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Banking Reform in China: An Assessment in Macroeconomic Perspective

by

NG Beoy Kui

Economic Growth Centre
Division of Economics
School of Humanities and Social Sciences
Nanyang Technological University
Nanyang Avenue
SINGAPORE 639798

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Working Paper No: 2007/07

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Banking Reform in China: An Assessment in Macroeconomic Perspective[1]

Ng Beoy Kui
Associate Professor
School of Humanities and Social Sciences
Nanyang Technological University
Nanyang Avenue, Singapore 639798
Email: abkng@ntu.edu.sg

Abstract

China has been delaying its adoption of a flexible exchange rate system with free capital flows. The main excuse is that its financial sector is still in its fragile stage and is not able to withstand any external shocks. A big bang approach towards such liberalization will only lead to financial crisis as observed by experiences of many Asia-Pacific countries during the Asian Financial Crisis. With this in mind, this paper attempts to uncover the approach and strategies adopted by China in its banking reform since 1978 and then assess these reform measures in macroeconomic perspective. The paper argues that since China is still lingering on export-oriented strategy in promoting economic growth and monetary independence for demand management is still a long way to go, it is still in China's best interest not to adopt a flexible exchange rate system at this point of time. As to capital account liberalization, the main focus is to engineer a controlled and systematic capital outflows through outward investment in particular portfolio investment. At the micro level, China should continue its banking reforms until the financial sector is strong enough to withstand the severe pressure of globalization. By then, will China, with its matured financial system be ready to consider the adoption of a flexible exchange system with free capital flows.

JEL Classification: E44, E5, G2, O16, O5

Keywords: China, banking reform, non-performing loans, state-owned enterprises, corporate governance, regulation and supervision, financial liberalization.

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[1] This paper is prepared for International Conference on Implications of A Transforming China: Domestic, Regional and global Impacts, held at Kuala Lumpur, 5-6 August 2007. The author would like to thank Ms Chen Wanyi for her research assistance.

Banking Reform in China:
An Assessment in Macroeconomic Perspective

Ng Beoy Kui

1. Introduction

Banking reform in China had started three decades ago in 1978. However, the deepening of the reform gained momentum only after the Asian Financial Crisis in 1997 as China is determined not to repeat the same mistakes committed by its Asian neighbours. With the accession to WTO in 2001, China further committed itself to opening up its services sector for global competition. After much effort made since 1998, China's banking sector looks much better with improvements in terms of capital adequacy, asset quality, financial liberalization and ownership structure. However, there are still many challenges ahead. Corporate governance in the financial sector needs to be strengthened further. Acceleration in consolidation in the banking sector through mergers and acquisitions may be needed so that the sector can withstand severe competition on a global scale. Such consolidation will provide synergy in bringing about competitive forces among banks. Of no less importance is the entry of foreign banks in the Chinese banking scene and such entry will have a long term impact on the Chinese banking industry in terms of scale and scope of banking business, globalization of banking operations and universalization of banking.

This paper attempts to uncover the approach and strategies adopted by China in its banking reform since 1978 and then assess these reform measures taking into consideration of its macroeconomic implications. Such macroeconomic perspective will help to explain at the current economic conditions the inappropriateness of adopting a flexible exchange rate with free capital flows.

The paper is divided into four sections. After the Introduction, the second section outlines the historical evolution of the banking reform since 1978 to provide a historical

background and perspective on the banking reform in China. The section also attempts to distinguish and chart the major trends of the reform, with the purpose of identifying the overall approach and policy strategies adopted in the banking reforms over the last three decades. The assessment of these approach and strategies is followed in the fourth section. The assessment also covers, among others, macroeconomic implications of the banking reform, especially in the macroeconomic policy framework. In conclusion, the paper argues that since China is still lingering on the export-oriented strategy in promoting economic growth and monetary independence for effective demand management is still a long way to go, it is still not in China's best interest to adopt a flexible exchange rate system with free flow of capital at this point of time.

2. Historical Evolution, Policy Approach and Implementation Strategy

Before the banking reform, China's financial sector encountered a number of intricate problems. Of these problems, the most prominent ones were as follows (Garcia-Herrero and others, 2005):

- Unbalanced financial sector;
- Fragmented financial market;
- Dominated by state-owned banks;
- Peculiar structure of balance sheet: (1) Loans are large part of assets; (2) Almost all liabilities are deposits;
- Poor asset quality- high non-performance loans;
- Low capitalization;
- Weak corporate governance

With the introduction of the banking reform, all these problems were expected to fade away with the establishment of a modern banking system with effective governance infrastructure.

2.1 Historical Evolution of Banking Reform

Prior to the “Open Door Policy” adopted in 1978, China was under the so-called a mono-bank system. Under the system, the People’s Bank of China (PBOC) was the main national bank, providing both the central banking commercial banking functions[2] in accordance to the State Plan. The Bank of China was established in 1949 under the umbrella of PBOC to provide foreign exchange services while the Agricultural Bank of China (ABC) which was also a part of PBOC under its Bureau of Rural Financial Management was set up in 1951 to provide financing in the agricultural sector.

With the “Open Door Policy” in 1978, China began its financial sector reform by changing the institutional structure of a mono-bank system. According to Chiu and Lewis (2006), financial sector reform in China can be divided into five distinct phases, as follows:

- Phase 1 (1979-85): Breaking up of the mono-bank system by setting up a multi-tier banking system through separating commercial banking functions from central banking functions;

- Phase 2 (1986-92): Setting up more financial institutions such as national and regional commercial banks, and the establishment of the Shanghai and Shenzhen stock markets in 1990 and 1991 respectively;

- Phase 3 (1993-97): Unify the dual exchange rate system; separate the apparatus of monetary from the fiscal side of the government; and the introduction of the Commercial Banking Act, 1995. Central banking functions were defined under the Act of PBOC.

[2] Commercial banking function here refers to mobilization of deposits and provision of loans. It does not imply that the function is performed on a commercial basis.

- Phase 4 (1998-2002): Attempts to resolve non-performing loans of banking institutions by forming asset management companies (AMC) and also by capital injections.

- Phase 5 (2003-2007): Separating regulatory function from central banking function by setting up the China Banking Regulator Commission (CBRC). Strengthening domestic financial institutions ahead of WTO accession commitments in 2006. Capital account liberalization through Qualified Foreign Institutional Investors (QFII) and Qualified Domestic Institutional Investors (QDII) schemes.

On the regulatory framework, there is a policy change, separating central banking policy making from regulatory functions. In April 2003, the regulatory and supervisory functions of PBOC were transferred to the China Banking Regulatory Commission (CBRC) (See Figure 1). PBOC is now entrusted mainly with implementation of monetary policy and exchange rate policy. PBOC also continue to regulate and supervise financial markets to ensure efficient allocation of resources and financial stability. Other regulatory institutions such as the China Securities Regulatory Commission (CSRC), the State Administration of Foreign Exchange (SAFE) and the China Insurance Regulatory Commission (CIRC) were also established to regulate different sectors of the finance industry.

<Insert Figure 1 here>

In January 2007, China convened its third National Financial Working Conference which laid out a medium-term policy direction for banking and financial reform (Hang Seng Bank, Feb/Mar 2007). The conference identified five key areas of future reform in the near term future, as follows:

- Deepen the reform of state-owned banks including restructuring the Agricultural Bank of China (ABC);

- Further development of the capital and insurance markets;
- Start reforming policy banks and allowing the China Development Bank (CDB) to operate commercially;
- Expand investment channels for foreign exchange reserves; and
- Improve the rural banking system

2.2 Policy Approach and Implementation Strategy

The overall approach and strategy of the banking reform is China can be aptly described by an aphorism, "crossing the river by feeling for the stones." (摸着石头过河) This is in line with the general gradual approach towards economic reforms since 1978. The initial banking reform involved with the breaking up of the mono-banking system and the establishment of new financial institutions. Only after 1998, did China began to address the issue of non-performing loans and capital adequacy. Despite the rapid economic growth over the same period, the banking reforms was slow by comparison due to its intricacy and intertwined with state-own enterprises and government finance. The problems have been dubbed by Dean (2001) as the 'Asian Governance Triangle' or 'Triangle of Woes'.

To resolved such thorny problems, China has to be very focus and systematic in its banking reform. The strategies adopted are to focus on restructuring of large banking institutions; to let small and medium banks have their own organic growth; and to have simultaneous reforms of state-owned enterprises and the banking sector to resolve the long outstanding NPLs arising from the 'Triangle of Woes'[3]. At the same time, China also applies external pressure so as to force domestic financial institutions to reform through global competition. The accession to WTO in 2001 and the subsequent commitments to opening up to foreign participation by December 2006 show China's political determination to develop a matured and modern financial system.

[3] For detailed discussion on this please refer to Ng and Thorud (2007).

2.2.1 Bank Restructuring and Regulations

Early reform measures concentrated on the shake-up of the mono-banking system dominated by the People's Bank of China (PBOC). The shake-up led to the rapid development of a multi-tier banking system with four state-owned banks, namely the Agricultural Bank of China (ABC), Bank of China (BOC), People's Construction Bank of China (later the China Construction Bank, CCB) and Industrial and Commercial Bank of China (ICBC). The multi-tier system became more complete with the formation of new national and regional commercial banks. The new national commercial banks included the Bank of Communication (1986), CITIC Industrial Bank (1987), Huaxia Bank (1992), and Everbright Bank (1992). The first private bank, Minsheng Bank, which was set up in 1996 also joined the group of national commercial banks. Meanwhile, several regional banks were also set up in response to the rapid development in the coastal provinces. Such regional banks include Xingye Bank of Fujian Province (1981), Huiting Urban Cooperative Bank (Sichuan Province, 1985), Zhao Shang Bank in Shenzhen (1986), Development Bank fo Shenzhen City (1987) and Development Bank of Guangdong Province (1988). In 1994, the policy lending functions of PBOC and four state-owned banks (the Big Fours) were taken over by three newly created policy banks, i.e. the Agricultural Development Bank (ADB), the State Development Bank (SDB) and Import-Export Bank (IEB).

The most drastic reform were the bank restructuring measures undertaken during the period 1998-2005. With the onset of the Asian Financial Crisis in 1997, there was a pressing need to address the long outstanding issues of poor asset qualities and low capitalization of the banking system. In line with the reform strategy of 'grasp the large and release the small,' the policy strategy was to focus on the restructuring of the four big state-owned banks, namely the Agricultural Bank of China, Bank of China, China Construction Bank and Industrial and Commercial Bank of China. The purpose is to introduce reform and yet still retain state ownership and control in large banking institutions with national importance (Brean, 2007).

Before the major bank restructuring, PBOC took unprecedented move in November 1998 in branch restructuring along the line of the US Federal Reserve System. Prior to the restructuring, the branch network covered a network of major branches in 27 provinces and four autonomous regions. After the restructuring, there were nine supra-regional offices cutting across provinces with direct control from the head office in Beijing. This is to prevent central bank branches from subjecting to provincial governments' pressure to extend excessive bank credit to finance local projects (Chiu and Lewis, 2006). Along with this restructuring, the government abandoned the long-standing credit quota system for state-owned banks. A new loan classification system in line with international standards was introduced in March 1998.

To meet the capital adequacy target and also to resolve the long-standing NPLs, official financial support since 1998 was estimated to be about US$400 billion (Chu and others, 2006) or 18% of 2005 GDP. Of this amount, US$95 billion was mainly used for recapitalization of the big four state-owned banks while the rest (US$305 billion) was used to dispose of NPLs from the big four state-owned banks, China Development Bank and Bank of Communications (BOCOM) (See Table 1).

<Insert Table 1 here>

To dispose NPL over-hang of the earlier era, four asset management corporations (AMCs) were set up in 1999 to purchase NPLs from the big four state-owned banks. The AMCs are as follows: Cinda, Great Wall, Huarong and Orient. Originally, each AMC was paired with a single state bank - Cinda with CCB, Great Wall with ABC, Orient for BOC and Huarong for ICBC respectively. Subsequently, the AMCs were allowed to purchase NPL packages from any of the four banks. The immediate mandate of AMCs is to recover US$121 billion of NPLs of these banks, arising from excessive borrowings from loss-making state-owned enterprises. The longer aim of the AMCs is to rehabilitate the loss-making state-owned enterprises and eventually liquidate their stakes by selling or listing the shares in the stock exchanges. Their main activity is debt-equity swaps that are

selected by the State Economic and Trade Commission (SETC). As at March 2005, NPLs amounting to US$168.5 billion has been transferred to AMCs (see Table 2).

<Insert Table 2 here>

Previously, bank regulation and supervision was directly under PBOC as part of its central banking functions. After April 2003, China Banking Regulatory Commission (CBRC) took over the functions. CBRC introduced a number of improvements in bank regulations (Garcia-Herrero, A and others, 2005). For instance, the five-tier loan classification system was further enhanced with a deadline by end of 2005. The 8% target of capital adequacy ratio as prescribed by the Bank for International Settlement (BIS) was introduced and all banks were expected to be complied by 2007. A risk-based supervision based on CAMELS[4] criteria will be applied to joint-stock commercial banks. In addition, related party lending is strictly prohibited. CBRC also set out seven performance indicators for BOC and CCB to benchmark with the top 100 largest banks in the world (Brean, 2007).

2.2.2 Financial Liberalization

Financial liberalization is also an essential part of the banking reform in China. There are four areas of financial liberalization, as follows:

- Ownership restructuring
- Interest rate liberalization
- Opening up to foreign competition (WTO and foreign bank entry)
- Capital account liberalization (QDII and QFII)

[4] The acronym CAMELS refers to the six components of bank's financial conditions that are assessed: capital adequacy, asset quality, management, earnings, liquidity and sensitivity to market risk. It is a rating system used by regulatory and supervisory authorities to evaluate the safety and soundness of financial institutions (Casu B. and others, 2006).

Ownership restructuring

Studies have shown that state-ownership of banks will not lead to efficiency (Boyreau-Debray and Wei, 2005). Privatization has been rejected as an option for ownership restructuring. The option undertaken by China is mainly through corporatization, i.e. through public listing of its shares in the local or foreign stock exchange. The other option is to increase the stake of foreign strategic investors or both. Public listing through the issue of IPO in the stock exchanges, in particular the Hong Kong Stock Exchange (HKSE) is aimed at exerting pressure on domestic banks to comply with corporate governance imposed by these exchanges. This will ensure public confidence, especially among the strategic investors. The introduction of strategic investors as minority shareholders will ensure that the big fours are still in the hands of China's national government. Secondly, the strategic investors can help restructure the banks internally with their vast experience in management skills, risk management, product development and access to international financial market. Table 3 shows a list of Chinese banks and their respective strategic investors with their shares of equity investment.

<Insert Table 3>

Four banks' ownership structure has been restructured through the issue of IPOs in the Hong Kong Stock Exchange and also through increase in foreign stakes, as follows:

- CCB issued IPOs on HKSE in 2005, raising US$8 billion in share capital. Its strategic investor is Bank of America with 9% stake.

- BOCOM issued IPOs on HKSE in 2005. HSBC acquired 2.6% of its stake.

- BOC issued US$9.7 billion IPO on HKSE. Minority stakes were acquired by Royal Bank of Scotland, Merill Lynch, Temasek Holdings of Singapore and Li Ka-shing group

- ICBC Issued US$14 billion IPO in HKSE. Its strategic investor is Goldman Sachs-led consortium.

Interest rate liberalization

Apart from ownership restructuring, interest rate liberalization was introduced as far back as 1996. However, the approach towards liberalization has been gradual and step by step, as follows:

- In 1996, interest rate liberalization was first introduced in inter-bank money market. Domestic loan interest rate corridor (band) was instituted.
- In 1997, interest rates in the bond repo market were set free.
- In 1998, Government bonds' issuing rate was market determined.
- In 2000, controls over foreign currency lending rates and large-value foreign currency deposit rates were removed.
- In 2004, domestic loan interest rate corridor (band) except credit cooperatives was lifted. The lower limit on interest rates of deposits was lifted.

Opening up to foreign competition (WTO and foreign entry)

Foreign banks were initially restricted to conduct banking business only in a few cities in China. These banks were only allowed to provide foreign currency transactions to foreign companies operating there (Ferri, 2005). Only from April 2002 onwards, a number of foreign banks were specifically allowed to offer foreign currency transactions to Chinese nationals and firms. Further liberalization measures were adopted since December 2003, with the government's permission to foreign banks to provide banking

services in reminbi or Chinese yuan (RMB) to Chinese firms in 13 cities. As at end of 2005, 84 of the 191 foreign banks in China were given a license each to conduct RMB banking business. However, these banks' local RMB business was restricted by their limited branching network and therefore access to cheap retail deposit funding. Moreover, they were also disadvantaged by the limits to inter-bank funding (Huang, 2002).

In 2001, China joined the World Trade Organization (WTO with the commitment that, among others, China would remove all the geographic and business restrictions on foreign banks in China within five years. In short, all foreign banks are allowed to set up branches in all other cities in China, conduct RMB business, and provide retailing banking services to both local and foreign nationals alike (Lin, 2001). The main purpose of such a move is to use of external pressures, via foreign bank competition to force domestic banks to restructure their management to enhance their competitiveness..

In addition to the accession to WTO, China also introduced strategic investors in domestic bank ownership structure. Previously, acquisition of domestic bank stakes by foreign entities required approval from the State Council which was normally not easy to come by. In December 2003, China took a drastic turn by encouraging foreign banks to invest in domestic banks as strategic investors. Under the new rule, foreign banks as a group can own stakes of a domestic bank up to 25%. However, each investor is allowed to own up to 20%. The injection of strategic investors into the domestic bank ownership structure is expected to improve their corporate governance and inject management expertise and recapitalization funds. More specifically, the introduction of foreign strategic investors a handy tool for (1) bank restructuring; (2) enhancing banking skills through business co-operation, (3) supplementing equity capital, without recourse to fiscal budget allocation and (4) boosting status of Chinese banks through foreign affiliation (Hope and Hu, 2006; Lung and Fineman, July 2005). Moreover, the participation is compatible with the state's overall control of the banks through provision of only minority stakes for foreign banks in the ownership structure.

Capital account liberalization (QDII and QFII)

China is still under IMF Article VIII and allowed to have exchange control over capital and financial accounts. Under the exchange control, RMB is non-convertible for capital and financial account transactions without prior approval from the Chinese authorities. Prior to 2002, only foreign direct investments (FDI) were given permission to flow into China while portfolio investments and other short-term capital flows were totally prohibited under its exchange control. In December 2002, China enacted the Qualified Foreign Institutional Investors (QFII) Act which allows foreign investors to invest Chinese securities, such as RMB denominated shares and Treasuries listed on China's stock exchanges or A-Shares; enterprise bonds, and other financial instruments as approved by the China Securities Regulatory Commission (CSRC). For each investor, the amount invested can range from US$50 million to US$800 million effective from June 2003. Since then, a number of prominent foreign institutional investors such as Citigroup, HSBC, UBS, Nomura Securities, Deutsche Bank, Morgan Stanley, Goldman Sachs, JP Morgan have been given permission to invest in domestic capital market. The purpose of such policy measure is to attract foreign investors to invest in the China domestic securities. Since long-term investment is non-speculative, such capital inflow will not jeopardize China's financial stability and at the same time act as a pressure for the securities market to improve its corporate governance.

On 24 August 2006, CSRC, PBOC and SAFE jointly issued the "Measures for the Administration of Investment in Domestic Securities by Qualified Foreign Institutional Investors" (the New QFII Rules) to supersede the original QFII introduced in 2002. The New QFII Rules became effective from 1st September 2006. Under the new rules, priority is still given to "QFII applicants which manage closed-ended China funds, pension funds, insurance funds and other professionally managed funds" as in the original QFII scheme. However, qualifying criteria in terms of assets-under-management (AUM) for fund management institutions and insurance companies has been reduced from a minimum of US$10 billion to US$5 billion. The AUM for commercial banks and other securities firms still remain at US$10 billion each. The capital lock-up period under the new rules

has been made more flexible. Initially, the lock-up period was fixed at one to three years. Under the new rules, it is flexible (the period can be as low as three months) and can be adjusted by SAFE, depending on China's economic and financial situation, foreign exchange movements, the balance of payments and policy arrangements of PBOC. Other operating difficulties were also removed. For instance, each fund manager was previously allowed to open just one account. With the new rules, they can open several sub-accounts to meet their operating needs. The QFII scheme has been operating since December 2002, but the investment quota under the scheme was only US$7.5 billion for 45 institutional investors as at end of December 2006. With the new rules, the quota is expected to increase to US$30 billion.

In another effort to liberalize its capital account, China introduced the "Qualified Domestic Institutional Investors" (QDII) scheme on 13 April 2006. The investment quota permitted is USD10.8 billion. The scheme became effective from September 2006 onwards. Basically, the scheme covers three sectors, as follows:

(1) Qualified commercial banks are allowed to mobilize RMB funds from domestic institutions and individuals, and invest in overseas fixed income and money market instruments.
(2) Qualified securities institutions are permitted to mobilize self-owned foreign exchange of domestic institutions and individuals (not purchase foreign exchange from the SAFE) and use the funds for overseas portfolio investment including buying shares and stocks.
(3) For qualified insurance companies, they are allowed to invest domestic currency fund to invest overseas in fixed income and money market instruments under the current QDII. Previously, they could only use funds received in foreign currencies to invest in these instruments.

Under the scheme, qualified investors are prohibited to invest in commodities, hedge funds or securities with a rating of less than BBB.

Effective from July 5, 2007, the new QDII quota increased from US$10.8 billion to US$14.2 billion. In addition, domestic brokers and fund mangers will also be allowed to invest clients' fund in overseas fixed income, equity and derivative securities[5]. Until then, only banks, securities firms and insurance companies were eligible for the QDII programme with various restrictions. However, these investments abroad are still restricted to Hong Kong financial market as Hong Kong is the only financial centre that has signed MOU with China for the scheme[6]. It is expected that the scheme will be extended to cover investments in the major financial centres in the world to help drain excess liquidity away from China. As at March 2007, 30 financial institutions- 11 domestic banks, seven foreign banks, 11 insurance companies and one mutual fund have been granted QDII status.

3. Assessment and Issues

The overall reform approach and strategy can be, as noted by Brean (2007), aptly described by the following three aphorisms, namely:

> "Cross the river by feeling for the stones" - Deng Xiaoping
> "Grasp the large and release the small"
> "It doesn't matter whether the cat is black or white, as long as it catches mice." - Deng Xiaoping

This is particular so for the banking reform. The reform approach has been of gradualism with no big bang style as one would have observed in the Russian case. It took slightly more than three decades in the banking reform to reach the current state. It is expected that China will take another decade or so before the financial sector to be a modern

[5] Citi China launched structured notes product under QDII in May 2007.
[6] In May 2007, CBRC issued a circular to remove the prohibition on direct investment in equity and its structured products. It allows investment in stocks listed on a market regulated by a regulator having signed a MOU with CBRC for QDII products. Currently, only HK Securities and Futures Commission is a Recognized Regulator.

financial system well-integrated with the international financial system. Gradualism will continue to be the hallmark of the banking reform in China. This is because the financial sector with advances in computer and telecommunication technology has to be handled with care. Any faults or mistakes made along the way will cause widespread systemic effect on the Chinese economy and the world financial system. The lesson from the Asian Financial Crisis in 1997 has shown that through globalization, massive financial flows without proper governance in the international financial architecture can destroy a successful economy overnight. This is particularly so as China has already well integrated with the world economy through trade and investment. The aphorism by Mao Zedong that "waiting for ten thousand years to get things done is far too long, what we want is completion within a day" (一万年太久，只争朝夕.) should not be applied here.

In terms of strategy, the approach of "grasp the large and release the small" (抓大放小) is noticeable in the restructuring of the Big Fours. While the bank restructuring also occurs in other smaller banks, the focus is still on the Big Fours since 1998. The cleaning up of NPLs through AMCs, and capital injections into the three banks of the Big Fours have been going on for almost a decade. The next step is the restructuring of the Agricultural Bank of China in the next few years. The other small and medium banks have been left alone without major reform. It is expected that once the reform of the Big Fours is completed, the next move will be introduce the same reform measures on other banks.

The other aphorism by Deng Xiaoping that "it doesn't matter whether the cat is black or white, as long as it catches mice" aptly describes the current strategy of the entry of foreign banks as strategic investors. However, there is one difference here; the "cats" must be within the control of the government through majority stake-holding. Whether such strategy introduced in 2002 will work itself out has yet to be seen.

In addition to the guides from the three aphorisms, the other noticeable strategy is the use of external pressure for accelerating reform process. The external pressure arise from foreign bank participation with no geographic, business and currency restrictions,

the introduction of foreign strategic investors, and the liberalization of capital account with the introduction of QFII and QDII. The advantage of such approach is that it prepares China's financial system to be well integrated with the international financial system. Secondly, it forces domestic banks to conform with international standards and practices in terms of corporate governance, risk management and competitive practices. Finally, the soundness of the financial sector through this reform measure will help China to withstand external shocks in the era of globalization.

3.1 Bank Restructuring and Regulatory Framework

There is much improvement in bank performance after the bank restructuring since 1998. Non-performing loans of the Big Fours have been reduced significantly. Through capital injections, capital adequacy ratios for most banks were above 8% target. Despite all these efforts, there is no guarantee that the new loans extended may also end up as new NPLs. Podpiera,(2006) noted that after the bank restructuring, the lending behaviour of most banks remained almost unchanged. Apart from the restructuring of the Big Fours, nothing has been done for the small and medium banks. It is time to consider the consolidation of these city banks and regional banks through mergers and acquisitions to make these banks more efficient and able to withstand competitive pressure from foreign banks.

In terms of institutional structure and regulatory framework, there has been significant changes and new direction in regulatory framework. By 2007, the regulatory framework for the financial sector in China comprises a host of regulatory and supervisory agencies. The more important ones are as follows:

- China Banking Regulatory Commission (CBRC)
- China Securities Regulatory Commission (CSRC)
- People's Bank of China (PBOC)
- State Administration of Foreign Exchange (SAFE)

- China Insurance Regulatory Commission (CIRC)

The division of labour in such a regulatory framework seems to be obvious. The main advantage is that such division of labour will lead to more focus in regulation and supervision with the objective of increasing efficiency. The major issue in such a framework is co-ordination problems, especially in enacting regulations and enforcement of corporate governance and risk management. The co-ordination problem will become less manageable as the distinction between banks and non-bank institutions become blur. More importantly, new financial products especially derivatives and structured products which covers the realms of both banking and securities business can hamper effective regulation and supervision from a diverse regulatory agencies. Secondly, the overlapping of authority among various regulatory agencies also will put a stumbling block to the spur of financial innovations and the provision of sophisticated financial services. As noted by Crooke (2006, p. 4):

> "…, the split in responsibilities between CBRC and CSRC has until recently hampered what has been approved to be sold in the structured products. Even though the CBRC's 2004 rules on banks conducting derivatives transactions potentially allows products linked to things other than rates to be designed and offered, a clear distinction between banking and securities and futures business in China is rooted in law. As a result, some market players believe this has made the banking regulator less willing to approve structured products linked to equities, funds or commodities, for example."

Finally, the separation of regulatory agencies will also deter the integration of banking and capital markets and subsequently, the development of universal banking in China. The universalization of banking business is the inevitable trend amidst globalization and global competition. The deterrence to such development will not help modernize and upgrade the financial system in China. In a healthy regulatory environment, a regulatory framework should foster greater competition, corporate governance and risk management in the financial sector.

Another important issue that the banking reform has not dealt with thus far is the financing of the private sector. Only in recent years, do some efforts have been made to handle the issue of financing the private sector.

Despite their declining contribution to GDP (40% as compared with 60% in 1980), large state-owned enterprises (SOEs) sit at the pinnacle of financial access (Linton, 2006). Private firms, be it foreign or domestic, face substantial capital access barriers and must use a wide variety of informal means to obtain access to funding. According to the All China Federation of Industry and Commerce reported by Zhou and Yang (2005), 58% of respondents regarded “financing by borrowing” as the biggest constraint facing by non-SOEs. The survey conducted by the National Association of Industry and Commerce also reveals that 35% of private enterprises have never borrowed from banks. Ironically, the debt-ridden SOEs accounts for a big chunk of domestic bank loans (70%). Over 90% of private firms surveyed by OECD-China National Bureau of Statistics study (OECD, 2005) also confirms the inaccessibility of bank credit by the private sector. Small and medium enterprises (SMEs), which contribute more than half of GDP obtained only 10% of total bank loans (Linton, 2006). Consequently, SMEs have to depend on personal financing, company’s retained earnings or resorting to ‘shadow markets’ for funding. The ‘shadow markets’ are informal credit markets to include money lenders, enterprise networks, underground financial organizations as well as SOEs through receivable financing.
This informal credit market provides as much as about 28% of the formal bank loans (Zhou and Yang, 2005). Between 1996 to 2001, informal credit accounted for three quarters of private sector credit (Tsai, 2006). Interest rates charged in such informal credit markets ranged from 12% to 200%, depending on the regions.

Tsai (2006) gives four reasons why private enterprises are neglected in formal bank credit market. Firstly, the banks need to provide soft loans to SOEs as a mean to avoid mass unemployment, a potential cause for social instability. Secondly, policy or targeted lending by banks somehow crowd out private lending. Thirdly, loan officers are incapable of evaluating loan applications and credit worthiness of private enterprises.

Lastly, it would be ironic to provide loans to capitalists in a socialist state and that can be politically sensitive.

To meet the demand for credit by private enterprises and to restrict the operation of the 'shadow markets', the government converted urban credit co-operatives into city commercial banks to increase efficiency and also to provide financial services to credit-worthy private enterprises. In 2001, local credit guarantee companies were set up to serve private borrowers. In addition, the China Banking Regulatory Commission (CBRC) issued "Guidelines on the Credit Business of Commercial Banks to Small Enterprises" in July 2005 to enhance the provision of financial services to private enterprises. Since then, various commercial banks establish special credit facilities to serve SMEs. At the end of 2005, two microfinance institutions were set up in Pingyao in Shanxi Province to provide credit to private enterprises with interest rates higher than that of commercial banks. Despite all these efforts, Tsai (2006) convinced that informal credit market will continue to exist because of its peculiar locational features and also a way to evade taxes by no requirement for revealing accounts in such market.

3.2 Ownership Restructuring and Foreign Strategic Investors

The means of ownership restructuring in the China's banking sector are corporatization through issues of initial public offerings (IPOs) and listing in the stock exchanges, as well as the introduction of foreign strategic investors since 2002. Privatization has not been the main channel of ownership restructuring. As such, majority stakeholders of the banking sector is still the government[7], as strategic investors as a group can only own up to 25% shares.

Foreign financial institutions are willing to serve as strategic investors despite the fact that they can only be minority stakeholders. They are basically attracted by China's rapid

[7] From the Chinese government's perspective, Ma(2006) argues that the issue of IPO and foreign equity participation provides an exit strategy for the state to recoup its equity investment in recapitalized banks.

economic growth, enormous, yet-untapped market potentials, and the opportunity to leverage local banks' name recognition, customer bases and distribution networks. In particular, the yet-untapped market potentials include retail mortgages, credit cards, consumer lending, wealth management, fund management, and trustee services. The strategic alliances can augment foreign banks' growth through their typically limited or non-existent local presence in China. The main concerns of foreign strategic investors (Hope and Hu 2006) are as follows:

- Poor corporate governance- no check and balances, few independent directors, no risk and audit committee, no transparency
- Minimum control and management – foreign ownership is restricted to 25%- may allow to have control over certain niches or line of business which they have expertise.
- Inadequate law and regulation – uncertainty and need more improvement
- Poor risk management- credit decisions are still driven by relationships, guarantees, and reliable collateral (buildings and land-use rights). Use of cash flow analysis is constrained by unreliability of accounts of enterprises. Corrupt practices and frauds are common.- Internal controls to curb operational risks is limited.

Long-standing problems such as above make foreign investors cautious and thereby hamper business cooperation. As the strategic investors have only minority stakes, they might find it hard to exert influence over management (Lung and Fineman 2005). Secondly, shareholding restrictions will also limit foreign investors' influence over medium-sized and small banks. Despite all these concerns, the Chinese government is more than willing "to mitigate some of these potential obstacles, in particular by establishing a legal system that supports banks more effectively, by limiting official intervention in the operations of the banks, and by ceding more voice to foreign strategic investors in the operations of the banks, …" (Hope and Hu, 2006). Foreign strategic investment has the potential to be very effective way to improve China's banking system."

Hansakul (2006) is equally optimistic about the participation of foreign strategic investors in China. He notes that penetrating the consumer banking market and the higher-margin SME sector will require more local networks and know-how which the foreign strategic investors are lacking. In this respect, the strategic partnership between foreign banks and Chinese banks is a logical step. While foreign banks can access to wider distribution channels and customer networks, Chinese banks with the help of strategic investors will be able to improve on credit and risk management, product innovations and IT system. In particular, having a foreign partner on board is expected to help Chinese banks to behave in accordance to a more commercially-driven, profit-oriented business culture.

3.3 Foreign Bank Participation and Capital Account Liberalization

One of the main concerns about foreign bank entry into China is that domestic depositors will divert their deposits away from domestic banks. Clearly, foreign banks are better managed while domestic banks are not. Secondly, domestic banks are still saddled with huge amount of NPLs. However, such exodus of bank customers is not likely to happen (Hansakul, December 2006) even though foreign banks are able to offer all types of RMB businesses to all types of customers in China (WTO requirements by December 2006). There are several reasons for this. Firstly, branch expansion of foreign banks will not be easy. There are red tapes to apply for branch licenses. For instance, foreign banks are required to have a representative office for three years before they can open a branch. In addition, the capital requirements for branching are equally prohibitive and high by international standards. In this respect, CBRC has taken steps to ease foreign bank applications for geographic expansion under a new banking regulations announced on November 15, 2006, ahead of the compliance date of 11th December 2006. Still, it will take a long time for foreign banks to expand their branch networks in China. In the near term, with a lack of branch network, foreign banks are comparatively at a disadvantage in conducting RMB business, especially in consumer banking. Secondly, domestic banks

with its vast branch network have already established close relationship with local clients and it may be difficult for foreign banks to establish such relationships within a short period of time. Finally, Chinese banks have improved their performance considerably over the years and have expanded their business successfully that foreign banks may find difficulty to compete on level-playing field. However, there is still ample opportunities for them to focus on current business areas such as loan syndication for large projects, investment banking, treasury products and wealth management. These are the areas where they can complement what is lacking in domestic banks. Moreover, the Chinese market is huge and the saturation level has yet to be reached.

China has been accused by the United States that it deliberately undervalues its currency to promote its exports, resulting in a huge trade surplus and accumulation of foreign exchange reserves for China (US-China ESRC, 2005). Various options have been put forward to address the issue for China to consider. One option is for China to adopt a flexible exchange with free capital flows which China rejects outright. China's argument is that its financial system is still in its fragile stage and not able to withstand any external shocks. The other option is to adopt a flexible exchange rate system before its current account liberalization (Prasad, Rumbaugh and Wang, 2005). However, China is adopting a different option; liberalizing selectively its capital account first before the adoption of a more flexible exchange rate. The limited capital account liberalization takes the form of QFII and QDII. The two schemes in a sense establish a two-way channel for capital to flow in and out of China via institutional investors (Hang Seng, September 2006). They will encourage currency trading and represent a real step toward convertibility of RMB in capital account items.

The two schemes are also strategically important in the sense that they help promote the integration of China's domestic capital markets with the international capital market. The QFII scheme allows foreign financial institutions to penetrate into Chinese capital market, thereby exerting pressure for listed firms to abide international practice of proper corporate governance and risk management. Similarly, the QDII scheme will allow domestic financial institutions to diversify their portfolios and gain access high-

yielding investments overseas. However, there is foreign exchange risk in these transactions and financial market in China currently is not sophisticated enough to provide investors hedging facilities. Nevertheless, the exposure to foreign competition through the two schemes, and together with the WTO accession will provide a training ground for domestic banks and their clients to deal with external shocks, especially exchange rate fluctuation.

Through the two schemes, domestic and foreign banks can forge alliances and cooperation in banking business. For instance, domestic QDII institutions are granted each with a larger foreign exchange conversion limit of US$2.5 billion while that of foreign bank is only US$ 500 million. At the same time, domestic banks with a wider branch networks and distribution are weak in terms of skills in internal control, marketing, investing and risk management in the global markets. Foreign banks, on the other hand are better positioned in these areas. Foreign banks also have vast experience in the business of custodianship and the QDII scheme grants these foreign banks the opportunity to act as custodians. In this respect, both domestic and foreign banks can work together for their respective mutual benefits. Such co-operation will also enhance financial integration of China's financial market with international capital markets in the long run.

3.4 Macroeconomic implications

As noted by Mundell (1963) and Krugman (1979), a country cannot achieve the three objectives of exchange rate stability, monetary policy independence and free capital flows simultaneously. It can only achieve one or two of these objectives but has to be at the expense of the third objective. This is the concept of "Impossible Trinity" or "Macroeconomic Trilemma." In the case of China, it values more a stable exchange rate environment and it prepares to forgo monetary policy independence and free capital flows. This is difficult to understand as China is adopting an export-led strategy in its economic development. The strategy also hinges on the inflow of foreign direct

investment. Stable exchange rate is therefore crucial to the success of such strategy which depends largely on international trade and investment. Secondly, RMB is not a convertible currency and therefore, thinly traded in the foreign exchange market. Consequently, any shocks in the foreign exchange market will lead to high volatility of RMB which in turn will affect trade and investment adversely. Secondly, monetary policy independence is meaningless to China as its financial and goods markets are very fragmented. Any changes in monetary aggregates and interest rates will have insignificant effect on the economy. Finally, free capital flows, in particular short-term capital flows can turn into speculative flows that would easily lead to currency crisis, banking collapse and stock market crashes. In this respect, China adopts non-convertibility of RMB for capital and financial transactions. With the imposition of this exchange control, China, at least can be selective in the type of capital flows, as noted in the QFII and QDII schemes.

<Insert Figure 2 here>

If financial sector reform, in particular the banking reform is successful, then China can readily change its exchange rate regime to a more flexible one. Such a change is desirable considering the fact that the export-led strategy may be faded away as the economy is becoming more developed and domestic demand will have a greater impact on economic growth. China has, indeed, expressed its desire to move away from the export-led strategy towards domestic demand management (Che Lo, 2007). Monetary policy will play an increasingly more important role in this kind of macroeconomic management. In particular, if financial sector reform can further remove the existing structural segmentation between banking and securities sector, monetary policy will have a more pervasive in its impact. Equally important is the interest rate liberalization that allows market forces to work in the domestic money and capital markets. The capital account liberalization through the introduction of QFII and QDII schemes, likewise, will encourage active RMB trading, paving the way for the deepening of foreign exchange market in China.

China has made a significant inroad in accelerating the pace of QDII since its inception in 2006. One of the key objectives of QDII is to engineer a rapid capital outflows as RMB is under severe pressure to appreciate. At the same time current account surplus and capital inflows have led to the rapid monetary expansion which in turn, contributes to the overheating of the Chinese economy. China's foreign exchange reserves is the largest in the world and has well exceeded US$ 1 trillion as at end of 2006. However, China may not be able to achieve the intended capital outflows for a number of reasons. Firstly, capital outflows may not easily come by because domestic stock markets are too attractive for local investors. Investment abroad will incur high opportunity costs. Secondly, CBRC has signed MOU only with Hong Kong. Investment in Hong Kong capital market through QDII is unlikely to be attractive to Chinese residents as Hong Kong dollar (which is pegged to US dollar) is depreciating against RMB. Thirdly, with such exchange risk, China's financial market is still not able to provide investors hedging facilities for exchange risk. However, in the longer term, QDII may be able to serve as a channel for exchange rate and capital flow management.

In short, banking soundness with well-developed financial market is the basic foundation for macroeconomic management and also a key element in maintaining macroeconomic stability.

4. Concluding Remarks

After the institutional reform to achieve a multi-tier banking system in the 1990s, China then moves on to address the more serious problems of NPLs and low capitalization. The low capitalization problem is much easier to resolve as China has a huge amount of foreign exchange reserves. The NPLs problem is much more complex and intricate as the problem involves a series of issues relating to reforms of state-owned enterprises as well as government finances. Such a typical case of "Asian Governance Triangle" requires not only political determination but also a change of banking business culture. Efforts have been made to increase competition, adherence to corporate governance and a shift towards commercially-driven banking business culture through

corporatization of state-owned banks, introduction of foreign strategic investors, accession to WTO and the implementation of QDII and QFII schemes. Further efforts are still needed to be done, especially in the area of corporate governance and risk management in a healthy regulatory framework..

China has made significant inroad in the globalization of banking operations but universalization of financial sector is still a long way to go. This is due in part to its compartmentalization in its regulatory framework. A more coordinated framework with PBOC as the supreme authority at its apex will be most welcome as PBOC is not only responsible for the implantation of monetary and exchange rate policy but also involves in the development of the financial sector. To withstand global competition and external shocks, city commercial banks and joint-stock commercial banks require immediate consolidation through mergers and acquisitions. Only with a strong foundation in the banking system, will China be ready to shift its exchange rate regime towards a more flexible one.

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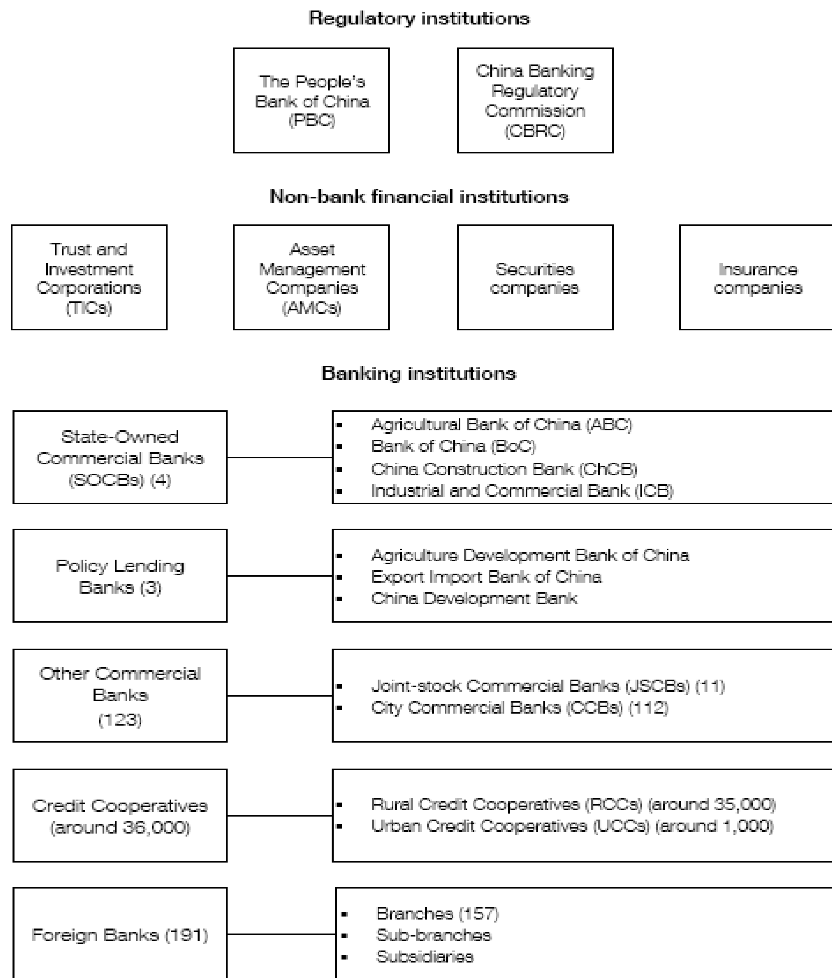
Figure 1: Banking Structure in China After April 2003



Source: Garcia-Herrero, A., Gavila, S., Santabarbara, D. (2005)

Table 1: Financial Support Measures

Date	Amount (US$ bn)	Recipient
Capital injection		
1998	33	Big four state-owned banks
Dec 2003	23	Bank of China (BOC)
Dec 2003	23	China Construction Bank (CCB)
Jun 2004	2	Bank of Communications (BOCOM)
Apr 2005	15	Industrial & Commercial Bank of China (ICBC)
Total	**95**	
NPL Carve-out		
1999-2000	169	Big four state-owned banks and China Development Bank (CDB)
2004	51	BOC, CCB and BOCOM
2005	85	ICBC
Total	**305**	

Source: FitRatings, May 2006

Table 2 – AMCs' Disposal of NPLs at March 2005

AMC	SOCB	Asset Transferred USD billions	Share of banks loans Outstanding (% at end-98)	NPL resolved	% NPL resolved	Cash recovery	% Cash recovery
Orient Asset Management	BoC	32.3	20.4	12.9	39.9	2.9	22.8
Great Wall Asset Management	ABC	41.8	24.6	25.8	61.8	2.7	10.4
Cinda Asset Management	CCB	45.0	21.7	18.56	41.2	6.2	33.6
Huarong Asset Management	ICBC	49.2	17.9	25.9	52.6	5.1	19.9
Total		**168.3**	**20.7**	**83.2**	**49.4**	**16.9**	**20.6**

Note: in USD billions at March-2005
Source: PBoC, CRBC, Annual reports, BIS working paper No. 115
Adapted from Garcia-Herrero et al, 2005

Table 3: Announced Foreign Direct Investment in Chinese Banks

Year	Target Banks	Strategic Investors	Equity Investment (%)
2006	Ningbo City Commercial Bank	OCBC	12.2
2006	ICBC	Goldman Sachs-led consortium	10.0
2005	Tianjin City Commercial Bank	Australia and New Zealand Bank	20.0
2005	BOC	RBS/Temasek/UBS/ADB	16.84
2005	CCB	BOA/ Temasek	14.1
2005	Bank of Communication	HSBC	19.9
2005	Bohai Bank	Standard Chartered Bank	19.9
2005	Huaxia Joint Stock Bank	Deutsche Bank/ Pangaea	20.9
2005	Hangzhou City Bank	Commonwealth Bank of Australia	19.9
2005	Bank of Beijing	ING/IFC	24.9
2004	Bank of Jinan	Commonwealth Bank of Australia	11.0
2004	Xian City Commercial Bank	IFC/ Bank of Nova Scotia	5.0
2004	Shenzhen Development Bank	Newbrigde Capital	17.9
2004	Minsheng Bank	IFC/ Temasek	6.2
2004	Industrial Bank	Hang Seng Bank/ IFC/ GIC	24.9
2002	Shanghai Pudong Development Bank	Citigroup	5.0
2002	Nanjing City Commercial Bank	IFC	15.0
2002	China Everbright Bank	IFC	4.9
2002	Bank of Shanghai	IFC/HSBC/HK Shanghai Com Bank	13.0

Source: Table 7 of Ng & Thorud (2007), adapted from Ma, 2006.

Table 4: China's Sources of Finance (Percentage Share, %)

	2001	2002	2003	2004	2005
Bank loans	75.9	80.2	85.1	82.9	78.1
Government bonds	15.7	14.4	10.0	10.8	9.5
Corporate bonds	0.9	1.4	1.0	1.1	6.4
Equity	7.6	4.0	3.9	5.2	6.0
Total	100.0	100.0	100.0	100.0	100.0

Source: Peoples' Bank of China

Table 5: Overview of Curb Market Activities in China

Legal	Quasi-Legal	Illegal
Interpersonal lending Trade credit Rotating credit associations (in some areas) Pawn shops (in some areas) Shareholding cooperatives	Rural cooperatives foundations (illegal since 1999) Red hat/hang-on enterprises[1] Financial societies/ capital mutual assistance associations Pawn shops (in some areas)	Professional brokers and money lenders (loan sharks) Private money houses Rotating credit associations (in some areas) Pyramidal investment schemes (scam) Diversion of bank loans via state unit

1. A privately owned enterprise is registered as a collective enterprise and therefore 'wearing a red hat" which symbolizes communism. A hang-on enterprise is a privately-owned enterprise registered as a subsidiary of SOEs. These two deceptive ways of registration is to ensure the access of bank credit.

Source: Tsai, August 2006.

Figure 2: Impossible Trinity