

CHINA'S BANKING PROBLEMS: COMMONALITIES WITH SOUTH-EAST AND EAST ASIA

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ABSTRACT

After the outbreak of the Asian Financial Crisis in the summer of 1997, the banking systems in the most affected countries (Thailand, Indonesia, South Korea) showed similar symptoms to those of the banking system in the P.R of China. The therapies applied in both cases are also, and understandably, quite similar. But the diagnoses of their distress are very different. In the East Asian countries, excessive unhedged and mostly short-term borrowing by the banks and/or domestic firms turned sour and laid bare a number of deep-seated defects in the financial system. Conversely, in China the causes of the weak position of the banks essentially stem from domestic factors. The banks still carry the legacy of the previous centrally-planned economy, in which the so-called banks were not really involved in autonomous financing but were essentially fiscal institutions. Besides, the widespread deficit position of the state-owned enterprise (SOE) sector has saddled the banks with a heavy overhang of non-performing loans.

ABOUT THE AUTHOR

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Introduction

The inspiration for this paper derives from the obvious observation that banking systems in the People's Republic of China and in the countries affected by what is commonly called the 'Asianⁱ financial crisis' (henceforth AFC) were, and still are, afflicted by a number of similar symptomsⁱⁱ and - continuing the medical analogy - also applied similar therapeutics. Hence the question arises whether the similarity of the symptoms and of the 'medicine' administered also allow the conclusion that the diagnoses, i.e. the causes of the diseases, are equally comparable. This paper argues that this is not the case.

I am confident that readers will show me some indulgence if, within the brief compass of this paper, I am led to impose some limitations on the treatment of the above mentioned subject matter, which is vast and complex. Accordingly:

- (i) I only sketch the outlines of the arguments, thus omitting much useful detail.
- (ii) I focus on the three countries in East Asia that were most affected by the AFC, viz. Thailand, Indonesia and South Korea. While several common features can readily be identified - amongst them, and most relevant to our subject, the fragility of their banking systems - their economic circumstances and institutional frameworks significantly differ. This is still the case today, after the bottoming out of the AFC: while Korea and, to a lesser degree, Thailand have staged an encouraging recovery, Indonesia remains mired in a deep crisis, after half-hearted initial attempts at stabilisation failed amidst political turbulence. Two other ASEAN countries, viz. Malaysia and the Philippines, are not explicitly treated, as they were less hurt; yet, some of the features that characterise the AFC also apply to them;
- (iii) I concentrate on the deposit, or commercial banks. They are the main component of the financial system and the authorities want to reconstruct them into the hub of a healthy and up-to-date modern financial system. I will not systematically look at the multifarious non-bank financial institutions, although they have been major vectors of the 'Asian financial flu' - were it only because they were generally supervised only loosely by the authorities.ⁱⁱⁱ

This paper is structured as follows:

- a) A somewhat stylised report on the AFC covering its main symptoms, its contagious nature, and its causes. As just mentioned, particular attention is paid to Thailand, Indonesia and South Korea.
- b) The quite limited impact of the AFC on the Chinese economy and financial system and the reasons why China remained largely unscathed.
- c) The critical condition of the banking system in China and its determining factors
- d) An overview of remedies to cure the ailing banking systems in China and in the AFC-affected countries.
- e) Some concluding remarks.

A The Origin and Spread of the East Asian Financial Turmoil, its Symptoms and Diagnosis

Four outstanding facets of the AFC should be mentioned offhand:

- (i) the turmoil was quite unexpected;
- (ii) it was contagious, i.e. it rapidly and pervasively spread to other countries outside Thailand, where it was ignited;
- (iii) it involved two crises, in that it soon engulfed in varying degrees both the banking system and foreign exchange markets;
- (iv) it caused a serious dip in economic activity and inflicted serious hardship on the economies.

These features emerge clearly from an overview of events and from their interpretation.

The unexpected but violent crisis Only a few years earlier, the countries in the region had been hailed as the artisans of the 'East Asian miracle', an expression that gave its title to a resounding publication by the World Bank (1993). Even government-directed credit policies in Japan and Korea got high marks (Vittas and Cho 1994). In the subsequent years, while their growth was somewhat slowing and a few observers drew attention to the need to shore up their banking systems, a major financial crisis was not at all anticipated, neither by market operators, nor by governments, nor by officials of international financial institutions.

Table 1: Main Macroeconomic Indicators Prior to the Crises

Indonesia	1994	1995	1996
GDP growth (%)	7.5	8.2	8.0
Inflation (%)	8.4	9.4	7.9
Savings (% of GDP)	29.2	29.0	28.8
Investment (% of GDP)	27.6	28.4	28.1
Fiscal balance (% of GDP)	0.0	0.8	1.4
Current account (% GDP)	-1.7	-3.3	-3.3
Malaysia	1994	1995	1996
GDP growth (%)	9.2	9.5	8.6
Inflation (%)	3.7	3.4	3.5
Savings (% of GDP)	32.7	33.5	36.7
Investment (% of GDP)	40.1	43.0	42.2
Fiscal balance (% of GDP)	1.4	1.3	1.1
Current account (% GDP)	-7.8	-10.0	-4.9
Philippines	1994	1995	1996
GDP growth (%)	4.4	4.8	5.7
Inflation (%)	9.0	8.1	8.4
Savings (% of GDP)	19.4	17.8	19.7
Investment (% of GDP)	23.6	22.2	23.2
Fiscal balance (% of GDP)	-1.6	-1.4	-0.4
Current account (% GDP)	-4.6	-4.4	-4.7
South Korea	1994	1995	1996
GDP growth (%)	8.6	8.9	7.1
Inflation (%)	6.3	4.5	4.9
Savings (% of GDP)	34.6	35.1	33.3
Investment (% of GDP)	35.7	36.6	36.8
Fiscal balance (% of GDP)	1.0	0.0	0.0
Current account (% GDP)	-1.2	-2.0	-4.9
Thailand	1994	1995	1996
GDP growth (%)	8.9	8.7	6.4
Inflation (%)	5.1	5.8	5.9
Savings (% of GDP)	34.9	34.3	33.1
Investment (% of GDP)	39.9	41.8	40.8
Fiscal balance (% of GDP)	2.0	2.6	1.6
Current account (% GDP)	-5.6	-8.0	-7.9

Source: Zhou Jianping, 2000.

The macro-economic fundamentals had indeed been consistently strong, as Table 1 shows. The East Asian countries staged rapid GDP growth in real terms. Even the Philippines, the slowest of the group still labouring under the legacy of the Marcos-era mismanagement, reached an average growth of close to 5 % p.a. Savings and investment ratios were very high. Government finances were sound and inflation remained within one digit. However, current

account balances were deeply in the red, but this could reflect rapidly growing economies and should not cause serious alarm as long as the imports were largely geared to productive investments, and the shortfall could be financed in a sound way - which proved not to be the case.

The crisis in Thailand Since 1984, the Thai baht has basically been pegged to the US dollar. When the Bank of Thailand withdrew its support for the baht in July 1997, it had already vainly consumed a large portion of its foreign exchange reserves since November 1996 in warding off three small speculative attacks against the baht.

The Thai crisis first affected the exchange market, but soon also overwhelmed the banking system. The loans in foreign exchange, which Thai firms had contracted through the banking system, most often without adequate hedging, acted as the main transmission belt. Such loans commanded much lower interest rates and the borrowers, as well as the Thai banks - to which should also be added, foreign lending banks - were under the illusion that the fixed exchange regime, supported by the authorities, amounted to an implicit safeguard against depreciations of the Baht. In the Thai case, the establishment of the Bangkok International Banking Facilities, as a pseudo offshore centre which was intended to transform Bangkok into a regional financial centre, had broadened the channels through which foreign financing could be obtained.

In the ensuing months, the crisis was bound to affect all Thai players in the financial area: firms could no longer service their borrowings in foreign exchange, the money supply contracted, and foreign banks no longer renewed their essentially short-term loans to their Thai counterparts. There was also capital flight by those Thai residents who could afford to convert baht assets into dollars, were it only to seek protection against their short position in foreign exchange. By the end of 1997, the baht had lost 45 % of its value against the US dollar. The real economy was soon plunging into a deep recession; consumer confidence sagged, the stock market slumped, as did the prices of real estate, into which a lot of speculative capital had been poured; many firms and some banks went broke; and unemployment was rising rapidly. Moreover, the higher interest rates which the authorities engineered once the crisis broke out to support the domestic currency exerted an additional deflationary impact on economic activity.

The contagion -Within two weeks of the unpegging and precipitous fall of the Baht, the Philippine peso, the Malaysian ringgit, the Indonesian rupiah and even the Singaporean dollar came under downward pressure in the exchange markets and caught the 'Asian flu' – an apt metaphor for the rapid spread of the AFC. However, the concurrent fall in the values of those domestic currencies does not imply that their causes and their intensities were the same; thus, the more modest slide of the Singaporean dollar reflected the depreciation of the Asian currencies that belonged to the basket to which the Singaporean dollar was linked.

Once these events unfolded, the initial tempest became a hurricane, fuelled by pervasive pessimism and widespread panic reactions not only amongst foreign operators but also amongst domestic enterprises and individuals. As Garten (1999, p. 79) remarks, "... contagion was as much in the mind of lenders and investors as in the markets". Whereas, a few years earlier, the very expression 'emerging markets' acted as a magnet for inbound financial flows, it now was viewed as a pillory, to be avoided by all means. One may submit the opinion, that such grouping-together of the countries under the same pejorative epithet does fundamentally explain the contagious nature of the AFC, more than the direct impact which events in one country, say Thailand, may have on other economies. As a matter of fact, as noticed by White (2000) whereas 'cross-country contagion' connotes a causal relationship, the economic and financial transactions between the affected countries in East and South East Asia remained rather modest.

The crisis in Indonesia A somewhat similar scenario unfolded in Indonesia although the Rupiah, unlike the Baht, was initially not viewed as an overvalued currency and was allowed to float within a modest band. But it became engulfed in the AFC towards the end of 1997. The rupiah plunged from around 2.500 Rp to the Us dollar to over Rp 15,000 in January 1998. The consequences of the collapse of the domestic currency on the real economy were similar to those in Thailand, but cut deeper since capital-account convertibility had been almost fully permitted in 1986. Besides, capital-account convertibility had been allowed and contrary to the situation elsewhere, most of the large foreign debts had been contracted directly by the corporate sector, instead of through the intermediary of the banking sector. Two other factors soon exacerbated the situation. First, a large number of private banks with weak underpinnings had been allowed to start operations. Amongst them were many house banks for industrial and commercial groups; even the central bank owned several commercial banks. Between those related parties the transactions were not conducted "at arm's length", to put it

euphemistically; hence, when the corporate sector got in trouble the banks also became contaminated. Besides, in the waning days of the Suharto regime, which indulged in large-scale financial corruption up to the top of the hierarchy, political instability was looming, and erupted into violence once the financial crisis took hold.

South Korea – This is the third country that became heavily affected by the AFC. Since Korea initiated an export-oriented growth strategy in the 1960s it has had a most impressive growth record, eventually qualifying it for membership of the OECD, the club of rich countries. Here also, developments in the exchange markets triggered a wholesale economic disaster. Although the ultimate causes were more complex, they were also rooted in the weak financial situation of the corporate sector and of the banks. Some pressures had built up already in 1996 as world prices of semiconductors, a major Korean export, plunged as a result of overproduction, much of it in Korea itself. The current account balance, which had been positive until 1993, was reversed in subsequent years and reached a deficit of 5 % in 1996. In the first semester of 1997, a few well-known conglomerates (chaebols) – amongst them Kia and Hanbo - went broke.

As pressure against the won built up, the central bank defended the W900/dollar parity line for several months; for many years, the won had been allowed to float within a narrow range. Although apparently successful, this strategy depleted the foreign exchange reserves and dried up liquidity in the domestic financial market, thus depriving Korean firms of much needed financial means. Once the government, in July 1997, allowed them to seek financing abroad they began borrowing large amounts on a short-term basis. (Previously, sizeable and unhedged foreign exchange liabilities had been built up mainly by way of issues of long-term bonds). One must also add that, until most recently, Korea has remained averse to inbound foreign direct investments.

At last on December 15, 1997, the Bank of Korea abandoned the fight and let the won float freely; it reached about 1700 won/dollar by the end of the year. The position of the won became critical, once Taiwan, the main competitor in the area of semiconductors, on October 17, 1997 devalued its (new) dollar. When a massive \$58bn international rescue loan was arranged of which \$21bn consisted of a stand-by loan by the IMF, the won rather rapidly regained part of the lost ground.

Without the outburst of the AFC elsewhere and its contagious impact on the perception of market participants about the soundness of the national currency, the situation in Korea would probably never have reached such an abyss. But worried market operators, already confronted with the financial disasters in Thailand and elsewhere, now turned a critical eye on Korea. They could easily identify pre-existing structural weaknesses in the banking and corporate systems that had previously been masked by the rapid growth of the economy and by prevailing optimism.

Korean firms were traditionally heavily indebted in domestic and foreign currencies. Thus, the debt–equity ratio of many of the major Korean firms reached 500 % at the start of the AFC (Park, 1999). This further eroded their already weak profitability and became disastrous as regards their foreign debts, which had to be serviced using earnings in the depreciated domestic currency. Besides, the large chaebols, the family-centred conglomerate groups which are so typical for Korea, lost their aura of excellence: they were equally heavily indebted and went on spreading their investments over a whole gamut of unconnected sectors. Cross shareholdings between the companies involved inflated the effective value of their equity. And because of insider links with other firms and with the government ('Korea Inc.'), their investments were often allocated less than optimally.

In such circumstances, the Korean banking system was bound to become seriously infected, all the more so in that prudential supervision of the banking system was notoriously underdeveloped. At the end of 1997, half of the 24 Korean banks did not meet the international capital adequacy standard of 8 % set under the auspices of the BIS. The real economy also suffered a decline of 5.8 % of GDP in 1998.

Comments on the Physiology of Financial Crises An abundant literature has been and is still being devoted to the many banking crises that have occurred in a great many countries - and not only in development or transition. In particular the East Asian financial scene has already attracted a lot of analysis.

Alternative models In broad outline, financial crisis models can be catalogued in two groups (see Jianping Zhou 2000). The 'classical' one ascribes the turmoil to the perception by market participants that the economic fundamentals in the country under review are no longer solid; thus, the current account balance may display a large deficit which is not financed by stable

resources from abroad, such as direct investments, but by short-term and readily reversible borrowings by the domestic banks or firms, or by the government. This may signal an overvaluation of the domestic currency, if it is pegged to the dollar or to a basket of currencies. Domestic credit creation may also exceed the demand for money. Quite often the shaky fiscal position of the government provokes a currency crisis, as it is covered by money creation which unleashes rapid inflation. Within such model a serious imbalance in international payments may trigger an exchange crisis; this then forces the abandonment of a fixed-rate system; and when, as a defensive measure, the government hikes interest rates, economic activity is dampened. Loss of confidence by consumers and investors deepens the recession in the economy and further weakens the banking system, which becomes increasingly plagued by 'non-performing loans'. This traditional model certainly does not fit the facts and circumstances of the AFC, where, as already stressed the fundamentals were sound: government finances were in good shape, and growth was expected to continue at a rapid pace.

An alternative model emphasises a defective banking system and the potential for contagion that can readily infect countries that are perceived to display similar features. The sequence is then the reverse, as banking problems lead to an exchange crisis. This new view appears more appropriate for explanation of what happened in East Asia, although, in my view, and as already noticed, there is a need to specify better what is meant by 'contagion'.

In an early, perceptive paper on the AFC, Krause (1998) argues that four factors must simultaneously come into play to trigger a financial crisis. As such, he mentions:

- (i) an overvalued domestic currency;
- (ii) the substantial build-up of foreign debt, contracted by domestic banks and/or firms and mainly of short maturity;
- (iii) the disarray of the public finances and/or a fragile domestic financial system;
- (iv) political uncertainties, mainly stemming from weak and hesitant governments which do not take rapid action when the crisis erupts and/or are applying the wrong medicine. In discussing this factor, he also points to mistakes by the International Monetary Fund, which initially made its massive lending conditional on deflationary fiscal and monetary measures, as if inflation were rampant and this inflation was due to budget deficits.

Although these factors have already been largely covered in the above description of the crisis in the three most affected countries, a few additional comments may be useful. As to the first factor, there is indeed a tendency for governments to stick too long, partly out of mistaken national pride, to the currency's parity even though the country undergoes a faster rise in its price level than that in the anchor country, i.e. the USA, and although the link with the dollar, which appreciated substantially after 1995, harmed the competitive position of its export sector. One of the outcomes of the AFC is that there is now less faith in the merits of pegged exchange rates in an environment of huge and potentially destabilising capital flows.

The second factor has obviously bedevilled many Asian countries. It is also related to the third one, as in the absence of a highly developed financial system (including a well-functioning forward market) domestic firms will tend to seek financing in foreign currencies, especially if, as is the case in Japan, interest rates are temptingly lower. But this has intensified their vulnerability to shocks in the exchange markets.

As regards the third factor in Krause's diagnosis, while the public government finances were sound in the East Asian countries, the weak structure of the financial system - which is the focus of this paper - must undoubtedly be retained as a contributory cause of the AFC. It is not just the demise of an individual bank that creates problems^{iv} but the shaky overall position of financial institutions. When a crisis erupts it soon engulfs the whole system, both on account of the domestic links between those institutions and the pessimistic perceptions of market operators abroad. The weakness of the banking systems is evidenced, in varying degrees, by such symptoms as:

- (i) inadequate supervision of the financial institutions;
- (ii) lending policy practices which fail adequately to assess the client creditworthiness and are based on personal relationships and 'trust', making loans easily renewable to please such privileged customers;
- (iii) governments frequently directing banking credits to what they view as priority sectors and lavishing concessionary conditions upon such projects;
- (iv) the fact that obviously, in the countries under review, the banking systems have been contaminated to a large degree by the rapidly deteriorating position of their corporate customers, once the crisis eroded the real economy. Yet, previously, many enterprises, as exemplified by the *chaebols* in Korea, were already over-indebted and became

highly vulnerable to a reversal of the rapid growth environment which they had hitherto uncritically enjoyed.

The instrumental role of a weak financial system in the origination and the spread of a systemic financial demise is also highlighted *a contrario* by the observation that economies in the region with a well developed banking system – Singapore, Hong Kong and Taiwan – endured the AFC and only suffered limited damage.

Krause did not retain ‘contagion’ as a fifth causal factor but discusses it separately. The rapid reverberation of shocks from one country to another is rooted in essence in globalisation, both of information about economic and financial parameters and of financial flows - at least into and out of countries that have liberalised their capital account. In this respect, two aspects stand out in my view. The first, mentioned by Krause, stresses the psychological dimension of contagion: “Like other assets, currency values are driven by expectations, not by history” (1998, p. 10). The revelation by an influential analyst of troubles in a major bank may induce market operators to wonder about the health of the overall banking system and of the country’s currency. Secondly, such operators, being in constant contact with each other, tend to take positions tending in the same direction. It is not necessary to talk of a sinister conspiracy in order to admit that, as was the case in East Asia, currencies can be ‘killed’ by large capital flows when confidence in them has been forfeited, although, admittedly, ‘momentum speculation’ is also practised, as was the case in Hong Kong.^v But the ‘bandwagon effect’ quite naturally pulls market practitioners into the same direction, and the confluence of individual movements of comparatively small flows of capital soon widens to a irresistible flood. As a result, prices on financial asset markets often ‘overshoot’ the levels that would seem rational. (Parisbas, 1998). This is even more the case as astronomical amounts are transacted in the exchange and other international financial markets by banks and large institutional investors: if only a small portion of those internationally, highly mobile funds is directed in favour of, or against, a comparatively small financial market, the outcome is bound to be disproportionately large and harmful.. This is what happened in East and South East Asia, indeed.

B The limited impact of the Asian crisis on the P.R. China

It was widely feared that the AFC would seriously hurt the Chinese economy and would, before long, prompt its government to devalue the Renminbi (RMB). This would have

unleashed a new, and destructive round of beggar-my-neighbour currency depreciations, which would have further destabilised the financial systems and deepened the plight of the real economies in the region. At times, in China, spokespersons for sectors whose exports suffered from competition from countries with depreciated currencies did advocate a lower RMB, but the Chinese government has consistently stated its resolve to maintain the parity. For this stance, it has reaped acclaim from the international community; yet, the government hinted that, were the AFC to last for a long period and deepen, a devaluation could not be excluded. Fortunately the AFC did bottom out fairly soon, and most of the affected countries achieved a significant recovery.

There were no compelling reasons for devaluation, indeed. Admittedly, export growth, which had reached 21% in 1997, fell back to less than one percent in 1998, and overall export prices declined by 7.5%, but similar developments occurred on the import ledger of the trade balance, so that the latter maintained a solid surplus.^{vi} Exports from China were negatively affected not only by the lower importing capacity of East Asian neighbours, but by the latter's strengthened competitive position in world export markets. But this factor should not be overrated, as exports are largely rooted in processing trade in labour-intensive goods, conducted by firms from Hong Kong or by other overseas Chinese; as the inputs thereto are imported into the mainland, the value added within China is modest. Besides, competing firms in, say, Indonesia, were often not capable of securing export financing as foreign banks ceased to accept credit letters drawn on Indonesian banks.

Not only had the current account already achieved a small surplus for many years, but China's foreign exchange reserves had grown to a comfortable \$143bn in 1997 and \$150bn in 1998, which represented around 10 months of imports. As against this, outstanding external debt at \$146bn in 1997 and \$154bn in 1998 was manageable, all the more in that little of it was short-term. Besides, and contrary to what happened for example in South Korea, the government had succeeded in monitoring most of the country's external debt, whose contracting anyhow in principle required government approval. Moreover, and unlike the situation in most countries in East Asia, gross capital inflows into China were predominantly comprised largely of direct foreign investments, which were made for the long haul and are not readily reversible.

Last not least, the lack of convertibility for capital account transactions erected a solid defence against destabilising capital flows; in principle, RMB assets could not be converted into US dollars or HK dollars - or *vice versa*. When current-account convertibility was instituted in December 1996, the government targeted the year 2000 for its extension to capital transactions. In the wake of the AFC this project has been shelved for an unspecified period. In a way, China has been fortunate in that the AFC did not erupt a few years later when full convertibility would already have been instituted.

The AFC has impacted on China's policies in two other ways, but these are positive. Previously, the South Korean *chaebol* had been upheld as a model for restructuring China's ailing state-owned enterprises. This concept has now lost its attraction as its congenital weaknesses became obvious. More importantly, the AFC has impressed upon China the urgent need to drastically restructure and modernise its fragile financial system. In this sense, the AFC has been a blessing in disguise. A high-level and exceptional financial conference convened in November 1997 put the rehabilitation of the financial system at the top of the political agenda—as will be documented in section D.

This is not to deny that during the few years during which the AFC was raging, the RMB remained unaffected. On the black market it was traded at a discount that reached up to 10%. Also, balance of payments statistics suggested that there was some capital flight out of China; reserves were growing much more slowly than the inflow of foreign direct investment would have suggested. The prohibition of capital account transactions could apparently not prevent the fact that through channels such as 'leads and lags' in cross-country payments, some funds were effectively siphoned out of China. On account of the intricate commercial relations between firms in Hong Kong and those in South China, and despite a number of measures which were swiftly taken by the Chinese government to counteract such manoeuvres, a fully waterproof lock cannot easily be constructed against the capital flight.

All in all, and in contrast to developments in the other East Asian countries, China was only marginally contaminated by the AFC. The slowdown in exports and inbound direct investment inflicted only limited harm on the real economy. But this happened at a time when the Chinese economy experienced a slowdown in its previous record growth rate of GDP to a still respectable 7% by mid-1998. This weakening was essentially due to domestic developments, not to vulnerability in the area of international finance. As a matter of fact,

consumers, facing massive layoffs in the overstuffed state-owned enterprises, became reluctant to spend. At the same time, the excessive investment of previous years had resulted in overproduction in a great many industrial sectors; this came more to the fore after 1996 when, thanks to a successful ‘soft landing’, the economy, which had become overheated in the preceding years, calmed down. The combination of these demand and supply factors caused a decline in the consumer price index which has now lasted for almost two years, thus further discouraging consumption. In order to maintain growth momentum, the government has launched a massive ‘Keynesian’ program of infrastructure projects, and of spending for social safety nets. These outlays were financed by way of additional government bond issues, taken up by the banking system, which enjoyed a continued influx of household savings.

C The critical position of the banking system in China

Today, the banking system in the P.R. China is still in poor shape and, in the light of balance sheet data, certainly worse off than that of the ‘crisis’ countries in East Asia (with the possible exception of Indonesia). As a starting point for a brief analysis let me refer to two sentences from a recent paper of Nicholas Lardy (2000, pp. 21 and 31) which updates his thorough book-length analysis in 1998 of the financial system in China:

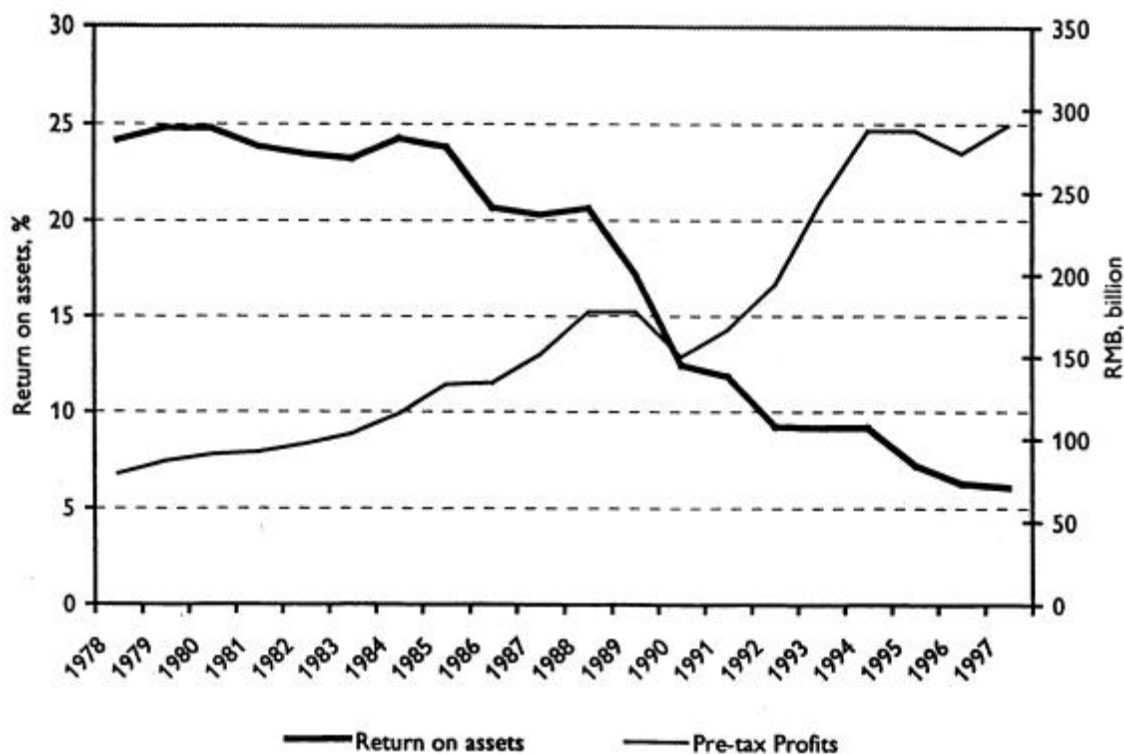
“By every available measure - capital adequacy loan loss reserves relative to assets, profitability, the magnitude of non-performing loans - the performance and health of China’s financial sector has deteriorated dramatically in recent years”

“While large parts of China’s financial system, particularly its large state-owned banks are insolvent they are not illiquid”

Non-performing loans The insolvent position - i.e. negative net worth, or liabilities exceeding assets - stems largely from the high proportion of ‘non-performing loans’. The Governor of China’s Central Bank acknowledged in 1998 that about 25 % of the loans merited this negative classification. But the effective ratio is no doubt significantly higher, if supervisory and accounting rules that have become customary in modern, sophisticated banking systems, were observed. Thus overdue interest payments were nonetheless capitalised, i.e. added to the amount of the loan (‘evergreening’) instead of triggering insolvency procedures; furthermore, the qualification as ‘bad’ was only attached to loans, when the principal (initial sum) was not amortised, and even then it was restricted to a low percentage of the outstanding loans. Each loan was also considered separately whereas in international usage, failure to service one loan

involves the activation of a 'cross default' clause to other borrowings by the same firm (Lardy, 1998). Besides, with a view to sidestepping restrictions on permissible activities imposed by the central bank in its supervisory rôle, banks had also engaged in large loans to their non-bank subsidiaries, which then often engaged in risky ventures, such as real estate projects; in the absence of consolidation between the parent bank and the subsidiaries, such loans escaped being classified as non-performing by the bank.

Low profitability During the 1990s, the thin capital base of the banks could not be complemented with additions from current profits, as the profitability deteriorated seriously. The return on assets of the largest financial institutions fell from an average of about 1.4% in 1985-87 to well under 0.3 % in 1995-97 (Figure 2). The above-mentioned bank lending procedures and inadequate provision for losses obviously result in the profitability of the banks being overestimated. Even more fundamentally, banks have been hit by the growing amounts of loans which continued to be directed by governments - especially at the sub-national levels - to state-owned enterprises, which for reasons to be explained shortly were in a shaky position and often incurred losses. State-owned enterprises, then, incubate the germs of the infection, which they transmit to the banks.

Figure 2: Profitability of State-Owned Industrial Enterprises*Source: Lardy, 1999.*

Legacy of the Centrally Planned Economy Besides, the banks, while having achieved perceptible progress in recent years, are still very weak in terms of their operational skills. This is basically a legacy of the pre-reform situation when under the centrally-planned economy (CPE) the (state) banks were essentially fiscal institutions and not autonomously-functioning, being mostly involved in extending loans to enterprises. Since Deng Xiaoping started his reforms China has progressively been moving to and is approximating a 'decentralised market economy' (DME) - which today displays highly sophisticated financial products and markets.

In these two alternative economic systems, the CPE and the DME, the roles of finance are diametrically opposed, both at the level of the banks and at that of the enterprises. This renders the task of reconstructing and remedying financial systems much more difficult than in countries such as those in East Asia, where the banks, despite their flaws, are operating within a market economy.

In the orthodox CPE financial flows are governed by the country's 'unified budget': the 'surpluses' (profits,^{vii} as well as funds set aside for depreciation of fixed assets^{viii}) are remitted back into that budget, and constitute one of the main sources of revenue for the state - the other consisting of turnover taxes which are charged to the consumers through higher prices of final goods. Against this, and in line with the logic of the CPE, the sums needed to cover the investments and the 'permanent' portion of the working capital needs of the state enterprises are granted interest-free. The latter are, in fact, part and parcel of the overall state, not only in terms of the ownership pattern, but also as regards their decision-making powers and procedures.

The banking system of the CPE consists in essence of a single state bank which issues the currency and acts as a transmission belt for the upward and downward financial flows between the state enterprises and the budget. Short-term credits are extended only for transitory working capital requirements. The branches of this unitary banking system collect the savings deposits of the citizens, this being the only form of monetary savings available. Needless to say, equity investments and markets are utterly unacceptable in a system that bans private ownership of the factors of production.

Such a unitary banking role - essentially performed by the People's Bank of China - offers a stark contrast to the functions that are performed by modern banking systems in DMEs. The main difference lies perhaps in the lack of a 'credit culture' in the CPE, whereas in a DME lending to enterprises is an essential activity of the banks, and firms themselves also extend credits, i.e. short-term payment delays, to their customers. The operational implications of the divergence in the basic philosophy of the CPE and DME paradigms are summarised in Table 2, which clearly shows the abyss that has to be crossed when a country such as China embarks on the transition to a DME.

Table 2 : Financial Instruments and Institutions under Alternative Economic Systems

Items	Centrally-managed Socialist Economy	Decentralised Capitalist Economy
Disposal of profits	to state budget as: direct taxes, profits depreciation funds	partly (a) retained with (depreciation funds) (b) paid as taxes to government, c/distributed as dividends to shareholders
Trade credits (“receivables”, “payables”)	None	important
Financing of investments	Through budget allocations	through depreciation / retained earnings / long-term borrowings / additional equity
Financing working capital	partly (a) through budget, (b) from banking system	through short-term bank loans
Interest rates	-none on budget allocations -only on bank loans for working capital	short-term or long-term interest rates shaped by market demand and supply, but influenced by central bank
Financing technological renovation	government, mainly to research institutes	-equity capital -specialised institutions -rapid depreciation (eg venture capital) -government contracts
Rôle of financial flows	passive replica of material (“real”) flows; through planned direct allocations	somewhat dissociated from real flows
Secondary markets	None	for shares, government and corporate bonds, short - term commercial credit instruments
Financial institutions	monolithic; one single banking system as “unified state controlling organ”; loans for part of circulating capital	plurality and competition; loans for various purposes
Rôle of financial officer in large enterprises	passive “registrar” rôle; low status	quite active; also watchdog function; high status

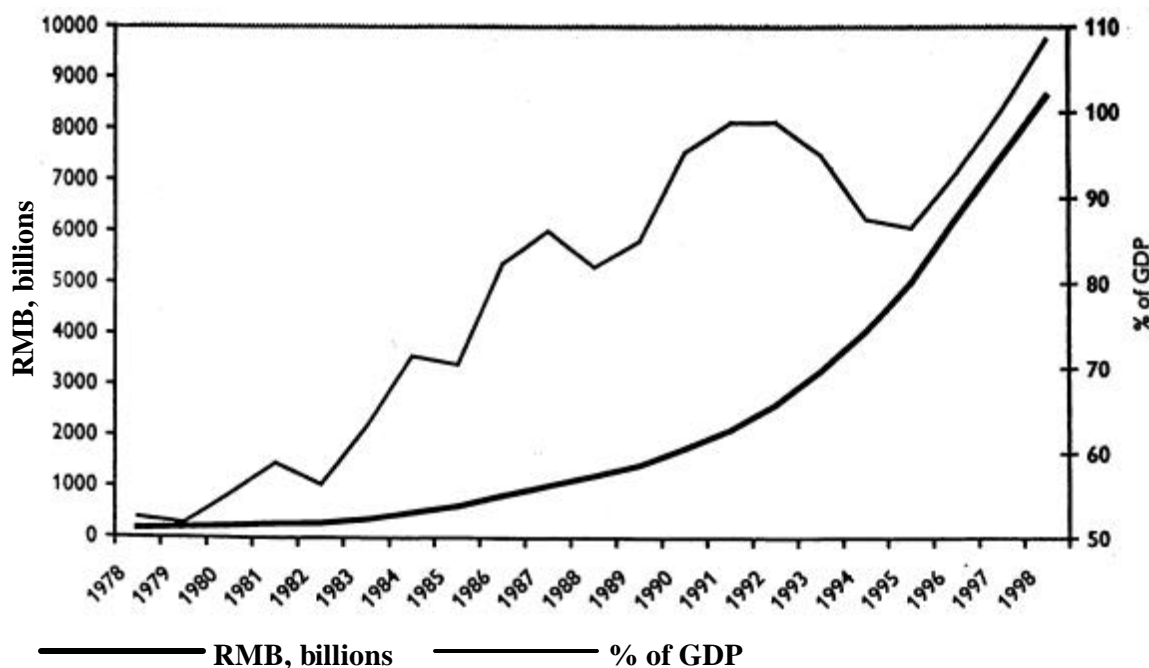
Source: Plasschaert, 1988.

Early reforms in China Previous to the outbreak of the AFC and the perception by the leadership of the urgency of financial reform, a number of steps had already been taken that would put bring the financial system closer to that of a DME. Without delving into excessive details one may mention, with respect to state enterprises, that in the early 1980s they were permitted to retain a substantial portion of their profits and to spend them for some specified purposes, amongst them investments and bonus payments to the workforce.^{ix} In 1984, the remittal of profits into the state’s budget was replaced by the payment of taxes on profits - a step whose conceptual importance then exceeded its practical one. Already in 1979, the State Council directed that investment was no longer going to be financed by budgetary grants within the overall ‘credit plan’ (in fact, a misnomer, as the funds obtained by the enterprises were predominantly grants) but instead by loans, which carry interest and whose principal is subject to reimbursement. Such a shift has been largely achieved between 1978 and 1982

(IMF, 1996). Reliance on loans has increased significantly during the 1990s as many state enterprises faced a serious deterioration of their profitability and hence of their capacity for self-financing.^x This has been caused both by liberalisation of prices, which had previously included a generous surplus ratio in consumer-goods sectors, and by the much-intensified competition that followed the entry of new types of enterprises, such as the flourishing rural industry and foreign direct investment sectors (see e.g. Naughton, 1995). The profitability of state owned enterprises was also eroded by some structural weaknesses that are inherent in the *modus operandi* of the CPE, namely their overstaffing and their duty to provide social services such as pensions and medical care directly. In a DME of course, social benefit distribution is devolved to nationwide systems of social security, to which employers are only responsible for a portion of the contributions.

Figure 2: Loans by Financial Institutions in China

Source: Lardy, 1999.



As illustrated in Figure 2, loans by financial institutions have also grown rapidly relative to GDP, except perhaps in the years 1992-94 when a credit squeeze was brought about in order to subdue inflationary pressures. Loans were extended not only for investments and working capital but also to cover operational losses of certain (generally large) state-owned enterprises. These loans were still directed by the authorities, under the 'credit plan', which has only gradually been phased out. Even though the need for drastic reform of the state-owned

enterprise sector has become officially acknowledged - especially at a Plenum of the Communist Party in November 1993, and a great many measures were subsequently enforced, concern for the social fallout of enterprise reforms following massive layoffs of workers has acted as a brake and explains largely why the lion's share of credit has continued to be extended to state-owned enterprises, notwithstanding their declining role in the Chinese economy.

The institutional format of the banking system has also been progressively remodelled. A major reform in 1984 replaced unitary banking with a two-tier system, whereby the People's Bank of China began to operate only as the central bank, whereas its previous 'commercial' activities were taken over by four large nationwide deposit banks. Although each of these is targeted at a specific economic sector, they have increasingly entered into competition especially as regards the attraction of deposits. These four banks are:

- (i) the Industrial and Commercial Bank of China (ICBC);
- (ii) the Agricultural Bank of China;
- (iii) China Construction Bank (CCB);
- (iv) the Bank of China (BOC), which engages in international transactions.

Banks (iii) and (iv) already existed before 1984, but were then mere divisions of the People's Bank of China.

The People's Bank is also entrusted with supervision of the deposit banks and other financial institutions. A 1995 law granted it, in principle, full autonomy vis-à-vis the Ministry of Finance; consequently, the central bank is no longer authorised to provide credits to the government, thus blocking an avenue of inflationary financing of budget deficits. Progressively, the People's Bank is also substituting direct 'quantity' instruments of monetary policy with market-g geared indirect instruments such as open-market operations but, as mentioned in the Introduction, considerations of space prevent the consideration of this aspect of the construction of a modern financial system.^{xi} Another important step was the establishment in 1994 of three 'policy banks', which are the vehicles for loans mandated by the government with subsidised interest rates. This frees the commercial banks from the burden of such loans and allows them to become more fully 'marketised', i.e. operating in the light of market parameters. The constitution of the policy banks is a step towards cleaning up the balance sheets of the commercial banks - an item that belongs to the next section.

The big four commercial banks have maintained a preponderant role in China's financial scene. Starting from the mid-1980s, however, a great number of other financial institutions have emerged. Amongst them are:

- (i) some commercial banks whose perimeter is limited to a region or a city;
- (ii) thousands of urban and rural credit unions, whose numbers are now being reduced by amalgamation. Together, these two categories accounted for 28 % of all assets at the end of 1998;
- (iii) non-bank financial institutions which have sprung up, often at the initiative of local governments, and more specifically a large number of "International Trust and Investment Companies" - amongst them the well known China International Trust and Investment Corporation (CITIC) – which raise funds from foreign sources to finance foreign-funded enterprises.

The fact that, for lack of space, (iii) are not considered in this paper does not by any means confer upon them an implicit certificate of excellence. They have proliferated beyond real needs, as is the case in other countries in East Asia, and have sometimes been notorious for their mismanagement and imprudent lending. At present, the government is reining them in.^{xii}

D A cursory look at the therapies for the banking crises

In the Introduction I have stated that attempted remedies for ailing banking systems appear quite similar in China and in the countries which experienced the AFC. This is not surprising as on the face of it, they largely display the same symptoms although their underlying causes were have been shown to diverge significantly. Accordingly, I will hereafter refer especially to the measures that were initiated, and in the process mention similar steps in other AFC countries. No full inventory of such measures or of the present state of affairs in each of the countries involved is thereby intended.^{xiii}

Bank Restructuring In broad outline, three major categories of remedy are being attempted. First and foremost, cleaning-up of the balance sheets of the banks, and of some other financial institutions, so that, freed from the burden of past non-performing loans which erodes or destroys their capital base, the banks could in future act as healthy and efficient instruments for resource allocation, mobilisation of savings, and accommodation of internal and international payments. This addresses the 'stock' aspect of bad loans. The second category covers a large gamut of measures aiming at improving the operational efficiency of the banks

and bringing them up to present-day standards. Without progress along such lines, the emergence of new flows of bad loans would soon necessitate a new round of costly bank recapitalisation. Last but not least, curing the banking system would be of no avail if the corporate sector continues to be over-indebted and indulges in imprudent or even ethically reprehensible practices.

In China an impressive series of steps have been initiated since 1998 when the seriousness of the banks' situation was acknowledged. Special attention is given to the 'big four' commercial state banks as they are intended to act as the mainstay of the financial system and are 'too big to let them fail'. In March 1998 a special Treasury bond issue amounting to RMB 270bn was made and taken up by the big four state banks themselves, which could thus draw on the funds released as a result of the lowering of their required reserve ratio from 13 % to 8%. The proceeds of the loan were used by the Ministry of Finance to uplift the capital base of the four banks to the level of the international standards recommended by the Bank for International Settlements.^{xiv} In 1998-99, for each of the four banks an 'asset management company' was set up to take over the bad loans, other than those that were irretrievably lost. The latter, specialised institutions supported by government funds, will then be in charge of recovering part of the value of the non-performing loans. By the end of 2000, about 1.2 trillion RMB (\$ 150bn) would thus have been transferred from the balance sheets of China's four principal banks into the books of the corresponding loan-recovery vehicles.

(Far Eastern Economic Review, June,15, 2000)

Table 3: Financial Sector Restructuring Methods

	Government Capital injection	Asset management corporation(s)	Domestic bank merger	Foreign bank takeover
China	∕	∕	∕	
India	∕	under examination	∕	allowed
Hong Kong (in 1980s)	∕		∕	
Indonesia	∕	∕	∕	proposed
Korea	∕	∕	∕	allowed
Malaysia	∕	∕	∕	
Philippines (in 1980s)		∕	∕	∕
Thailand	∕	∕	∕	∕
Argentina			∕	∕
Brazil			∕	∕
Chile (in 1980s)	∕	∕	∕	
Colombia	∕	∕	∕	allowed
Mexico	∕	∕	∕	∕
Venezuela	∕	∕		
Czech Republic		∕	∕	allowed
Hungary	∕	∕	∕	
Poland	∕		∕	allowed
Russia	∕		∕	
Saudi Arabia (1970s & 80s)	∕		∕	
Memorandum:				
Finland (early 1990s)	∕	∕	∕	
Norway (1988-93)	∕		∕	
Sweden (early 1990s)	∕	∕		
Japan	∕	∕		

Source: Hawkins and Turner, 1999.

Such restructuring measures (discussed in great detail by Hawkins and Turner, 1999), have become a standard item in the toolkit of measures to deal with the banking crisis in the AFC countries, as shown in Table 3 above. In addition (as in Indonesia with its plethora of weak private banks), mergers of domestic banks have become rather frequent, most often spurred by the authorities, whereas a number of unviable banks have been closed. Takeovers by foreign banks are now occurring in Thailand, Indonesia, and even South Korea, which has reversed its previous opposition to foreign participation. In China, accession to the WTO is likely to set the stage for a number of joint ventures between foreign and domestic banking institutions.

Apart from the cleaning-up of balance sheets, a great number of other steps are being taken in China in rapid succession. They aim at creating a genuine 'credit culture' and awareness of efficient risk management. The credit plan', a CPE hangover which had been gradually scaled

down, is no longer a binding constraint on the banks but only performs the role of an indicative non-binding target. This way, the state-owned banks will now be able to extend credit to all types of enterprises according to the latter's ability to generate an adequate cashflow. In principle, loss-making state-owned firms will no longer be able to obtain ready credit and pre-empt them. A new scheme of loan classification, in line with international standards, is also being introduced, and the scope for making provision for non-performing loans is being considerably expanded. The Central Bank has also been re-organised into nine regional offices on lines similar to those of the Federal Reserve System in the USA. This new pattern cuts across the previous provincial borderlines. The Central bank wants to roll back the interference of local governments who were pressuring branches to finance their pet projects. Senior bank managers at branch level will no longer be appointed by local government. Similar measures have also been taken in the AFC countries, where risk management has been notoriously defective and adequate supervision was equally lacking..

One major aim of the reforms consists in breaking the cosy relations between banks and closely-related families or firms, such as the *chaebols* in South Korea. Such 'insider banking' has contributed to the overburdening of the banks with poor-quality loans based more on privileged connections than on a professional analysis of creditworthiness. In this realm, Korea has already achieved appreciable progress whereas Indonesia is lagging behind.

The Corporate Sector This then leads finally to the situation in the corporate sector itself. In the AFC countries, to the extent that the economy rebounds, higher turnover and lower interest rates will extricate a growing number of firms from virtual bankruptcy. Besides, the redress of their currency (although the Indonesian Rupiah has relapsed) renders their foreign debts more manageable and improves the prospects for debt rescheduling with foreign creditors. The number of firms in critical condition is however very large; in September 1999 the hangover of non-performing loans was estimated by private-sector specialists at 60-80 % of outstanding loans in Indonesia, 50-70 % in Thailand and 20-30 % in Korea (Asian Development Bank 2000, p.25). Hence, hard structural measures that lift corporate governance to modern standards will be needed. They will probably take time to gain wide acceptance, even if governments impose adequate rules, in such areas as accountancy, disclosure of information and the sanctioning of corrupt practices.

In China, the problem of the large number of underperforming state-owned enterprises has been a priority item in government policy since November 1993 when the Party plenum adopted a sweeping strategy in this area. The main principle was that the state should 'grasp hold of the large but release the small [enterprises]' (*zhuada fangxiao*). A selected group of about 1,000 large enterprises would be given special care in order to revitalise them into units capable of sustaining strong competition. A number of pilot programs were launched in various cities; amongst them the formation of enterprise groups, a type of holding company grouping a number of firms, has been promoted.

In 1997, the government stated that the SOE problem should be resolved by the year 2000. Soon, it became evident that this objective could not be reached and will need more time; the slowdown in the Chinese economy, the onset of the AFC and the social impact of massive lay-offs of workers all counselled for a slower pace of SOE reform. Yet in the most recent years a lot has been accomplished. Thousands of smaller SOEs - those typically owned by sub-national governments - have been 'released', i.e. removed from the state sector. This has largely been achieved by converting them into so-called 'shareholding co-operatives', whereby, at the initiative of local governments, workers and managers become the shareholders and owners. (See International Monetary Fund, 1998).

Another main avenue of SOE reform relates to measures addressing a whole sector. Amongst them, the textile sector has been singled out: a large number of production units has been closed or merged, millions of spindles idled, and just in Shanghai 600,000 workers have been laid off. In such circumstances, the building-up of a system of social security for unemployment including unemployment benefits is of the utmost importance. The undeniable progress in this field, however, does not seem able to cope with the scope of the intended downsizing of the workforce in SOEs; as a result, other, more temporary income-relief measures are being taken. Most recent reports show nonetheless that the bottom of the financial plight of the state owned enterprises may have been left behind, thanks partly to the above mentioned measures but also to a strengthening economy. In 1999, for the whole sector of state-owned enterprises (admittedly already significantly thinned out), profits exceeded losses; the latter were down by 15 %, to RMB 130bn;. this amounts to a hopeful reversal of the 1998 results. (The Economist Intelligence Unit, May 2000).

E Concluding Remarks

A few more general remarks emerge from the above analysis.

Firstly, despite the many similarities, three factors nevertheless differentiate the banking scene in China from those of the other countries under review:

- (i) The causes of their banking crises differ in many respects, as explained in the previous section. Thus, the foreign exchange troubles of the banks and/or their customers was the main cause of the financial debacle in East Asia, whereas China had only limited exposure to such destabilising external factors.
- (ii) The task ahead in China is much more laborious, as it necessitates the transformation, almost *ab ovo*, of that which under the CPE was essentially a budgetary mechanism into a genuine banking system, whereas in East Asia experience of commercialised banking in open economies had already been built up over several decades - although the crisis that erupted in 1997-8 would expose deep-seated defects.
- (iii) China however scores one advantage, as, contrary to the AFC countries, it has so far not been caught in one of the sudden financial hurricanes which have obliged governments and their foreign advisors (amongst them, most conspicuously, the IMF) to have recourse to emergency therapeutics in the midst of widespread panic. In China, despite its insolvency in technical terms when viewed as a whole, the banking system is not in such a critical situation as to necessitate the application of strong medicine, immediately and in strong doses. In other words, there is now no need for urgent stabilisation policies. As long as the influx of savings remains ample and confidence in the banking sector persists, the measures can be sequenced in an orderly way in accordance with the gradualist approach so characteristic of China's overall reform path. Yet on account of their extensive reach, reforms must proceed on multiple fronts, forcefully and concomitantly.

Secondly, as Claessens (1999) remarks, "Systematic bank restructuring, a lengthy process, requires sufficient public resources and deep changes in institutions, rules of the game and attitudes." The burdens which public finances must shoulder for the restructuring of the banking systems - involving their recapitalisation, the funding of 'asset management companies', and the institution of deposit guarantee schemes to avert a destructive run on the banks - is staggering. (See table 4 on recapitalisation^{xv}) As regards China, the eventual price

tag of the banking restructuring for the state finances, already burdened by many claims for additional outlays, is likely to be very high, as the recovery rate for non performing loans is likely to be very low (Far Eastern Economic Review, 2000, June 15.). A significant uplifting of the presently low tax revenues/ GDP ratio is therefore a priority task, but this is obviously a topic which lies outside the compass of this paper.

Table 4: Fiscal Costs of Recapitalisation, Selected Crisis Countries, Mid-October 1999

Cost (% of 1998 GDP)	Indonesia	Korea	Malaysia	Thailand
Estimated recapitalisation cost	58.3	16.0	10.0	31.9
Funds disbursed	10.6	12.5	4.2	23.9
Expected additional costs	47.7	3.6	5.8	8.0

Source: Asian Development Bank, 2000.

Thirdly, the measures taken in AFC countries and in China belong to a toolkit which has evolved in recent years in the light of a great many banking crises. There is often a wide gap between principles / legal prescriptions and implementation. Equally, managing the reconstruction of sick banking systems and (in China) transforming them into ‘marketised’ financing vehicles requires skilful articulation and sequencing of measures by the authorities.

Fourthly, the AFC has exposed the structural weaknesses of the financial systems in the countries involved. When rapid growth could no longer cover them up, and/or when external disturbances arose, they became highly vulnerable. These weaknesses must be partly attributed to certain attitudes and methods of doing business which had become endemic in Asia, namely frequent collusion between banks and their economically or politically powerful clients, and the granting of credits on the basis of connections instead of the merits of the project submitted. Such procedures are bound to give rise to unsafe banking practices, and even to ‘rent seeking’ and corruption. (see e.g. Backman, 1998). Banks and companies in East Asia and China will have to institute more professional rules and standards of corporate governance. But the modernisation of their banking and corporate systems, if successful, promises to put their economies once again on the path of rapid and sounder growth.

Finally, while the AFC was a serious crisis and exhibited some Asian characteristics, East Asia does not hold a monopoly on financial crises. Disturbances threatening the whole banking system have occurred in recent decades in a large and apparently growing number of countries, including highly developed ones. Part of the blame for the AFC, however, must be laid not only on the weak banking systems and the governments of the countries concerned, but also on the havoc which large and easily reversible capital flows can wreak on comparatively small financial systems and economies. This enhances the need for those countries to strengthen their financial systems, but also puts an inescapable responsibility upon the international financial community to devise mechanisms to forestall them.

NOTES

ⁱ The countries affected were located in East and in South East Asia. For convenience, I use the expression “Asian” (eg Asian Financial Crisis).

ⁱⁱ That during the 1990’s the Japanese banks, previously hailed as world champions, were also affected by various dysfunctions that in part explain the lacklustre performance of the Japanese economy, is worthy of a footnote. To extend the comparison of afflicted banking systems to Japan would however overstretch the compass of this paper. Besides, the situation of Japan, a highly-developed economy, cannot possibly be compared with that of the developing countries under review.

ⁱⁱⁱ The “ITICs” (International Trust and Investment Companies) in China and the merchant banks in Korea are appropriate examples.

^{iv} As happens elsewhere: witness the collapse of *Crédit Lyonnais*, which saddled France with a bill of more than FF 100bn to clean up the bank’s balance sheet.

^v Deliberately-taken short positions, in both securities and exchange markets, repeatedly hit Hong Kong in 1997-98. Manipulators hoped that interest rate hikes by authorities operating with strict regard to criteria for maintaining the value of their currency would depress the share market, thus allowing them to reap ready profits. Instead, Hong Kong defended its currency by forward sales of US dollars and by buying stocks. This gambit defeated speculators. See BIS Annual report (1999).

^{vi} In 1999 the value of exports rose by 6 %, while that of imports rose by 18 %. Following the recovery in East Asia, exports rebounded from the second semester onwards.

^{vii} I prefer the word ‘surplus’ to ‘profit’ as the latter has been anathema in the Soviet Union until the 1970s, and as in DMEs the pursuit of profits connotes an active role for the entrepreneur, not the passive one that is typical for the head of a state enterprise under the CPE.

^{viii} This orthodox system had been slightly relaxed in China, as from the 1960s onwards firms could retain a small portion of (very low) depreciation allowances and even of ‘profits’.

^{ix} Under pressure from workers, the enterprises tended to spend those ‘profits’ on generous wage supplements, thus prompting the government to impose a tax on excessive bonuses.

^x Whereas in 1987 manufacturing firms financed three-fifths of their needs from earnings retained after tax, this proportion had dropped to one-tenth by 1996. (Lardy, 1999, p. 18)

^{xi} Interest rates are still essentially fixed by the Ministry of Finance, and do not reflect market conditions or risk profiles. Since recently, however, interest rates on bank loans can be modulated within a narrow band around the administratively-fixed rates.

^{xii} A famous case is that of the Guangdong International Trust and Investment Company (GITIC) which operated in China’s fastest-growing province. I became an important player in the financial field, and China’s best-known borrower on world capital markets. But “... due to poor management, deposits with unusually high interest rates, illegal interbank business and evasion of supervision, GITIC failed to meet its maturing debts in 1998... Among the total of 240 creditors, 135 were foreign and their claims accounted for about half of the total.” (Jun Zhu 1999, p. 313). As many of the loans had not been approved by the appropriate central authority, they did not benefit from governmental guarantees, whereas foreign lenders thought they enjoyed an implicit guarantee.

^{xiii} For fairly comprehensive treatment of bank restructuring see Hawkins and Turner (1999), Hawkins(1999) and Claessens (1999), and for China YKMo (1999).

^{xiv} The substitution, on the asset side of the banks’ balance sheet, of government bonds for a reserve position with the central bank means some improvement in the profit performance of the banks, as the former type of assets carries a higher interest rate than the second one.

^{xv} Even though the government bond issues that are typically issued to fund those programs are taken up by residents, thus amounting to a transfer from households to the government (and banks).

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