"The impact of China's financial market structure and regulations on Chinese and foreign investors"

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1 Introduction[1]

In the beginning I would like to state that, as this whole conference was designed under the objective to deliver more detailed information about the current situation and main problems concerning the daily business of investors and foreign banks in China, I don't want to spend much time with a detailed overview about the structure of China's financial system, about theoretical approaches and macroeconomic features. This short discussion will follow in section 2. Instead I will in chapter 3 focus on what all the existing regulations mean to somebody interested participating in the "big Chinese growth party" that could be recognised in the last two decades. Part 4 will show some basic requirements the PRC has to meet in the next years for a sufficient reform of both financial and enterprise sector. I will close with a short outlook.

2 Financial market development in China - an overview

Talking about the development of financial markets in the PRC could last longer than the whole four day meeting we are participating in if all the important details should be recognised. In this part I do not want to discuss institutions belonging to the financial sector with which foreign investors and banks cannot co-operate. As a result the so-called "Non Bank financial institutions" and insurance companies will drop out of this analysis.

Potential risks in the financial sector

In recent discussions during the last two years it is pointed out that the risk now more often cited as facing the People's Republic of China is that of a potential banking or financial crisis. In the debate as to how such crises are generated, the following factors are among those felt potentially likely to act as a trigger:[2]

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[1] The facts presented in this paper are the result of a research study done by Schlotthauer and Nestmann (1998) while staying in Beijing for a field research. The author would like to thank Peter Nestmann and the staff of the Delegation of German Industry and Commerce for helpful comments.

[2] Cf. Goldstein/Turner (1996), pp. 8ff.

- the strong influence exerted by government authorities and inadequate financial monitoring of directed lending;
- pronounced credit expansion, especially in boom phases, and collapses in asset prices;
- insufficient preparation for the complete liberalisation of the financial sector (especially as regards banking supervision, accounting rules, training of bank personnel, and decision-making structures);
- marked mismatches between the terms and/or currencies of assets and liabilities;
- volatility in macroeconomic parameters (especially fluctuating real exchange rates and world-wide interest-rate differentials).

If this risks are analysed in detail, it can be shown that especially the strong government influence on the banks and insufficient preparation for the complete liberalisation of banks and capital markets are the main problems that can be recognised in China.[3] This is the reason why I will now focus on this two parts of the financial system.

2.1 Banking system

The banking system evolved - similar to that in other transition economies - from a system in which the functions of the central bank and that of commercial banks (or capital markets, too) are concentrated in one bank, the so-called "monobank". Because of this the task of establishing a banking system similar to that in Western economies[4] is a very difficult one. The difficulties arise from two different parts:

- first China faces the problem with which all developing countries have to cope: the installation of an efficient banking system providing the collecting of deposits and offering the chance to finance investment;
- second, China has to solve the financial sector problems arising from the transition process: a lot of banks still have a high number of "bad loans" which will to be irrecoverable. In addition, during the transition process, all the institutions

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[3] Cf. Schlotthauer (1999), p. 13.

working in the centrally planned economic system are now fading away and the building of institutions itself is another main task which, too, impedes the creation of a sound financial system.

The banking system in China is today still tightly controlled by government authorities (see Figure 1).[5] Especially the four major state-owned commercial banks, but also a large number of regional banks established by provincial governments, are 'directed' in their lending by political considerations and not by economic viability. Their lending is set by a credit plan, which allows a large number of inefficient SOEs to continue in operation, thus guaranteeing jobs for a while longer. Real credit growth has continued to increase as the state direction of lending has continued even in the 1990s (see Table 1). At the same time, China's banks need not fear any pressure from foreign competitors (see 3.3 for a detailed discussion).

Table 1: Rate of growth in lending by Chinese banks (in %)

	1983-89	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**
nominal growth	17,0	23,6	20,0	22,3	42,1	23,8	22,9	25,3
real growth[1]	8,0	21,5	17,3	16,9	29,1	2,1	8,1	19,2

1 = nom. growth - inflation rate; Source: IMF (1997), p. 49

As the financial situation of the SOEs has gone from bad to worse, the difficulties of the banks have grown more acute as well, due to a rising proportion of irrecoverable loans. It is estimated that bad loans will make up 30% of the banks' total assets in 1999 - a figure exceeded only by the banks in Thailand (40%) and Indonesia (60%). These estimates are rare in excess of the official figure published at the start of the year by the central bank, the People's Bank of China (PBC), citing 'absolutely irrecoverable receivables' at 5-6% of the total.[6] Clearly, then, China's own authorities apply different standards when evaluating these risks. Fitch IBCA, the first international rating agency to operate in China, is working on the assumption that the total cost of recapitalising the banking sector will come to 10% of the country's GDP. According to one of the top managers at

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[4] Of course the sense of this target "establishing a western-like banking system" could be discussed critically. But this would entail a detailed overview of the discussion about the development of financial markets as a whole.

[5] See also Kunnasmaa (1996).

[6] Cf. Schlotthauer (1999), p. 130.

the China Construction Bank, $60 billion (approx. 6% of GDP) will be needed to carry out this task at the big four state-owned commercial banks alone.

For the time being, the commercial banks are still benefiting from the high propensity to save among the Chinese public. By the end of 1998, people had accumulated total savings worth $645 billion. On the other hand, that means the financial sector would run into problems if Chinese savers and investors were to lose their confidence in domestic banks - indeed, that could pave the way for a severe financial crisis. As James Harding has put it,

> "at the end of the day, Chinese depositors believe their deposits are safe in Chinese banks, (...) But if the time were ever to come when Chinese depositors started to have their doubts, China could end up wishing it were more like, well, south-east Asia, Russia or Brazil."[7]

One of the advantages in China's situation is that a larger proportion of foreign debt than in other Asian countries is borne by the state, and a correspondingly smaller one by banks and by private-sector non-banking businesses.[8] Marked fluctuations in, for example, the real exchange rate coupled with a high proportion of foreign-currency debt can act to trigger off a banking crisis, either directly (via the banks' positions) or indirectly (as the balance sheets of manufacturing and trading companies deteriorate). The People's Republic of China is not exposed to any such risk of a banking and financial crisis being set off by deteriorating macroeconomic data.

2.2 Capital markets

The capital markets in China are still underdeveloped. There are only two stock exchanges working, in Shanghai and Shenzhen, which still show numerous restrictions. The shares traded on the markets are divided into two segments:[9]

- **A-shares**, which are denominated in RMB and can only be held by Chinese;
- **B-shares**, which are denominated in US$ (Shanghai) and HK$ (Shenzhen) and can only be bought by foreign investors. The allowance for a Chinese

[7] Harding (1999), p. 13.
[8] Cf. Corsetti et al. (1998).
[9] Cf. von Stein/Bund (1998), p. 301f.

company to issue B-shares is linked to an examination by an international accounting firm (which of course causes additionally high costs).

A lot of analysis can be found where the importance of the financial markets in the Chinese transition process is stressed.[10] But this studies do not include the issues arising from the Chinese-specific mentality and their investment behaviour. As to quote it in one sentence (which was originally analysed for Taiwan but can also be transferred to all Chinese):

> "Moreover, they see stock exchange trading as a big gamble [...]. They are not interested in fundamental share market analysis but stick to the 'Boom and Burst' principle."[11]

As a result the importance of financial markets in undermining the transition and especially financing the privatisation of state-owned enterprises and newly established private enterprises is often stressed too much. If a privatisation programme is planned as the emission of enterprise shares via the stock exchange it cannot be expected that the buyers of stocks are really interested in becoming an entrepreneur but only want to gamble. This is caused by the regulation that gambling is officially not allowed which makes the "investors" move to other fields (like the stock exchange).

Advantages resulting from the SAR Hong Kong

An important step forward to the installation of efficient financial markets was the adoption of the Hong Kong stock exchange (SEHK). The PRC now has a "harbour" which offers the opportunity to increase the flow of funds from foreign investors again. The stock exchange in Hong Kong is a highly liberalised and in the whole world accepted financial centre and the third-largest in Asia in terms of market capitalisation (after Tokyo and Osaka). Another important factor is the well-developed banking system divided into three tiers. [12] Together with the external stability resulting from the "Currency board" arrangement foreign investors can be sure of the system's stability.

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[10] See von Stein/Bund (1998) as an example where no detailed knowledge of Chinese-specific characteristics can be found.
[11] Dunn/Soong (1998), p. 163.
[12] Cf. Schüller (1998).

In several years of the Chinese transition the SEHK already acted as the main financing centre for China itself which was one main factor for SEHK today's importance. At the SEHK Chinese companies can issue **H-shares** which are denominated in HK$ and can be sold world-wide. This offers a big chance for Chinese companies channelling foreign funds to their portfolio. As the Chinese government did not show too many interests in changing the economic system of Hong Kong at all the SEHK will continue serving as China's "leading financial system". But **problems** might arise from two **developments**:

- As Hong Kong, and especially the stock market, was also affected by the Asian crises, the Chinese government decided to intervene on the stock market using parts of Hong Kong's high foreign reserves.[13] If such actions would be repeated foreign investors might loose a lot of confidence in the stability and ongoing liberal policy of the financial market.
- It now seems that the Chinese government is interested in establishing Shanghai as the most important stock exchange. But with Shanghai's market still underdeveloped the Chinese government should recognise that it will need the SEHK to finance the ongoing transition.

3 Financial market development's influence...

3.1 ... on Chinese enterprises

3.1.1 restrictions concerning foreign currency

As shown in Chapter 2 and Figure 1 Chinese enterprises face a lot of restrictions concerning financing their activities.[14] Every transaction denominated in foreign currency has to be legalised at the SAFE (State Administration of Foreign Exchange). This restriction is part of the widely established controls for capital account transactions with which China aims to keep better chances controlling the fixed exchange rate of the RMB Yuan to the US$.

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[13] Cf. Schlotthauer (1999), p. 127, fn. 20.
[14] I tend not to use the expression "investment" because a lot of funds given from banks to enterprises are used to finance daily activities, e.g. payments of loan bills.

Some loosening of this regulations took place at the beginning of 1999 when companies receiving foreign currency for exports were allowed to maintain 15 % of this money in their portfolio. But this loosening was rejected as China experienced further problems through illegal capital outflows (it is estimated that they were about 40 billion US$ in 1998).[15]

3.1.2 restrictions concerning RMB-business

The main restrictions Chinese companies face when applying for RMB-denominated loans is that the state commercial banks still have to fulfil quotas directed to them by the state via the credit plan. This might result in a shortening of loans to "not preferred companies". This companies then have to fall back on financing their investment with loans from either the "Non-bank financial institutions" or the informal financial sector. Of course another, in the last years very popular way financing the needs was to find a financially sound foreign joint venture partner which was asked to bring along enough money (a further discussion of this subject will be held in 3.2).

One big advantage of Chinese customers lending from Chinese banks might be that they must not necessarily repay their loans to the banks. This is a common sense told in China which might, too, explain why foreign banks have so many problems establishing their own business in China.

3.2 ... on foreign investors

Starting an investment in China the need for credit is very high, especially when a co-operation with a Chinese partner exists. Because the credit amount lent from the "home bank" might be scarce, it is necessary to receive some further finance in China itself, which could be either denominated in foreign currency, causing an extra devaluation risk, or in Chinese currency RMB Yuan.

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[15] A lot of Chinese companies managed this illegal outflows through upgrading the amount of import bills thus asking the SAFE for a higher amount of foreign currency to be approved; see Schlotthauer/Nestmann (1998).

3.2.1 Loans in foreign currency

Loans in foreign currency can be applied at both Chinese and foreign banks, usually they are denominated in US$. The process of application is - as most things in China are - complicated. Opening a special loan account needs two permissions from the "SAFE":[16]

- a "White Card" which shows the registration of business denominated in foreign currency by the SAFE, this must be renewed every year;
- an "Intelligence card" issued by and only valid for this province.

Every loan agreement and every exchange to RMB has to be registered by the SAFE, too. Additionally, the SAFE made further restrictions on the maximum amount one company is allowed to possess in foreign currency.

Table 2: Maximum amount of foreign currency

Capital deposited (US$)	Maximum amount in foreign currency (in US$)
less than 2 Mio.	300,000
2 Mio. up to 6 Mio.	900,000
6 Mio. up to 30 Mio.	4.5 Mio.
30 Mio. and more	7.5 Mio.

Source: Schlotthauer/Nestmann (1998), p. 23.

Due to the outburst of the Asian crises the Chinese government made further restrictions impeding the financing in foreign currency. To discuss them in detail would need too much time, but generally it can be stated that, e.g. earlier repayment of loans, international payments and new applications for loans in foreign currency became even more difficult or are almost impossible now. In addition, even foreign banks, especially those from Germany hit by the Russian financial crises, decrease their lending for investment projects in China, sometimes up to 1 Billion DM from each bank.

3.2.2 Loans in RMB

For payments inside China the finance should be in RMB but this can be a little bit complicated to realise. While applying for a loan at a Chinese bank the foreign investor need to offer some documents with the application form:

- a balance sheet approved by a Chinese auditing company;
- further "normal information" about the company's situation;
- a detailed plan about the realisation of the project.

To secure the loan the Chinese banks generally ask for a "Standby Letter of Credit (SLC)" issued by a foreign bank which guarantees the repayment of the credit. The assets of the enterprise can also be used as a security but the calculation of their value is far below the real one so a SLC is always additionally needed. Securities offered by a Chinese joint venture partner are generally not accepted so the whole loan covering has to be done by the foreign investor. In September 98 things became more complicated when another regulation starts working: SLC have to be registered at the SAFE, too ("contingent foreign debt registration").

Further problems arising from the lending practice Chinese banks showed in 98. Although loan contracts were already signed the banks did not pay out the money. This is in part a result of more restrictions concerning RMB-business with foreigners which were not understood by Chinese banks, too, which therefore decided to stop lending for a while. Applying for a medium- or long-term loan requires an extra authorisation by the State Planning Commission. This prolongs the from application until pay out. And there are only some state commercial banks being able to offer long-term contracts.

3.3 ... on foreign banks

The activities of foreign banks in China are tightly restricted. China's banks need not fear any pressure from foreign competitors. The foreign banks are subject to both regional and quantitative restraints in their RMB-denominated business. They are at all not allowed to lend money and accept deposits in Chinese currency RMB. There are only two exceptions:

- In the Shanghai Special Economic Zone "Pudong" 19 foreign banks are allowed to take part in RMB business (lending, deposits, interbank-market-activity);
- In Shenzhen the PBoC plans to issue permissions for RMB-business to foreign banks, too.

[16] Cf. Schlotthauer/Nestmann (1998).

In both towns the group of potential customers is restricted, only to Foreign Invested Enterprises, foreign individuals and selected Chinese enterprises. Till the End of July 98 the banks' activities were of a very small size, due to further regulations they faced. Only in August 98 the PBoC started relaxing the controls and let the foreign banks expand their business. But they still face various restrictions which make it nearly impossible to deal with most Chinese customers. Instead the foreign banks (like most service providers) have to wait until the PRC will join the WTO. In this case the Chinese government already made further offers to, e.g., foreign banks, insurers and auditing companies for expanding their business.

4 Reforming the financial system

In this chapter I only want to outline in a short manner which tasks China has to solve in the next years. A detailed discussion cannot be held because of the complexity of the problems. This might be the objective of further research projects.

4.1 Bank's portfolio restructuring

A task that must be solved in the near future is the restructuring of state commercial banks' portfolios. These banks have to get rid of the irrecoverable loans they had to lend to state-owned enterprises in the era of planned economy. If there won't be a solution in the near future the Chinese banking system might rely on further financing of inefficient state-owned enterprises just to keep themselves alive and therefore a credit contraction for private-owned enterprises.

In connection with the enterprise reform the government also has to find ways for the role of banks in enterprise reform. Up to 1999 the Chinese approach was different from other transition economies as China government did not implement measures for restructuring.[17] The different measures can be seen in Table 3:

[17] Cf. Dittus (1994),

Table 3: Restructuring state-owned banks and enterprises

		Recapitalisation of banks: Yes	Recapitalisation of banks: No
participate in enterprise restructuring	**Yes**	Poland **III**	impossible
	No	Hungary **II**	China **I**

Source: Dittus (1994).

In 1999 an approach was started to establish an independently working institution dealing with the non-repayable loans. This institution is along the lines with the "Resolution Trust Corporation" in the USA which was build after the breakdown of several savings corporations in the USA at the end of the 80s.[18] It will recapitalise the state-owned commercial banks which makes them able to start a new approach in their lending policy not dependent on the former customers.

4.2 Liberalisation of the financial sector for foreign banks

Most Chinese banks do not have the skills necessary for creating an efficiently working banking system. This shows that a deeper involvement of foreign banks can be helpful for the future development of Chinese banks. A first approach is a project implemented by the World Bank Group which aims at creating a clearing system for a more efficient settlements of national payments.[19]

Another possibility could be that foreign banks join the development of the Chinese financial system by, e.g., building up sino-foreign joint ventures. This could be a way recapitalising and delivering a lot of know how to the still under-developed Chinese banks. This approach would also help to calm down the Chinese fears that the banking system (and the service sector as a whole) is

[18] Cf. Economist (1999), p. 71.

[19] International payments are - in contrast to national - not a source of problems as China is participating in the SWIFT-System for clearing international payments; cf. Schlotthauer/Nestmann (1998).

totally given away to foreigners.[20] The main problem linked with this approach would be the need for a further liberalisation of the capital account which China has avoided for a long time.[21] If the authorities allow more foreign banks to deal in Chinese currency and Chinese banks doing foreign currency-denominated business the capital controls must - at least gradually - be shifted as the integration of financial institutions in global financial markets will make it harder to control capital flows and the PRC might also loose a lot of attractiveness to foreign investors as they obey the development of China more critically now.[22]

4.3 Establishing of an effective banking supervision and regulations

The Asian crises has shown that establishing an effective and independent banking supervision is a main task the state has to solve. Otherwise there would be great danger that inefficient or closely to the bank connected enterprises would have an advantage receiving more funds and the development process as a whole might slow down.[23] This is a problem especially in China where most commercial banks are still under state control and where the bank's staff and the enterprises' managers are still connected with each other in the so-called "guanxi"-networks. In practice this means that - apart from the ministries - an institution should be installed that will act in line with internationally accepted guidelines. Especially the regulations from the Bank for International Settlements, Basle, should be met and supervised in detail.[24] It follows that all the Chinese banks have to keep an eye on, e.g., their capital adequacy ratio which means that their equity capital must at least be 8 % of their risk-weighted assets.

As a means of establishing more efficient supervisory structures and curtailing the influence of local politicians, further reforms of the PBC are being implemented. In particular, its branch structure is being reshaped to consist of nine regional entities, all of which will include several provinces in their ambit. In addition, a

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[20] This fears are not Chinese-specific but can also be found in lots of transition economies of Eastern Europe and the former Soviet Union.

[21] The still existing capital controls are an important element of the Chinese successful reforms, as McKinnon pointed out in an analysis of Asian currency arrangements; see McKinnon (1998).

[22] As an example of the ongoing discussion about problems in China one article might be quoted: N.N. (1999b), p. 11.

[23] See also Corsetti et al. (1998).

central financial institution for dealing with non-repayable loans is will solve a lot of problems (see 4.1).

In addition the People's Bank of China must continue establishing an standardised auditing system to have an unique overview of the commercial bank's accounts and financial situation. Only if it is possible for the whole country and banking system to compare the banks' individual solvency situation with that of other banks in- and outside of China a conclusion about the loss and profit situation and the future prospects can be drawn. As an important step toward this requests in 1998 the Fitch IBCA together with China Chengxin Credit Co. started a joint venture rating agency for financial institutions in China.[25] From now on it will be easier to judge China's commercial banks.

5 Conclusion and prospects

Discussing all the restrictions concerning the financial sector in China makes the question arise which reforms to implement first and what difficulties (similar to other Asian countries) China might face in the near future. The possibility of China being threatened by a financial crises leading to an economic crises is given and the Chinese government should continue its reform pace. Regarding all the warnings that are now coming from various sides it should not be forgot that China has always been able to solve their economic problems in an efficient manner:

> [...] but at least China has a leader who, unlike his Japanese counterparts, recognises problems and is quick and flexible in response."[26]

Therefore foreign investors should not be afraid continuing their activities in China just because of the development in different sectors. When they are aware of the difficulties they might face and will be well prepared, an investment in China still offers a lot of chances. The Chinese government is trying to do better in investment circumstances for foreign investors.

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[24] This would include that the newly established capital adequacy restrictions of the BIS will be fulfilled by Chinese banks, too; see BIS (1999) for a detailed discussion of new requirements.
[25] Cf. Schlotthauer/Nestmann (1998), p. 8.
[26] Vgl. n.N. (1999a), p. 15.

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Figure 1: Regulation of the Chinese financial system