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Some unorthodox thoughts on China's unorthodox financial sector

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1. Problems in China's banking system

China's banks are undeniably in serious financial straits. Citigroup (2002) has estimated that the ratio of nonperforming loans (NPLs) at the four biggest state-owned commercial banks (SOCBs) to be about 35% at the beginning of 2002, and that the average capital adequacy ratio (CAR) of these four SOCBs to be 5%. In short, the bank recapitalization in late 1998, which had raised CAR to over 8%, was a wasted effort. The primary reasons for this rapid deterioration in the financial health of the banks are that the composition of the customer base has not changed, so that state-owned enterprises (SOEs) remain the biggest borrowers, and that there has been intermittent pressure on the banks since 1997 from the government to expand investment credit in order to combat deflation, and to expand social stability loans to reduce firm closures. The result is that the SOCBs are now in need of another round of recapitalization.

In this situation of a fragile banking system, China has committed itself to opening up the banking system completely within 5 years of WTO accession (which it joined in December 2001). Foreign banks could conduct transactions in foreign currencies from the beginning of WTO membership, conduct transactions with the local corporate sector in Renminbi after 2 years, and conduct transactions with local households in local currencies after 5 years. Although foreign banks are likely to compete only in the coastal cities, at least in the initial period, the pressure on domestic banks could be high as the big four banks earn almost all of their profits from about the coastal cities. Because there is no explicit depositor insurance in

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China, the obvious question is whether depositors will believe that these foreign banks will drive the SOCBs into open bankruptcy, and hence rush to withdraw their savings from the SOCBs, setting in motion the vicious downward spiral of credit contraction, leading to business failures, rendering sound financial institutions insolvent, and contracting credit further.

My view is that even if pressures on the state banks do occur through depositor withdrawals, a full-blown crisis will not necessarily occur, since the central bank will be able to issue currency to the state banks to meet the withdrawals. This expansion of high-power money cannot be easily translated into a loss of foreign reserves, because capital controls (which I support) remain in place and are likely to do so for the forseeable future. The resulting expansion of high-power money will also not have much impact on inflation, because this is mainly a shift out of bank deposits into cash, or from some banks to others, and not a shift into goods. Even if depositors start hoarding goods, this may be a good outcome right now because of the current deflation. Simply put, the government has the technical ability to accommodate shifts in bank deposit preferences, even a modest bank run, without risking exchange rate collapse or a runaway inflation.

However, the fact that the government can prevent a bank run from causing a financial meltdown is not good enough. If the banking system is plagued by frequent bank runs, its role as a financial intermediary will be greatly reduced, and economic growth could suffer significantly. The real issue is not whether depositor shifts, or a bank run could be accommodated, but how to prevent a banking crisis from occurring in the first place. Because depositors have the incentive to withdraw their funds as long as the banks are seen to be insolvent, the prevention of banks requires that the government keep the banks adequately capitalized at all times. Since the government already recapitalized the banks in 1998 and clearly needs to do so again now, the important question is how many more rounds of bank recapitalization China can afford without generating an economic crisis?

2. China's fiscal sustainability

The simple fact is that fiscal sustainability lies at the heart of whether a banking crisis would actually occur. As long as the state is perceived to be able and willing to bail out the SOCBs, depositors would retain their confidence in the SOCBs regardless of the actual state of their balance sheets. The stock of publicly acknowledged government debt is presently only 16% of GDP, and so it is usual to hear official assurances that the current fiscal deficits of less than 3% of GDP do not pose a problem for debt servicing by the state. However, the analytically correct measure of public debt should be the consolidated debt of the state sector, which would include at least some part of the contingent liabilities (e.g., foreign debts of SOEs and SOCBs and unfunded pension schemes in the SOE sector) that the state might have to assume responsibility for when the state-owned units default on their financial obligations. We note that if an analyst counts NPLs as contingent liabilities, then she is really computing what the public debt will be after one more round of bank recapitalization, i.e., the second bank recapitalization since 1997. According to Fan (in press), the consolidated public debt at

the end of 2001 was 72% of GDP; according to Citibank (2002), it could be as high as 115%. Thus, is China's present debt–GDP ratio too low or too high?

To answer this question, we note that the central government debt–GDP ratios in Italy, Sweden, and the United States were, respectively, 117.6%, 70.8%, and 50.5% in 1995.[1] Thus, if China undertakes its second bank recapitalization since 1997, its public debt will still be within the range seen in advanced OECD countries that are not experiencing fiscal crises. However, there are two important points to be made to show that this finding is not an optimistic one.

First, the forthcoming recapitalization of China's banks appears to be the last major one that the government could implement in the short term without risking the stability of the domestic financial markets and its credit standing in the international financial markets. A third recapitalization (since 1997) will push the debt–GDP ratio to over 150%, well above the OECD norm.

Second, if China recapitalizes the SOCBs a second time, then it will have to compromise the expansionary fiscal policies that have been keeping GDP growth above 7% since 1997. This is because China raises much less state revenue as a share of GDP, than the OECD countries, and hence has a much lower capacity to service its public debt. The revenue–GDP ratio was 16.2% for China in 2001, 30% for Italy in 1995, 38% for Sweden in 1995, and 21% for the US in 1996.[2] Until China increases its tax collection, the second recapitalization of the SOCBs could require the government to reduce infrastructure spending that would amount to 2.5% of GDP. China's experience in the reform era is that frequent changes to the tax system have not been able to raising revenue significantly for a sustained period, because increasing tax collection is as much a political challenge as it is an administrative challenge.

In summary, China's consolidated debt–GDP ratio will be relatively high by international standards after a second bank recapitalization, while its revenue–GDP ratio will remain relatively low. The greatest threat to the stability of China's financial market is fiscal sustainability, and the biggest threat to fiscal sustainability is successive rounds of bank recapitalization.

3. WTO-induced changes in the financial sector may make macroeconomic management more effective

At a superficial level, the systemic deflationary pressures that have plagued China since 1997 have their sources in two Keynesian maladies, the liquidity trap and the paradox of thrift. The liquidity trap refers to the phenomenon of the last few years where monetary policy does not seem to work. China has tried to boost the domestic economy with successive cuts in interest rates, but the rise in credit creation has been disappointing. Credit growth was much lower than expected, except for brief intervals when the central bank leaned heavily upon the

[1] The US ratio is for 1996. Ratios were constructed from the IMF's *International Financial Statistics*.

[2] The revenue–GDP ratio for China is from Deutsche Bank (2002) which estimated that it will rise to 16.4% in 2002 and 16.6% in 2003. Debt–GDP and revenue–GDP ratios for other countries are from the IMF database.

banks. The paradox of thrift refers to the low level of private aggregate demand because the private saving rate has been increasing. The Chinese government has concluded that, because private aggregate demand is falling and monetary policy seems incapable of stimulating it, the key to maintaining macroeconomic stability is government spending.

At a deeper level, however, both of these phenomena, we suggest, spring from the same cause, which is the absence of adequate financial intermediation in China. For example, why is China suffering from an apparent liquidity trap? The main reason seems to be that state bank managers have been told that if the ratio of NPLs were to go up 2 years consecutively, they would lose their jobs. The traditional client base of the state banks is state enterprises, of which half to two-thirds are reporting zero or negative profits. By extending more loans to state enterprises, the NPL ratio would inevitably rise. However, at the same time, state banks are even less willing to lend to non-state enterprises, and for very good reasons. The accounting practices of the non-state enterprises are neither uniform nor transparent, and it lending to them is also politically more risky; a loan to an SOE might be a bad economic decision, but a loan to non-state enterprise that goes bad could potentially be a bad political decision as well, as the bank manager could be accused of consorting with the private sector to embezzle the state.[3] The liquidity trap arises then because the banks are lending less to the SOEs and are refusing to lend meaningful amounts to the private enterprises. The only activity that the SOCBs are happy to allocate their funds to is the purchase of state bonds, i.e., the financing of the government's deficit. The fundamental step to eliminating the liquidity trap is to end the bias against lending to the private sector.

For the paradox of thrift, the right solution to the insufficient domestic demand in the Chinese economy is not mainly for the government to use up the private savings in public investments, but to set up mechanisms to channel private savings into increased private investments. This is where the entry of foreign banks will be exceedingly important. Foreign banks will be concentrating their activities in the large coastal cities, where the SOCBs are now making the bulk of their profits. This increased competition in the profit centers of the SOCBs could push them to focus on areas of banking where they do have a comparative advantage over the foreign banks.

China's SOCBs do have a comparative advantage in operating in the inner provinces and the rural areas because of their existing extensive branch systems. The state banks have traditionally neglected the inland provinces and the rural areas. The number of rural banks has actually decreased in the 1985–1995 period. One reason is that the regulated interest rate for loans in China made it unprofitable to extend small loans. Large loans and small loans require the same amount of paper work and time to process. It is only natural that rural banks should charge a higher interest rate since the cost of monitoring and processing the loan is higher. However, because the government-set margin that rural branches can charge above the government-set lending rate in urban areas is too low to cover the additional costs and higher

[3] The Chinese government has sought to increase bank lending to private individuals by encouraging banks to establish mortgage loans, which are perceived as less risky because of their seemingly fully collateralized nature. Mortgage lending, however, is a totally new product to be provided to a totally new set of customers, and so the state banks have understandably been slow in setting up this market.

default risk, banks have retreated from lending in the rural areas (Woo, 2000). The liberalization of interest rates combined with increased competition in the coastal urban markets will motivate the SOCBs to expand their activities in the long-neglected inland provinces and rural areas.

What has been happening in the face of strong rural industrial growth is that a lot of informal rural financial institutions have sprouted up to meet the financing needs of the rural industries. Given the illegal nature of these rural financial institutions, they live under the constant threat of closure, and so they tend to focus only on the short run and take more risks. It is not surprising that these risky rural financial institutions have often failed. Whenever they have failed, the government has had to bail them out in order to maintain political stability. The government has therefore been clamping down even harder on these illegal financial intermediaries, because the government does not want to choose between the risk of bailing them out and the risk of having social instability. The government's increasingly strict enforcement of the ban on private financial intermediation is exactly the opposite to what ought to be done. The efficient solution is to allow private financial intermediaries in the rural area, and bring them under proper prudential supervision.

The general principle, and a trend that the Chinese government will find increasingly costly to prevent, is to reduce interest rate controls and allow private banks to come into existence. The improvement in financial intermediation induced by WTO membership can help to eliminate the liquidity trap and reduce the paradox of thrift through improved financial intermediation, and hence ease the task of macroeconomic management.[4]

The entry of foreign banks will also improve financial intermediation by enabling the transfer of modern banking technology through a seldom-mentioned channel. In the future, when a successful Chinese enterprise group establishes a bank, it will do so by hiring away the local managers employed by the foreign-owned banks. This is exactly the Southeast Asian experience, where the top managers of all the biggest domestic banks were all ex-employees of foreign banks. This is perhaps what the Chinese leadership sees and why it is willing to allow the entry of foreign banks, giving them national treatment within 5 years of WTO membership. The Chinese leadership must surely be betting that in the short run, there could be significant displacement of Chinese state banks by foreign banks, but in the long run, Chinese banks (most likely private ones) will rise in importance. Twenty years from now, the international financial world may have more to fear from Chinese banks than vice versa.

I should also mention that entry of Western banks into China's financial markets is not the same thing as capital market liberalization. I do not believe that China would be well served by significant opening of the capital account in the next few years, because that could subject China to rapid swings of short-term capital in the same manner that has whipsawed the economies of Southeast Asia and Latin America (Sachs & Woo, 2000). The pace of capital market liberalization should depend on the pace of improvements in the capacity of the state to monitor and regulate the financial markets. With a prematurely open capital account, foreign banks could suddenly become a conduit for large-scale capital flight, for rapid swings

[4] For a formal model and empirical investigation of the macroeconomic consequences of inadequate financial intermediation (in other countries, especially in Taiwan), see Liu and Woo (1994).

in short-term lending and repayments, or as a facilitator of bank runs (in which depositors do not merely switch banks, or switch from domestic banks to domestic currency, but actually switch from domestic deposits to foreign assets).

Finally, I want to argue that if the Chinese government continues to discriminate heavily against domestic private banks, then there is really little to be gained by recapitalizing the SOCBs. The perceived solvency of the government and the credibility of its implicit guarantee of deposits are what prevent serious bank runs from happening, and not the perceived solvency of the SOCBs themselves. This suggests that one possibly effective way to slow down the pace of NPL creation in an SOCB-dominated financial system is to keep the NPLs on the books of the SOCBs, and, as suggested by Fan (in press), "the financial status of these loans should be constantly watched and openly discussed" in the public media.

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