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1. REFORM OF CHINA'S STATE-OWNED ENTERPRISES

Harry G. Broadman¹

At the heart of the seventeen year old Chinese "economic miracle" lies an industrialization strategy that has combined the introduction of market forces, gradual reduction of mandatory planning, decentralization, autonomy in economic management, and opening the economy to international trade and foreign investment. While most successful development experiences feature industrialization as the key ingredient, reform in economies undergoing transition faces serious obstacles, and there is no generic model to serve as a guide. Indeed, China has yet to put in place a complete or fully consistent alternative to the earlier centrally-planned model. But the transformation of China from a Soviet-style command system to a "socialist market economy" has pivoted on the skillful use of the country's economic and resource base.

China's economic performance is traceable to reforms that have transformed its industrial landscape into one where the share of state ownership in industrial enterprises has declined (but remains significant), and non-state enterprises, relatively unshackled by government policy and facing a highly competitive environment, thrive. This has occurred amidst an overall policy climate that increasingly simulates market conditions by encouraging state-owned enterprises to behave as commercial, profit-oriented entities. Notwithstanding this considerable progress, a significant portion of the industrial sector is still handicapped by systemic weaknesses and technological backwardness. China cannot afford to slacken the pace of reform.

CHINESE INDUSTRIAL STRUCTURE AND PERFORMANCE

Enterprise Ownership Forms and Size Distribution

There are about 9.9 million industrial enterprises in China. Of these, 104,700 are state-owned enterprises (SOEs), which are generally located in urban areas; 1.8 million are collectively-owned enterprises (COEs), both rural township and village enterprises (TVEs) and urban collectives; 8.0 million are private businesses, which are family or individually-owned private entities with no more than seven employees; and 32,100 are other types of enterprises, which include private firms employing more than seven

persons, foreign-owned enterprises, and foreign-domestic joint ventures. The vast majority of enterprises in China are of relatively small scale.

Both SOEs and COEs are "public sector" enterprises. However, because of significant differences between the two in terms of location, ownership form, property rights regime, functional structure, and the policy environment that governs their conduct and performance, COEs operate in a fashion more similar to competitive enterprises than to traditional public enterprises. While SOEs are mostly located in urban areas, most COEs are TVEs, located in rural areas. Functionally, SOEs not only carry out productive operations, but also are burdened with having to provide social services, including housing, education, hospitals, social security (pensions and unemployment, accident and health insurance), food services, and fuel and retail outlets. COEs, on the other hand, generally perform only productive functions and thus can focus more squarely on commercial objectives. Unlike SOEs, which historically have had access to on-budget subsidies from government (at the central and sub-central levels) and off-budget subsidized credits from (the state-owned) banks, COEs have had to operate in an environment free of direct fiscal and quasi-fiscal government subsidies. However, COEs do rely on SOEs as sources of capital, labor, technology, materials, and output markets. This dependence means that some of the observed superior performance of COEs may be illusory.

SOEs account for about 43 percent of the country's gross value of industrial output (GVIO); COEs account for about 38 percent (TVEs account for 26 percent); private businesses account for about 8 percent; and other firms account for 10 percent. This pattern of industrial organization is in stark contrast to that at the beginning of reform. In 1978, the share of GVIO accounted for by SOEs was about 78 percent and collectives accounted for about 22 percent. While the non-state sector has been the major source of employment growth since the beginning of reform, SOE employment is growing, and today about 70 percent of Chinese industrial workers at or above the village level are still employed in SOEs. SOEs also provide a disproportionate share of tax revenues for government at virtually all levels—the center, provinces, municipalities, and counties. As a result, SOEs represent a pivotal, perhaps *the* pivotal, resource—acting as both a determinant and a constraint—in China's economic policy choices.

Enterprise Performance

Although small in scale and occupying relatively specialized market niches, non-state enterprises have proven to be powerful generators of employment, output, and exports, and are generally efficient and dynamic. Perhaps most

important, the emergence and rapid growth of these firms has done much to change the competitive market environment in which *all* enterprises operate, including SOEs. Notwithstanding the salutary effects of non-state firms on the degree of competition in the market, many—though by no means all—SOEs continue to have serious problems. In part, these problems are structural: (a) excessive and rigid patterns of corporate integration (e.g., extensive vertical integration and/or exaggerated diversity of product lines); (b) use of obsolete and often inappropriate technology; (c) virtual absence of multiplant economies of scale, especially across regions; (d) prevalence of plant production designs at less-than-minimum efficient scale; and (e) excessive investment in heavy industry at the expense of higher value-added activities, including services. In addition, SOEs' performance suffers because of the "social burdens" they carry.

China's economic reform program has had a strong, positive impact on SOE structure, output growth, and performance. Total factor productivity growth has increased, and hundreds of otherwise unprofitable, smaller SOEs have been closed or transformed into joint ventures or collectives. A significant number of SOEs are also on the technological frontier, developing new products and processes and effectively diffusing such innovations in the markets they dominate. A growing number of SOEs are not only increasingly economically successful in the domestic market, but have also become major exporters and international investors.

Still, many large and medium-sized SOEs continue to exhibit poor performance. For example, while annual total factor productivity for SOEs is rising, its growth is only about one-third to one-half the corresponding rate for non-state enterprises. SOE losses are sizeable, estimated at between 2.4 percent and 5.3 percent of GDP annually. As a result, many SOEs have required substantial fiscal and quasi-fiscal public subsidies, often occurring in a disguised manner through the financial system as directed credits. While explicit and implicit fiscal (i.e., on-budget) subsidies as a percent of GDP have been declining in recent years (from about 5.9 percent in 1990 to about 3.5 percent in 1993), quasi-fiscal (i.e., financial system) subsidies as a percent of GDP have been increasing (from about 3.8 percent in 1990 to about 6.0 percent in 1993). The net result is that total subsidies to SOEs are large and remain virtually unchanged. This is an unsustainable structural situation and has obvious implications for macroeconomic performance, resource allocation and social stability.

Pollution associated with China's burgeoning industrial growth, including reliance on high-polluting heavy industry, continues to exact a sizeable toll on the Chinese people and the environment. China's industrial

sector—not only SOEs but also non-state enterprises—is the major generator of massive water, solid waste, and air pollution in the country.

HISTORICAL SOURCES OF CHINA'S INDUSTRIAL SECTOR PROBLEMS

There are three main historical sources of the problems of China's industrial sector: (a) inefficient internal enterprise incentive and governance systems; (b) a distorted policy and regulatory regime; and (c) lack of well-developed factor markets. Inefficiencies in internal incentive and governance systems are rooted in the earlier regime of central economic planning, under which SOEs were generally established by administrative fiat rather than by market forces and thus suffered from poor "initial condition" decisions with respect to location, scale, product lines, capital-labor mix, and technology; the linking of SOEs' productive functions with the provision of social services; and the administrative involvement of government in SOE business decision-making.

The policy and regulatory regime—comprising taxation, credit, price regulations, direct subsidies, tariff and nontariff trade barriers, foreign direct investment rules, and environmental regulations—has attempted to channel incipient market forces to serve often-conflicting policy goals. Many of these policies have been incoherent and uneven in application, causing distortions in resource allocation, both across regions and industries. While there has been improvement in recent years on many of these fronts, problems remain; in some cases, progress has regressed, e.g., some eliminated price controls have been re-instituted. A particularly visible weakness of the regulatory regime is environmental protection.

The absence of viable and flexible factor markets has also made the transition to a market economy difficult. With capital markets still at an early stage of development, firms that are dynamic have relied mainly on internally generated savings, while money-losing firms have received subsidies from the government; bankrupt firms have been artificially kept in business. Rigidities in labor markets due, among other things, to the absence of a free-standing "social safety net" have made it difficult for the movement of workers from areas with excess supplies of labor to areas with excess demand for labor, and for SOEs to shed labor as they have sought to become more efficient. While technology markets have emerged with much improved patent and trademark protection, immobility of scientific personnel, small production scales, and restrictions on entry of certain foreign investments still impede the transformation of research and development

(R&D) discoveries into marketable products and processes and technological diffusion.

THE RECORD OF CHINA'S INDUSTRIAL REFORMS

The Chinese authorities have recognized that the nation's pace and pattern of industrial growth must be sustained if economic development is to proceed. As a result, since the market opening of the country in 1978, a series of reforms were launched that decentralized economic decision-making, introduced market forces and competition into the industrial sector, and liberalized the external sector. Achieving even better industrial performance and sustaining high rates of economic growth have required that China accelerate the earlier reforms of its overall industrial organization, and more recent reforms have tended in that direction.

Achievements from 1978 to the Present

Throughout the 1978-92 period, numerous reforms were introduced, almost always in the Chinese gradualist and incremental style, and often first as experiments in certain regions and then replicated in other locales. The most salient policy experiments during the period included the introduction of the Contract Responsibility System (CRS), "corporatization" of SOEs, and the New Operating Mechanism (NOM) and the subsequent codification of its 14 Autonomous Management Rights. In addition, prices and production were increasingly decontrolled, and trade and foreign investment liberalized. Furthermore, labor, capital, and technology market reforms were introduced.

The period since late-1992 has witnessed several significant new tranches of enterprise reforms. The reaffirmation of the leadership's commitment to economic reform launched in the 1980s was first made evident in October 1992 with the change in the official economic philosophy from a "planned economy on the basis of socialist public ownership" to a "socialist market economy." In November 1993, the 3rd Plenary Session of the 14th Party Congress issued the Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure. This Decision outlines a 50-point agenda for economic reform to be attained by the end of the century across an unprecedented array of interrelated fronts, including: (a) creating a "modern enterprise system;" (b) encouraging the development of diversified ownership forms of enterprises, including the "privately owned, individually owned, and foreign-invested" sectors; and (c) requiring the state to provide for different ownership forms of enterprises to be able to compete on "equal terms" in the marketplace. The Decision is undoubtedly the most ambitious

plan for China's economic reform since the launching of reform in 1978, and may well prove to be a watershed in China's modern economic history. But it is only a blueprint statement of principles and does not contain a detailed plan for implementation. Establishing a program for implementation of the agenda embodied in the Decision is the challenge now being undertaken by the Chinese.

The "10,000 - 1,000 - 100 - 10" enterprise reform experiment, announced in January 1994, is the latest effort in this regard. This reform will provide for: 10,000 large SOEs to adopt completely within 2 years the new accounting standards (introduced in July 1993), new asset evaluation techniques, and the full set of the "14" autonomous management rights; 1,000 large SOEs to adopt within 2 to 3 years the new state asset administration regulations (promulgated in July 1994) and to delegate within 2 to 3 years their assets to a state assets supervisory committee, charged with deciding on methods to enhance asset value; 100 large and medium-sized SOEs (within 2 years) to be fully "corporatized" as limited liability or limited liability shareholding companies under the Company Law; and 10 municipalities to undergo comprehensive urban enterprise, economic, and social policy reform, including SOE restructuring, technology upgrading, mergers and consolidations, bankruptcy, and divestiture of social services. In fact, 18 rather than 10 pilot municipalities have been chosen for "comprehensive urban reform."

Remaining Problems to be Addressed

Notwithstanding the real progress of China's industrial reforms to date, several problems remain unresolved. First, reforms have not appreciably squeezed out economically wasteful resource use in most SOE operations, nor raised the productivity of resources employed in economically efficient uses to technologically feasible levels. Second, they have not provided for sufficiently market-based governance autonomy and risk-reward incentive structures for SOE management. Third, reforms have not effectively reduced on a broad scale certain distortions in the policy regime governing enterprise conduct and performance. Finally, the reforms have not engendered self-sustaining factor markets, without which the efficient performance of industrial enterprises is ultimately constrained.

Dealing with "the SOE problem" is still central. What is required is to modify the existing proactive policy regime into one that combines: (a) a program for phasing out SOE fiscal and quasi-fiscal subsidies; (b) a nurturing environment that allows for autonomy of management, recombinations of corporate assets and open exit and entry; (c) the shedding of redundant labor

and enterprise social service responsibilities, while simultaneously ensuring the existence of a government-sponsored "social safety net;" (d) creating employment growth conditions, particularly in high value-added services industries; and (e) development of an independent, viable financial system.

THE AGENDA FOR FURTHER REFORM OF CHINA'S INDUSTRIAL SECTOR

China's government has charted an ambitious agenda for the continued development of the country's industrial sector. It generally reflects the objectives articulated above and seeks to modernize enterprise incentive and governance systems and diversify corporate ownership; improve further the policy and regulatory regime; and develop factor markets.

Modernizing Enterprise Incentive and Governance Systems

Separating the Government and Productive Sectors. Building on past reforms, efforts must continue the process of delegating business decision-making to SOEs, imposing hard budget constraints, and creating a market-oriented institutional framework for the state to exercise its ownership rights over its assets. In particular, SOE governance structures, property rights, and managerial control mechanisms are sorely in need of realignment with principles of economic efficiency and greater specificity. The role, function, and structure of the system of state asset administration also need significantly greater refinement.

Restructuring SOEs. Because of their continued critical role in the economy and the absence of fully developed factor markets, many SOEs require a proactive policy of restructuring. Ignoring the problems posed by the lack of a proactive restructuring policy risks incurring unnecessary resource costs and social reversals that could delay the transition to a market economy. Further reform efforts must focus on: (a) creating a nationwide market-driven restructuring capability that would have a multiplier effect across many industries and allow enterprises to consolidate, diversify, divest, exit, and engage in asset sales and purchases so as to recombine capital and labor in new ways; (b) establishing mechanisms for enterprises to pass many of their social service burdens to government so that they are financed through public revenues (or in the case of housing, passed to newly developed markets); (c) creating credible and politically viable mechanisms to shed redundant labor, ease the adjustment of displaced workers into the labor market, and create new employment opportunities, particularly in high

value-added services activities; and (d) increasing the pace of corporatizing enterprises.

Enhancing the Policy Environment for the Non-State Sector. The Third Plenum's Decision calls for a policy context that moves from "benign neglect" to active encouragement and development of non-state enterprises. Implementation of this policy objective will necessitate the establishment of: (a) clearly and well-defined property rights for non-state enterprises and the management autonomy and obligations that go with them; (b) broad policy neutrality across enterprise ownership forms; and (c) equal access to factor markets, especially the financial system, for state and non-state enterprises.

Improving the Policy and Regulatory Regime

Reducing Distortions in the Policy Framework. Further reforms are needed regarding: (a) prices, to completely decontrol lingering price ceilings and further rationalize relative prices (e.g., in the energy, grain, and cotton sectors); (b) investment policy, to eliminate directed credit allocation schemes and rationalize and limit on- and off-budget financing and investment approval plans; (c) competition and regulatory policy; (d) foreign trade policy, to continue the liberalization of import tariff and nontariff barriers, especially the import license regime, the elimination of remaining indirect export subsidies, and the further granting of direct export and import rights to enterprises (of all ownership types); (e) foreign direct investment policy, to streamline the regulatory apparatus governing screening of foreign direct investment as well as to further open the sectors in which such investment is permitted; and (f) tax policy, to establish greater neutrality among economic activities and across income groups.

Mitigating Industrial Pollution and Environmental Damage. There remains considerable scope for improvements in integrating environmental management effectively into economic policies. The pollution management system still relies heavily on administrative command rather than market-based mechanisms. There is thus a need to improve economic incentives to adopt clean production techniques and waste disposal, which includes the imposition of fees, fines, and compensation payments on any enterprise that fails to meet environmental standards. Enforcement of penalties and collection of levies are currently weak. Further reforms must focus on: (a) eliminating pricing policies that encourage excessive energy and materials consumption; (b) the implementation of regulatory incentives/disincentives that internalize the costs of pollution; and (c) strengthening regulatory institutions for pollution control, including monitoring and enforcement capabilities.

Developing Factor Markets

Enhancing the Labor Market. Development of a labor market is hampered because SOEs remain burdened with social service functions, notably the provision of housing, education, health services, and social security (i.e., pensions and unemployment, accident and health insurance). Moreover, notwithstanding the gradual introduction of the labor contract system, SOEs are burdened with the obligation of providing permanent employment to their workers. There is an urgent need to design implementable programs to accelerate the establishment of: (a) government sponsored education, labor retraining, job information networks, and unemployment compensation; (b) employer-employee funded portable pensions; and (c) commercial housing markets.

Capital Market and Financial Sector Reform. Restructuring of "real sector" enterprises requires that commercial banks, investment and merchant banks, and nonbank financial institutions have an incentive to intermediate funds so that firms can afford new investments in technology and machines. The government believes creating the mechanisms for monetary control is a top priority. Reforms being planned or already underway include: (a) development of indirect monetary policy instruments, such as open market operations, gradual liberalization of interest rates, development of government securities markets, and creation of a modern payment system; (b) institutional restructuring of the People's Bank of China (PBC) to facilitate centralized monetary policy management; (c) the transformation of the state specialized banks into commercial banks; and (d) the establishment of a system of policy banks, including a state development bank, an agricultural policy bank, and an export-import bank.

Promoting Diffusion of Technology. The government is now committed to speeding technological innovation through: (a) improving enforcement of recently implemented intellectual property legislation; (b) providing for the mobility of technical personnel from academic research institutions into the productive sector; (c) creating market-driven engineering agents to adapt international and domestic technology to local inputs and conditions; and (d) fostering the transfer of technology from abroad through foreign investment, licensing, and "build-operate-transfer" (BOT) or turnkey contracts.

CONCLUSION

China's economic growth has been sustained because the economy has been decentralized and there has been increased autonomy ceded to state-owned

enterprises and opportunities for growth in the non-state sector. Consolidation of the successes engendered by that strategy requires further fundamental reforms, i.e., changes in the internal incentive and governance systems of SOEs, such as through clearer definition of property rights, and greater ownership diversification.

At the same time, the SOE market environment needs to be enhanced through: greater price competition; development of bona fide markets for labor, capital, and technology; and reduction of inter-regional and international barriers to entry and exit. The SOE-based social welfare system also needs to be reformed. Imposition of a "hard budget constraint" will require phasing out subsidies, collecting taxes, and eliminating inter-enterprise debts and soft bank loans.

Achieving China's goal of industrial modernity will require farsighted policies backed by resource mobilization on a scale equivalent to the recent past. China cannot afford to slacken the pace of change. It must continue down its path of incremental implementation of reforms. In no small way that has been part of the secret of China's economic success and its ability to maintain growth.

Note

1. This paper draws upon an earlier report by the author, *Meeting the Challenge of Chinese Enterprise Reform*, which was published by the World Bank in April 1995.

24. BANKING REFORM

China's Banking Reforms

"Description of China's Financial Institutions and Markets," Internal Memo, Federal Reserve Board, April 22, 1998.

"Financial Sector Reforms in China," Hassanali Mehran, IMF.

"Banking Sector Development and Policy Issues." IMF

China's Banking Reforms

China's leaders last November convened an extraordinary national financial conference--attended by top central and provincial officials--to respond to the Asian crisis, and bank officials since then have unveiled a series of banking reforms. China's central bank governor Dai Xianglong has stated the goal of the reforms is to establish a "modern financial system" appropriate for a market economy in three years. The reforms include:

- Restructuring the central bank during the next three years by eliminating many of the roughly 40 provincial branches and establishing a structure similar to the US Federal Reserve with about 10 regional offices. The intent is to reduce interference by municipal and provincial officials into central bank operations. About 50,000 jobs may be lost during the restructuring, according to a Hong Kong press report.
- A similar reorganization--by eliminating or merging many municipal branches--of the four large state commercial banks that dominate the banking system during the next three years. Central financial officials intend that these banks focus their operations on large cities and large enterprises in key sectors, and expand their activities overseas to gain experience in international investment banking, according to press reports.
- Establishing about 200 new local banks in smaller cities to replace the branches of the four large state banks and provide loans to non-state as well as state firms.
- Scrapping mandatory credit quotas for the four large state commercial banks as of 1 January in favor of a so-called asset-liability ratio credit management system in which the growth of lending is limited by the growth in deposits. China's 14 smaller commercial banks already had shifted to this system.
- A special issue of 270 billion yuan in treasury bonds later this year to recapitalize the four large state commercial banks. The state banks will buy the bonds using funds released by the lowering of the required reserve ratio by 5 percentage points in March, and then the Ministry of Finance will use the proceeds from the sale of the bonds to recapitalize the four largest state commercial banks, according to Hong Kong press. China's central bank governor Dai has stated that the banks will raise their capital adequacy ratios to 8 percent this year, according to official Chinese press.
- Replacing the existing system of classifying loans that is based strictly on performance with a new risk-based system closer to international standards by the end of 1998.
- A national audit of financial assets starting in April to more accurately determine the volume of non-performing loans and who is responsible for them. Chinese banking officials acknowledge that 20 percent are nonperforming, but that only about 5 or 6 percent are ultimately nonrecoverable.

Financial Reforms

The Chinese banking sector is in worse condition than those of Korea and Thailand just prior to the onset of the Asian financial crisis. However, Chinese banks are mostly state-owned and are unlikely to collapse under pressure. Nevertheless, reforming the banking sector is vital to the modernization of the Chinese economy. Since the SOEs are the major recipients of bank credits, the restructuring of the banking sector and the reform of the SOEs must move in tandem. The Chinese government has concluded from the recent Asian financial crisis that its domestic banking sector must be strengthened before its financial sector can be opened.

- It is estimated that about 25 percent of total outstanding loans are non-performing.

The government announced recently that it would issue 270 billion yuan (\$33 billion) worth of special bonds to recapitalize the four big state banks which account for 90 percent of bank lending. The funds for recapitalization, however, will come from the banks' deposit reserves which are not counted as bank capital. The reserve requirements for banks were lowered in March to 8 percent from 18-20 percent, thereby releasing fresh funds to the banking system. The four big state banks are required to use part of the newly released funds to purchase 270 billion yuan worth of treasury bonds which will be counted as part of their capital.

- Government-directed bank lending policy has been abolished. The government in January abolished its past system of assigning lending quotas to banks based on the annual credit plan established by the State Council. Future lending will be based on commercial criteria.
- China's central bank, the People's Bank of China, will be reorganized to reduce local officials influence on the lending policy of its local branches. Provincial offices of the People's Bank boundaries will be established.
- State banks were ordered recently to adopt international standards in classifying their loans.
- The government plans to develop a mortgage market which should broaden the lending activities of the banks.

INTERNAL FR

John Fernald
April 22, 1998**Description of China's Financial Institutions and Markets****Overview**

- Under central planning, finance plays a passive role. As China has moved away from the plan towards the market, a more active and diverse financial system has developed. Ultimately, China hopes to develop a system that allocates resources efficiently and sharpens indirect instruments of macroeconomic control such as open market operations.
- The People's Bank of China, the central bank, supervises the financial system.
- The next most important set of financial institutions are four specialized state banks: the Bank of China, the Industrial and Commercial Bank of China, the Agricultural Bank of China, and the China Construction Bank. These banks have been given considerable leeway in recent years to seek business in new areas, but the banking system remains highly segmented and uncompetitive.
- Three new policy lending banks were established in the first half of 1994 to take over some of the quasi-fiscal policy lending of the state banks, such as for fixed investments in priority projects. They are funded primarily by selling domestic bonds to the state banks; hence, the state banks still bear some of the risk of these policy loans. In addition, the state banks continue to provide substantial quasi-fiscal lending, especially for working capital as opposed to lending for fixed investment.
- Foreign bank presence in China remains relatively small and circumscribed. At the end of 1997, there were 142 foreign bank branches in China; Japanese banks have the greatest presence, followed by Hong Kong banks. Four U.S. banks had branches in China in 1996, with total assets of \$1.0 billion. In addition, 26 U.S. banks had representative offices.
- In early 1997, China licensed nine foreign banks, including Citibank, to undertake local-currency business for foreign-invested enterprises and foreign nationals. Chinese authorities have not fully defined the limits on local-currency activity, but it appears these banks must rely on renminbi deposits to make renminbi loans, with the total quantity of these loans limited as well by the quantity of foreign-currency deposits.
- In January 1996, China established a unified national interbank market. Previously, the interbank market in China was fragmented into numerous local markets and much "interbank" activity was, in fact, between branches of the same bank. Since July 1996, interbank interest rates have been market determined.
- In 1990, securities exchanges opened in Shanghai and Shenzhen. Trading involves government and enterprise bonds as well as shares in joint-stock companies. The capitalization of China's stock markets was about \$200 billion at the end of 1997. Share prices have tended to be volatile.

Introduction

Under Chinese central planning, finance played a passive role. The state designed a physical plan and the credit plan accommodated it. As China has moved away from the plan and towards the market, a more active and diverse financial system has developed. However, financial reform remains incomplete. A major problem is that financial reforms are integrally connected with reforms in other areas such as state-owned enterprises and tax collection. Ultimately, China hopes to develop a financial system that allocates resources efficiently and facilitates the use of indirect monetary instruments such as open market operations.

The remainder of this note describes Chinese financial institutions and markets, and foreign involvement in China's financial markets.

Domestic Institutions

The People's Bank of China (PBOC), the nation's central bank, is at the core of the system. The PBOC sets monetary policy subject to the approval of the State Council, China's cabinet. The PBOC regulates banks and many other financial institutions. (See the separate note on the PBOC.)

The next most important set of institutions are the four major state commercial banks, which primarily lend to the state-owned sector. As of September 1997, these four banks held 70 percent of the assets of China's financial system. Traditionally, these banks have specialized in their operations.¹ All four state banks have in recent years been permitted to seek business in areas not originally intended for them. Nevertheless, banking operations remain highly segmented, minimizing the competition among these banks. Typically, half or more of specialized bank lending has been at the direction of some level of government, either to state-owned enterprises (SOEs) or to desired policy projects such as infrastructure investment. A Commercial Bank Law, enacted in 1995, seeks to make the banks act more like traditional Western commercial banks. Both Chinese and Western analysts suggest that the banks are unlikely to act on a fully commercial banking basis for some time. For example, few bankers have the skills to properly assess credit quality. However, the banks have begun making progress by, for example, improving local branch reporting, implementing asset/liability controls, and investing heavily in new technologies.

Enormous quantities of bad loans remain on the books of the banks. Government authorities acknowledge that more than 20 percent of bank loans are nonperforming, although they usually argue that only 5 to 6 percent of loans

¹ The Industrial and Commercial Bank of China provides fixed and working capital to industrial areas; the Agricultural Bank of China does the same in rural areas. The Bank of China traditionally handles all foreign exchange transactions, while the China Construction Bank (until recently called the People's Construction Bank of China) provides financing for construction projects.

are unrecoverable. Western observers usually estimate that the proportion of non-performing and unrecoverable loans is much higher.

Three new policy lending banks were established in the first half of 1994 to take over some of the quasi-fiscal policy lending of the state banks, such as for fixed investments in priority projects. The State Development Bank and the Agricultural Development Bank took over directed domestic-policy lending, while the China Export-Import Bank provides foreign trade financing. Although they receive some state revenue and have issued several international bonds, they are funded primarily by selling domestic bonds to the state banks; hence, the state banks still bear some of the risk of these policy loans. In addition, the state banks continue to provide substantial quasi-fiscal lending, especially for working capital as opposed to lending for fixed investment.

Other banking institutions are smaller than the state banks but of growing importance. These include several smaller commercial banks (such as the Bank of Communications, which has a branch in the United States), created to increase competition in the financial sector. Other institutions include several provincial development banks, and an extensive network of rural and urban credit cooperatives.

The nonbank sector has grown steadily since 1978. In terms of assets, the most important nonbank financial institutions (NBFIs) are trust and investment companies, whose activities include domestic currency loans, direct investment, and trust business (e.g., intermediating lending by one enterprise to another). The People's Insurance Company of China accounts for about three-quarters of China's insurance market. Other institutions, though relatively small, continue to expand rapidly. As new financial institutions have developed, the regulatory framework has often not kept pace, contributing to the difficulties faced by the center in seeking to control the economy.

Foreign Institutions

Foreign bank presence in China remains tightly restricted. Foreign bank branches may operate in only 24 cities and, except for the nine foreign banks in Pudong that are allowed to provide renminbi service, foreign banks are limited to foreign currency business. At the end of 1997, there were 142 foreign bank branches in China, with total assets of \$38 billion (equal to about 3 percent of the assets of the domestic financial system). More than 500 other foreign financial institutions had representative offices in China. Japanese financial institutions had the greatest representation in China, accounting for about one-quarter of branches or representative offices of foreign financial institutions; Hong Kong institutions had the second greatest representation, accounting for about one-eighth of offices. In 1996, four U.S. banks had branches in China, with total assets of \$1.0 billion. In order of assets, the banks were Citibank, Bank of America, Chase Manhattan, and First National Bank of Chicago. In addition, 26 U.S. banks had representative offices.

In early 1997, China licensed nine foreign banks, including Citibank, to undertake local-currency business for foreign-invested enterprises and foreign nationals. Only 35 percent of liabilities can be denominated in local currency, and only about 8 percent of local-currency loans can be funded from the interbank market (described below). Hence, these banks must rely on renminbi deposits to make renminbi loans, with the total quantity of these loans limited as well by the quantity of foreign-currency deposits.

Three foreign insurance companies, including the American International Group (AIG), operate in Shanghai or Guangzhou, the only cities currently open to foreign insurers. A number of foreign brokerages, securities companies, and accounting firms also operate in China, mostly in Shanghai and Shenzhen.

Money and Capital Markets

In January 1996, China established a unified national interbank market. Previously, there were numerous fragmented interbank markets, and much "interbank" activity was, in fact, between branches of the same bank. This short-term money market has never been a strictly interbank market, since it still includes numerous non-bank financial institutions (NBFIs). Lending and borrowing can now take place for periods up to 120 days; in the past, much of the borrowing, particularly by NBFIs, was much longer term.

The national interbank market has two levels. The first is the National Interbank Trading Center, which links the headquarters of the commercial banks as well as 35 Regional Finance Centers (RFCs). The second is the RFCs, which link bank branches and NBFIs at a local level. In order to clear the market, the RFC is a party to each transaction, and hence bears some liquidity and interest risks.²

China began issuing treasury bonds in 1981. These bonds were sold involuntarily to enterprises and individuals. Since 1991, China has generally relied instead on voluntary placement, although in 1993 authorities returned temporarily to involuntary placement, since interest rates did not keep pace with inflation. Even when voluntary, the placement of new bonds is not routine: the placement is conducted like a political campaign. In early 1996, China for the first time began issuing a few discount treasury bills with maturities of one year or less, in order to provide instruments for central bank intervention. Nevertheless, short-term issues remain the exception; most debt has a maturity of between two and five years. In addition, the majority of government debt issues have not been legally tradeable. At the end of 1996, the total outstanding stock of government debt was about 8 percent of GDP (equivalent

² In several conversations last fall, PBOC economists indicated that the interbank market works poorly. One major problem is that the RFCs bear the credit risk at a local level--so they are considered very safe, and everyone wants to lend to them. At the same time, borrowers do not always think they need to repay, since the RFC is owned by the PBOC. At the time, these economists suggested that reforms to the system would be implemented shortly.

to \$65 billion). Since the mid-1980s, SOEs and financial institutions have also issued domestic (though not foreign) bonds, subject to an annual quota which is generally very restrictive. (In 1997, enterprises issued about \$1 billion in bonds, but press reports suggest that issues will increase substantially in 1998.)

Secondary bond trading was introduced in 1988, and a nationwide electronic trading network was established in 1991. This secondary market lacks liquidity, however, both because not all bonds can be legally traded, and because the majority of outstanding treasury bonds are in the hands of individual investors, who tend to hold bonds to maturity. In 1995, China opened futures markets in Treasury bonds, but it closed the markets later that same year, following several market-manipulation scandals. A treasury bond repurchase (repo) market was established in 1992, with trading volume becoming sizeable in early 1996. Anecdotal evidence indicates that the repo market is often a place where securities firms and other non-banks borrow short-term from the banks, often to fund speculative activities. The domestic bond market remains closed to foreigners.

In 1990, securities exchanges opened in Shanghai and Shenzhen. Trading involves government and enterprise bonds as well as shares in joint-stock companies. The capitalization of China's stock markets was about \$200 billion (about 20 percent of GDP) at the end of 1997. China has intentionally segmented the stock market, establishing one class of shares that only domestic residents can purchase (known as A shares) and one class that only foreign residents can purchase (B shares). In addition, about 40 companies have foreign-only shares in Hong Kong, and several have shares in New York. The majority of companies with foreign-only shares also have a domestic-only share. These shares are identical except for who is allowed to own them and the currencies in which they trade (foreign-only shares trade in Hong Kong or U.S. dollars), yet they trade at very different prices. When converted to a common currency, foreigners typically pay about *one-quarter* the price paid by a Chinese resident for the same share. This pricing difference appears to reflect primarily the high prices paid by Chinese residents, who have few formal investment alternatives other than bank accounts; domestic price-earnings ratios are currently about 40.

Share prices, particularly for domestic shares, have been volatile. For example, from 1993 through 1997, the daily standard deviation of price changes for domestic shares was about 3.3 percent, compared with about 2 percent for foreign shares; by comparison, the S&P 500 Index had a daily standard deviation of about 0.8 percent over this period. Following a rapid runup in share prices in December 1996, authorities attempted to discourage stock speculation by announcing that they would not support the stock market if it fell, and by announcing an increase in new share issues for 1997. In response, the Shanghai and Shenzhen markets fell more than 30 percent over a two-week period. Early in 1997, the runup in prices resumed. In May and June, 1997, China passed a number of additional regulations, seeking primarily to limit the ability of banks to speculate in the stock market. According to one PBOC

economist, almost every commercial bank branch was involved with the stock market. Since 1995, banks cannot own securities companies. However, they continued to lend heavily to securities companies, and also traded for themselves.

Despite these restrictions, for 1997 as a whole, domestic shares rose about 25 percent, while foreign shares fell about 10 percent. Much of the difference reflects the effects of the Asian financial crisis--domestic shares were largely unaffected, while foreign shares fell sharply following declines in the Hang Seng in late 1997. As of April 15, 1998, domestic shares were up about 9 percent from the beginning of the year, while foreign shares were down about 5 percent.

What is a market interest rate in China?

China sets most interest rates administratively. Although informal credit markets exist, there is little data on those loan terms. It appears there are only two officially sanctioned financial markets with market-determined interest rates: the interbank market and the treasury bond repo market. The attached chart shows 7-day interbank and repo rates (data are Friday closing prices), as well as the one-year lending rate, which is fairly representative of official interest rates. The interbank rate tends to be relatively smooth, and is almost always *higher* than the lending rate. The repo rate is highly volatile, and has fallen substantially since mid-1997, when China restricted activity in the repo market in order to limit speculative activity in financial markets.

Planned Reforms

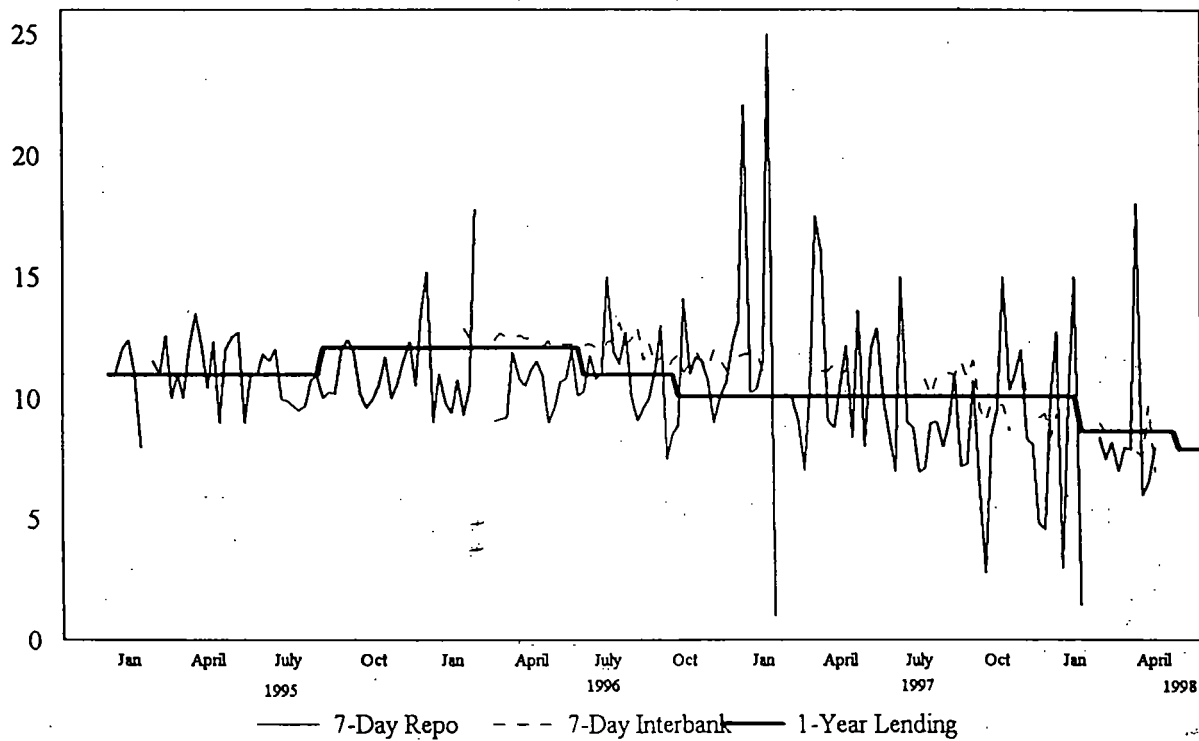
In early 1998, China announced sweeping financial market reforms, in part in response to Asia's recent financial crises. Within three years, China hopes to have a reasonably viable commercially oriented financial system, with reformed banks at the core.³ Reforms include first, removing credit quotas so that banks lend on the basis of merit and asset-liability ratios. Second, China plans to issue 270 billion renminbi (\$33 billion) in special Treasury bonds to increase the capital of the four major state banks, with a stated goal of helping them reach a minimum capital-adequacy ratio of 8 percent. (It appears that the bonds will be sold primarily to the banks, who will purchase them using funds freed up by a reduction in required reserves. Nevertheless, the move has the advantage of making explicit that the government takes responsibility for at least some of the bad loans on the books of the banks.) Third, the PBOC announced the adoption of a five-category loan classification system based on international standards, in order to help banks spot and monitor bad loans more effectively. In April, authorities plan to begin conducting broad examinations

³ In conversation with Vice Chair Rivlin in early April, PBOC Deputy Governor Liu MingKang suggested that the timetable for financial reforms was two years, with enterprise reforms in three years.

7

of financial institutions, in part to identify the true extent of bad loans. Finally, the reforms would include restructuring the PBOC along the lines of the Federal Reserve System.

Chinese Interest Rates
Weekly Data (Friday Closing)



Financial Sector Reforms in China

HASSANALI MEHRAN AND MARC QUINTYN

国际金融机构资产(净)	171.8	181.7	185.8	175.4
中央政府债权	1582.8	1582.8	1582.8	1582.8
存款货币银行债权	9297.7	9382.1	9382.1	9382.1
非货币金融机构债权				
非金融部门				
货币				
发行货币				
对金融机构负债				
缴存准备金				
存款货币银行				
在人行存款				
存款货币银行				
非金融机构存款				

China's financial reform—an integral part of its transition to a market economy—has been characterized by pragmatism and gradualism. During the first decade of reforms, policymakers have emphasized institutional development, with the result that market development has lagged behind.

IN 1978, CHINA embarked on a gradual but far-reaching economic reform. Since then, China's economy has been significantly modernized and opened up to the rest of the world. The reform process has affected all sectors of the economy. In addition, the concept of reform itself has also evolved. The most dramatic change took place in 1992, when the Party officially recognized that a market system was not incompatible with the ideals of socialism and subsequently proclaimed the idea of establishing a "socialist market economy." The concept of a socialist market economy implies an economy in which market mechanisms govern economic interactions but the public sector maintains

ownership of the most important means of production.

In the wake of this decision, the Chinese leadership outlined and approved a comprehensive reform strategy for the remainder of the century. This strategy explicitly mentioned financial reform as a key element in efforts to create efficient financial markets in order to strengthen the authorities' capability to carry out macroeconomic management using indirect monetary instruments.

Major achievements since 1978

Financial sector development is a complex and multifaceted process. It involves the balanced development of three essential ele-

ments: institutions, instruments, and markets. Banks and other financial institutions—as well as the financial infrastructure, including the payments system—need to be established. A range of financial instruments need to be developed and made available to market participants to invest and trade. Development of the market presupposes the free operation of the price/interest rate mechanism.

Institution building started in the early years of reform with the establishment of a two-tier banking system. Gradually, the People's Bank of China (PBC) was divested of all its "commercial" activities. In 1984, the PBC became China's central bank. However, monetary and credit policy continued to take the form of a credit plan that was implemented through a set of credit quotas for each bank and direct bank financing of enterprises. Since the credit plan was an aggregation of sectoral and local financing needs done from the bottom up, an expansionary bias was inherent in the system. This impaired the PBC's ability to manage monetary developments—a problem that was not really addressed until 1992–93, when work on a new central bank law started. Central banking received a new impetus in 1995 when this law was enacted, giving the central bank the legal foundation to operate in a market environment under the leadership of the State Council.

Despite the above-mentioned dilemma, monetary policy's role in macroeconomic management has significantly increased. The PBC has introduced reserve requirements and lending facilities to commercial banks to support its monetary policy actions, which remained guided by the credit plan. However, the effectiveness of the credit plan has been decreasing since the late 1980s, mainly because its institutional coverage has lagged behind the expansion of the banking sector. In 1994, direct central bank lending to the government was discontinued, and preparations for increased reliance on indirect monetary policy instruments were started in earnest. These changes have signaled the start of the phasing out of the credit plan.

In the early reform years, four state-owned specialized banks—the Agricultural Bank of China (ABC), the People's Construction Bank of China (PCBC), the Industrial and Commercial Bank of China (ICBC), and the Bank of China (BOC)—were established to improve the allocation of financial resources to specific sectors. Starting in 1984, selected new banks were permitted to operate alongside these four banks, which, at the same time, were formally allowed to diversify their opera-

tions. During the second half of the 1980s, a flourishing network of nonbank financial institutions (NBFIs) emerged. Since then, the four state-owned specialized banks have been used to implement the government's financial policies, as laid out in the credit plan, and other banks and NBFIs have enjoyed more freedom in their operations.

The establishment in 1994 of three policy lending banks intended to channel credit to infrastructure and other priority areas, and the enactment of China's new commercial bank law in 1995 are meant to encourage market-based management and pricing principles. Chinese lawmakers also intend to sepa-

“... financial reform has not followed a rigid, comprehensive blueprint but instead has been characterized by pragmatism and gradualism.”

rate banking from other business. New legislation designed to regulate and streamline NBFIs is being formulated.

The development of financial instruments has been limited to the capital market. No nationally integrated money market has as yet been developed, and most banks lack the skills to develop new products that could create competition in the financial sector. Local interbank centers have been emerging since 1986. Although they have played a useful role in the local redistribution of surplus funds, they have not operated as interbank markets in the traditional sense. Since NBFIs and even some enterprises can participate, these centers often serve as channels for long-term financing of nonbank and nonfinancial institutions, thereby circumventing the credit plan.

The absence of nationally organized money markets—one of the salient features of China's financial sector in the early 1990s—is related to its slow start on interest rate liberalization, its lack of a modern payments and settlement infrastructure, and the banks' inefficient administrative organization. The lack of nationally integrated interbank and money markets has, in turn, hampered efforts to achieve the transition to indirect instruments of monetary policy. In the absence of an interbank market where surplus funds could be redistributed, the existing indirect instruments have been used to channel liquidity from one region or entity to another. The authorities have regulated liquidity by adjusting reserve requirements and using the PBC's

lending facilities for banks while maintaining relatively stable interest rates.

Capital market development, though, has become one of the striking features of China's reform process. In 1981, the authorities resumed the issuance of government securities, mainly to complement financing provided through the credit plan. Shortly thereafter, the authorities permitted the issuance of other types of bonds—including enterprise bonds—and enterprise shares, even though they remained strictly controlled in order to avoid conflicts with the priorities set in the credit plan. Since 1988, secondary markets in bonds and stocks have been allowed to operate, which has further boosted capital market development. The stock exchanges of Shanghai and Shenzhen have become the exponents of China's flourishing capital market activity.

For most of the period since 1978, market development and liberalization have lagged behind institution building, at least in the domestic financial sector. An attempt at liberalizing interest rates

during 1986–88 (banks were allowed to set lending and deposit rates freely within specified margins above the administered rate) was brought to a temporary halt in the mid-1980s because of the inflationary developments of 1988–89. Since the early 1990s, banks and NBFIs have again been granted the freedom to vary lending rates within prespecified margins, with the width of the margin depending on the type of institution.

Market development has made significant strides in the foreign exchange sector. The establishment of swap centers in 1986 marked the introduction of an embryonic foreign exchange market in China. Until 1992–93, turnover in this market, which was organized under the supervision of the State Administration for Exchange Control, grew steadily. A new phase started at the beginning of 1994, when the exchange rates between the different swap centers (swap rates) were unified and one national foreign exchange market was created. At the same time, the official rate and swap rate were unified.

How were reforms introduced?

Like reforms in other sectors of the Chinese economy, financial reform has not followed a rigid, comprehensive blueprint but instead has been characterized by pragmatism and gradualism. In short, reform in China has been evolutionary rather than revolutionary. The size and diversity of the country, as well as the decentralization of decision making early in the reform process, have allowed policymakers to adopt

small-scale experimental approaches—which were subsequently adopted, in some instances, on a national scale—and be selective in starting reforms.

Examples of this approach in the financial sector include opening local interbank centers in selected cities in 1986 and secondary markets in government securities in six cities in 1988. In both instances, other cities were allowed to pursue these courses of action after the authorities had received sufficient indications that the initial experiments had been successful. The establishment of stock exchanges at the end of the 1980s is a third example. The local authorities in Shanghai and Shenzhen initially encouraged the development of stock exchanges in their cities without support from the national authorities. In 1990, the central government recognized Shanghai's as the nation's major stock exchange experiment. In 1991, it went on to recognize the development of the Shenzhen exchange. At the same time, stock exchange experiments in other cities were put on hold.

Selectivity in undertaking reforms is closely linked to the experimental approach. At the beginning, the Chinese authorities selected certain provinces or regions to play leading roles in the reform process. The Special Economic Zones (SEZs) are the most striking examples of this: they were allowed the autonomy to offer special (financial and other) advantages to attract foreign investors. Branches of foreign banks could be opened in the SEZs. Credit quotas were more flexible, and bank branches were allowed more freedom in setting their lending and deposit rates in SEZs than elsewhere in China. As a result, economic growth in the SEZs has far outpaced that in the rest of the country.

Intermediate control mechanisms have been established to smooth the transition from one economic system to the other and to familiarize economic agents with the features and mechanisms of the newly emerging system. Examples are the establishment of a two-tier pricing system (1984), the introduction of a swap market in foreign exchange retention rights (1986) to improve the use of foreign exchange, the introduction of indirect monetary policy instruments (1984), the granting of freedom to the banks in setting interest rates (1986), and the establishment of local interbank markets to encourage banks' liquid asset management (1986).

Assessment

Financial development in China started from a very low level, since the financial sec-

tor was almost nonexistent. Seen against this background, China's record of financial sector development is impressive; nonetheless, its agenda for further reform remains highly challenging. An assessment of China's achievements in developing its financial sector reveals that the authorities have thus far devoted more effort to institutional development than to the process of creating markets, including the liberalization of financial operations, while the development of financial instruments has been confined to the capital markets. This perceived imbalance in development arises principally from the position of

"China's record of financial sector development is impressive; nonetheless, its agenda for further reform remains highly challenging."

China's financial system at the end of the 1970s and the authorities' preference for an intermediate macroeconomic control system.

The monetary sector in particular was at the heart of this control mechanism whereby, de facto, control techniques of a planned economy continued to dominate and market-based techniques served only a complementary role. This combination reflected the authorities' desire to use the newly established financial sector, for as long as possible, as the main vehicle for an interventionist economic development strategy. The line adopted by the Chinese leadership with respect to the role of the emerging financial sector in the economy is very similar to the approach taken by the authorities of several other East Asian countries and reflects a conviction that maintaining tight control over the sector's price mechanism would ensure that it remained an important vehicle in the government's financial allocation policies. This control has continued to take the form of administered interest rates, directed credits, and accompanying interest rate subsidies.

Agenda for continuing reform

The upshot of the strategy adopted thus far is that future financial reforms will need to emphasize liberalization measures focused on interest rates and the exchange system.

The strategy adopted by the Third Plenum of the Fourteenth Central Committee of the Communist Party in March 1993 implicitly recognized that if the imbalance between

institution building and market liberalization in the financial system were protracted, it could become an impediment to further liberalization and a better allocation of financial resources in the Chinese economy.

To be successful, domestic and external financial liberalization will need to be underpinned by other reforms, including an accelerated commercialization of state-owned banks, establishment of effective banking supervision, and reform of the accounting system used by the banks. Liberalization, in turn, will give a new impetus to money and capital market development and the concomitant development of new financial instruments. These reforms, taken together, will facilitate the development of indirect monetary policy instruments, which will complete China's transition to a market-based financial system.

In 1995, preparations started for the development of a nationally integrated interbank market in 1996 and a phased liberalization of interest rates that is to be completed by 2000. Both projects are to some extent intertwined, since the first phase of interest rate liberalization will focus on interbank rates. A phased interest rate liberalization, starting in January 1996, will allow the authorities to address problems posed by the precarious position of the state-owned enterprise sector—the main reason why interest rate liberalization was postponed for a long time.

Lessons learned

What lessons can the rest of the world draw from China's experience with the development and reform of the financial markets?

• First, China's 15-year experience clearly underlines the importance of building a widely and deeply developed banking system. Starting from a system in which a few "banks" operated as government departments assigned to implement the authorities' credit plan and, in fact, had a mere accounting role, the authorities have managed to establish a fairly diversified financial sector with universal and regional banks and a variety of NBFIs. While this sector has contributed to the country's high savings ratio and its rapid pace of monetization, it has fallen short as a mechanism for channeling financial resources to the most productive sectors.

• Second, one aspect of institution building that did not receive sufficient attention during the first decade of reforms is the enactment of legislation to support financial market development. Central bank and commercial bank laws were enacted as recently as 1995, while

other key legislation, covering such subjects as NBFIs and negotiable instruments, is still in preparation. The lack of a solid legislative underpinning has certainly had an adverse impact on China's financial reforms. For instance, as emerging market forces began to have an impact and the financial system expanded, the need to strengthen the supervisory authority of the PBC was strongly felt. Initially, the PBC's relationship with the state-owned banks was only that of *primus inter pares*. The PBC managed gradually to establish its authority over the banks and the newly emerging parts of the financial system. Yet the country's political and administrative structure and the tendency to decentralize decision making, in combination with a lack of supporting legislation, initially gave the local authorities more influence over PBC branches and branches of the specialized banks than the PBC's own headquarters had. This unsatisfactory situation was finally addressed by the 1995 central bank law, which established the authority of the PBC headquarters over its branches and the financial sector as a whole.

Likewise, the lack of solid legislation has delayed the commercialization of the state-owned banks. Their protracted dependence on the government and its policies has resulted in

their failure to develop financial sophistication and prevented them from making more effective use of market instruments in their operations. In addition, their internal administrative and managerial structures, which have given branches a high degree of independence vis-à-vis headquarters, make it difficult for these banks to operate as one integrated entity within a market environment. Technical factors, such as the lack of modern accounting practices, aggravate these problems.

• Third, a gradual approach to liberalization has perhaps been postponed for too long and may have led to distortions elsewhere in the economy. While the government tried to keep a firm grip on financial market development to ensure that the banking sector remained a major vehicle for its financial policies, it could not prevent market forces from making themselves felt and, on occasion, interfering with the government's plans. The emergence of the NBFIs has no doubt enriched the financial landscape but it has also posed challenges to the government, which was forced to include certain types of NBFIs in its credit plan to ensure continued adequacy of control. In the government securities market, the "market" itself initiated secondary market trading, which was afterwards allowed officially, but this development also

posed some new challenges for the government. For instance, the market increasingly wanted to see secondary market price movements reflected in the prices of primary issues whereas the government tried to stick to administratively set prices. In 1993 and 1994, for example, the government had to raise the interest rates on its securities when they were issued, in order to meet the market's demands.

For a long time, political resistance to interest rate liberalization was strong, mainly because of the weak financial position of the state-owned enterprises. The importance of liberalization as the next step in the reform process has now been recognized. This explains why further reforms in China could now, more than during the first 15 years of its reform, benefit by applying the lessons learned by other countries—in particular, the East Asian countries—that liberalized their financial systems and adopted market-based monetary policy techniques. [F&D]

This article is based on a longer paper by the authors and others, "Monetary and Exchange System Reforms in China: Achievements and Agenda for the Future," forthcoming in the IMF's Occasional Paper series.



STAFF PAPERS

Staff Papers is a quarterly economic journal, published in March, June, September, and December. It contains historical and empirical analyses of various macroeconomic issues prepared by IMF staff members. A special section of the December 1995 issue celebrates the International Monetary Fund's first fifty years with these articles:

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ALBERTO FERRARI

III. BANKING SECTOR DEVELOPMENT AND POLICY ISSUES¹

A. Introduction

1. Over the past two decades, the banking sector has evolved from a monobank system to a two-tier system with several types of banking institutions. Reforms in recent years have sought to strengthen the commercial orientation of the banking system, which had played a central role in financing the state's economic plan in the 1980s and early 1990s and continues to face pressures to lend to loss-making state enterprises.²
2. The authorities recognize that increasing the commercial orientation of the financial sector needs to be accompanied by intensified and redirected efforts in prudential supervision—which in the past had tended to focus on ensuring compliance with credit plan targets—and strengthening banks' financial position. In this regard, accounting and provisioning rules are presently very weak, not only limiting the effectiveness of prudential supervision, but also making it difficult to assess the strength of the banking sector. Nevertheless, several indicators suggest a significant deterioration in banks' financial position in recent years.
3. The chapter is organized as follows: section B outlines, from an institutional perspective, the evolution of the financial sector in China. The present regulatory framework for banking operations is described in section C. Section D provides an overview of banking supervision, while section E analyzes the financial position of the four state commercial banks, the largest institutions in the banking system. Concluding observations are included in section F.

B. Institutional Development

4. Until the start of the reform process in 1978, the main function of the banking system was to mobilize savings to complement the financing of the economic plan, for which most investment funds were allocated through budgetary grants.³ The People's Bank of China (PBC) served as a "monobank," and its specialized departments were responsible for the

¹This chapter was prepared by Mr. Husain (ext. 34941), who is available to answer questions related to the chapter before the Board discussion.

²Sachs and Woo (1997; pages 17 and 25) quote statements by senior leaders indicating that banks continue to face pressures—particularly from local governments—to lend to loss-making state enterprises. Bashford and O'Neill (1997) quote comments by the PBC Governor stating that the central bank aims to stem the influence of local governments on bank lending to inefficient state enterprises.

³See Mehran et al. (1996) for a detailed description of financial sector development in China.

settlement of enterprises' transactions, collection of household deposits, and administration of funds for working capital and short-term investment not covered by budgetary grants.

5. During the early years of reform (1978-83), a two-tier banking system was established with the PBC fulfilling the role of a central bank but continuing to perform some commercial operations. Two specialized banks—the People's Construction Bank of China (PCBC) and the Bank of China (BOC)—which had previously operated as departments within the PBC, became independent banks specializing in the construction sector and foreign transactions, respectively. Another specialized bank, the Agricultural Bank of China (ABC), was established to take over the PBC's rural banking business, and the number of rural credit cooperatives (RCCs)—which were set up to provide small-scale rural banking services—expanded rapidly. The first nonbank financial institutions (NBFIs) in China were also formed during the early 1980s.

6. The establishment of the two-tier banking system was accompanied by a shift in the allocation of investment funds from budgetary grants to bank loans. However, the banking system continued to serve as a conduit for implementing the central plan for physical output, and the financial viability of projects and their repayment capacity were not given primary consideration in lending decisions.

7. Continued financial reforms and development during the mid-1980s supported a further rise in the share of bank loans in the total investment financing of state enterprises. In 1983, the PBC was formally established as the central bank, and a fourth specialized bank—the Industrial and Commercial Bank of China (ICBC)—was created in 1984 to take over the PBC's urban commercial operations. In subsequent years, urban credit cooperatives (UCCs) were set up to serve small individually or collectively owned enterprises. New banks were formed at the provincial level, and numerous NBFIs—including trust and investment companies (TICs), securities firms, finance companies, leasing companies, and insurance firms—were established. Measures were taken to enhance competition in the banking sector, including granting permission to the specialized banks to engage in operations outside their area of specialization; allowing banks to conduct foreign transactions; permitting the two new "nationwide" or "universal" commercial banks to compete with the specialized banks in all forms of business; and allowing foreign banks to open branches in special economic zones, albeit only for foreign trade-related operations. These financial reforms coincided with a further cut in budgetary support for state enterprises and an expansion in enterprises' control over their after-tax profits, thereby boosting the importance of financial intermediation for enterprise operations.

8. During 1988-91, however, financial development slowed and, in certain areas, was reversed as a rectification program was introduced in the wake of a sharp recession and mounting inflationary pressures. Structural reforms were given lower priority than stabilization, and nascent indirect instruments of macroeconomic control were supplemented with administrative measures. As a result, the share of budgetary funds in investment financing rose as the role of directed credit expanded. The flexibility in setting interest rates within

specified bands—which had been accorded to banks in the mid-1980s—was narrowed, and the specialization of the major banks was reasserted. In the NBFIs sector, a number of TICs were closed or merged with the specialized banks.

9. In recent years growth in the number and type of financial institutions has resumed as the authorities have sought to gradually increase the commercial orientation of the financial sector. Laws on central and commercial banking have been enacted, and three policy banks⁴ were established in 1994 to take up the policy-directed lending activities⁵ of the specialized banks, which were redesignated as “state commercial banks.” Two additional nationwide commercial banks were licensed, along with six other commercial banks of regional significance and two “housing savings banks.” In addition, some of the UCCs and RCCs have been merged and consolidated into city and rural united banks, respectively. Foreign banks have been allowed to open branches in Shanghai and 13 other cities, and eight foreign bank branches were granted permission in early 1997 to engage in limited renminbi business.⁶ The growth in the number of nonbank financial institutions has been limited, however, as the authorities have sought to separate banking and nonbanking business and banks have been required to divest of their nonbank subsidiaries.⁷

10. At present, the financial intermediaries include the four state commercial banks, the policy banks, four nationwide banks, several other commercial banks, around 50,000 rural and 5,100 urban credit cooperatives, TICs, finance companies, securities firms, insurance companies, and leasing companies (Table III.1). As of end-1994, financial institutions employed 2.7 million workers in over 210,000 branches and offices, of which the state commercial banks accounted for around 1.6 million and 147,000, respectively.

⁴The policy banks are the State Development Bank of China (SDBC), which is responsible for financing key construction and infrastructure projects and strategic industries; the Export-Import Bank of China (EIBC), which provides buyers and sellers credits in support of export and import activities; and the Agricultural Development Bank of China (ADBC), whose activities include the financing of agricultural development and the government's procurement of agricultural products. The policy banks are financed by bond issues, although the ADBC also accepts deposits.

⁵While there is no uniform definition of policy lending, policy loans tend to fulfill the following criteria: they are made at the request of—or strongly encouraged by—the government to promote its economic, industrial, and sectoral policies and to ensure funding for priority activities; and they may or may not meet banks' commercial criteria for loans.

⁶A joint-venture bank was also granted permission to engage in renminbi business.

⁷The divestiture process was largely completed in 1996.

11. Notwithstanding progress under recent reforms, the extent of commercialization in the financial sector remains limited and banking operations are concentrated in the four state commercial banks (Table III.2).⁸ Although the policy banks have commenced operations, the state commercial banks continue to lend to special projects and key industries identified by the State Planning Commission. Moreover, the transfer of some policy loans to the policy banks has been small in relation to the state commercial banks' total loan portfolios, a sizable share of which comprises policy-directed loans. In addition, the market shares of the large banks remain high despite the reforms, and the share of credit extended to the nonstate sector has not increased substantially (Table III.3).⁹

12. While there has been a narrowing in its scope, the credit plan remains the main instrument of monetary policy and continues to cover a large share of credit extended by the banking system.¹⁰ In the past, the credit plan applied to virtually all financial institutions, and individual projects and loan amounts were specified. The trend in recent years, however, has been to reduce the number of institutions covered by the plan and, for those banks that remain under the credit plan, to be allowed somewhat greater autonomy in choosing projects, within an overall credit ceiling.

13. In addition to having their lending decisions influenced by the credit plan, banks are subject to controls on interest rates, for both deposits and loans. The structure of interest rates administered by the PBC is very complex, consisting of more than 50 rates. For loans, different interest rates apply to different maturities, and distinctions are made between loans for working capital and fixed investment. Moreover, rates are different for industrial and commercial loans, agricultural loans, and household loans. On the deposit side, individuals' deposits are distinguished from institutional deposits, and the PBC sets interest rates for the entire maturity structure for both types of deposits. In recent years, some flexibility in interest rates for working capital loans has been allowed with the introduction of bands within which banks may set rates, both deposit and lending rates have been changed more frequently than in

⁸The four state commercial banks account for around two thirds of financial institutions' total assets and 70 percent of total deposits.

⁹Loans to individually- or collectively-owned enterprises, joint ventures, foreign-funded enterprises, and cooperatives—which together comprise the nonstate sector—amounted to 21 percent of total banking sector loans in 1995. However, this figure may understate lending to the nonstate sector, as some state enterprises on-lend bank credit to their nonstate subsidiaries. The nonstate sector, particularly foreign-funded enterprises, also rely on direct foreign borrowing to finance operations.

¹⁰In 1996, for example, the credit plan covered around 60 percent of the net credit growth of the entire banking sector. At present, lending operations of the state commercial banks, the policy banks, and two of the nationwide banks are covered by the credit plan.

the past, and the administrative ceiling on interbank interest rates has been lifted.¹¹ However, banks' interest margins are thin, although interest rate adjustments undertaken in 1995 and 1996 raised margins slightly.^{12 13}

C. Regulatory Framework

14. A component of the authorities' program to gradually commercialize the banking sector has been the enactment of a legal framework for banking which, until 1995, had consisted of a loose amalgamation of provisional regulations. Despite comprehensive new legislation—including the PBC law and the commercial banking law—based on concepts of risk and competition, progress in transforming bank operations has been slow.

15. The Law of the People's Republic of China on the PBC—enacted in 1995—establishes the PBC as a legal entity, specifies its autonomy, and defines its functions. An agency under the authority of the State Council, the PBC is to be free from intervention by local governments or other administrative organs at all levels. The PBC is endowed with its own capital and must publish its balance sheet and profit and loss statement on an annual basis. Losses sustained by the PBC are to be offset by state allocations, and the PBC is not to finance the budget except under exceptional circumstances. In addition to managing the issue of currency and implementing the credit plan, the PBC is responsible for formulating and implementing monetary policy and supervising the financial system under the leadership of the State Council.

16. The commercial bank law—also enacted in 1995—sets out the legal framework for transforming state banks into commercial entities. The law subjects commercial banks to prudential regulations under the supervision of the PBC, which is also conferred with the responsibility for setting credit ceilings that the banks may not exceed. Specific financial and prudential ratios—the asset-liability ratio management system—are defined in the law. These targets—which include a loan-to-deposit ratio, exposure limits, and capital adequacy

¹¹Since 1988 interest rate subsidies for deposits of three-year or longer maturities have been introduced during periods of high inflation to ensure that real long-term deposit interest rates remain at least zero. However, the cost of the subsidies has been borne by the budget and not the commercial banks.

¹²Interest margins in January 1995 for one-year and five-year maturities were 0.7 percent and 0.9 percent, respectively, and -2.3 percent for maturities of ten years or more. The interest rate adjustments in 1996 improved margins by an average of ½ percentage point.

¹³A detailed discussion of recent interest rate developments is contained in Chapter II of People's Republic of China—Recent Economic Developments (SM/97/145, 6/12/97).

requirements—are to be phased in according to individual bank circumstances.¹⁴ The three policy banks are not subject to this law, and their operations are guided by individual charters.

17. An important element of the commercial bank law is the potential for commercial autonomy it accords to banks. Banks must operate independently and take responsibility for their own profits and losses, and each bank is held responsible for the activities of all its branches, in marked contrast with past practice which permitted branches to act independently. The law explicitly states that no interference with commercial bank operations will be allowed. However, the state commercial banks are urged to continue to provide loans to special projects approved by the State Council. While in principle banks have the right to refuse to finance a special project, in practice funding for such projects is rarely denied.

18. To focus banks' operations on lending to enterprises and to limit exposure to risks, the commercial bank law establishes a separation of banking and nonbanking activities. Banks are barred from investing in NBFIs—whose operations are deemed more volatile and speculative than banking activities. New laws have been passed for negotiable bills, insurance, audit, and general bankruptcy, and laws under final consideration include those for guarantees, contracts, trust operations, and securities.

D. Supervision System

19. To support commercialization of the financial system, the authorities are in the process of strengthening the banking supervision system, the traditional role of which had been to verify compliance with the economic and credit plans. The focus of the system is shifting toward prudential supervision and strengthening financial institutions' internal systems of risk management and control. While steps have been taken to upgrade the supervisory and regulatory environment, including through increasing resources dedicated to supervisory activities, effective prudential supervision is severely limited by weak accounting and loan classification systems in the banks, and a shortage of professional skills, among both the bankers and the supervisors.

20. The national supervision plan is formulated at the PBC head office, and on-site inspections of financial institutions at the national level are carried out. Regular on-site inspections are scheduled once every three years for domestic and foreign banks and NBFIs. Collectively owned financial institutions (e.g., credit cooperatives) are inspected every two years. In some cases, banks' own internal audit teams assist with the inspection while, in other cases, the supervisors rely completely on the results of the banks' internal auditors. In contrast with past practice, banks are now supervised as whole legal entities. Organizational units of the PBC at the provincial, county, and township levels supervise banking units at the same level (e.g., provincial, county, or township). Their findings are communicated to the next

¹⁴The asset-liability ratio system is described in detail in Box 4 of People's Republic of China—Recent Economic Developments (SM/97/145, 6/12/97).

higher level unit of the PBC for approval and consolidation with findings of other similar units.

21. Measures taken in recent years have sought to place more emphasis on prudential—rather than economic—regulation of the banking system, although compliance with credit plan ceilings is still required of the state commercial banks, the policy banks, and two of the nationwide banks. In addition to the introduction, mainly for prudential purposes, of the asset-liability ratio management system, the PBC has instructed all commercial banks to form internal audit departments to monitor risks and improve internal controls. Supervision of the RCCs—which had previously been the responsibility of the ABC—has become, since 1996, the direct responsibility of the PBC, and efforts are being directed toward increasing the quality and frequency of on-site examinations of all financial institutions. To this end, the PBC has established a training institute to upgrade the prudential supervision skills of its 12,000 bank supervisors.

22. The PBC also conducts off-site monitoring of financial institutions' asset liability ratios on a regular basis. Traditionally, banks were required to submit the following types of reports to the PBC: annual credit and resource mobilization plans; statistical returns documenting the execution of these plans; and a balance sheet and profit and loss statement. In recent years, the focus of off-site supervision has shifted toward monitoring banks' compliance with 16 prescribed asset-liability ratios, based on monthly and quarterly reporting by banks of some 850 items, including both prudential indicators as well as other statistical information.

23. The quality of banking supervision is severely limited, however, by weak accounting standards. In particular, inappropriate rules and practices with regard to income recognition, loan classification, and loan-loss provisioning distort the financial position conveyed by banks' balance sheets. For example, banks are required to accrue interest for two years on nonperforming loans, compared with international practice of 90 days. Moreover, rules on loan classification impose limits on the proportion of loans that may be reported as nonperforming, potentially creating a wedge between the reported and actual quality of banks' loan portfolios. In addition, banks must obtain permission from several different agencies in order to provision for loan losses, and face a provisioning limit of 1 percent of total loans. As a result, the information contained in banks' balance sheets limits the usefulness of prudential analysis.

E. Bank Soundness

24. The substantial share of policy loans in bank lending—many of which have been to loss-making SOEs—has resulted in weakness in banks' balance sheets. In addition, the poor accounting standards, together with rapid growth in assets and liabilities in recent years

without accompanying growth in capital,¹⁵ may have caused banks to become under-capitalized.

25. However, assessment of the underlying soundness of China's banks is complicated by several factors. First, only limited public information is available on critical financial variables, including the extent of nonperforming loans. Second, the definition of nonperforming loans is based on overdue payments, which is easy to manipulate and to varies across banks. Third, the financial data that are available are weakened by the poor accounting practices and likely distort the true financial position of the banks, particularly with respect to capital strength and profitability. Hence, indicators of bank soundness should be interpreted with caution, and quantitative estimates may be seen as indicative of broad trends rather than precise measures of banks' financial strength. Because of these qualifications, and since the four state commercial banks account for around two thirds of bank lending, the analysis below of bank soundness is confined to these four banks.

26. Although official data on nonperforming loans are not published, it has been suggested that such loans could amount to 20 percent or more of the state commercial banks' loan portfolios.¹⁶ Within the nonperforming category, loans are classified as over due, in distress, or bad. Overdue loans are those for which repayments are behind schedule by less than three years, while loans in distress are loans that have been in arrears for three years or more. Bad loans are those that are judged unlikely to be repaid. Under the asset-liability ratio management system, limits are imposed on each type of nonperforming loan—8 percent, 5 percent, and 2 percent of total loans, respectively, for overdue, distress, and bad loans.¹⁷

27. Loan-loss provisioning by the state commercial banks has tended to be inadequate, particularly in view of the sizable share of nonperforming loans on their balance sheets. In part, this reflects the limit on the amount of provisioning that may be undertaken, as well as the drawn-out procedures required to obtain permission to provision against nonperforming

¹⁵The combined balance sheet of the state commercial banks (Table 4 in Chapter II of the *Recent Economic Developments* paper) indicates very little growth in paid-in capital during 1993-96.

¹⁶Faison (1996) quotes a statement by the PBC Governor indicating that 8 percent of loans outstanding are to enterprises that were behind in their repayment schedules by three years or more, while another 12 percent were late by less than three years. Some private estimates of the proportion of nonperforming loans in total loans are higher, including an estimate by Jardine Fleming cited in Roell (1997) of 29 percent. There has also been some ambiguity with regard to the definition of nonperforming loans in news reports, with the concepts of "bad loans" and "nonperforming loans" sometimes used interchangeably.

¹⁷Introduced in 1994, these limits are to be phased in gradually.

loans.¹⁸ According to published balance sheets of the large banks, the ICBC, the ABC, and the PCBC together had loan loss reserves of Y 13 billion at end-1994 and Y 21 billion at end-1995 (Table III.4). On a bank-by-bank basis, loan-loss reserves amounted to 0.5 percent of total loans in 1994 for the ICBC and the ABC, and 0.7 percent for the PCBC. In 1995, loan-loss reserves by the ICBC amounted to 0.8 percent of total loans, and 0.6 percent for the ABC and the PCBC.¹⁹

28. As regards banks' profitability, two major factors limit the validity of published data. First, the recognition of accrued interest as income overstates, possibly by a sizable amount, true profits. Second, the inadequate provisioning against loan losses tends to understate expenditure. Despite the resulting tendency of these factors to overstate profitability, the return on assets for each of the four banks has declined significantly during the 1990s.²⁰ Indeed, even with profits inflated by poor accounting and provisioning rules, the profitability of at least three of the banks—the ICBC, the ABC, and the PCBC—is weak in comparison with major banks in other countries, largely on account of low interest margins (Table III.5).²¹

29. The accounting and provisioning rules have also had an adverse impact on banks' capital position. These rules give rise to an overstatement of profit, which is then taxed at the rate of 55 percent.²² This practice has, as a result, eroded banks' underlying capital base, but is not reflected in banks' balance sheets. Even the published balance sheet statistics, however,

¹⁸International best practice is to provision 15-25 percent for loans classified as substandard, 50 percent for loans classified as doubtful, and 100 percent for loans classified as losses. In addition, some countries require banks to undertake a general provision equivalent to 1-2 percent of total loans. General provisions are normally not tax deductible, while specific provision are.

¹⁹For the BOC, the magnitude of loan-loss reserves and the extent of loan-loss provisioning are difficult to assess from its published balance sheet.

²⁰The return on assets is the ratio of pre-income tax profits divided by total assets. Data for certain years in some of the banks' balance sheets do not distinguish between business taxes and income tax. Since the former are deducted from the profit measure employed in this calculation, while the latter are not, the figure for pre-income tax profit had to be approximated in some cases.

²¹The return on assets averaged 0.2-0.3 percent for these banks in 1994-95, compared with an average of 0.6 percent for the four largest banks in Germany (1992), 1 percent in the United States (1992), 2 percent in Hong Kong (1995), and well over 2 percent in Brazil (1992).

²²The income tax rate applying to domestic banks was lowered to 33 percent, the same rate that applies to domestic enterprises, effective 1997. At the same time, however, the business turnover tax rate was raised from 5 percent to 8 percent.

indicate a steady decline in capital relative to assets for each of the four state commercial banks.²³ Capital-asset ratios (unadjusted for risk) of the ICBC, the ABC, and the PCBC at end-1995 were on average one half as high as at end-1989. The BOC's capital-asset ratio also declined in the early 1990s, but recovered somewhat in 1994-95 and was significantly higher than the other banks at end-1995.

30. While data weaknesses and limitations limit the use of these indicators as measures of the state commercial banks' financial strength, they nevertheless suggest that the banks' financial position has eroded steadily in recent years. If these banks are to operate on a commercial basis, the burden of past policy loans will need to be removed and the pressure to continue to lend to loss-making state enterprises will have to be eased. Moreover, adequate supervision of banking operations will have to be complemented by improvements in accounting, classification, and provisioning, and classification standards. In this context, the Government is considering a recapitalization of the state commercial banks to strengthen their financial position.

F. Conclusions

31. Institutional development and financial market reforms have strengthened the legal underpinnings for increasing the commercialization of the banking sector. Notable measures in recent years have included the enactment of the central bank and commercial bank laws which provide a legal foundation for commercializing bank operations; gradual narrowing in the scope of the credit plan in order to increase banks' autonomy over lending decisions; and creation of policy banks to facilitate the separation of policy- and commercially-based loans.

32. Nevertheless, much remains to be done to commercialize banking activity, including the removal of pressures—particularly from local governments—to support loss-making state enterprises. Indeed, the cessation of policy lending by the state commercial banks' will improve their financial strength.

33. Continued progress in the transition to a market-based financial system will need to be supported by enhanced prudential supervision, with a view to improving, inter alia, the quality

²³Risk-weighted capital adequacy statistics, while compiled by the PBC in the context of the asset-liability ratio management system, are generally not published. An exception is the BOC, which reported a risk-weighted tier one capital adequacy ratio of almost 13 percent at end-1995. It should be noted, however, that although the asset-liability system requires a risk-weighted ratio of at least 8 percent, in line with the minimum standard recommended by the Basle Committee on Banking Supervision, the risk weights applied in China differ from those used in other countries. For example, the risk weight for loans to other commercial banks is zero in China, compared with 100 percent in other countries. Claims on public enterprises receive weights from 10 percent to 50 percent, whereas the weight accorded in other countries to all customer loans of standard quality is 100 percent.

of bank loans. In this context, accounting and provisioning standards will have to be upgraded in order to facilitate prudential analysis and accurately assess banks' financial position. The appropriate functioning of banks in a commercial and competitive environment will also require that banks are adequately capitalized. However, any recapitalization should be closely linked with progress in commercialization to ensure a sustained strengthening of banks' balance sheets.

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Table III.1. China: Financial Institutions' Branches and Staff, 1990-94

(In thousands; end of year)

	1990	1991	1992	1993	1994
Branches					
State banks	125.1	123.4	120.6	138.8	151.9
Insurance companies	3.1	3.4	4.2	5.0	5.2
Rural credit cooperatives	58.2	57.9	52.8	50.9	50.7
Urban credit cooperatives	3.4	3.5	4.0	4.8	5.2
Trust and investment companies	...	0.4	0.4	0.4	0.4
Finance companies	...	...	0.0	0.0	0.0
Securities companies	...	...	0.0	0.0	0.0
Staff					
State banks	1,421.7	1,499.8	1,617.4	1,778.1	1,874.5
Insurance companies	85.7	93.4	105.6	115.9	122.9
Rural credit cooperatives	517.1	539.2	563.2	594.0	614.5
Urban credit cooperatives	68.7	77.4	91.0	122.9	161.3
Trust and investment companies	...	46.4	...	65.0	...

Source: People's Bank of China, *China Financial Outlook*.

Table III.2. China: Market Share of Financial Institutions, 1988-95

(In percent of total financial institutions' assets¹)

	1988	1993	1994	1995
Policy banks	0.0	0.0	5.6	6.7
State Development Bank of China	0.0	0.0	1.0	1.8
Agricultural Development Bank of China	0.0	0.0	4.6	4.9
Export and Import Bank of China	0.0	0.0	0.0	0.1
State commercial banks	85.4	84.2	79.8	72.7
Industrial and Commercial Bank of China	27.2	31.1	29.5	28.0
Agricultural Bank of China	14.6	16.8	14.0	11.1
Bank of China	27.1	19.4	20.6	18.0
People's Construction Bank of China	16.4	16.9	15.7	15.5
Nationwide banks	6.2	5.8	4.9	4.6
Other banks	0.2	1.1	1.6	1.8
Credit cooperatives	8.2	8.9	8.1	13.7
Urban credit cooperatives	1.0	3.0	2.4	4.1
Rural credit cooperatives	7.2	6.0	5.7	9.6

Source: Data provided by the Chinese authorities.

¹ Total financial assets excluding foreign banks and NBFIs. Data for these institutions are not available for years prior to 1995. For 1995, state commercial banks' share in total financial assets, including foreign banks and NBFIs, was around two thirds.

Table III.3. China: Distribution of Financial Institutions' Assets and Liabilities, 1985-95

	1985	1990	1991	1992	1993	1994	1995
(In percent of total deposits)							
Enterprises	40.7	29.2	27.9	30.6	29.0	32.6	31.9
Treasury	8.6	2.7	2.7	1.0	1.6	2.1	1.9
Government depts. and organizations	7.6	4.4	4.2	2.9	2.4	2.1	1.7
Individuals	35.4	53.6	54.7	54.1	54.9	55.8	57.3
Urban	24.8	50.8	51.1	50.1	51.3	53.2	55.1
Rural	10.6	2.8	3.6	4.0	3.6	2.6	2.2
Other	7.7	10.0	10.5	11.3	12.0	7.5	7.3
(In percent of total loans)							
Industrial production	16.7	20.1	19.9	18.8	18.8	18.2	18.1
Supply and marketing	6.5	3.7	3.3	3.1	3.0	2.5	2.1
Commercial	44.9	32.6	31.4	29.2	27.7	25.1	24.6
Construction	4.5	3.8	3.4	3.4	3.2	2.8	2.1
Urban & township collectives	5.3	5.5	5.3	5.8	6.0	5.1	4.3
Individual proprietors	0.2	0.2	0.2	0.3	0.3	0.4	0.4
Agriculture	7.1	13.6	13.9	14.7	14.7	11.4	6.0
Fixed assets	11.9	12.7	14.3	14.9	15.8	19.4	19.8
Joint-ventures, foreign, and cooperative enterprises	0.0	0.0	0.0	0.0	0.0	1.9	2.0
Other loans	3.0	7.6	8.4	9.8	10.6	13.2	20.6
(In percent)							
Memorandum items:							
Nonstate sector loans/total loans ¹	14.0	23.2	23.7	25.6	26.3	23.5	21.0

Source: People's Bank of China, *Almanac of China's Finance and Banking*; and staff estimates.

¹ Includes collectives, individuals, agriculture, joint-ventures, foreign-funded enterprises, and cooperatives, as well as one half of other loans.

Table III.4. China: Financial Position of the State Commercial Banks, 1989-95

	(In billions of yuan)						
	1989	1990	1991	1992	1993	1994	1995
Assets							
Industrial and Commercial							
Bank of China (ICBC)	772.5	938.4	1117.5	1433.7	1959.1	2633.9	3107.5
Agricultural Bank of China (ABC)	448.0	554.0	686.8	868.1	1056.5	1253.1	1231.0
Bank of China (BOC)	677.4	859.1	1107.7	1422.1	1731.3	1837.9	1995.1
People's Construction Bank of China (PCBC)	407.3	518.6	669.4	815.9	1065.7	1397.5	1722.7
Loans							
ICBC	575.2	687.2	797.1	933.7	1112.8	1276.8	1481.1
ABC	305.8	377.4	457.8	546.8	652.9	578.6	690.1
BOC	247.5	332.5	414.3	496.6	605.8	870.3	958.8
PCBC	150.0	192.8	260.0	345.3	459.9	557.1	777.8
Loans from the PBC							
ICBC ¹	173.7	202.4	217.8	239.5	351.4	279.9	263.8
ABC	118.3	143.9	175.0	208.1	278.5	84.7	86.9
BOC	96.3	109.9	115.8	124.4	157.1	176.1	185.2
PCBC	25.3	44.0	73.3	93.6	169.9	155.5	147.1
Loan-loss reserves							
ICBC	...	...	...	...	...	6.2	11.3
ABC	0.3	0.2	0.3	0.5	0.2	2.8	4.3
BOC	...	...	...	...	...	...	...
PCBC	0.2	0.2	0.3	0.5	1.0	3.7	5.0
Capital and reserves							
ICBC	50.5	55.3	64.0	70.4	88.0	93.9	104.0
ABC	28.0	30.1	32.3	34.5	31.6	47.6	45.1
BOC	36.3	42.8	53.5	63.2	69.4	81.3	95.1
PCBC	29.8	32.4	34.7	37.2	35.2	43.0	45.0
Pre-tax profits²							
ICBC	15.2	13.3	15.9	16.1	8.2	4.2	4.7
ABC	1.9	1.2	2.2	1.6	3.7	1.2	4.3
BOC	5.1	6.2	8.3	10.2	9.8	9.8	10.4
PCBC	1.7	1.9	1.9	4.0	2.6	2.8	6.2

Source: People's Bank of China, *Almanac of China's Finance and Banking*; and staff estimates.

¹ ICBC's balance sheets refer to "borrowings" in 1994-95 and "borrowing from PBC" in previous years.

² Refers to pre-income tax profits. Business and other taxes are included in expenses. Data for the ABC in certain years did not distinguish income taxes from other taxes; total taxes for those years were divided using the average proportion in recent years.

Table III.5. China: Selected Financial Statistics of the State Commercial Banks, 1989-95

	(In percent)						
	1989	1990	1991	1992	1993	1994	1995
Loans from PBC/Total loans							
Industrial and Commercial							
Bank of China (ICBC) ¹	30.2	29.5	27.3	25.7	31.6	21.9	17.8
Agricultural Bank of China (ABC)	38.7	38.1	38.2	38.1	42.7	14.6	12.6
Bank of China (BOC)	38.9	33.1	28.0	25.1	25.9	20.2	19.3
People's Construction Bank of China (PCBC)	16.9	22.8	28.2	27.1	~~36.9~~	27.9	18.9
Return on assets ²							
ICBC	2.0	1.4	1.4	1.1	0.4	0.2	0.2
ABC	0.4	0.2	0.3	0.2	0.3	0.1	0.3
BOC	0.8	0.7	0.7	0.7	0.6	0.5	0.5
PCBC	0.4	0.4	0.3	0.5	0.2	0.2	0.4
Capital/assets ³							
ICBC	6.5	5.9	5.7	4.9	4.5	3.6	3.3
ABC	6.3	5.4	4.7	4.0	3.0	3.8	3.7
BOC	5.4	5.0	4.8	4.4	4.0	4.4	4.8
PCBC	7.3	6.2	5.2	4.6	3.3	3.1	2.6
Loan-loss reserves/loans							
ICBC	...	...	...	...	...	0.5	0.8
ABC	0.1	0.1	0.1	0.1	0.0	0.5	0.6
BOC	...	...	...	...	...	...	...
PCBC	0.1	0.1	0.1	0.1	0.2	0.7	0.6

Source: People's Bank of China, *Almanac of China's Finance and Banking*; and staff estimates.

¹ ICBC's balance sheets refer to "borrowings" in 1994-95 and "borrowing from PBC" in previous years.

² Refers to pre-income tax profits, divided by assets. Business and other taxes are included in expenses. Data for the ABC in certain years did not distinguish income taxes from other taxes; total taxes for those years were divided using the average proportion in recent years.

³ Capital and reserves divided by total assets.

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V. EXTERNAL SECTOR OPENING¹

A. Introduction

1. The gradual liberalization and opening of the external sector has been a key element of China's economic reforms in the past two decades. Prior to 1978, China's exchange and trade system was based on the foreign exchange and trade plans, which were integral parts of the overall economic planning system and regulated the allocation of foreign exchange as well as exports and imports. A high degree of autarky was an important objective. The role of imports was to fill domestic shortfalls in raw materials and capital goods, and exports were planned so as to generate the foreign exchange necessary to pay for imports, with the trade balance generally in moderate surplus.² With external borrowing strictly controlled through the foreign borrowing plan, external debt in relation to GDP was very low,³ and the economy was practically closed to foreign direct investment.

2. Since the late 1970s, wide-ranging reforms have been introduced to open the Chinese economy. This chapter discusses the main features of this process, focussing on three key areas: the exchange system, the trade system, and foreign direct investment.⁴ Even though progress with external sector reforms has not always been even, much has been achieved. The exchange regime has been transformed into a market-based system with current account convertibility, and the trade system has been freed from the shackles of central planning. China's "open door" policy towards foreign direct investment (FDI) within the framework of open economic zones⁵ has led to a steady rise and, since 1993, a surge in FDI inflows. Controls on other capital flows have been maintained, and although external debt has

increased significantly, it has remained moderate in relation to the size of the economy.⁶ While these results are impressive, challenges lie ahead. In the trade system, tariffs are still high and nontariff restrictions numerous. In the area of foreign direct investment, the many foreign-funded enterprises (FFE's)⁷ established in recent years have yet to be fully integrated into the domestic economy.

F. Results of External Sector Reforms

34. Nearly two decades of reforms have significantly transformed China's external sector. The transition from a centrally planned and controlled exchange regime to a market-based exchange system with current account convertibility has been a remarkable achievement and has played a key role in the opening of the economy. Significant progress has also been achieved in the reform of the trade system where the planning framework has been successfully dismantled, although the lowering of tariff and nontariff trade barriers remains a challenge. Finally, the door for foreign investors has been opened gradually and now provides access on a scale that would have seemed unimaginable at the beginning of the reform process.

35. While the visible changes in the exchange, trade, and investment regime are useful indicators of the extent of the transformation of China's external sector, the results of the reforms ultimately need to be judged by the effective changes they have engendered in terms of greater openness to foreign trade and investment. As regards foreign direct investment, the results have been spectacular. After increasing slowly but steadily during the 1980s, FDI inflows began to surge in 1993, averaging nearly \$35 billion annually and accounting for some 15 percent of total domestic fixed investment in the past four years (Chart V.2). Since 1993, China has on average absorbed nearly half of total annual FDI inflows into developing countries, compared with 15-20 percent in the 1980s. The proliferation of FFEs and their strong export orientation resulted in a rapid expansion of FFE exports, which grew at an average annual rate of 65 percent during 1986-96, increasing their share in total exports (customs basis) from 2 percent in 1986 to over 40 percent a decade later. Given their heavy concentration in the export sector, the role of FFEs in the overall economy is not as dominant. Nevertheless, by 1995, FFEs accounted for close to 15 percent of industrial value added. China's "open door" policy has no doubt achieved its objective to promote export growth through foreign investment.

36. Openness to foreign trade has also increased considerably since the initiation of reforms. Merchandise exports as a share of GDP have risen from 8 percent in 1982-83 to over 20 percent on average in the past four years (Chart V.3). Similarly, the import/GDP ratio has increased significantly (Chart V.4). While China's trade shares are still lower than in other east Asian countries, they are substantial, given the size of the Chinese economy. However, since the late 1980s, the growing openness of the Chinese economy as reflected in rising export and import shares has mainly been due to the rapid expansion of FFE trade. For the other sectors of the economy, the export/GDP ratio was broadly unchanged at around 15 percent from 1988 to 1995 and has declined in 1996. The ratio of imports to GDP for the "non FFE" sectors has declined since 1988. By 1996, it had fallen well below 10 percent, comparable to the level in the mid 1980s.

37. The developments in export and import ratios suggest that the direct effects of China's external opening have mostly been reflected in the FFE sector and have so far failed to permeate the whole economy. This result reflects the focus of external sector reforms, which have emphasized the promotion of FDI in special zones and predominantly outward-oriented

activities, while lagging in the opening of the rest of the economy through comprehensive trade liberalization. The orientation of external sector reforms has had a profound impact on regional income developments. Provinces which have received large shares of FDI inflows due to their open economic zones have tended to grow much more rapidly than other regions. Guandong, the province in which the first three SEZs were established, increased its share in total output from 5 percent in 1983 to more than 9 percent in 1995,⁷⁴ while per capita income in the province rose from 126 percent of the national average in 1987 to 163 percent in 1994. As some of the regions with high concentrations of open-economic zones had few advantages at the outset, external sector reforms have, to some extent, helped level income disparities among the coastal regions.⁷⁵ They contributed, however, to growing disparities between the coastal regions on the one hand and inland provinces on the other.

38. In view of the considerable regional differences in economic growth, the focus of economic policies has begun to shift toward the regions that have tended to lag behind. In this context, external sector policies will have to address two main challenges. They will have to achieve a better integration of FFEs into the domestic economy and open the domestic "non-FFE" sectors. The former will require a leveling of the playing field for domestic and foreign-funded enterprises and among different regions, the latter will require a broadening and deepening of trade reform.

⁷⁴The figure for 1983 refers to the share in gross agricultural and industrial output, while the figure for 1995 refers to the share in GDP.

⁷⁵Fujian, where one of the original SEZs is located, was initially much less developed than many other regions. In 1987, its per capita GDP was below the average for the whole country; by 1994 per capita GDP in the province had risen to 1.4 times the national average.

REMARKS OF THE HONORABLE
CHARLENE BARSHEFSKY
U.S. TRADE REPRESENTATIVE
BEFORE THE
U.S.-CHINA BUSINESS COUNCIL
JANUARY 29, 1998

China at the Crossroads of Reform

I want to thank you for this opportunity to address you today, just at the beginning of the Chinese New Year. The U.S.-China Business Council has been one of the most active organization in providing the Administration with information and advice on developments in China and on the multitude of trade issues that have become the focus of our bilateral and multilateral trade agenda with China. Thank you for your valuable assistance.

Any discussion of trade with Asia must begin with the issue of the current financial crisis. As the President said in his State of the Union message, the countries of Asia are major customers of the United States; they are our strategic partners. Their stability bolsters our security and our domestic economic health. The world's economies are more and more interconnected and interdependent. Today, an economic crisis anywhere can affect economies everywhere. Making the negative impact of the crisis as small as possible is therefore an imperative.

We cannot expect that Asia will sort out its problems without us, and we cannot afford the consequences if it does not. As the President said, these economies must reform or recovery is impossible. We must be in a position to help them do it. And for that reason, Congress should renew our commitment to the IMF. In addition, Japan, as the world's second largest economy must play a more active role in helping to bring Asia out of its current economic crisis. Its efforts to date have been woefully inadequate. Japan must stimulate domestic demand. It must deregulate its economy. It must open up to provide a market of first resort for the tremendous productive capacity of the region.

China has a role in this process as well, and we welcome statements by Chinese officials in recent weeks, committing to exchange rate stability and economic reform.

As the 15th Peoples Congress approaches, the Chinese government stands at a crossroads. The direction that China takes as we enter the 21st century will profoundly affect Asia, America and the world for decades. China will choose its own destiny, but its decisions will affect our national interests in such diverse areas as peace and stability in Asia -- including our ongoing efforts to dismantle North Korea's nuclear weapons program -- keeping weapons of mass destruction out of unstable hands, fighting drug-trafficking, alien smuggling and international organized crime, protecting human rights and religious freedom, and making global trade and investment as free, fair and open as possible.

Engagement with China in each of these areas is crucial to our national security and to advancing fundamental American interests and values. The manner in which we engage China will help determine whether it abides by international norms and becomes integrated into the international community, or whether it becomes an unpredictable and destabilizing presence in the world.

Fifty years ago, the United States faced a great moment of decision. The decision: whether to open the nation to the challenges and opportunities of a global economy, or hide behind nostalgia and an isolationist vision.

After World War I, the United States turned inward with dire consequences. After World War II, America pursued a different course. We led the world in the creation of the institutions that are the foundation of the international economy to this day: the GATT (now the WTO), the IMF, the World Bank. The decision to open the country to international competition has created sustained prosperity for three generations of Americans -- and for the world.

Today, China faces its own great moment of decision with the inherent domestic conflicts that this generates. Analogies between systems as diverse as those of the United States and China are always dangerous. But China, too, faces a basic choice between openness and integration on the one hand, and protection and isolation on the other. We believe the choice is clear. It is in both our countries' interests for China to choose the path that establishes the rule of law, opens its economy, and provides economic growth and stability in this strategic region.

Most fundamentally, U.S. trade policy toward China acts to encourage China's openness and integration into the international economic community. We have pursued this goal through a strong complementary policy that combines bilateral, regional (APEC), and multilateral initiatives. Our bilateral trade agreements cover specific segments of U.S. trade, but have also served to build the foundation for progress in China's WTO accession negotiations. China's accession to the WTO is critical to creating an effective framework for our trade relationship.

Our efforts on trade cannot be separated, in turn, from the broader considerations of creating a more open, rules-based society in China. Reforms of China's legal system, enactment of new laws and regulations, and notions of due process and transparency all build a better trade relationship and, in part, will spring from that relationship. In the WTO accession negotiations, as in the case of our negotiations on intellectual property rights (IPR) enforcement and other bilateral areas, we are working with China to create a regime that strengthens the legal system and the rule of law in general.

Embedded in each of our bilateral agreements -- in particular a hallmark of the intellectual property rights agreements -- are broader international norms to which China has committed: transparency of laws and procedures, access to administrative or judicial decision making, curbs on the arbitrary exercise of bureaucratic discretion. Each of our ongoing negotiations -- in the context of China's accession to the WTO and bilaterally, on services, market access and IPR -- is

also grounded in international norms and practices and in the necessity of adherence to a rules-based regime.

If we look at the agreement on the protection of intellectual property rights, we see most obviously a case of clear U.S. economic interest: eliminating theft through piracy of our most creative industries. But the agreements we reached with China did more than simply establish an advantageous environment for U.S. business. Those agreements also embody increased access for and to America's idea industries -- books, films, music, and software. Beyond this, embedded in the agreements are the seeds of important American ideals: the development and publication of laws; consistency in decision making; recourse to law enforcement; the availability of administrative and judicial proceedings and greater transparency in the processes of government.

Adherence to these ideals by China requires political will. But the foundation established in the IPR and other agreements, all contribute toward the development of a broader and deeper concept -- that is, the development of the rule of law. And the foundation that our bilateral agreements have laid are the bases on which negotiations on China's integration into the world trading system will advance.

The progress that was achieved last year on China's accession to the WTO in the areas of IPR, transparency and judicial review owe their genesis to our underlying bilateral agreements. These commitments were also the building blocks for progress in the WTO on other key rules and principles:

- ▶ On trading rights -- the right to import and export products, both manufactured and agricultural;
- ▶ On non-discrimination -- elimination of practices that discriminate against imported goods and foreign producers of goods in China such as dual pricing;
- ▶ On agriculture -- the commitment not to use export subsidies;
- On uniform application of all laws affecting trade in goods and services, such as tariffs and licensing requirements.

But China's integration into the world trading system and its accession to the WTO is not dependent solely on commitments to internationally agreed rules and principles. Equally important are the market access obligations of the WTO and, for an acceding country such as China, those obligations are substantial. Since the GATT was founded in 1947, contracting parties have engaged in seven rounds of trade negotiations, the last being the Uruguay Round, the benefits of which have been extended to China. And since the Uruguay Round, we have completed global agreements on information technology, basic telecommunications services and, most recently, global financial services, including banking, securities and insurance. China will

have to assume obligations commensurate with its place as a major trading power and with the benefits it receives.

Having made progress on some of the key WTO rules and principles, market access negotiations advanced late last year for the first time in several years, at the Presidential summit in Washington and later, in Vancouver at the APEC Trade Ministers meeting and at the two Presidents' bilateral meeting.

At the summit in Washington, President Jiang committed that China will join the Information Technology Agreement (ITA) as soon as possible. The ITA calls for the elimination of tariffs on all information technology products such as computers, semiconductors, telecommunications and other related equipment generally by the year 2000. These are the growth areas of the 21st century. China's commitment to join the ITA represented a dramatic shift in China's policy since, previously, China had refused to participate in any zero-for-zero sectoral arrangements. This commitment is independent of China's accession to the WTO.

The other major achievement of the summit was the expressed recognition by President Jiang that the basis for accession would be on commercially meaningful, not political, terms. Up until December 1994, when China had hoped to enter the WTO as a founding member, China had pressed to accede to the WTO on a political basis. China, like many other countries, misinterpreted the nature of the WTO. It is not a political institution. It embodies, instead, a comprehensive contractual arrangement among trading partners that defines the principles and terms on which trade will take place. The binding dispute settlement process underscores the contractual nature of the arrangement. China's explicit recognition that the terms of accession are commercial, not political, demonstrated that a firmer foundation for real negotiations exists.

• Further progress on market access was achieved in Vancouver at the two Presidents' bilateral meeting in the context of the APEC Ministerial and Leaders meeting. China's Trade Minister Wu Yi, as confirmed by her President, made a number of proposals that form the basis for more serious negotiations on market access for goods. Minister Wu proposed:

- to significantly reduce tariffs for agricultural and manufactured products, generally by the year 2000, and to sharply limit the number and range of tariff peaks;
- to participate fully in other zero-for-zero sectoral arrangements;
- to eliminate all non-tariff measures affecting manufactured products, generally by the year 2000, and to provide substantial import growth during the phase out period.

In addition to the proposals that Minister Wu made, China provided a new offer on services. While we remain far apart on this critical area, we have begun for the first time to discuss the defining principles of market access for services, principles such as the form of

establishment -- whether wholly owned, branch, or joint venture -- comprehensive coverage of services sectors, and elimination of geographic and numerical restrictions..

Our engagement with China on trade -- whether in Geneva, the summit in Washington, or in Vancouver -- has resulted in important progress on China's WTO accession. Much more work is, however, necessary on the complex issues of market access and WTO rules. For example, U.S. market access requests have yet to be fully addressed. While China presented a new services offer, important areas like distribution, telecommunications, financial and professional services were not approached in ways that are commercially meaningful. In addition, negotiations on agricultural market access, a traditionally contentious area of negotiations with every country, have only just begun. Finally, additional work remains on WTO rules covering such critical areas as standards, technology transfer, trade related investment measures and adequate safeguards. The substantial economic role of China's state-owned enterprises gives rise to a number of serious issues which must also be addressed.

It will take hard work and political commitment to achieve a commercially meaningful agreement, one based on the principles of the WTO. The trade deficit, which has more than doubled over the last four years, further complicates the situation. Chinese buying missions, like the one that preceded the Summit, are welcome but do not solve limitations on market access for U.S. manufactured goods, agriculture and services. Yet, while the task ahead of us is considerable, the progress made in the last year is both important and encouraging.

Let me take a final moment to review briefly the bilateral trade agenda with China and its intersection with the WTO accession process. We are concerned about the failure to resolve longstanding sanitary and phytosanitary issues affecting citrus, pacific-Northwest wheat, pork and poultry. These could precipitate disputes like those involving IPR and textiles. China's practice of granting licenses for e.g., insurance providers on an experimental basis pits company against company and country against country. This piecemeal approach increases tensions.

Equally important, China has taken certain recent protectionist measures that have adversely affected U.S. interests. For example, in October, China raised the tariff on soybean oil to 20%. That increase occurred just at the time when U.S. soybean oil products were entering world markets. Because of pressure from the United States, China has since reversed that tariff increase but it demonstrates that on the bilateral side, we cannot stand still waiting with the systemic changes that WTO accession will bring.

Nowhere is the necessity for a strong bilateral approach more evident than in the case of intellectual property rights. Our efforts over the last four years, including two bilateral agreements, have generated positive results:

- China has closed 58 CD and CD-ROM production lines and the Chinese have destroyed the masters and molds being used to produce these products.

- China has arrested more than 250 people for IPR piracy and imposed prison sentences of up to 17 years.
- China has seized more than six millions CD's illegally smuggled into China.

More efforts are necessary to increase market access for legitimate products and to combat piracy, especially "end-user" software piracy by public and private entities. But we have used a consistent and forceful approach to bring China's IPR laws and enforcement up to world standards. Most important, our bilateral efforts have helped to establish the infrastructure so important to guarantee that protection will continue and improve.

Conclusion

The integration of China into the international trading system is in the interests of both China and the United States. Accomplishing this objective will require intensive efforts. It is not easy, but we have established important momentum. With respect to the WTO, the pace of accession remains in China's hands. Most important, it is substance that will drive those negotiations. There are some who would argue that China should be admitted now and "deal with the problems later." The rising trade deficit, the role of state-owned enterprises in China's economy, the uncertain shape of current reform efforts, and a weak legal regime are but a few of the many reasons why this position is untenable. We are far better off ensuring that all parties understand the obligations that WTO membership brings, starting off on the best foot possible. The U.S.-China relationship is crucial. It is important to the nation and to the world. We cannot ignore the problems, we need to solve them.

Thank you.

increased significantly, it has remained moderate in relation to the size of the economy.⁶ While these results are impressive, challenges lie ahead. In the trade system, tariffs are still high and nontariff restrictions numerous. In the area of foreign direct investment, the many foreign-funded enterprises (FFE)s⁷ established in recent years have yet to be fully integrated into the domestic economy.

B. Reform of the Exchange System

3. At the beginning of reforms in the late 1970s, foreign exchange was allocated administratively on the basis of the foreign exchange plan. Foreign trade was managed by a handful of foreign trading companies (FTCs), which executed the trade plan under the auspices of the Ministry of Foreign Trade, transactions between FTCs and domestic enterprises were carried out at a variety of different settlement rates,⁸ while FTCs and the Bank of China (BOC) traded at the official exchange rate, which then was determined on the basis of a basket of currencies. With the increasing decentralization of trade and the scaling back of mandatory planning, however, changes in the allocation mechanism of foreign exchange became necessary.

4. The transition to a market-based exchange system, like other reforms in China, was gradual and experimental, spanning a period of some 15 years. The transitional arrangements were based on three key elements: an exchange retention quota system, which gave firms with foreign exchange earnings the right of disposal over part of their earnings; varying types of arrangements for trading retention quotas, which eventually developed into a rudimentary foreign exchange market; and, associated with these arrangements, multiple exchange rates, which permitted a gradual increase in the share of transactions carried out at market-oriented exchange rates.

5. Foreign exchange retention quotas were introduced as early as 1979. While foreign exchange earnings from exports were subject to a general surrender requirement, the retention quota system allowed firms to obtain foreign exchange for imports at the official exchange rate equivalent to a certain proportion of their earnings. The quotas were initially relatively low, around 25 percent, but were raised significantly in the second half of the 1980s, particularly in 1988. By the end of the decade, a complex system of quotas differentiated by

⁶In 1996, outstanding external debt was equivalent to 14 percent of GDP.

⁷The term foreign-funded enterprises is used to describe fully foreign-owned enterprises as well as joint ventures.

⁸For a detailed description of China's reforms in the foreign exchange system, see Bell, Khor, and Kochhar (1993), World Bank (1994), Wall, Jiang, and Yin (1996), and Mehran, Quintyn, Nordman, and Laurens (1996).

region, industrial sector, and type of exports ("in" or "above" plan) had evolved.⁹ Retention quotas were streamlined in 1991 with the introduction of a uniform quota of 80 percent for general commodities,¹⁰ and a clearly defined scheme for the allocation of quotas between FTCs, originating enterprises, and local governments, which previously had varied considerably.¹¹ Some sectoral differentiation was, however, retained,¹² and the central government reserved the right to buy back part of the quota allocated to FTCs and producing enterprises at the monthly average exchange rate at foreign exchange adjustment centers.¹³ The retention quota system applied mainly to domestic enterprises, while FFEs could choose to retain their foreign exchange earnings directly in foreign exchange accounts.¹⁴

6. In order to enhance the role of the retention quotas, trading mechanisms were needed. In 1980, some localities began to allow trading (swaps) of excess retained foreign exchange between firms. These swaps had to be carried out through the BOC at exchange rates that were permitted to fluctuate within narrow margins around the rate used for the surrender of foreign exchange. Given these constraints, as well as some restrictions imposed subsequently on the use of accumulated retention quotas,¹⁵ the scope of these early swap transactions remained limited.

⁹The differentiation of retention quotas appears to have had a significant impact on the relative export performance of different industrial sectors. See Wall, Jiang, and Yin (1996).

¹⁰Excluding commodities such as crude oil and petroleum derivatives.

¹¹Sixty percentage points of the retention quota were to accrue to the FTC, 10 percentage points to the originating enterprise, and 10 percentage points to the local government. Producing enterprises with direct trading rights were allowed to retain the share of the FTC.

¹²Exports of special commodities, such as mechanical and electronic products, were eligible for a 100 percent retention quota, of which 80 percentage points accrued to the FTC, 10 percentage points to the originating enterprise, and 10 percentage points to the local government.

¹³The "buy back" option applied to 20 percentage points of the FTC share and the full share of the producing enterprise. The role of foreign exchange adjustment centers is discussed below.

¹⁴In a few locations, however, cash retention schemes were introduced for domestic enterprises on an experimental basis.

¹⁵In 1984, faced with a decline in official reserves, the central government effectively froze enterprises' accumulated retention quotas. See World Bank (1994).

7. Independent swap centers were set up on an experimental basis in 1985-86. Initially, access to these foreign exchange adjustment centers (FEACs) was restricted to FFEs¹⁶ and the exchange rate remained controlled. In 1988, however, trading at market-determined exchange rates was allowed,¹⁷ and all enterprises with retention quotas were granted access to FEACs. As a result, both the number of such centers and the volume of transactions expanded rapidly.¹⁸ In late 1991, all domestic residents were allowed to sell foreign exchange at the swap rate at designated bank branches, implying virtually unrestricted access to the market for sales. Access for purchases required, however, approval by the State Administration of Exchange Control (SAEC), and was guided by a priority list, which included key imports as well as foreign debt service payments.¹⁹ Nevertheless, although the swap centers were not fully integrated at the national level, they developed into a nascent foreign exchange market.²⁰

8. The coexistence of different types of foreign exchange allocation mechanisms entailed multiple exchange rates during most of the transition period. In 1981, following the introduction of retention quotas, the system of multiple internal settlement rates employed earlier was replaced by a single internal settlement rate, which was more depreciated than the official exchange rate. This rate was used for all trade-related transactions (including initial swaps of retention quotas), while the official exchange rate applied to non-trade-related transactions. Subsequently, the official exchange rate was allowed to depreciate gradually toward the internal settlement rate and from early 1985 on, all transactions were carried out at the official exchange rate (Chart V.1).

9. A multiple exchange rate system reemerged soon with the establishment of the FEACs.²¹ The exchange rate prevailing in these centers was considerably more depreciated than the official rate, which applied to the surrender of export earnings, priority imports, and

¹⁶FFE were subject to a foreign exchange balancing requirement, i.e., they were obliged to ensure self-sufficiency in foreign exchange. In 1986, this requirement was modified to apply to the sector as a whole, allowing individual enterprises to meet shortages by purchasing foreign exchange from other FFEs. FEACs were set up to facilitate this exchange. For a detailed description of the system, see Tseng et al. (1994), p.9, and Khor (1993).

¹⁷The People's Bank of China had, however, the right to intervene through purchases or sales of foreign exchange.

¹⁸By late 1988, 80 swap centers had been established.

¹⁹Regulations for purchases of foreign exchange at the swap centers were issued by the State Administration of Exchange Control in early 1989.

²⁰As a result of regional segmentation, exchange rates in different swap centers varied.

²¹Although the system was characterized by two exchange rates, the official rate and the swap rate, exporters effectively faced a variety of different exchange rates due to the differentiation of retention quotas.

many non-trade-related transactions, including foreign exchange certificates (FECs).²² The gap between the official exchange rate and the swap market rate narrowed in 1990-91 with two devaluations of the official rate,²³ but widened again in 1993 when the swap rate depreciated sharply against the background of an overheating economy and a deterioration in the trade balance. Initial efforts to cap the swap rate were soon abandoned and eventually gave way to a sweeping reform of the exchange system.

10. On January 1, 1994, the exchange rates were unified at the prevailing swap market rate, the retention quota system was abolished,²⁴ and FECs were discontinued.²⁵ Although domestic enterprises continued to be subject to a surrender requirement for trade- and non-trade-related foreign exchange receipts, they were allowed to hold foreign exchange accounts in connection with several types of transactions, such as foreign borrowing and stock issues and approved debt service payments.²⁶ More importantly, access to the foreign exchange market for most trade and trade-related transactions no longer required SAEC approval.²⁷ SAEC approval was still needed for non-trade-related current payments by Chinese nationals, such as travel expenses, and for FFEs that wished to access the swap market.²⁸

11. Shortly after the unification of the exchange rates, in April 1994, a nationally integrated electronic trading system, the China Foreign Exchange Trading System (CFETS)

²²Foreign exchange remitted or brought into the country by foreigners was converted at the official exchange rate into yuan-denominated FECs, which could be used for domestic purchases, generally at lower prices than domestic currency purchases.

²³The arrangement for the official exchange rate was formally described as a managed float, but the exchange rate of the renminbi vis-a-vis the US dollar was unchanged from mid-1986 to end-1989.

²⁴Enterprises with outstanding retention quotas were allowed to purchase foreign exchange at the official exchange rate of December 1993 until end-1994.

²⁵Existing FECs were withdrawn from circulation at the official exchange of end-1993. The conversion was to be completed by mid-1995, but some small remaining amounts were converted through mid 1996.

²⁶Foreign exchange accounts were also permitted for individual foreign and Chinese nationals, FFEs, and other foreign entities, such as embassies and international organizations.

²⁷Foreign exchange could be purchased at designated financial institutions upon presentation of the relevant documentation.

²⁸Although from April 1994, FFEs were required to obtain SAEC approval to open a foreign exchange account, they continued to be free to remit profits from their foreign exchange accounts. Foreign employees of FFEs were free to transfer their salaries (net of taxes and living expenses) abroad.

was established to link major swap centers with the interbank market and overcome the fragmentation of the regional swap markets. The CFETS quickly developed into a unified wholesale foreign exchange market,²⁹ even though the rules for participation differed for domestic and foreign banks,³⁰ as well as domestic enterprises and FFEs.³¹ The exchange arrangement was a managed float, with the People's Bank of China (PBC) intervening through purchases and sales of foreign exchange.³²

12. Reforms in the exchange system since the 1994 unification have focused on the removal of the remaining restrictions on current payments and transfers to pave the way for acceptance of the Fund's Article VIII. Regulations concerning FFEs' access to the foreign exchange market were eased in 1995,³³ and in 1996, the restrictions associated with the

²⁹The CFETS is based on membership, which is open to domestic banks (head offices as well as branches), foreign banks, and a number of nonbank financial institutions. The system provides trading and settlement services to its members. By assuming responsibility for settlement, the CFETS effectively assumes the credit risk in each transaction. Transactions in swap centers that are not directly linked to the system take place at the exchange rate established in the CFETS. For a detailed description of the system, see Mehran, Quintyn, Nordman, and Laurens (1996).

³⁰While designated domestic banks and their branches are allowed to trade on their own account, other domestic financial institutions and foreign banks can only trade on behalf of their customers.

³¹Domestic enterprises have only access to the bank retail market, which is subject to different settlement arrangements than the wholesale market, while FFEs can trade directly, through their banks, in the wholesale market.

³²For a detailed description of the system see International Monetary Fund (1995), Appendix I.

³³FFE no longer required approval for accessing the foreign exchange market, provided their transactions were within the limits of their pre-approved annual foreign exchange plans.

foreign exchange balancing requirement for these enterprises were removed.³⁴ Limits on purchases of foreign exchange for current payments and transfers became indicative, with SAEC³⁵ indicating access for all bona fide current transactions.³⁶ Following these changes, China accepted the obligations of Article VIII effective December 1, 1996.

C. Reform of the Trade System

13. In the reform of China's trade system over the past two decades, the expansion of trading rights and gradual phasing out of mandatory planning have played a key role. However, as the system became more decentralized and the plan was scaled back, other instruments to regulate exports and imports, such as tariffs and licenses, gained importance. At the beginning of the 1990s, China's trade regime was characterized by a complex and rather intransparent system of high and widely differentiated tariffs as well as numerous, frequently overlapping, nontariff trade barriers (NTBs). Since then some progress has been made scaling back these measures, but a broad-based liberalization lies ahead.

14. The proliferation of FTCs has been instrumental in the decentralization of China's trade system. From a dozen of companies executing foreign trade in the late 1970s, the

³⁴On April 1, 1996, the restrictions arising from the SAEC's authority to freeze the foreign exchange accounts of FFEs and subsequently deny them access to the foreign exchange market were removed. Nonetheless, FFEs remained subject to an annual exchange control examination, which focused on the enterprises' compliance with their contractual obligations and China's exchange regulations. FFEs could be denied access to the foreign exchange market upon failure of the examination. The "Regulations on the Sale and Purchase of and Payment in Foreign Exchange" of July 1, 1996 eliminated the restrictions on FFEs' access to the foreign exchange market for current payments and transfers, as well as most remaining restrictions on current payments and transfers, such as the nontransferability of investment income by nonresident Chinese emigrants, and the non-transferability of proceeds from sales of personal items by nonresidents.

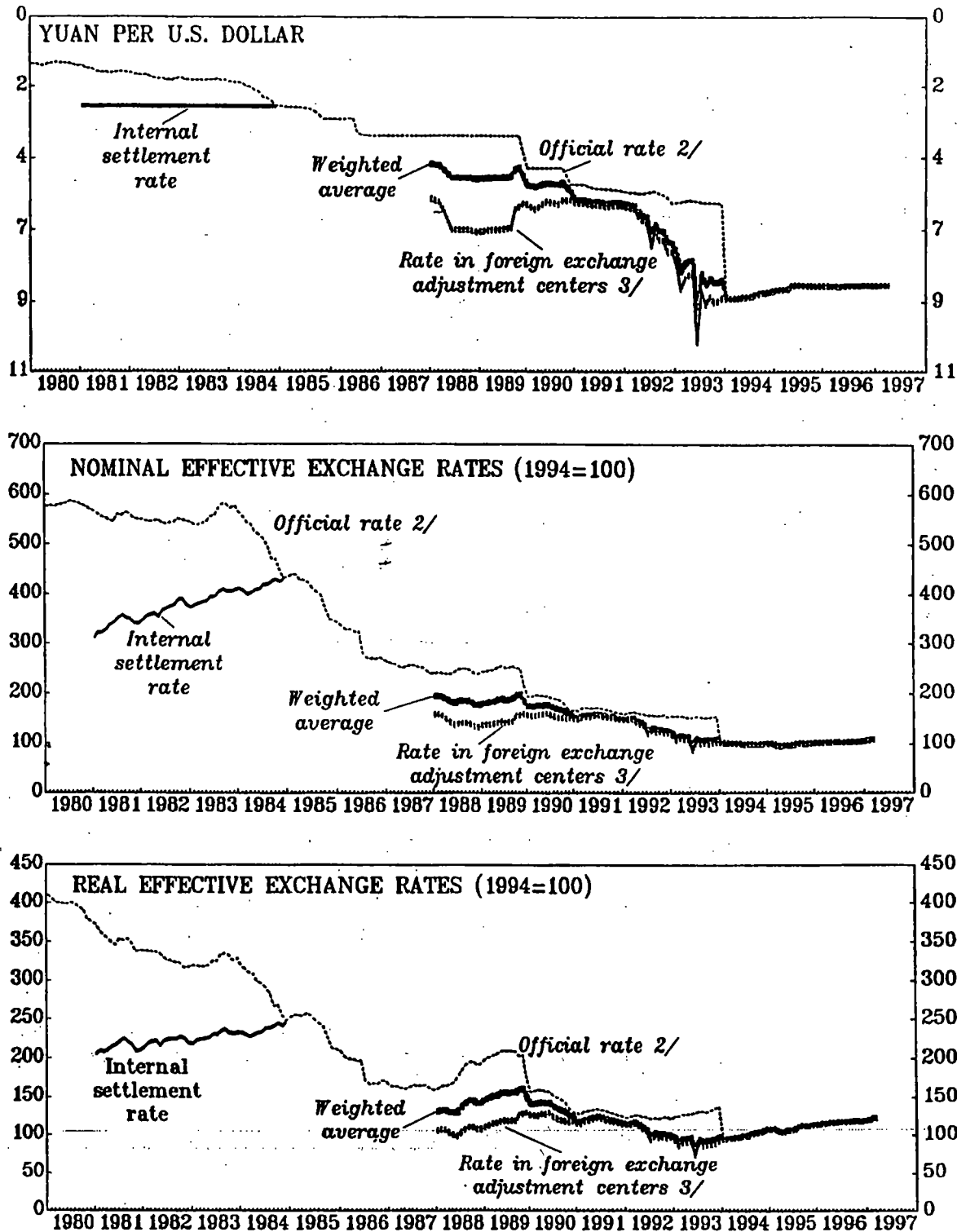
³⁵Shortly after acceptance of Article VIII, the name of SAEC was changed into State Administration of Foreign Exchange (SAFE).

³⁶The policy to approve all bona fide requests for foreign exchange for current payments and transfers was announced in an official statement on November 28, 1996 and subsequently incorporated in the "Foreign Exchange Administration Regulation of the People's Republic of China.

CHART V.1

CHINA

EXCHANGE RATE DEVELOPMENTS, 1980-1997 1/



Sources: Data provided by the Chinese authorities; and staff estimates.

1/ Monthly averages; downward movement indicates depreciation of the renminbi.

2/ On January 1, 1994, the exchange rates were unified at Y 8.7 per U.S. dollar. Since then the rate has been determined in the interbank market.

3/ These centers were established in late 1986, but the exchange rate in the centers became market-determined only in 1988.

Table V.2. China: Average Import Tariff Rates for China and Selected Asian Countries 1/

(In percentage points)

	Unweighted average import tariff	Standard deviation of tariff rates
China	36.3	28.0
Indonesia	19.4	16.1
Korea	9.0	6.6
Malaysia	14.3	14.0
Philippines	20.0	11.0
Thailand	23.1	16.9
Vietnam	12.0	15.5

Source: World Bank, *World Development Indicators*.

1/ For the period 1990-93.

Table V.3. China: Import Tariffs, 1992-96

(In percent, at end-year)

	1992	1993	1994	1995	1996
Unweighted average tariff	39.2	36.4	35.9	35.6	23.4
Weighted average tariff 1/	31.2	30.7	...	28.1	19.8
Maximum rate	220	...	...	150	122
Standard deviation	27.4	...	...	23.8	16.7
Memorandum items:					
Concessional imports in percent of total imports 2/	50.4	54.0	62.0	60.0	65.0
Tariff revenue as a percentage of imports 3/	4.4	3.2	2.9	2.7	2.8

Sources: World Bank and staff estimates.

1/ Calculated on the basis of 1992 import shares.

2/ Ratio of imports subject to tariff concessions to total imports; based on c.i.f. customs values. Concessional imports include the following categories: imports for processing and assembling, imports for processing with imported materials, equipment and materials imported by FFEs, equipment for processing and assembling, compensation trade, and border trade.

3/ Total budgetary tariff revenue as a percentage of import values (customs basis converted to f.o.b.). Budgetary tariff revenue includes also revenue from export tariffs, but the latter involves relatively small amounts.