

Executive Summary

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China's Reform Gradualism Called into Question

1. The Chinese experience of economic reform coupled with rapid economic growth has been hailed as a success story for a “gradualist” approach to the transition from planned to market economy. But questions are now being raised as to whether such plaudits are truly justified. Nicholas Lardy of the Brookings Institution in the United States pointed out in his recent book, *China's Unfinished Economic Revolution*, that as the result of its “gradualist” economic reform China has generated more problems than it has resolved. One reason why China's reform is called gradualist is that China has been very cautious about liberalization of capital allocation. **Precisely for this reason, Lardy argues, gradualism has thwarted efficient capital allocation, retarded the weeding out of inefficient enterprises, and unnecessarily aggrandized banks' bad loans and enterprise deficits.**

2. The question of whether or not a “big bang approach,” i.e., sudden liberalization of the financial markets, could have better effected “efficient capital allocation” must be considered with caution. There is no question, however, that China, with its gradualism, has generated enormous non-performing loans in its financial sector, and these have invited a deflationary situation in spite of the country's rapid economic growth in the early 1990s. **This examines, first of all, why the non-performing loan problem emerged in China's financial sector, then goes on to examine how China can possibly overcome this problem.** Before going into these topics, however, we must first consider the two leitmotifs that run through the history of China's economic reform. This is a necessary step to accurately understand the nature of the Chinese reform.

Exit of the Government

3. The first leitmotif is “the exit of the government,” i.e., government withdrawal from the corporate sector activities. It is true that during the 1980s, the government, under the slogan, “Separation of Government and Enterprises,” executed almost complete withdrawal from the production-related activities of enterprises. There remain areas, however, from which the government is yet to take its leave: the areas of enterprise financing and appointment of enterprise managers. Take, for example, an enterprise's investment decision-making processes: the government is still deeply involved in investment planning decisions, placing restrictions the autonomy of decisions to be made by the lending banks and the management of the enterprise concerned. Government approval is still required when state-owned enterprises borrow money from state-owned banks. Moreover, the disposal of non-performing loans is heavily managed by the government, which is simultaneously the owner of, and a stakeholder in, the state-owned enterprises. **Complete government withdrawal from the financial arena is surely to be desired, if only to prevent non-performing loans.**

4. For historical reasons, Chinese government offices — and in particular local governments — have been the main players, not a third party, in economic activities. There have been cases of irrational investment decisions by the government and these are prone to generating non-performing loans. The government is directly responsible for China's past economic inefficiency. In addition, the need to maintain social stability demands that the government even now continue to assume a negative attitude toward workforce reduction. The government itself is thus a deeply interested party with regard

to economic activities. When a government so deeply involved in the interests concerned must approve or disapprove business bankruptcies and evaluate non-performing assets, the likelihood of biased decisions is considerable. **Government withdrawal from the practicalities of non-performing loan disposal is thus also highly desirable.**

Maintenance of Capital

5. The second leitmotif concerns how enterprises are to be made to commit to the maintenance of capital. Enterprise assets are financed by capital and debt. Capital is a buffer to cushion the enterprise against business risks. To maintain capital, it is necessary for the enterprise to provide depreciation costs so that they can offset capital attrition, and to properly compensate capital owners for capital costs. **But in China's transition to market economy, systems and institutions thwarting the maintenance of capital have survived for too long. This lack of attention to the maintenance of capital is largely responsible for the current non-performing loan problems.** The *Bo Gai Tai* policy of the mid-80s, which shifted the fund source for state-owned enterprises from the state treasury to bank loans, was a case in point. Under this policy, state enterprises were not urged to maintain their capital as a buffer to risks, but were made to depend on bank loans. This practice was predicated on the wishful assumption on the part of the government that business performance would quickly improve if only enterprises were brought under hard budget constraints from above. As a result, some state-enterprises went to the extreme of operating without any capital of their own. A system had been put in place which made it impossible for enterprises to build up their own financial security.

6. A number of the characteristics of the Chinese economy discussed in this book are related to the above problems. Among the points discussed are: (1) how the presence of banks in the macro money flow is too large; (2) how enterprises depend too heavily on borrowings from banks; (3) how fund allocations to labor are excessively large; (4) how corporate governance is not functioning effectively, and (5) how formation of capital markets is still to be encouraged. In addition, there is the issue of severe management-level corruption working against enterprises. This phenomenon is also related to the lax attitude of management toward internal financial regulation. All of these issues are characterized by a common theme: the dual question of how to promote the maintenance of capital by enterprises, and of how to secure a proper share of funds to do this. Since government protection is being withdrawn from enterprises, they urgently need to increase their own capital as their buffer to cushion against risks.

7. In failing to pay proper attention to the maintenance of capital and to capital owners' rights, the Chinese system has impeded capital accumulation by enterprises. This has led to their burgeoning borrowing from banks, caused instability of management and deteriorating profitability, and eventually generated non-performing loans. As has been theoretically proven, neglect of the need for maintenance of capital is a phenomenon caused by the worker-control type of enterprise management seen in the former Communist countries (Masahiko Aoki, Takayuki Itami, *Kigyo no Keizaigaku* [The Economics of Firms], Chapter 8, Section 4, Iwanami Shoten). Indeed, it could be said that China's progress toward enterprise reform and financial reform has been a path of trial and error in the quest for how to establish a system for maintenance of capital.

The Mechanism Generating Non-Performing Loans

8. China's non-performing loan situation has been greatly influenced by the trial and error in the processes of government withdrawal from the financial arena and the establishment of capital maintenance. Let us take a brief look back on the history of this trial and error. We will first examine the concrete factors that generated the non-performing loan problem, namely, the mechanism that gave rise to non-performing loans, the change in the nature of financial systems in the wake of an explosive increase in personal deposits, and the impact which marketization of the economy has made on the relationships between the government and enterprises.

9. **The major factor giving rise to non-performing loans within the banking sector in China is the deterioration in business performance of the state enterprises.** The system that prevailed was such that it systematically hampered capital accumulation by enterprises and allowed banks to supply easy loans. The non-performing loan situation was further exacerbated by changes in the economic environment caused by the progress of marketization. Examining banks' balance sheets, it is clear that as a result of increasing personal deposits, liability restrictions became very tight. The asset side, on the other hand, has shown serious deterioration as the performance of state-owned enterprises has worsened. **While state enterprises were able to shift the consequences of their poor performance onto the banks, the banks had no means of passing on the burden.**

10. As a very recent development, banks have become aware of the excessive risks they have taken on, and have begun to pick and choose which enterprises they do business with. **But the size of enterprises' non-performing debts has far surpassed the level which the enterprises and banks involved can possibly handle by themselves. This is a destabilizing force within the financial system as a whole.** The disposal of non-performing loans thus emerges as an urgent and unavoidable task. Achievement of the task will certainly require government participation, but, being a party to the non-performing loan generating mechanism, the government can hardly pass fair judgment on the responsibilities of the banks and the enterprises.

Changes in the Nature of the Financial Systems due to Increasing Personal Deposits

11. In the process of economic reform, flexible wage systems were introduced to provide work incentives to labor. Consequently, workers' incomes increased. This explains why the household sector has taken the place of the government treasury as the main saving body in the country. China's saving rate is currently at almost 40% of the GDP, one of the highest national figures in the world. The pattern of inter-sector financial flow in China since 1991 shows that the household sector more than offsets the fund shortfalls in the enterprise and government sectors. The surplus also flows abroad in the form of investment. **China has become a net capital supplier.**

12. **It is clear, then, that China has international solvency. This is one of the economic fundamentals that has enabled China to maintain a stable exchange rate since 1994.** Looking at production, the importance of the role of direct investment is undeniable. But on the macro financial side, China has no need to depend on foreign sources. This macro characteristic closely resembles that of Japan. It should also be noted that the contribution made by households to the saving ratio has greatly altered the contents of bank balance sheets. **In fact the growing might of household deposits is undermining the traditional interdependence of the government, enterprises, and banks.**

The Changing Role of the Government

13. State-owned enterprises in China can generally be understood as enterprises owned by the central government and controlled by local governments. The local government, as the supervisor of state-owned enterprises in its territory, traditionally regarded enterprises as a means to achieve two goals: growth of the local economy and employment security for the local urban labor force. With this in mind, the local government would intervene in the management of state-owned enterprises. It is clear that this intervention kept state-owned enterprises inefficient and their financial performance poor. But in the second half of the 1990s the state-owned enterprises, faced with sharper competition on the market and drastic financial reforms, have become unable to shoulder economically unjustified burdens. The need for change in the style of local government involvement in state-owned enterprises has thus become urgent. **The government-enterprise relationship is thus indeed beginning to diverge from its traditional protector-protectee and profit receiver-supplier patterns.**

The Potential to Solve China's Non-Performing Loan Problem with Domestic Funds

14. So far we have explained how institutional problems have generated non-performing loans, and how changes in circumstances, centering on marketization, have modified the behaviors of government, enterprises, and banks. In the process of this transformation, "withdrawal of the government" and "maintenance of capital," have come to be recognized as key issues. The Chinese economy is in fact moving toward the resolution of these two problems. The following discusses the second major issue, of whether China can resolve the non-performing loan problem.

15. Disposal of non-performing loans has now become an urgent task. For the fundamental resolution of this problem, several hurdles must be overcome. These pertain, among other things, to the establishment of an effective judiciary system, to the introduction of a secondary securities market for asset liquidation, and to the availability of able personnel for enterprise restructuring, which is a task requiring a high level of capabilities. All of these requirements are still to be met. In 1999 the government announced that the four state-owned commercial banks would each organize separate asset management companies to which bad loans would be transferred for settlement. **But from what has been disclosed of their content and policies, these asset management companies do not appear to be sufficiently equipped to handle the enormous task they have been set.** Their debt-collection rate is likely to be quite low, which will mean that the colossal cost of bank rehabilitation will have to be met by the government treasury.

16. Simulations presented in this book show that **public debt will expand to 50% of the GDP at a future point in time, but will then decrease. This means that public debt is unlikely to cause a serious crisis to China's long-term fiscal situation.** To avert a real economic crisis, China will have to inject much capital into the settlement of bad loans. We know the country has enough funds to settle non-performing loans. The remaining problem is whether China can exercise appropriate political power to coordinate the complicated and conflicting interests that stand in the way of general settlement.

Macroeconomic Stability

17. The value of the Chinese Yuan, (RMB), has been an intermittent topic of concern for the world currency exchange market since the Asian economic crisis. The non-performing loan situation, some observers fear, may negatively affect the yuan's position on the exchange market, forcing China to become delinquent on external payments. But despite the seriousness of the problems of China's domestic financial systems, we do not believe that they will amount to an external payment crisis. The Chinese economy in fact closely resembles the Japanese economy in structure. In other words, **despite the serious nature of its problems, China is capable of overcoming them with its own economic resources.**

18. We should finally note, however, that the non-performing loan issue may, of course, expand and worsen should China fail to settle it at an early stage. As already indicated, it is doubtful whether the Chinese government agencies, especially local governments, can settle non-performing loans efficiently and fairly, given the fact that they themselves are interested parties. **Whether or not China can avert an economic crisis will largely depend on timely exercise of its political powers to promptly and effectively coordinate the complicated interests of all the parties involved before its macro fundamentals begin to be affected.**

(Mariko Watanabe)

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