China.

no longer purely state owned (or collectively owned). It has become a mixed system, with at least one private bank and a number of branches of foreign banks. However, in sharp contrast to the notable accomplishments in organizational restructuring, little progress has been made in changing the functions of the financial institutions as specified by the laws and regulations. While the rest of the economy moves steadily toward a market-oriented system, the financial sector remains virtually unchanged. Consequently, the system now faces some deep-rooted problems.

AN INEFFECTUAL CENTRAL BANK

The first major weakness of the financial system is its ineffectual central bank. The PBC was first established as a central bank in 1983. But it was not until 1995 that the People's Congress enacted the PBC Law, which provided the legal framework for the role and functions of the PBC as China's central bank. The fundamental task of the PBC is to maintain monetary stability and financial health of the economy.³ While the goal is clearly specified and the organizational structure is in place, the PBC lacks the autonomy to set monetary policies independently and the appropriate instruments to implement monetary policies.

The PBC Law stipulates that the PBC is to formulate and implement monetary policy "under the leadership of the State Council" (Dai and Gui, 1997, p. 275). Thus, by design, key policy decisions on annual money supply, interest rates, and the allocation of credit must be approved by the State Council.⁴

³By monetary stability, we mean economic growth with neither high inflation nor deflation.

⁴Apparently to justify the subordination of the PBC to the State Council, Liu Hongru, former Vice Governor of the PBC, argues that not all independent central banks can control inflation and that some less independent ones can (Hainan, 1992, p. 179). The implication is that central bank independence is neither a necessary nor a sufficient condition for inflation control. That being the case, the PBC's lack of independence should not be a serious handicap. Some economists in China disagree. They believe that central bank independence is of paramount importance (Dong, 1994, p. 970; DRC, 1994, p. 70). Empirical studies do provide some foundation for their view. For example, based on data for 16 countries in 1955–1990, Long and Summers have found a strong inverse correlation between central bank independence and inflation (Long

The lack of independence could have serious consequences if the primary goals of the government and the central bank come into conflict. The overriding goal of the government is economic growth, and that of the PBC, monetary stability. In principle, the two ends need not be competing. Indeed, the PBC Law stipulates that the aim of monetary policy is to maintain monetary stability and thereby promote economic growth. The former is to be the prerequisite for the latter. However, Zhou Zhengqing, the Vice Governor of PBC, has a different interpretation of the PBC Law. He lists price stability and economic growth as two separate, parallel goals (Hainan, 1992, p. 25). The subtle difference in perception is important, because it raises the question of which policy objective would take precedence should a conflict arise. The answer seems clear. The PBC is to operate under the direction of the State Council, which means that central bank policies must be subordinate to government policies.

Worse still, until 1998, branches of the central bank were set up at each administrative level. Thus, there were 31 branches at the provincial level and about 2,000 branches at the county level. Very often, officials of local governments pressured the local branches of the central bank to increase their loans, making it difficult for the PBC to control money supply. The local branches of the PBC had to accommodate the demands of the local officials, mainly because bank managers were controlled by local governments and party committees, and their careers depended on their relationship with the local officials.

The situation changed in 1998 when the government reorganized the PBC into nine regional branches. The intent was to remove the possibility of the local officials interfering with central bank policy. The new organizational structure represented a step toward independence of the PBC from local governments. How effective it will be remains to be seen, because the influence of local government officials is based not only on geographical proximity, but also on the network of their personal relationships.

Another factor limiting the effectiveness of central bank policy is that effective instruments of monetary policy available to the PBC are

and Summers, 1992, pp. 103–108). See also Alesina, 1988; Grilli, Masciandaro, and Tabellini, 1991; and Cukierman, 1992.

largely missing. In theory, a number of policy instruments are at its disposal, including both direct controls over the volume and distribution of bank credit and indirect measures such as changing the reserve requirements, setting interest rates, lending to commercial banks, and conducting open market operations. In practice, the indirect measures are of limited use, except perhaps lending to commercial banks. Consider, for example, open market operations. As noted by Cheng (1999, p. 14), in the late 1990s, the total outstanding stock of treasury bills was too small to accommodate open market operations without causing large swings in interest rates. In 1999, the PBC injected 192 billion yuan into the money supply through open market operations (Liu, Wang, and Li, 2001, p. 56). This amounted to only 12 percent of the increase in broad money supply in that year (SA 01, p. 79). Likewise, the volume of rediscounts is too small to be of any significance. Changing the rediscount rate would raise or lower the capital costs to the commercial banks and signal that the central bank is tightening or loosening credit. Indeed, since 1998, the PBC has adjusted the rediscount rate several times. However, the state banks are rather insensitive to changes in the rediscount rate, because, like all SOEs, they are not overly concerned with the cost of borrowing. The PBC can also set the basic interest rates for commercial bank lending and deposits, in order to influence money supply through the effect of interest changes on the demand for and supply of bank funds. But again, the PBC's interest rate policies are subject to various constraints. The government has a long established policy to set lending rates below market levels so as to subsidize the SOEs, and that leaves little room for the PBC to raise lending rates. Nor does it have much leeway in lowering these rates, because a lower lending rate would adversely affect the banks' profitability since there are lower bounds to the deposit rates.

As will be noted below, personal savings are the most important component of national savings and the bulk of personal savings is deposited in banks. If deposit rates are low, particularly relative to inflation, people might reduce their bank deposits, thus shrinking the supply of banks' loanable funds. In theory, raising the reserve ratio would force the banks to rely more heavily on central bank credit. However, because central bank lending is subject to government control, that too may not be an effective policy instrument. In the end, the PBC has to rely on direct controls to curb inflation. The

problem with direct controls is that these measures are relatively inflexible, and in recent years their effectiveness has been eroded by financial transitions outside the formal sector.

To sum up, the institutional framework for central bank management is inherently flawed in that the PBC remains a tool of government policy, passively accommodating what the government dictates, rather than actively and independently controlling money supply to achieve monetary stability. Aside from being primarily a monetary policy implementer rather than a policymaker, the PBC is also poorly equipped to control money supply. Its attempts to carry out monetary policies have been persistently undermined by local governments, commercial banks, and other financial institutions. The weaknesses of the PBC are evidenced by the four episodes of rapid inflation during the two decades since 1978 (SY 00, p. 289; Hainan, 1992, pp. 29–34). In all cases, inflation was preceded by large and abrupt increases in money supply (Yi, 1994, pp. 50–51; SA 01, p. 79). Not surprisingly, an empirical study based on data for 1979–1993 by the State Statistical Bureau (SSB) finds a significant relationship between money supply and price changes, given a lag of two years: The elasticity of retail price changes with respect to changes in money supply was as high as 0.32 (Ren, Qiu, and Yan, 1995).

A FRAGILE COMMERCIAL BANKING SYSTEM

A second major weakness of China's financial system is its fragile banking sector. Table 7.1 shows the structure of assets of financial institutions in China in 2000.⁵ Clearly, the banking sector is by far the majority component of the financial system. This sector's assets accounted for 96 percent of the total for the financial system as a whole. The banking sector, in turn, is dominated by four state banks. The predominance of the state banks means that whatever troubles the state banks will hurt the banking and even the entire financial

⁵The data for Table 7.1 are drawn from China's financial statistics yearbook. Possibly, statistics for some financial institutions have not been included, such as some provincial investment trusts and private credit unions. But the omissions are believed to be relatively small.

Table 7.1
Assets of China's Financial Institutions, 2000
(in billions of yuan)

Financial Institution	Total Assets
Banks	17,507.5
State-owned commercial banks	
Industrial and Commercial Bank of China	3,973.7
Bank of China	2,893.3
Construction Bank of China	2,531.7
Agricultural Bank of China	2,184.9
Policy banks	
State Development Bank	808.3
Agricultural Development Bank	770.8
Export-Import Bank	68.3
Others	
Bank of Communications	628.2
CITIC Industrial Bank	234.6
Regional banks	1,057.1
Urban credit cooperatives	678.5
Rural credit cooperatives	1,393.1
Foreign banks	285.0
Investment trusts	378.4
Security dealers	68.8
Insurance companies	124.1
Total	18,078.8

SOURCE: Almanac, 2001, pp. 362–363, 421–436, 474–489.

NOTES: The regional banks include the Merchant Bank, Guangdong Development Bank, Shanghai Pudong Development Bank, China Everbright Bank, Shengzhen Development Bank, Fujian Development Bank, Huaxia Bank, China Minsheng Bank, and Yantai Housing Savings Bank. The investment trusts include China International Trust and Investment Corporation (CITIC), Zhong Mei Trust and Investment Corporation, and Shanghai Investment Trust Corporation. The security dealers include the Huaxia Security Company and the China Southern Security Company. The insurance companies include nine life and property insurance companies.

system. It so happens that the state banks are facing some formidable problems at this stage. Nonperforming loans in their portfolios have been piling up, and their profits are dwindling.

The Chinese define bad loans to include overdue loans (*yuqi daikuan*), i.e., loans that have not been repaid by the due date; nonperforming loans (*daizhi daikuan*), i.e., loans that have been overdue for over two years; and nonrecoverable loans (*daizhang daikuan*), i.e., loans to be written off as losses. There is no definitive estimate of the size of bad loans that the state banks have accumulated. Avail-

able estimates vary widely. According to Dai Xianglong, Governor of China's central bank, bad loans of the four state banks amounted to only 9 percent of GDP, not alarmingly large, and roughly the same as that in Japan in 1997 (Zhao, 2001, p. 3; *The Economist*, March 8, 1997, p. S16). However, unofficial estimates are considerably higher, 23–33 percent of GDP in 1999 (Yuan, 2000, p. 12; SY 01, pp. 49, 638). Higher still are some estimates by researchers outside China, which put the share of bad loans at 40–53 percent of GDP in 1999 (Zhao, 2001, p. 3; WSJ, September 29, 1999, p. A14; SA 00, p. 14). The highest estimate is that by Standard and Poor's, which placed bad loans at 60 percent of GDP for 1997 (*The Economist*, February 14, 1998, p. 37).

Two tentative conclusions can be drawn from the various estimates. First, the problem of bad debts in the state banks is serious. Even by official measures, the size of bad loans is rather large, about 26.6 percent of total loans in 2000 (*Shihjie ribao* [Chinese Daily News], November 2, 2001, p. C6). In fact, the true size of the bad loans is, in all likelihood, considerably larger than the official figures suggest, because the banks often roll over the bad loans, so they do not show on their balance sheets (Yuan, 2000, p. 12; *Jingji ribao* [Economic Daily], February 20, 1995, p. 7). Moreover, the definition of bad loans used by Chinese banks is much more lenient than Western standards.⁶

Second, the problem is apparently worsening in recent years. According to one report, the bad loan ratio has been rising by 2 percentage points a year (*The Economist*, September 13, 1997, p. 26). Even if the ratio remained unchanged, the amount of bad loans in absolute terms has been rising rapidly, because total loans by state banks increased 1.9-fold during 1995–2000 (SY 96, p. 614; Almanac, 2001, p. 375).

The large bad debt overhang is merely a symptom of some deep-rooted problems in the banking sector: the persistence of government-directed policy loans; the perverse behavior of the state banks'

⁶Beginning in 2002, China adopted the international risk classification system, so that the official bad loan ratio may have risen (*Xin bao* [Hong Kong Economic Journal], May 25, 2002, p. 10). The implication is that recent ratios are on the low side by international standards. Thus, *The Economist* (March 8, 1997, p. S16) believed that the bad loan ratio may be twice the official estimate if a stricter standard is used.

major borrowers, the SOEs; and shortcomings in the management of the state banks themselves.⁷ In sharp contrast to the policy of sustained economic liberalization of the real (nonfinancial) sector, the Communist Party leaders had, from the very beginning, decided to retain authoritarianism over the financial sector. Accordingly, the state banks are given dual functions. They serve, first of all, as financial agents to support various government policies, and secondarily, as financial intermediaries in a market economy that mobilize savings and allocate capital to screened borrowers based on credit and risk assessment and corporate governance. The Commercial Bank Law promulgated in 1994 states that, after a transition period of unspecified duration, all banks are to operate as independent legal entities responsible in management, risk taking, profit and loss, and general prudence. In the interim, however, they must lend according to the needs of the national economy, social developments, and the state's industrial policy as mandated by the State Council. Specifically, these policy loans include loans to finance infrastructure investment, fixed investment and working capital of the SOEs, sectoral or regional development assistance, and credit for procurement of key agricultural products and for mandatory imports. They also include loans to finance such programs as poverty alleviation in minority areas, education and housing, and most important, financial support of insolvent SOEs for fear that massive unemployment from bankrupt SOEs might cause widespread social unrest.

Not only the central government but also local governments actively interfere with bank lending. As noted earlier, government officials often pressure banks to support local expansion programs and pet projects. These projects are generally designed with little regard to the community's comparative advantages or economies of scale. Examples are the numerous small cigarette plants, wineries, coke and petroleum refineries, and textile factories. Local officials have enormous leverage over the banks, because they administratively supervise the local branches of the state banks, they negotiate with the central bank over the amount of loan quota the local banks can lend, they decide how much of the existing loans to the local SOEs are to be repaid, and they are in a position to assist the banks in such mat-

⁷Policy loans refer to loans made by the state banks at the instruction of the government, to support certain government policies, such as subsidizing ethnic groups.

ters as hiring, housing, and education of the bank employees' children.

The dual roles of the state banks, both as the government policy agents and as market-driven financial intermediaries, are obviously inconsistent. When conflicts occur, the latter function is sacrificed. For this reason, the process of transforming the state banks into genuine commercial banks has been thwarted for decades. In an attempt to resolve the conflict, the government set up three policy banks in 1994 to take over policy lending, so that the four state banks can henceforth concentrate on commercial lending according to market principles.⁸ However, establishing policy banks helps but does not relieve the state banks of their existing heavy burden, because the policy banks only took over a small portion of the policy loans that the state banks accumulated.⁹ The four state banks are still stuck with large chunks of outstanding policy loans. Worse still, they are not entirely free from new policy lending yet. By extending policy loans, the state banks are actually performing many fiscal functions of the government, which the state used to finance through the state budget. This was necessary because the state's fiscal capacity to mobilize resources through the state budget has diminished sharply.¹⁰ Meanwhile, the demand for public services has been rising. Under the circumstances, the government simply shifts the fiscal burden to the state banks. Unless and until the state banks' burden is lifted, they have little choice but to continue their policy lending.

The problem with policy lending is that these loans are made mainly on the basis of social and political considerations, rather than on commercial criteria, such as financial viability of projects and creditworthiness of borrowers. The chance of their being repaid is minimal. The result is that most if not all of these loans become bad

⁸The three policy banks are the State Development Bank, the Export-Import Bank, and the Agricultural Development Bank. They took over the policy lending of the investment companies of the State Planning Commission, the Bank of China, and the Agricultural Bank of China, respectively.

⁹The Agricultural Bank of China and the Industrial and Commercial Bank of China have transferred some policy loans to the Agricultural Development Bank. But the State Development Bank has not inherited any policy loans from the Construction Bank of China (World Bank, 1996, p. 33).

¹⁰The amount of resources mobilized through the state budget declined from 31 percent of GDP in 1978 to 15 percent in 2000 (SA 01, p. 67).

loans. To be sure, some policy loans are based on economic considerations, e.g., loans to finance technical innovation and industrial restructuring. These loans are made on the assumption that government bureaucrats are farsighted enough to determine what will be viable and profitable industries in the future. More often than not, the officials err and the loans turn sour. Examples are the many duplicative plants built by local governments (Wu, 1992, p. 50).

Another major factor underlying the growth of bad loans is the poor performance of the SOEs, the most important borrowers of the state banks. To a large extent, the state banks' bad loans originate in their lending to the SOEs.¹¹ Why have so many loans to the SOEs turned bad? To begin with, the debt-to-equity ratio of the SOEs is rather high, about 79 percent in 1996. The relatively high ratio suggests that the SOEs have to carry a rather heavy debt burden. Debt service alone amounted to 10 percent of GDP in 1997 (Zhao, 2001, p. 25; SA 00, p. 14). The high debt-equity ratio should cause no problem if the SOEs were profitable. Unfortunately, this was not the case. Various indicators suggest that the profitability of the SOEs have been on the decline since 1978.¹² Worse still, not only do many SOEs fail to make profits, they have substantial operating losses. In 1997, over 39 percent of all the industrial SOEs incurred operating losses, compared to 19 percent in 1978. Their losses totaled 74.4 billion yuan in 1997, compared to 4.2 billion in 1978. In 1997, their losses actually exceeded earnings of the profitable industrial SOEs by a wide margin (Zhang, 1998, p. 33; SA 98, p. 112). Some SOEs incur losses because the state set prices of their products at below market prices. These include SOEs in such industries as coal, crude oil, electric power, water supply, transportation, and trade. Others are producers of heavy industrial materials and military goods, which now face declining demand for their products. Still others are the numerous

¹¹About 75 percent of the bad loans of the state banks were loans to SOEs and collective enterprises (Zhao, 2001, p. 7).

¹²Their profits per unit of gross output of industrial SOEs have dropped from 15.5 percent in 1978 to 1.6 percent in 1997. So have profits per unit of capital dropped, from 22.9 to 0.8 percent. Over the same period, the ratio of working capital to gross value of output rose from 32 to 80 percent (SSB, 1985, pp. 125–126; SA 98, p. 112). Likewise, profits per unit of gross output in state-owned construction enterprises dropped from 6.9 to 0.4 percent during 1980–2000 (SSB, 1988, p. 77; SY 01, p. 524). Similar trends are found in railroads and trade.

small factories built by local governments that flood the market with their consumer durables. Most lose money simply because of their poor management, or misuse of funds, e.g., speculating in real estate development and in the stock market. The loss makers often make no effort to repay bank loans, on the grounds that early or late payments should not matter, since both the banks and SOEs are state owned, and therefore these are debts between members of the same family. Some even use irregular means to deliberately evade repayment (*Jingji ribao* [Economic Daily], September 1, 1994, p. 4). The banks, for their part, are reluctant to enforce repayment, partly because bringing the issue into the open would make public the poor quality of their portfolios, partly because the government discourages bankrupting the SOEs, and partly because there is yet no effective legal means to recover substantial portions of the loans in bankruptcy proceedings. For all these reasons, bad loans continue to accumulate, even though the loans are being used for wage payments of loss making SOEs or for production of goods that are non-marketable.

Some bad loans result not from policy lending or from the poor performance of SOEs, but from bad management of the banks. The state banks' autonomy in making loans is rather limited. Where they are free to lend, they lack the motivation and the pressure to do so according to commercial principles. Efficiency in the use of funds is unrelated to the interests of the managers or the employees. Like all SOEs, the state banks face soft budget constraints. They are not penalized even when they are overloaded with bad loans. Nor are they forced into bankruptcy when they are insolvent. Thus, they are under no pressure to ensure safe and remunerative use of their funds. If the loans go bad, as many did in financing real estate development in the 1990s, so be it (Zhao, 2001, p. 20).

Another problem is that competition within the banking sector is quite limited. Nonstate banks do exist, including one private bank, branches of foreign banks, and numerous credit cooperatives. But they are relatively small in terms of assets or loans, and their expansion has been held back for fear that they might take away too much of the state banks' business. In short, there are no market forces to pressure the state banks to operate more efficiently.

Moreover, long accustomed to policy lending, the state banks have little experience in assessing credit. They are unfamiliar with asset and liquidity management techniques, accounting standards that are needed for performance review and risk assessment, and systems of corporate governance. They are also handicapped by a substandard infrastructure in the banking sector. The quality of the services provided by the banking staff is rather poor because of lack of training (*South China Morning Post*, July 1, 1995, p. B4). The information system is far from adequate for efficient management decisionmaking. The legal framework is so weak that lawlessness both inside and outside the banking sector becomes quite common. As Cheng notes (1999, pp. 15, 20), corruption has been rampant and loan contracts are flouted with impunity. Under all these unfavorable internal and external conditions, commercialization of the state banks is hardly feasible, and bad loans are the inevitable result.

According to a survey by the PBC of the four state banks in 2001, the relative importance of the three main sources of bad loans is as follows: 35 percent originate from policy lending and related causes, 43 percent from poor performance of the SOEs, and 22 percent from mismanagement of the banks (*Xin bao* [Hong Kong Economic Journal], May 17, 2002, p. 11; Zhao, 2001, pp. 19–20). Whether or not these figures accurately reflect the true pattern is really not important to our discussion. What is significant is that reducing and eliminating the three types of bad loans all require formidable reforms. Getting rid of policy loans involves reorienting the functions of the central government away from direct allocation of resources among industries, projects, and firms. It also requires fiscal reforms to remove the local governments' incentive to suboptimize at the regional level, and to relieve the banks of the burden of supporting activities that should be funded through the state budget, e.g., loans to promote "stability and unity." Above all, it calls for strong political will to implement and enforce the many laws and regulations. Furthermore, the debt-ridden SOEs and the state banks themselves badly need enterprise reforms, and perhaps privatization. The point is that these reforms cannot be accomplished overnight. That means the bad loans will be there for some time to come.

If the bad loans are likely to continue to mount, the only alternative for the banks to reduce their fragility is to increase the capital of the banks. Unfortunately, the prospects of improving the state banks'

capitalization by their own efforts are rather dim, because they have inadequate loan-loss provisions, because their operating margins and profitability are low, and because their poor credit rating makes it difficult to raise capital in domestic and international financial markets. Prior to 1988, China's banks had no reserves for bad debt. Unrecoverable loans remained on the books as part of bank assets. In 1995, the PBC required all banks to set aside an amount equivalent to 0.8 percent of total loans as provision for bad debt. In 1996, the loan-loss ratio for the five largest banks was only 0.5 percent (*South China Morning Post*, December 21, 1995, p. B5; Cheng, 1999, p. 9). The meager reserves of 0.5 percent of total loans can hardly cover the low official estimate of unrecoverable loans, 2.9 percent (for 1998), not to mention the much higher unofficial estimate of 20 percent (Yuan, 2000, p. 12; Tian and Sun, 1995).

One of the reasons why loss provisions are inadequate is that the state banks' profitability has been declining since the 1980s. The four state banks' returns on assets have dropped markedly from 1.4 percent in 1987 to 0.4 percent in 1996, and further to 0.26 percent in the late 1990s (*The Economist*, May 2, 1998, p. 65; Zhao, 2001, p. 108). The causes of low profitability are many. The policy loans are largely in the nature of grants or subsidies rather than income-generating loans. The banks' poor management is certainly a factor. Another important factor is the government interest rate policy. In China, interest rates on loans and deposits are uniformly set by the PBC. Interest rates on loans have been deliberately kept low, partly to lower the cost of financing SOEs and public projects, and partly to pass the banks' monopoly profits to users of bank credit.¹³ Interest rates on deposits cannot be set too low. Otherwise deposits are not forthcoming. The result is a rather narrow spread between the loan and deposit rates.¹⁴

Just as the rising volume of bad loans and declining profitability continue to deplete the banks' financial resources, structural

¹³Some borrowers who have access to bank credit at subsidized rates make money simply by borrowing from the banks and lending to others at high interest rates.

¹⁴For example, it was only 0.7, 1.1, 2.6 percentage points in 1990, 1995, and 1998, respectively (World Bank, *World Development Report* [WDR], 1994, p. 184; World Bank, 1997g, p. 216; World Bank, *Entering the 21st Century: World Development Report 1999/2000*, Oxford University Press, Oxford, 1999, p. 260).

changes in the financial institutions' assets and liabilities further complicate the banks' liquidity problem. The share of medium- and long-term loans in total bank loans increased sharply, from 2.3 percent in 1980 to 28.1 percent in 2000. Yet, the share of savings deposits in total bank deposits dropped from 62.1 to 49.7 percent over the same period.¹⁵ The use of more and more short-term funds to finance long-term projects increases the risk of a liquidity crunch. This is particularly the case with the state banks, because, to them, deposits represent hard liabilities, whereas their loans to the SOEs are largely soft loans, the repayment of which is rather uncertain.

UNREGULATED FINANCIAL INSTITUTIONS

One distinct feature of China's rapid economic growth since the early 1980s is that it was led by the rise of the nonstate enterprises. Toward the end of the 1990s, these enterprises were facing increasing difficulties in getting adequate funds from the banking system, mainly because of the government's strong bias against them in allocating credit. They therefore have to seek financing outside the banking sector, from such sources as capital markets, investment trusts, inter-enterprise lending, and the informal financial sector.

Throughout the 1990s, capital markets remained underdeveloped and poorly regulated. They served mainly as channels for the government to finance public projects or investment of the SOEs. Non-state enterprises have only limited access.¹⁶ In any case, total funds raised in the stock and bond markets have been relatively small.¹⁷ This is mainly because the government keeps a tight rein over the listing of stocks on the main boards or the floating of bonds, ostensibly to protect the investors, but apparently also to regulate the scale of nonbank borrowing and to ensure consistency of the flow of financial resources with government industrial policies (Ma, 1993, p. 2).

¹⁵SSB, 1999, pp. 64, 66; SY 01, pp. 304, 637–638.

¹⁶Thus, only a handful of the 1,000-odd companies listed in China's two stock exchanges are privately controlled (*The Economist*, June 30, 2002, p. 72).

¹⁷In 2000, they amounted to only 14 percent of the total funds provided by financial institutions and capital markets in China (SA 01, pp. 78, 82).

Notwithstanding stringent government control, irregular borrowing in pseudo-capital markets has been rampant. Many enterprises issued shares for sale to their own employees and the public. Others sold securities with fixed returns under various names, but not as bonds, so as to bypass the procedure of having the securities assessed and approved by the authorities (*Ming pao*, September 12, 1985, p. 8; *Liaowang* [Outlook], No. 16, April 19, 1993, p. 3; *Jingji ribao* [Economic Daily], September 4, 1994, p. 5). The practice was not limited to borrowing by enterprises. Many government organizations and public institutions, like hospitals and schools, also actively raised funds from their employees, sometimes on a compulsory basis (*China Daily*, April 24, 1993, p. 4).

In both the formal and pseudo-formal capital markets, the regulatory framework is rather weak. The Shanghai and the Shenzhen exchanges are plagued by price manipulation and poor oversight (WSJ, February 24, 2000, p. A14). Insiders' trading of issues on the main boards is not uncommon. Many enterprises have to pay interest rates as high as 20–30 percent per annum, several times the bank rate for savings deposits (*Liaowang*, No. 18, May 3, 1993, p. 17). Few companies can guarantee to make that much profits year after year. Defaults on the loans often result.

Another source of finance outside the banking sector is the investment and trust companies (ITCs), which were developed to raise funds from foreign and domestic creditors. Since the 1980s, ITCs have proliferated, as local governments, particularly those in the coastal provinces, strived hard to attract foreign investments. Just as in the case of other financial institutions, strict regulations governing the operations of the ITCs exist but are only loosely enforced. A survey of hundreds of ITCs in 1985 revealed that more than one-third did not have sufficient capital, did not maintain adequate minimum reserves, and violated lending and interest rate regulations (Holz, 1992, pp. 116–117). Many invested in ill-advised projects and became debt ridden.¹⁸ Subsequently, the government decided to restructure

¹⁸By 2000, it was estimated that the trust firms had bad debts totaling US\$ 25 billion, while less than half of their assets, US\$ 50 billion, were recoverable (WSJ, February 16, 2000, p. A23). In 1998, Guangdong International Trust and Investment Corporation failed. It had only US\$ 785 million in assets, against US\$ 4,700 million in liabilities (WSJ, September 2, 1999, p. A18).

and shut down more than 150 of the 240 debt-ridden ITCs through mergers and closures. Once again, China's experience with the ITCs points to a critical problem in the financial system. Like the banks, ITCs apparently have little difficulty in raising funds, but they lack the expertise and prudence in managing the funds.

A third type of nonbank financial institution includes those in the informal sector, such as private lending among individuals and enterprises, money shops and loan brokers, traditional credit unions, farmers' cooperative funds, pawn shops, and unlicensed private banks (Deng and Xu, 1994, pp. 110–117; *China Daily*, November 7, 1992, p. 1). Some of these institutions operate primarily for profit (e.g., loan brokers), while others provide financial help to the needy (e.g., mutual aid funds). Some are legal (e.g., the farmers' cooperative funds), while others are not (e.g., money shops and unlicensed private banks). By some guesses, the informal sector provided half the credit in the economy in the early 1990s (*The Economist*, July 3, 1993, p. 30). Thus, informal financial institutions thrive in the coastal provinces such as Guangdong, Zhejiang, and Fujian where nonstate enterprises flourish. Some local governments at the village and county level overspend and have to borrow from the informal sector (Yang, 1997, pp. 146–149). Then there are people who borrow to finance conspicuous consumption (*Wen hui pao*, August 7, 1990, p. 10).

The major suppliers of funds are the individuals with savings who seek better returns in curb markets where interest rates are much higher than bank deposit rates.¹⁹ To some degree, the supply of funds in these markets relieved the acute shortage of capital for the nonstate enterprises. In that sense, it helps to sustain economic growth. But it also creates some problems. Because the informal sector is little regulated and supervised, it has become a hot bed for financial disputes. If and when these projects fail, the lenders cannot always recoup funds, because some loans are illegal, and, even if they are legal, the underdeveloped legal system provides no protection. Sometimes, the lenders resort to force to collect their debts, creating problems of law and order. If and when the local governments can-

¹⁹For example, the curb market rate in 1993 was 40 percent per annum, compared to the bank fixed deposit rate of 11 percent (one year period) (*The Economist*, March 18, 1995, p. S16; SY 98, p. 671).

not pay their debts, they often shift the burden to the peasants by increasing arbitrary levies, creating strong resentments among the public (Yang, 1997, pp. 148–149).

ADVERSE SCENARIOS: FINANCIAL CRISES AND SLACK ECONOMIC GROWTH

With an ineffectual central bank, a highly fragile banking system, and nonbank institutions lacking an effective regulatory framework, the stage is set for potential financial crises. A number of abrupt changes in the economic and social environment could trigger a financial crisis. Earlier, we noted that the insolvent state banks have been keeping the insolvent SOEs afloat with unrecoverable loans. Thus far, the perverse one-way drain of the banks' resources has not brought on a financial crisis, because the supply of bank funds from its two main sources has been readily forthcoming: growth of deposits and central bank lending. Nonetheless, that the system has not collapsed does not signify the absence of a crisis risk. The State Council controls central bank lending, and it is unlikely to turn off the tap unless absolutely necessary. Deposits are a different matter. In the past two decades, bank deposits have been growing rapidly through good and bad times. This is because the depositors believe that the government would always stand behind the state banks. However, policies can change under pressure, and so can people's perceptions.

One such possibility is a crisis originating in the informal sector. Because the curb lending rates are high—some 20–30 percent per annum—borrowing occurs to finance projects with relatively high expected returns, which often have high risks, such as speculations in real estate and stock markets. The weak regulatory framework could not stop a financial bubble from growing, and if a large number of these projects fail, the lenders would be in trouble, because the state would probably not come to their rescue. A crisis in the informal sector could spread to the formal sector through the contagion of fear and a rush for liquidity by the bank depositors.

Another potential trigger of financial crises is a loss of confidence of the domestic savers in the government's guarantee of the value of their bank deposits. This could occur when the real interest rate drops sharply because of high inflation. To protect the real value of

their savings, people might withdraw their deposits and shift into real assets. A bank run would then ensue (Lardy, 1998, pp. 201–202). This actually happened in 1988. The incident was brief and did not develop into a full-scale crisis because the government quickly introduced index-based deposits to keep the real interest rate from falling, while taking other measures to curb inflation. As will be pointed out presently, the risk of recurring inflation is there, and we cannot preclude the possibility of people running away from financial assets to avoid the inflation tax.

Similarly, a run from the domestic currency could occur, as a result of political and social turmoil, military conflicts, or competitive devaluation among China's trading partners and rivals. China has been able to avert serious consequences of the Asian financial crisis of 1997–1998. But this does not mean that the financial system is immune to external shocks, especially now that China has joined the World Trade Organization and the economy will become increasingly integrated with the outside world.

Even if no financial crisis occurs, the basic weaknesses of the financial system could stifle economic growth through their negative effects on inflation, savings, and efficiency in the use of financial resources. Our discussions of the nature and causes of China's financial problems indicate that many of China's financial difficulties are, in effect, the price that government elected to pay for postponing fiscal and enterprise reforms. China faces persistent budget deficits, mainly because the tax system fails to increase revenues fast enough to cover the mounting expenditures on defense, subsidies, debt service, environmental protection, and institutional building. Increasingly, the government relies on the state banks to finance public investments, welfare expenditures, and subsidies to loss-making SOEs. By shouldering these fiscal burdens, the banks help to reduce the risks of state budget crunch, wholesale SOE bankruptcies, and massive open unemployment. The cost is that the PBC loses control of money supply, because these noneconomic demands for bank credit are inflexible and constantly expanding. The loans to the ailing SOEs are often used to pay wages or to produce unmarketable goods. The result is an increase in aggregate demand without a corresponding increase in aggregate supply. In addition, the priority goal of the central and local governments is economic growth, and the banks are under great pressure to support government development poli-

cies. Under the circumstances, high inflation could recur as it did in the 1980s and 1990s.

An empirical study of inflation and economic growth based on data for 122 countries has shown that the effect of inflation on growth is significantly negative (Barro, 1998, pp. 89–118). Such adverse effects could happen in China. For example, inflation could deter investment because it increases risks of investment decisions. A high rate of inflation suggests that the government has lost macroeconomic control. There would be uncertainties regarding the political will of the leaders to control inflation, the measures they might take, and the effectiveness of these measures. In times of inflation, volatile relative prices do not convey signals of changing supply and demand by producers and consumers. More often than not, enterprise managers are more interested in rent-seeking through short-term speculation than in making profits through long-term investments.

Moreover, inflation has important distributional effects. Real income is shifted from those with fixed incomes, such as workers and employees, to those whose incomes vary with inflation, such as entrepreneurs and holders of physical or foreign assets. In China, the former group is fairly large. In 2000, 53 percent of the total urban workforce were workers and employees (SA 01, pp. 41–42). To the extent that income changes affect work incentives, inflation could reduce the effective labor input from the large number of workers and employees. Worse still, discontent among workers and employees could degenerate into social upheavals.

Apart from the negative effects of inflation, the financial system's weaknesses could slow economic growth through their adverse effects on the supply of savings and on the efficiency of resource allocation. In the past two decades, domestic savings have played a major role in the rapid economic growth. However, since 1993, the investment rate has continually declined, from 43.5 percent in 1993 to 36.9 percent in 2000 (SA 01, p. 28). The domestic savings rate must have declined even more sharply, because net foreign lending and direct foreign investment have been rising during the period (SA 01, p. 156). The rising volume of the state banks' bad loans might well have contributed to the decline. As a source of total bank funds, household savings deposits have become increasingly important, rising from 8.2 percent of total assets in 1978 to 43.4 percent in 2000

(SSB, 1999, p. 64; Almanac, 2001, p. 360). Meanwhile, the SOEs absorbed 82.8 percent of state bank lending in 1998 (Holz and Zhu, 2000, p. 76). A considerable proportion of these loans is unrecoverable. In short, large sums of household savings have been channeled to the insolvent SOEs through the state banks. The process could escalate to a crisis if, for some reason, households should decide to save less or to shift their savings elsewhere. Even if no crisis occurs, the process could drain the banks' loanable resources, because lending to the SOEs is a one-way flow of funds into a bottomless pit. The banks' capacity to support healthy projects could thus be greatly reduced, restricting the growth of investment. Among those that suffer the most from such constraints would be the nonstate enterprises. These enterprises happen to be the more productive units in the economy. The credit squeeze on a more efficient sector represents a misallocation of financial resources that lowers the growth of total factor productivity.

The shortcomings of the financial system could also impede economic growth through the system's effects on the structure of investment. We note earlier that inflation could recur because of the ineffectual central bank. With nominal interest rates set by the government at low levels, inflation could depress the real interest rate to near or subzero levels, as it did in 1988–1989 and 1993–1995. Negative interest rates could make capital-intensive investments appear more attractive. Large investments based on illusions of low capital costs could have dire consequences. They could worsen the problem of existing massive unemployment, because the number of jobs created per unit of investment would be lower than in the case of labor-intensive investments. If these capital-intensive industries should face strong competition in domestic or world markets from enterprises with more truly favorable comparative advantages, they could go under and tie up scarce resources indefinitely, just as the “third-line” industries did in the past.²⁰

As in the case of massive unemployment, we roughly quantify the effects of a deteriorating financial system, first, by using the World Bank's model of sustained growth as a benchmark, and then by al-

²⁰Third-line industries are those built in the mountainous areas in the interior of China during the 1960s and 1970s in preparation for war.

lowing for changes in the parameters due to the worsening of the financial problems. In the World Bank model, the projected GDP growth rate of 6.6 percent is decomposed into three contributing factors: a 35 percent investment rate that contributes 4.6 percentage points to GDP growth, labor inputs growing at 0.8 percent per year that generate 0.5 percentage points to GDP growth, and total factor productivity growing at 1.5 percent per year.²¹

In the two adverse scenarios, we postulate a discernible drop in the investment rate from 35 to 33 and 30 percent, mainly as a result of a slowdown in the growth of the banks' resources that are available for investment, as the banks' subsidies to the ailing SOEs continue to expand, and as depositors and investors become increasingly concerned over the financial health of the economic system. We also assume a decline in the growth of employment from 0.8 to 0.7 and 0.6 percent, to provide a range of possible changes. Total factor productivity also falls from 1.5 to 1.3 and 1.2 percent, mainly as a consequence of the government's diverting the bulk of financial resources to the less productive state sector, thus constraining the growth of the more dynamic nonstate sector. Given these assumptions, the projected GDP growth drops to 6.1 and 5.6 percent. In short, the deteriorating financial system could set back economic growth by 0.5 to 1.0 percentage points.

²¹For sources of data, see Chapter Two.