EDC Economics

Glen Hodgson
Vice President and Deputy Chief Economist
ghodgson@edc.ca

August 2004

Can China's Banking System be Reformed?[1]

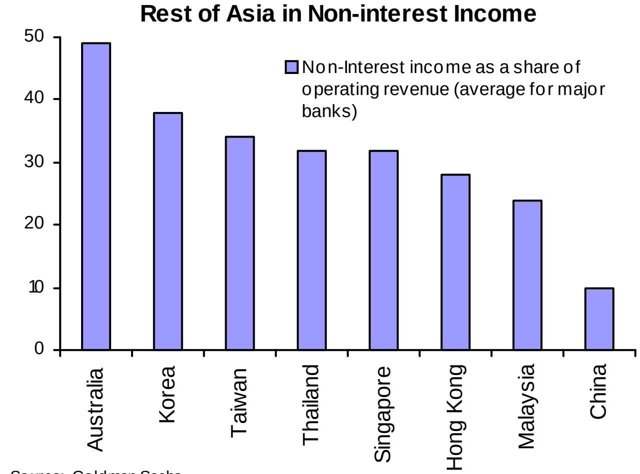
The Issue

A well-functioning financial and banking system is the lifeblood of sustained economic growth for virtually every country. There is general agreement among economists that a lack of financial sector depth, typified by over-reliance on banks as the source of financial intermediation, was a critical factor in the Asian crisis of the late 1990s. For China, banking sector reform is key to sustaining its success in economic transformation – and therefore is the potential Achilles Heel of Chinese economic reform.[2]

The Current Banking System

What are the stylized facts of the current Chinese banking system? Today's system has emerged from banking under communism, where banks were used for what is called "policy lending". Rather than converting savings into investment and consumption at market-guided rates of interest, the Chinese banking system of the past 50 years has gathered savings from individuals and transferring them to the political and social priorities of the Party. Little wonder, then, that non-performing loans (NPLs) represent 20 per cent or more of outstanding loans for the entire banking system – a legacy of the communist planned economy.

Chinese State Banks are Far behind the Rest of Asia in Non-interest Income



Source: Goldman Sachs

The financial sector is anchored by four large state banks -- Bank of China, China Construction Bank, Industrial and Commercial Bank and Agricultural Bank of China – employing 1.4 million workers in 116,000 branches across China. While their market share has declined, these banks still account for nearly 75 per cent of all bank assets. However, due to their planned economy legacy, the NPLs of the Big Four were estimated in

---

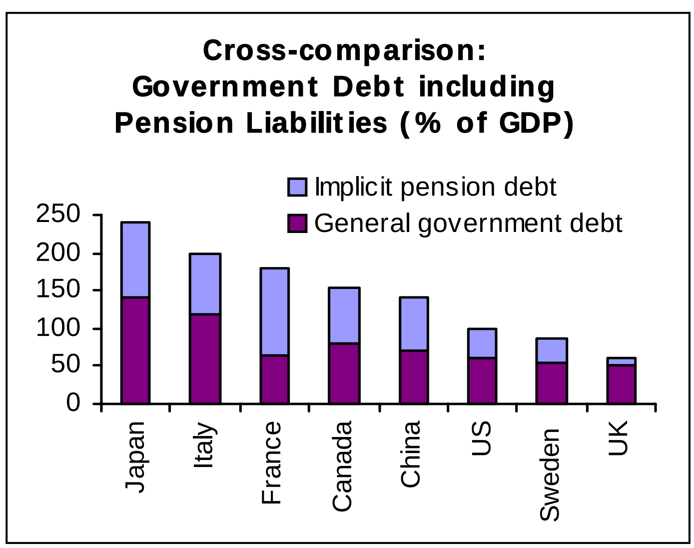
[1] Drawn from G. Hodgson, "The Risks to China's Economic Transformation: Can They Be Managed?", June 2004, available at www.edc.ca.
[2] A recent Fitch report also used the term "Achilles Heel", in reference to the Russian banking system. We would beg to differ with Fitch; the Russian banking system is far from healthy, but we believe there are other structural factors, such as over-dependence on the oil & gas sector and insufficient reform in the rest of the economy, that pose greater risk to Russian development than the banking system.

2003 at 25 per cent of assets by the government, with private sector estimates approaching 40 per cent. By western accounting standards, these banks would have been insolvent long ago. A large number of other state and cooperative banks have also emerged, usually with a sectoral or regional operating mandate. Finally, more than 170 foreign banks have also been permitted to enter the Chinese market, but they represent only 1 per cent of outstanding loans.

Given the size of the NPL problem, banking sector reform is at the top of the government's agenda. While foreign bank entry could bring some competitive vitality to the sector, the make-or-break decision-making will be related to the four large state banks and whether they can be transformed into sustainable commercial entities. The reforms began in 1998, with a US $33 billion recapitalization of the Big Four. Four asset-management companies (AMCs) were then created in 1999, removing US$170 billion in bad assets from the banks' books. However, these first two steps had only limited success. The AMCs' track record shows that they have not been very effective in improving recovery; the banks' books showed only a one-time positive adjustment with little real progress in operational effectiveness in the intervening years.

As a further step in the reform process, at the end of 2003 the government re-capitalized the Bank of China and the China Construction Bank with a further US$45 billion, accompanied by a write-off of the two banks' accumulated NPLs. The two banks have effectively become pilots in an ambitious project to convert them into full commercial companies, eventually with external shareholders, modernized governance structures and public stock listings.[3] China's huge foreign exchange reserves are the source of funds for re-capitalization; the state entity through which the new capital was funneled expects the two banks to earn a return comparable to US Treasury bonds and to pay a regular dividend on the investment.

In addition, significant regulatory changes are currently well underway to improve the quality of future banking assets. China's new regulatory body, the Chinese Bank Regulatory Commission (CBRC), is introducing new prudential regulations that will substantially improve the regulators' ability to accurately assess both the financial health of Chinese banks and the quality of their management. Further, new capital adequacy requirements will substantially toughen up the hitherto lax capital requirements imposed on Chinese banks.



Ultimately, because the major banks, AMCs and most other financial institutions are owned by the state, the government's books will bear the cost and risk of bank reform. Should a banking crisis occur, it would be fiscal in nature. China's official public debt is around 15 per cent of GDP, but if other contingent liabilities related to bank restructuring and external debts are added in, the ratio rises to around 85 per cent. The ratio is even higher

[3] Fitch Ratings, "China's Banks: the Recap and Beyond", April 2004.

when implicit pension liabilities are rolled in. Yet lower interest rates and strong, sustained economic growth has meant an improvement in the government's debt service position over the past six years. As one indication, total debt and interest payments as a share of government spending are down to half the level in 1998. In international terms, China's debt and implicit pension liabilities are actually below those of many industrial economies with aging populations like Japan, Italy, France – and Canada.

Assessment of Reform Capacity

So is the glass half-empty or half-full in terms of China's capacity to reform the banking system? The Big Four's share of outstanding domestic credits has declined significantly over the past decade. Credit unions, credit co-operatives, city banks, foreign venture capital funds and equity markets are all increasingly open to private sector business demands. The more-or-less successful reform efforts to date demonstrate a serious commitment to address the potential threat of China's banking system to future development, and China appears to have the fiscal capacity needed to carry though on banking sector reform. Finally, under its WTO accession agreement, China has committed to a gradual opening of specific bank markets to foreign banks, starting with limited access to foreign currency business in 2002 and eventually progressing to retail banking services in 2006.

On the other side of the ledger, however, the current stock of NPLs is still huge as a share of GDP. Managing the overhang of non-performing loans will draw on significant fiscal resources for years to come. Recent evidence suggests that two of the Big Four -- Bank of China and China Construction Bank – are making efforts to accelerate internal reforms and as a consequence have reduced their NPL ratios considerably. Still, a new wave of NPLs may be waiting in the wings for these and other banks due to the frenzied pace of investment in 2003 and into early 2004.

The playing field for foreign bank entry is hardly level, notwithstanding WTO entry commitments. The minimum regulatory capital required for a foreign bank to obtain a license to operate a foreign branch has been very high, which has no doubt discouraged foreign bank entry. On that score, Chinese authorities have just announced that they are reducing the minimum capital per foreign branch from Rmb 500 million to Rmb 300 million (US$36 million), which is certainly a positive step if foreign bank entry, and resulting financial market competition, is to be encouraged. But ultimately, changing the credit culture within the Big Four and other state banks may be the greatest challenge if a second NPL wave is to be avoided. An entire generation of bankers is in the midst of being re-educated, learning to extend credit based on financial criteria and not socio-political objectives. The success of that "cultural revolution" inside the state banking sector has yet to be demonstrated.

Conclusion

On balance, it is our assessment that the Chinese central authorities have the capacity to manage the badly-needed reform of the banking system. The evolving reform agenda to date demonstrates a serious commitment to address the potential threat to future development posed by China's evolving banking system, and China appears to have the fiscal capacity needed to carry though on banking sector reform.

Nevertheless, the risks are plentiful. Fundamental changes will be needed in individual banks' internal credit culture. There will be a fiscal cost to systemic adjustment. And China needs to continue along a path that encourages foreign bank entry, in order to ensure sufficient competition and bring new innovation in financial intermediation. Financial sector reform remains the financial Achilles Heel to China's economic transformation; it is premature to declare victory with so many significant steps still to be taken.