



WILEY FINANCE

CHINA'S EMERGING FINANCIAL MARKETS

Challenges and Global Impact

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China's emerging financial systems are already a vital part of global systems. Little understood, they nonetheless will play a large role in the future. The financial debacle in the Western world in recent times has made obsolete the references to certain Western banks in this book. It has not changed the fundamental situation in China, however, and that situation is reflected in these chapters. The authors have provided a benchmark that shows where China stands today, 30 years after the start of the national policy to reform and open the country. They have also provided a baseline for the next era. Their words represent the concentrated intelligence of the most senior and far-sighted people in the field. We express our deep appreciation for their contributions.

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Zhu Min
Cai Jinqing
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There could not have been in all of history so rapid a development in a functional financial system, and in particular of banking institutions, as in China over recent decades. The old framework was a dominant state-owned and state-run “bank” providing funds for state-owned enterprises (SOEs) in accord with state-directed priorities. It was not, in fact, a banking system at all, which implies a variety of institutions free to respond to the needs of individuals and businesses.

An enormous effort has been required to achieve the needed transition. There was the huge financial cost implicit in dealing with the unpaid and unpayable obligations assumed under the old system by many SOEs that burdened bank balance sheets.

There was the broad political challenge of accepting and supporting a more decentralized, market-responsive financial system as a part of economic reform. Not least, there has been the intellectual and educational need to adapt to the methods and requirements of a more open and competitive economic environment.

Today, the state still has majority ownership of a small group of very large banks and insurance companies, but those institutions have private stockholders, in some cases with foreign participation. They have been joined by a growing number of smaller institutions established with private capital, and by a few affiliates of foreign banks and insurance companies.

A basic framework of supervision and regulation is in place, and a central bank has been provided with the essential tools for conducting monetary policy. International accounting standards are being introduced, along with growing attention to credit analysis, risk management, and the need to operate efficiently with a reasonable margin of profit.

Now there is room to compete in responding to business and individual needs; indeed, there is a necessity to do so. Success is dependent upon the ability to cover expenses, with a margin of profit. As a result, attention needs to be paid to efficiency, to developing a “credit culture” to protect against weak loans, and to provide the variety of financial services required for a modern economy.

Plainly, that process is incomplete. Virtually every chapter in this new volume is replete not just with reports of progress, but of unfinished business. Some of the analysis is technical and detailed, but the basic theme is quite clear.

Chinese banking has become part—a growing part—of the world of finance, supporting the rapid economic growth of China. The basic trend seems to me well-established—more sensitivity to market forces, growing flexibility in pricing, greater reliance on private capital, and, over time, more participation in foreign markets by Chinese banks and by foreign financial institutions in China.

In a country with more than a billion citizens, with massive needs for capital on the one hand, but an equally strong capacity to generate savings on the other, efficient financial intermediation is not an option. It has become an essential ingredient in the effort to sustain rapid growth within China, and a part of its increasing trade with other countries.

The Chinese system is still dominated by institutions, and particularly by very large institutions, with majority government ownership. But the driving force is more and more market-oriented, with a variety of services developing for individuals and with sources of credit for businesses. Lending to SOEs, while still substantial, is receding in relative importance, lending practices are more disciplined, and the provision of credit is increasingly responsive to the needs of business firms rather than to official direction.

No doubt, much remains to be done in terms of technology, in staff training, and in management, to meet the needs of the growing economy. My sense is that foreign participation is assisting in that process, and is capable of still greater contribution.

At the same time, those guiding and participating in the development of the Chinese financial market will want to be alert to important lessons of Western experience, the need to guard against speculative excesses, to maintain adequate capital and effective supervision, and, most importantly, to keep reasonable monetary stability. These lessons are necessary for all nations that want to benefit from a growing, productive economy able to compete effectively in the world.

Paul A. Volcker

INTRODUCTION

Zhou Xiaochuan

Governor, People's Bank of China

One overarching conclusion can be made in reviewing the progress of financial reforms in China and in looking to the future: only firm adherence to Reform and Opening will allow us to make further progress and assure China's financial and economic stability.

PRINCIPALS UNDERLYING FINANCIAL REFORMS

Improvements in China's financial system and its ongoing alignment with market forces in recent years are due primarily to the process of Reform and Opening. Only by creating sound financial institutions can we participate in markets, take advantage of business opportunities, support growth in China's as well as the world's economy, and, finally, preserve stability.

The government has made it clear in recent years that it has firmly decided to achieve financial reform. At the same time, this cannot be accomplished in one fell swoop—it is a long process. Some actions can achieve fast-paced results, while others require the extended accumulation of experience. The next stages will take ongoing determination. They will involve strengthening reforms in both economic and financial systems.

Reform is an exercise in systems engineering. The various parts of the process require integration and a high degree of popular participation. Reform of this sort is not a kind of guerrilla operation with dispersed forces; it requires a full-scale frontal attack.

Institutional reform is the foundation of financial stability. All new developments in financial markets present new challenges to financial stability. We can recognize the importance of preserving stability when we look at the subprime mortgage crisis in the US and related

market volatility. Financial stability is closely related to the health of economic and financial institutions. The Chinese government has tried to maintain a balance among three key policy goals: reform, growth, and stability. One of the implications of the phrase “scientific approach to economic development” is that these three must preserve an appropriate balance. Balance must also be maintained in the relationship between government-directed macroeconomic measures and the self-adjusting mechanisms of microeconomic forces.

Progress in reforms to date gives us confidence that the next steps in Reform and Opening will succeed. It also allows China to put increasing weight on Reform and Opening in furthering economic growth by allowing reformed mechanisms to work. We have more experience now in this regard, and hence more confidence.

CHINA'S FINANCIAL SYSTEM A DECADE AGO

In looking at China's financial reforms in the past few years, it is useful to remember the condition of our finances during the Asian Financial Crisis some 10 years ago. My personal summary of the situation back then includes the following observations.

The percentage of nonperforming loans (NPLs) in commercial banks was high. At the time of the crisis, the reported rate of NPLs was 25%, but due to problems in accounting standards, methods of classifying loans, and overall financial discipline, the market evaluation put the rate at more like 35–40%.

This high rate was brought on to a large degree by the intertwined nature of commercial loans and loans made in response to policy objectives. It was also related to the prevailing “credit culture” at the time. A common saying was that bank loans in China were mainly “relationship loans”; that is, essentially a function of one's relationships.

Commercial banks were not operated as “enterprises” to an adequate degree 10 years ago. There was no clear mandate to run a bank with profit as the key objective; instead, banks were operating under the directives of government institutions. The process of enterprise reform had already begun in China at the time of the Asian Financial Crisis, but there had not yet been great progress. The concept of corporate governance had not even been broached in preliminary fashion. Government and regulatory organizations gave no guidance in appropriate governance measures—institutions generally

proceeded with their own understanding of how to do things. In general, financial institutions at the time, like all government institutions, lacked business objectives and lacked both motivating and restraining mechanisms for accomplishing those objectives.

There was a sizable gap between international and Chinese laws, regulations, and rules. The gap between Chinese accounting standards and world standards was particularly large. China's standard loan classification at the time mainly related to the term of the loan and was not, as it is now, divided into a five-tiered structure.

Standards for information disclosure of listed companies were woefully inadequate, so insider trading and share price manipulation were common. Financial reports were not significant since they relied on inadequate accounting standards. Key laws such as the Corporate Law, Securities Law, and Bankruptcy Law were incomplete at the time.

Capital markets in China were still in a rudimentary stage 10 years ago. With immature markets, price determination mechanisms were poor, investment rationale was not developed, and problems abounded.

Regulatory systems at the time of the Asian Financial Crisis were highly unsatisfactory. Throughout the crisis, China debated how best to set up more effective systems. In addition to regulatory systems, an improved overall environment required the setting up of a whole series of rules and regulations. Training of regulators was necessary to raise the level of professionalism and define regulatory goals—all of these had been absent and were now imperative. Setting up systems, organizations, rules, and procedures has been a key task in the intervening years.

Mechanisms for restraining certain behavior and for evaluating performance were insufficient. Indeed, it was unclear exactly what kind of mechanisms should be used with regard to financial institutions. During the crisis, the key criterion used by the Chinese government in judging a financial institution was the percentage of NPLs in its portfolio. It was difficult, however, to know which loans among those NPLs were policy-related loans and which were of a commercial nature. It was hard to differentiate the causes for NPLs, allocate responsibilities, and know how to balance provision for NPLs. In fact, focusing on NPLs was not an easy way to apply restraints on behavior or to evaluate the soundness of a bank. Using the Basel I capital adequacy ratios and core regulatory principles in restraining and evaluating financial institutions became an urgent task. At the

same time, this was not an easy thing to accomplish since many commercial banks had negative capital adequacy ratios at the time.

Relatively severe financial pressures existed 10 years ago in the overall economy, and financial services and capacity to innovate in meeting challenges were inadequate. Since financial institutions were unhealthy, and since regulation was insufficient, there were strong financial pressures pulling in the opposite direction to reform. Basically, we could not encourage financial markets to develop and financial products to be developed out of fear that worse problems would appear, and indeed many problems did appear. Some financial institutions wanted to issue new products and some exchanges wanted to trade in new derivative products, but at the time, any application had little chance of being approved within a four- to five-year timeframe. The reason was that institutions were unhealthy, the risk was overly concentrated, and many felt that the new products would run into trouble. One important issue was that China knew it had to encourage the growth of institutional investors, since complex new products could not be sold to retail buyers. At that time, however, the number of Chinese institutional investors was extremely small and financial pressures made it hard for them to grow.

Confidence in the RMB sank at the time of the Asian Financial Crisis. Although China's balance of trade had moved into a positive position by the 1990s, and foreign businessmen were investing in China, an examination of the international balance of payments in the 1990s shows mostly negative numbers, and at times the capital outflow was extreme. This showed a lack of confidence in the RMB with a strong trend toward capital flight. Under these conditions, currency controls were relatively stringent. Opportunities for Chinese businessmen to seize opportunities and participate in international markets were slim.

Administrative interference in banking operations was still prevalent at that time. From 1993, China began to encourage a division of state or government and business or enterprise, and to discourage government interference in policies relating to commercial-type loans of commercial banks. The central government did indeed begin to operate in this direction. There were substantial differences in the way regional governments responded, however.

During the Asian Financial Crisis, one of the main tasks of reform therefore was to insist that regional governments obey the demands of the central government in not applying administrative pressure to loan-making decisions.

THE PACE OF CHINA'S FINANCIAL REFORMS

From the previous section on the starting point of China's financial reforms—at the time of the Asian Financial Crisis—we can see that taking action was an urgent necessity. Many international authorities described China's situation back then in grave terms. Three basic evaluations surfaced: (1) that China's financial system was a large time-bomb that could go off at any time; (2) that China's commercial banks were technically insolvent; and (3) that China's financial system would be a drag on its economic growth, making it impossible for the system to service the economy and support development.

Given this situation, the Chinese government was determined to carry out reforms. The ailments were multifaceted, but a unified, systematic, overall approach was necessary. It had to be carefully designed, organized, and executed in sequential stages. The Asian Financial Crisis was a tremendous shock to many Asian countries and China was no exception. Many outsiders thought that its effect on China was limited, but China too saw many institutions go bankrupt or close down at the time, and a large number of businesses faced serious losses. Consumer confidence eroded, the economy entered a deflationary period, and in fact the influence on China was extreme. From another angle, however, one could say that the experience hastened the recognition that reform was an urgent necessity.

Pressures were great at the time decisions were being made, but distinctions were made between fast-paced reforms and those that would require a more deliberate approach. The latter, according to the Chinese phrase, recognized that you cannot tug on growing shoots to make a plant grow faster, since you will simply pull up the roots. Longer term reforms included a change to the culture of credit, the development of institutional investors, investor education in rational decision-making, improvement of corporate governance structures, and so on. These were all going to take a long time. At that time, human resources that could enable corporate governance structures were generally not available. Independent directors or outside directors on Boards had to be put through special classes at local universities, in order to learn what was involved, to understand the responsibilities of Boards of Directors, to learn how to conduct proper meetings, and so on. Ten years ago, very few people had much experience in evaluating balance sheets and financial reports.

Other aspects of reform were more pressing. They required not only fast action, but the need to see fast results. One such matter was the

need to stop the co-mingling of policy-type loans, made in furtherance of government policies, and commercial loans. Commercial banking had to be forced to enter the path of real commerce, in a way that met the requirements of business enterprises.

A second task was to clean up the balance sheets of financial institutions in a decisive way. Both the Asian Financial Crisis and the Japanese experience had shown that dilatory action was counterproductive. Action had to be decisive or problems would stay unresolved for years. Balance sheet problems would then affect the ability of the financial system to provide the necessary support for overall economic growth. In times of crisis, financial institutions focused on their own pressing problems and had no ability to contribute to building the economy.

A third matter was to establish modern standards of all kinds, including those relating to laws and regulations, accounting standards, disclosure requirements, loan classifications, and provisions and tax codes, and at the same time to set up guidelines for corporate governance. China actually did address these things quite briskly, but it is one thing to be quick in setting up standards and another to implement methods to enforce the standards.

A fourth task was to strengthen regulation. It was necessary to recognize the lessons of past experience and to change the organizational structure of financial regulation, while requiring that institutions themselves develop the human resources to meet regulatory requirements.

The fifth matter was to establish restraining mechanisms in requiring compliance with capital adequacy ratios. This included strengthening compliance with the Basel Accord in the banking system, and with comparable mechanisms in the securities and insurance industries. Without these, any improvement in financial institutions would be slow.

MAIN ASPECTS OF CHINESE FINANCIAL REFORM

Given the above considerations, the main components of China's financial reform include the following issues.

1. Cleaning up and restructuring banks, and improving macroeconomic measures that allow the preconditions for their reform, then implementing a financial reorganization of state-owned commercial banks. The first banks to go through this process were the

Bank of Communications, the Bank of China, the China Construction Bank, and later the Industrial and Commercial Bank of China. The process is ongoing and the next bank to undergo financial restructuring will be the Agricultural Bank of China.

2. Requiring that reconfigured financial institutions, including securities firms and insurance companies, become shareholder companies to the extent that is possible. This includes listing on exchanges, implementing control mechanisms, and setting up adequate corporate governance structures. Without a shareholder system and listing on exchanges, it is hard for corporate governance to take hold, given traditional influences. It is also hard to accomplish serious external oversight and regulation. At the same time, many measures related to opening to the outside have been beneficial in promoting the establishment and stability of corporate governance structures.
3. Truly changing all kinds of standards and rules. After the Asian Financial Crisis, China revised its accounting standards a number of times and these revisions greatly improved China's standards, allowing them to approach international standards. In terms of classification of loans, China began to require strict adherence to a five-tiered classification system, to require capital adequacy ratios as in the Basel Accord, and it required a clear timetable for achieving results. Currently, most banks can comply with Basel I standards; Basel II is to be implemented in large banks within two to three years. In addition, progress has been made in information disclosure requirements and in corporate governance regulations.
4. Strengthening regulation—in 2003, China set up a Banking Regulatory Commission and strengthened the organizational structure of regulation. At the same time, it clarified regulatory principles.
5. Emphasizing the guidance mechanisms of currency policy. Macroeconomic measures must be in alignment with the soundness of financial institutions. Institutions must approach the market in accord with government policy guidance with regard to currencies.
6. Doing away with outdated and excessive administrative controls. When financial institutions exhibit healthy operations, then they should be encouraged to become more involved in international markets, to compete with international institutions in their own lines of business, and to engage in product and organizational innovation. Circumstances have changed in China: we cannot always be requiring administrative review and approval for every new step. This includes entry into the market, initiating new

- products, and foreign exchange controls. All of these have to move forward in a new direction and become aligned with market forces.
7. Improving the “financial ecosystem”—in the past, administrative interference was concentrated more in certain financial affairs and certain regions. Regional governmental protection was extended in some cases relating to debts; inadequate enforcement in some cases meant that nationally based financial institutions were being taken advantage of on a regional basis. Local and regional-level governments used to feel this was fine, but a conceptual change is gradually penetrating the system in this regard. It is recognized that only with adequate enforcement and credibility will more financial resources be committed to regional development. Only if the regional financial ecosystem is well-managed, administrative interference is minimized, enforcement is adequate, and credibility is emphasized, will there be more resources in the future. Only then will the region’s economy move forward. This change has marked an extremely important conceptual shift since the time of the Asian Financial Crisis.

A SYSTEMIC APPROACH TO CHINA’S FINANCIAL REFORMS

Looking back at the content and the context of China’s financial reforms since the Asian Financial Crisis, we see that the Chinese government has proceeded in a sequential manner. One reform has been linked to the next, guided by careful research and design, and implemented in an organized fashion with sets of coordinated actions. Naturally, many unexpected things have happened in the course of economic and financial development. Generally speaking, though, the positive experience of systemic reform has guided the process.

Putting Chinese financial institutions on a healthy track has given them a basis on which to participate in international markets. We must maintain a high degree of vigilance, however, with regard to problems of risk and financial stability. The recent extreme perturbations in international financial markets remind us that markets are often not stable. Macroeconomic government policies and the ability of institutions themselves to moderate risk and maintain soundness are both extremely important aspects of financial security.

We will continue to press forward with ongoing financial reform and financial opening in China. In January 2007, a meeting of the Working Group on National Finance was held in Beijing. It laid out

arrangements for the next stages, including the further development of capital markets, building up the insurance industry, reforming the State Development Bank, establishing depository insurance, and so on. Certain future steps can be foreseen, but the world economy continues to present us with new challenges and new circumstances. As we encounter obstacles, we will be making appropriate adjustments, and constantly moving forward with financial Reform and Opening.

China's Emerging Financial Industries and Implications

Zhu Min

Group Executive Vice-President, Bank of China

China's economic growth since reform policies started in 1978 is broadly recognized. For 30 years, the economy has maintained an astounding average annual growth rate of 9.6%. GDP reached US\$4 trillion in 2008, making China the world's third-largest economy after the United States (nearly US\$14 trillion) and Japan (around US\$4.3 trillion). Systemic reform over this period has brought fundamental changes, most importantly a parting of the ways with the old planned economy system. Production of state-owned enterprises (SOEs) was only 9.7% of GDP in 2008, down from 89.1% in 1978. The structure of China's economy has also changed profoundly. If one divides economic production into three main areas of agricultural, industrial, and services, China's GDP in 1978 was 28.2% agricultural, 47.9% in manufacturing, and 23.9% in services. By 2007, these percentages had changed to 11.3%, 48.6%, and 40.1%.

Urbanization has proceeded at a phenomenal pace. Eighteen percent of China's population lived in cities in 1978; in 2007, almost half, or 44.9% of the population lived in cities. China's "opening" policies have caused international trade to increase at an average of 23.6% per year over the course of 30 years. Total trade too has risen from 9.7% of GDP in 1978 to 66.4% of GDP in 2007. At the same time, China has maintained stable macroeconomic policies with financial deficits that are, on average, less than 1.1% of GDP. Inflation has been kept at a fairly low level. Incomes have shown constant increase:

per capita GDP of US\$280 in 1978 had risen to US\$3,180 in 2008. Three hundred million people have been lifted out of poverty, and life expectancy in China has gone from 68 years in 1978 to 73 years in 2007.

These are extraordinary figures. China's financial industries, however, have seen even more momentous change. In 1978, there was only one People's Bank of China (PBC) responsible for the functions of a central bank, commercial banks, and everything to do with finance. China now has a banking structure that includes a variety of institutions: an independent central bank, policy banks responsible for funding state policy initiatives, large commercial banks, medium-sized commercial banks owned by shareholders, small municipal banks, and rural credit cooperatives. Assets in the banking industry as a whole have gone from RMB115.5 billion in 1978 to RMB52 trillion in 2007. This 500-fold increase has been achieved by growth with an average of nearly 20% per year. Savings deposits of Chinese citizens have gone from RMB21.1 billion in 1978 to RMB17.25 trillion in 2007, an 800-fold increase, with average annual growth of 25%. China's stock markets began from a base of zero in late 1990, when the Shanghai Stock Exchange was founded. By the end of 2007, there were 1,550 listed companies on this exchange, and more than 132 million investor accounts of Chinese citizens. Market capitalization on the exchange totaled RMB32.7 trillion, equivalent to 140% of China's GDP, making the Shanghai Stock Exchange the fifth-largest stock market in the world. In the 25 years since China declared in 1972 that it had neither domestic nor foreign debt, the country has assumed the responsibility for both. China first reissued government bonds in 1981. Since then, the bond market has gone on to include a fairly complete array of government bonds, corporate bonds, short-term financing, and asset-backed securities (ABS), on the scale of RMB12.3 trillion or some 47% of GDP. This has to be one of the most dramatic turnarounds in the history of finance.

In this overview to the book *China's Emerging Financial Markets*, I will review China's 30 years of reforms in the financial sector, sum up the lessons and look to the future. In Section I, I review China's financial reforms. In Section II, I discuss the opening of China's financial sector to the outside world. In Section III, I summarize new challenges facing the industry. In Section IV, I look to the future of the industry, particularly given the impact of global integration.