

The domino that did not fall: why China survived the financial crisis

When the financial crisis unexpectedly hit the high-performing East and Southeast Asian economies in mid-1997, it was widely believed that the People's Republic of China (PRC) would be the next domino to fall. China's extensive intra-regional trade and investment linkages with the rest of Asia, and the fact that the Chinese economy suffers from many of the same debilitating structural problems that long plagued (and ultimately did incalculable damage) to the Republic of Korea (South Korea), Thailand, Malaysia and Indonesia – namely, fragile bank-dominated financial systems, poor prudential surveillance and weak central bank regulation and supervision of commercial banks, a large build-up of non-performing loans due in part to excessive lending to inefficient, over-leveraged state enterprises, and a largely state-owned financial sector that may be almost insolvent – led many observers to conclude that the contagion's virulent spread to China was imminent.

However, the Middle Kingdom beat the odds. Although the Asian flu affected China in both its external trade account and external capital account, nevertheless, like the Great Wall, China not only remained conspicuously insulated from a region-wide financial meltdown of unprecedented severity, but the mighty dynamo fueling its economy has missed only a few beats during the crisis and since.¹ China's ability to sustain a strong gross domestic product (GDP) growth performance of 8.8 per cent in 1997 and 7.8 per cent in 1998 and over 8.0 per cent in 1999,² continued success in attracting foreign direct investment (FDI),³ in running healthy current account surpluses (roughly 3 per cent in 1998–99), and in maintaining the stability of its currency, the RMB (*renminbi*) in the face of plummeting currency devaluations and precipitous asset price deflation elsewhere in the region and beyond, is simply miraculous.⁴ In a region where China's intentions are viewed with much suspicion, the PRC's handling of the crisis earned it plaudits. Chuan Leekpai, the Prime Minister of Thailand, on more than one occasion has publicly thanked China for maintaining the value of the *renminbi* and for contributing US\$1 billion to the IMF package for Thailand. Similarly,

Singapore's minister for information, the indefatigable George Yeo, while accusing Japan of abdicating its global responsibilities, noted that "the determination of the Chinese government not to devalue the renminbi in order not to destabilize Asia further will long be remembered" (Kelley 1998, 28). Another observer noted that the RMB was a "pillar of stability" in the region (Dassu 1998).

How did China respond to the Asian financial crisis? Why did China come through such a severe region-wide economic contraction relatively unscathed? What explains the resilience of the Chinese economy, and can the PRC continue to remain insulated from the uncertainty that still pervades the region and beyond? What lessons can be learned from China's experience? And what policy measures must China implement to insulate itself further from the seemingly unpredictable (and volatile) international financial and currency markets? The following sections discuss these inter-related issues. The core argument is that China's handling of the crisis, and in particular, the country's ability to withstand the crisis, must be understood within the context of its domestic political economy. While it was arguably in China's interest not to devalue the RMB during the height of crisis, there are forces at work within the economy that may force China to rethink this strategy in the future.

The economy: underlying strengths

Never in recorded history has an economy grown so rapidly and as extensively as that of post-Mao China. The Third Plenum of the Eleventh Communist Party Congress in December 1978 saw the rise of the late Deng Xiaoping as the paramount leader and the launching of his pragmatic economic program aimed at ostensibly creating a "socialist market economy with Chinese characteristics." Between 1978 and 1995–96, the PRC's economy grew at an unprecedented average rate of 9.5 per cent per year, notching up an all-time high of a 14.2 per cent growth-rate of GDP in 1992. Over the period 1980–1993, the annual growth-rates of agriculture, industry and services were 5.3 per cent, 11.5 per cent and 11.1 per cent respectively. Overall, China's gross national product (GNP) has more than quadrupled since the early 1980s (J. Y. Lin, Cai and Li 1996, 1–17). The additional 20 per cent added to China's GDP on July 1, 1997 when Hong Kong became a Special Administrative Region of the People's Republic was a bonus. China's rapid transformation into a veritable "dragon economy" is reflected in the fact that, based on purchasing-power calculations, it is currently the second largest economy after the United States, a far cry from the bottom rungs of the economic development ladder it occupied less than two decades ago.⁵

Market-oriented policies epitomizing Deng Xiaoping's gradualist strategy of "crossing the river by groping for stepping-stones" have been the

catalyst behind China's phenomenal economic growth. The core of this strategy has been "decentralization." In the Chinese context, decentralization has meant, on the one hand, devolving the power of decision-making from the central to local governments, and on the other hand, from planning authorities to state-owned enterprises. It is widely recognized that the devolution of government power and authority from the central to sub-national or local governments (the latter including provinces, prefectures, counties, townships, municipalities and villages) has been the engine behind China's rapid economic expansion. In their seminal paper, Montinola, Qian and Weingast (1995) have called this "Federalism, Chinese Style." That is, the Chinese-style "fiscal federalism" was fundamentally "market-preserving federalism." By devolving regulatory authority from the central to the local governments, the interventionist role of the central government was limited. The theory provides two possible mechanisms for aligning local government's interest with promoting markets. One is through inter-jurisdictional competition under factor and goods mobility to discipline interventionist local governments. That is, decentralized control over the economy by sub-national governments within a common market prevents the central government from interfering in markets, besides reducing their scope for rent-seeking. Another is through linking local government expenditure with the revenue generated to ensure that the local governments face the financial consequences of their decisions. Moreover, inter-governmental competition over mobile sources of revenue constrains individual sub-national governments.⁶

It should also be noted that the devolution of authority in the PRC was accompanied by the provision of fiscal incentives, and local governments were encouraged and rewarded by promoting the development of their local economies. For example, the formal budgetary revenue starting in 1980, the "fiscal contracting system" known by the nickname of "eating from separate kitchens" replaced the previous system of "unified revenue collection and unified spending," known as "eating from one big pot." Under the new fiscal system local governments entered into long-term (usually five-year) fiscal contracts with higher-level governments, and many were allowed to retain 100 per cent at the margin to make them "residual claimants." In addition, local governments also received "extra-budgetary funds" that were not subject to sharing, not to mention the "off-budget funds" that were not even incorporated into the budgetary process and thus not recorded.

It is well known that agricultural reform was the first reform success in the PRC. In the countryside, the de-collectivization of agriculture, the restoration of rural markets and the changes in the grain procurement system – indeed, the complete replacement of the decrepit and corruption-ridden agricultural collectivization system with the incentive-based "household responsibility system" in 1979 is seen by many as key to China's economic success.⁷ For example, according to Jean Oi (1992), the household responsibility system, which transferred the income rights over agricultural production

from collectives to individual households, significantly enhanced the production incentives of peasants, while depriving local governments of a major source of income (see also J. Y. Lin, Cai and Li 1996, 130–8). At the same time, China's fiscal reform granted local governments the right to retain part of the extra tax revenue they raised. In other words, the higher the rate of economic growth, the higher the tax revenue, and the greater the income of local governments. Given such an important stake in economic growth, local governments were motivated to mobilize resources under their jurisdiction to engage in entrepreneurial activities. They established and ran rural enterprises and took the profits to pay for expenditures and reinvestment. Thus, increased fiscal incentives gave rise to a new form of state-led growth in rural China – what Oi calls “local state corporatism.” Under this system, local governments “treat enterprises within their administrative purview as one component of a larger corporate whole” (Oi 1992, 99). By causing local governments to function like a large corporation with diversified businesses and facing fairly hard budget constraints, including bearing the risks of their investments in industry, the household responsibility system served as the engine of China's economic development. Oi compellingly argues that local state corporatism explains why China has been able to achieve rapid economic growth without privatization and why state officials have not been resistant to reform.

The Chinese political leadership has long viewed agriculture as the foundation of the economy. This is hardly surprising, given the fact the country has 22 per cent of the world's population, but only 7 per cent of its arable land, and that some 800 million people still live in rural communities. China's economic reforms began in agriculture in the late 1970s. Because this sector had been heavily repressed under central planning, its liberalization had immediate payoffs. Specifically, the adoption of the household responsibility system resulted in an immediate and dramatic increase in agricultural production and productivity – putting an end to China's long history of shortages of farm produce. Between 1981 and 1984 agriculture grew on average by 10 per cent a year, generating higher rural savings and investment, and the release and reallocation of labor for employment in agriculture and in the emerging rural industries (World Bank 1996b, 20–21). The agricultural growth was critical, because by mid-1975 the per capita consumption of grain, cooking oil and meat protein was lower than it had been in the 1950s, and malnutrition and hunger were a growing problem (Dernberger 1999, 609). Indeed, under Maoist collectivism (1952–78) total agricultural factor productivity fell sharply, and rural per capita incomes grew by an average of only 0.5 per cent between 1957 and 1977 – not to mention the estimated 16.5 million to 29.5 million people who perished during the ill-fated Great Leap Forward (J. Y. Lin 1990). In sharp contrast, during the post-Mao era the agricultural sector (measured in terms of farm output) has grown consistently at the impressive rate of 6 per cent per year.

Net rural incomes have risen from less than 150 *yuan* in 1978 to roughly 400 *yuan* in 1985, and reached approximately 2,000 *yuan* by 1997.⁸ In real per capita terms, rural incomes increased by 63 per cent between 1985 and 1997 (Nyberg and Rozelle 1999). This has led to a significant improvement in the living standards of China's peasants, who have seen their consumption increase at an annual rate of 7.8 per cent per annum between 1979 and 1992.⁹ Agricultural growth has also provided the surplus needed to sustain the rapidly expanding industrial base and the growing urban population (J. Y. Lin, Cai and Li 1996, 1–17).

The initial success of the rural reforms encouraged the government to broaden reforms to include the urban-industrial sectors in 1984, and to gradually dismantle the central planning system. In the industrial sector important reform measures implemented included experiments to grant the state-owned enterprises (SOEs) more autonomy in production and employment decisions (“the contract responsibility system”), the extension of the dual-track system to industrial prices, and the introduction of enterprise taxation. These reforms gave the SOE managers greater autonomy and allowed the firm to keep a larger share of its profits (under the “profit-retention system”) for bonuses and self-investment (J. Y. Lin, Cai and Li 1996, 138–46). Under the dual-track pricing system, state firms that fulfilled their existing quotas under the plan were now able to market any surplus without fear of their quota's increasing. Eventually, as the above-quota and marketed share became dominant, the central plan was gradually dismantled – what Barry Naughton (1995) has called “growing out of the plan.”

In sharp contrast to what happens in most developing nations, China's handling of surplus, or so-called “floating,” rural labor made redundant as the result of gains in agricultural productivity (estimated to be between 120 and 140 million persons), has been impressive. In 1984, as the central government decentralized fiscal power and allowed provincial and local governments to retain and reinvest locally generated revenues, it created a powerful incentive for the development of local businesses. To meet this demand, the government astutely encouraged the development of rural township and village enterprises (TVEs).¹⁰ Although still predominantly collectively-owned, the TVEs had a big advantage over their competitors, the state-owned enterprises. The TVEs operated free from government restraints, were not subject to any planning targets, were responsible for their own profits and losses, and could buy inputs and sell products freely wherever there was a demand, including on export markets.¹¹ The majority of TVEs are small and medium-sized firms, and their products are generally labor-intensive in nature. Currently, TVEs dominate the building materials and agricultural machinery industries, including textiles and garments, processed foods and beverages, and coal and cement. TVEs account for a growing share of the production of electronics and telecom equipment. The growth and performance of the TVEs has been extraordinary. The TVEs have grown from

1.52 million in 1978 to roughly 23 million in 1996 (Yabuki and Harner 1998, 143–44). Owned as they are by local government, private citizens, and other local enterprises, the TVEs' share in GDP has risen from 13 per cent in 1985 to 31 per cent in 1994. Output has grown by some 25 per cent a year since the mid-1980s, and in 1996 the TVEs accounted for a third of total industrial growth in China, besides creating 130 million jobs between 1980 and 1996, absorbing nearly 30 per cent of the 450 million laborers in the countryside (World Bank 1996b, 50–1; Yabuki and Harner 1998, 144; J. Y. Lin, Cai and Li 1996, 179–81).

Central to China's economic growth has been the liberalization of the foreign trade and investment regime, and the adoption of an ambitious "open-door" strategy. Prior to the introduction of the Deng reforms, China remained a backward and closed economy, with foreign trade amounting to a minuscule 4.7 per cent of GNP. However, the liberalization of the foreign-trade and exchange-rate regimes, followed by further wide-ranging reforms introduced in 1988 (which included increased retention of foreign exchange and easier access to foreign-exchange adjustment centers established in 1986), enabled businesses (i.e. the enterprises) to buy and sell foreign exchange at a depreciated rate known as the "swap rate" and greatly helped to boost exports. China's foreign trade as percentage of its GNP jumped to 10.8 per cent in 1988 (Zheng 2001, 65). By the early 1990s, foreign trade had grown to an unprecedented US\$200 billion, or roughly 40 per cent of GNP (Cerra and Dayal-Gulati 1999).

Before 1994, liberalization of foreign-exchange markets followed a dual-track approach, in that there existed an official rate and a "swap rate" (i.e. the market rate). On January 1, 1994 China unified its exchange rate by bringing the official rate into line with the prevailing swap-market rate, resulting in a depreciation in the official rate by about 50 per cent (i.e. the *yuan* was devalued by 50 per cent).¹² China's pre-emptive devaluation, even as it led to a real exchange appreciation for the dollar-pegged currencies in Southeast Asia (significantly undercutting their export competitiveness), created an export boom for China.¹³ Moreover, reform measures such as (a) the abolition of the retention quota system for foreign exchange, (b) the revision of the tax system to allow a zero value-added tax (VAT) rating for exports by domestic firms and the newly established foreign-funded enterprises,¹⁴ (c) further relaxation of China's open-door policy towards foreign direct investment, including the provision of special tax incentives to foreign investment in technology-intensive industries, and (d) generous tariff concessions (including lower income-tax rates and tax holidays) to firms operating in the coastal special economic zones only served further to enhance China's international competitiveness, and helped it to expand its export markets greatly. Between 1990 and 1997, Chinese exports to industrialized countries have grown at an average rate of 15.5 per cent per annum, and for the period 1995–1997, which saw a decline in world trade growth, China's

exports to the United States grew by 8 per cent, while Japanese exports declined by 2.4 per cent. Overall, since the start of the reform period, China's share of world trade has almost quadrupled.¹⁵

Although, China's exports have slowed since the Asian financial crisis, China's trade surplus continues to remain at a historically high level. In 1990 China's foreign-exchange reserves were only US\$40 billion, compared to Japan's US\$100 billion; however, by 1997 they had increased to US\$111 billion in comparison to Japan's US\$150 billion.¹⁶ By the beginning of 1999, China's foreign-exchange reserves had risen to US\$150 billion (equivalent to twelve to fourteen months of imports), thanks to robust trade performance and massive inflows of foreign capital, which have largely taken the form of FDI. While FDI was negligible before 1978, by early 1999 foreign direct investment in joint ventures and wholly foreign-owned companies in China exceeded one-quarter of a trillion US dollars, several times larger than the cumulative FDI since the Second World War in Japan, South Korea and Taiwan combined (Lardy 1999, 3). The bulk of the FDI has been invested in industries in the Special Economic Zones (SEZs) set up in Guangdong, Fujian and Hainan in 1980–81, in Economic and Technological Zones (ETDZs) set up in 1984 and in the Free Trade Zones (FTZs) established in fourteen coastal cities, followed by several more FTZs in Dalian, Guangzhou, Zhangjiang, Tianjin, Shenzhen, and Pudong New Area in Shanghai. While China's large and growing reserves are matched by growing external liabilities, it is important to note that the bulk of these liabilities have long-term maturities, thereby making the external debt manageable. Moreover, China's foreign debt is at a low level compared with that of other Asian countries, with the debt/GDP ratio at 16.0 per cent and the debt-service ratio (i.e. debt service vs percentage of exports) at 8.5 per cent in 1998. As was noted earlier, the debt also has long maturity, with short-term debt making up only 19.7 per cent of total debt in 1996.¹⁷ Given this, it is not surprising that China is amongst a handful of developing economies with an investment-grade rating on its sovereign external debt.

Finally, the evidence is unequivocal: the fruits of post-reform economic development have trickled down to broad segments of the Chinese population. For example, per capita consumption has increased four times for eggs and eight times for poultry, and the per person living space has more than doubled in the urban areas and nearly tripled in the rural areas. Average disposable per capita income has quadrupled since the early 1980s, and Chinese households are saving on average some 40 per cent of their income. Indeed, total household bank deposits measured against the GDP increased from less than 6 per cent in 1978 to more than 60 per cent in 1998. All this has helped to improve dramatically the living conditions of the majority of China's 1.3 billion inhabitants. The number of people living in absolute poverty has been substantially reduced, from over 250 million to about 50 million in two decades. Life expectancy has increased from 64.3 years in

the 1970s to 70.8 years in 1996, and infant mortality has dropped from over 50 per thousand in the 1970s to less than 30 per thousand in the 1990s.¹⁸

By any standards post-reform China's economic achievements are enviable. Yet, to his credit, China's amiable economic czar, Premier Zhu Rongji, and his team of able technocrats have not been lulled into complacency. It seems they have grasped the essential lesson, the so-called "paradox" of the Asian financial crisis: that strong macroeconomic fundamentals, while necessary, are not always sufficient for averting currency crises or providing immunity from virulent contagions. Acutely aware of their economy's underlying structural weaknesses, they remain deeply concerned. As the next section shows, their concerns are not misplaced.

The economy: underlying weaknesses

An important lesson of Mexico's peso crisis of 1994 and the Asian financial crisis was that a sound banking sector is the single most essential element of a healthy financial system. This is particularly relevant in transitional economies like the PRC, where markets for corporate securities are limited and much of the lending unsecuritized. In such settings the banking sector constitutes the main institutions that can (and must) effectively evaluate and monitor the risks and returns on financial intermediation, including the evaluation of borrowers' creditworthiness, and can enforce financial contracts, loan recovery and the realization of collateral. Given these awesome responsibilities and their potentially far-reaching economic impact (both good and bad), it is critical that governments, including the central bank and related regulatory and supervisory agencies, establish clear legal and institutional guidelines, implement adequate prudential supervision and regulation (including rules to ensure that there is no undue reliance on deposits many times larger than banks' capital or assets that are longer-term and less liquid than liabilities) and accounting and auditing practices that are clearly defined and adhered to. Such transparency is important so that the banks (and other financial institutions) cannot mask problems such as a high proportion of non-performing loans, and, for banks involved in international transactions, that a healthy balance between assets and liabilities denominated in different currencies exists. Asia's financial crisis vividly demonstrated that systemic problems in the banking and financial sector are accidents just waiting to happen – or more appropriately, waiting to "explode" without warning and quickly engulf the economy as a whole.¹⁹

According to *The Economist*, China has "the worst banking system in Asia."²⁰ Sorely lacking in professional competence and institutional autonomy, burdened with balance-sheets that conceal many worthless assets, undercapitalized by international standards, unable to offer a wide range of services and products, and subject to political interference, it is arguably the

Achilles' heel of the entire economy. While the central reformers have instituted some important measures to create the institutional structures of a modern financial system, much more financial deepening is necessary to move China away from its present "socialist market economy" status.²¹ As during the era of central planning, the central government continues to dominate other economic agents in the marketplace. Although stock markets were established in Shanghai and Shenzhen in 1990, and the activities of domestic (and some foreign)²² commercial banks and non-banking financial institutions, in particular, insurance companies, trusts and brokerage houses, security firms, and Credit Cooperatives (both rural and urban) have gradually expanded, China's financial markets remain fundamentally bank-dominated – *and virtually all banks in China are state-owned*. In other words, although China has done away with the heavy reliance on budgetary financing of investment characteristic of the pre-reform era, and investment, particularly in the state sector, is now financed primarily by banks, the banking institutions are state-owned. Bank lending is huge in relation to GDP, while alternative channels of intermediation (whether private commercial banks, stock or corporate bond markets or capital markets) remain underdeveloped and plagued by government regulation and interference. Currently, state banks account for approximately nine-tenths of all financial intermediation between savers and investors, a ratio that exceeds that found in almost all other Asian countries.²³ The banks' near total monopoly and the lack of competition in the financial sector have stunted the development of capital markets, resulting in systematic underpricing of loans by banks, not to mention inefficient financial intermediation, almost non-existent credit risk-assessment, and diminishing rates of return for savers who have no real alternative to bank deposits.

Establishing the institutional framework of a modern financial system has been particularly difficult because economic decentralization has not been accompanied by parallel political and institutional reforms. Specifically, the fiscal and administrative devolution gave provincial and local governments broad discretionary authority regarding economic investment and allocation without simultaneously enhancing the banking sector's regulatory and supervisory capabilities.²⁴ Over time, this dense network of local political machines made of party officials, bureaucrats, managers and bankers, who repay their special commercial privileges with political loyalty and financial kickbacks, greatly undermined the central government's control over macroeconomic aggregates. An overview of this unfolding process is necessary for context.

During the Maoist period China's financial sector was essentially limited to a Soviet-style monobank. The People's Bank of China (PBC), founded in 1949, was the supreme bank in the country. While the PBC served as both a central bank (since 1984) and government treasury (managed foreign-exchange reserves, currency issuance and credit distribution), as well as a commercial bank (receiving deposits from households and enterprises and

making loans), in practice the PBC functioned mainly as an accounting body, its major task being to take in household deposits (which were often the only asset households could hold) and to keep track of financial transactions that corresponded to allocations under the annual plan. As Figure 5.1 shows, the PBC directs and supervises all of China's banking system.

Figure 5.1 *Structure of China's banking system*

People's Bank of China

(Central bank)

1 *Policy banks*

(about RMB1,380 billion in assets at 1999 year-end)

- State Development Bank of China
- Export–Import Bank of China
- Agricultural Development Bank of China

2 *State-owned commercial banks*

(RMB9,552 billion in assets at 1999 year-end)

- Industrial and Commercial Bank of China
- Agricultural Bank of China
- Bank of China
- China Construction Bank

3 *“Share-ownership” commercial banks*

(about RMB1,680 billion in assets as of 1999 year-end)

- Bank of Communication
- CITIC Industrial Bank
- China Everbright Bank
- Huaxia Bank
- Minsheng Bank
- Guangdong Development Bank
- Shenzhen Development Bank
- Shenzhen Merchants Bank
- Fujian Industrial Bank
- Pudong Development Bank
- Hainan Development Bank
- Yantai Housing Savings Bank
- Bengbu Housing Savings Bank
- China Investment Bank

4 *Urban cooperative banks*

(RMB1,650 billion in assets at 1999 year-end)

- there are roughly 160 urban cooperative banks

5 *Non-bank financial institutions*

- Financial trust and investment corps
 - Finance companies
 - Finance leasing companies
 - Rural credit cooperatives
 - Urban credit cooperatives
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On January 1, 1984, in an effort to eliminate the PBC's conflict of interest (inherent in its supervisory and commercial roles), and to enhance its ability to formulate and conduct monetary policy independently, it was granted the status of a central bank. As a central bank, the PBC enjoys industry-level status. That is, it controls the money supply, determines interest and deposit rates, and handles foreign-exchange reserves through its division, the State Administration of Exchange Control. It also oversees banks' operations, using the credit plan to control administratively overall lending, and supervises the People's Insurance Company of China. Despite this, the PBC's commercial activities were further devolved and transferred to the more "independent" (yet still state-owned) commercial banks, including a newly established fourth state-owned commercial or "specialized bank," the Industrial and Commercial Bank of China – which took over from the PBC various commercial functions and now is the largest of the four state-owned banks. Together the "big four" state-owned commercial banks account for about 75 per cent of outstanding loans, have 150,000 branches and employ 1.7 million staff.

Since 1986, the State Council has approved the establishment of a number of share-holding company-based commercial banks at both national and regional levels, as well as non-bank financial institutions such as credit cooperatives, insurance companies and international trust and investment corporations (ITICs). These were set up mainly to attract foreign investment, raise funds for local development projects and make investments on China's stock markets. Apart from the China International Trust and Investment Corporation, all the ITICs are controlled by provincial and municipal governments. However, such seemingly prudent decentralization and the separation of powers did not make China's banking system any more "independent," transparent or efficient. On the contrary, while the PBC continued to allocate the total credit target for each specialized bank, and individual targets for their respective branches, it left the monitoring to the provincial and local PBC branches. In fact, horizontal political control over the PBC branches at the provincial, municipal and county levels gave local officials wide discretion over lending decisions. Moreover, the fact that local government officials had to be consulted before the center appoints a local bank governor (not to mention that the governor's promotion and future prospects depend on the local government's evaluation) predictably allowed the various local and regional governments and political bosses quickly to exert considerable pressure on their local branches of the PBC for credit and loans. Last, but not least, the "soft budget" constraints faced by the specialized banks (which do not bear the risks of their loan decisions), and the fact that the PBC sets interest rates that are below market rates, facilitate the quick issuing of loans and easy credit to support an array of SOEs (state-owned enterprises) both healthy and ailing, not to mention the local and regional governments' appetite for speculative investments in real estate and other lucrative ventures.

By 1987, it was painfully clear that the central government was unable to keep the growth of money supply in check, or to prevent “soft lending” (loans made without reference to commercial criteria), and had simply lost control of the money supply. Local banks (which are local branches of the PBC), and the specialized banks, under pressure from local governments, often exceeded lending limits laid down by the central authorities to subsidize the state enterprises and other pet projects (including illicit ones) in their localities. Indeed, it was not unusual for the state enterprises to roll over due loans automatically, or not to repay their loans, and for the banks to finance the deficits of local governments, including issuing loans at below the official interest rates and funding the junkets of public officials. Following Deng Xiaoping’s promotional “southern tour” in Spring 1992, during which he emphasized the need to accelerate economic reforms, the lid literally came off the money supply. As the central bank, unable to impose the necessary hard budget constraints on local banks, passively moved to the sidelines, the regional and local governments and their cronies, with both explicit and implicit support from the local banks, embarked on a nationwide credit and investment binge. Many literally plundered the banks to fuel their desire to build even more skyscrapers and high-tech industrial parks in their town, not to mention numerous other wasteful and speculative activities.²⁵ According to Jingping (1995, 20–1):

As local governments sought accelerated development, the bank was obliged to provide capital indiscriminately . . . In one county of Hunan Province, for example, the vice county magistrate ordered the president of the local bank branch to turn over the bank’s seal so the magistrate could issue letters of credit at will. It was common for local officials to force bankers to provide loans to favored projects.

Predictably, the provincial and local governments’ pursuit of an excessive expansionary monetary policy not only fueled rising inflation (that jumped to some 37 per cent in 1987–88), but also official corruption and graft. Indeed, China’s experience questions the conventional view that decentralization improves efficiency, or that delegation of greater autonomy to local authorities or firm-level management will eradicate the “soft budget constraints.” In fact, official corruption has reached epidemic proportions, and China earned the dubious distinction of being one of the most corrupt countries in Asia, surpassing kleptomaniac states like Myanmar and Suharto’s Indonesia (Pei 1999).

Finally, on January 1, 1994, Vice-Premier Rongji stepped in to cool the overheated and unsustainable growth. Besides curtailing the runaway local bank loans and commercial credit by squeezing lending and suspending wasteful projects, he announced a series of bank and financial sector reforms. First, in an effort to loosen (if not break) the grip of the local and provincial leaders, all directors of regional branches of the PBC were now to

be appointed directly by Beijing. Second, all projects above a certain scale now had to be approved by the governor of the PBC in Beijing. Third, in an effort to transform the state-owned commercial banks into real commercial banks, they were no longer required to carry out policy loans to the state-owned enterprises.²⁶ Rather, all bank-financed government investment was now to flow through the three newly created policy banks: the State Development Bank of China (to provide loans for infrastructure and key industrial development), the Agricultural Development Bank of China (to provide rural infrastructure and finances for crop purchases and food reserves), and the Export–Import Bank of China (to provide trade finance for machinery and electronic exports). These three policy banks were now responsible for the provision of preferential loans to projects deemed important according to government policies. It was hoped that the separation of the banks' commercial and policy-lending functions would prevent the transfer of funds earmarked for state projects to other projects. Fourth, the new rules prohibited the PBC from issuing loans to enterprises. And finally, the so-called "icing on the cake," the promulgation of the Central Bank Law and Commercial Bank Law (in March 1995) enhanced the independence of the state-owned commercial banks and their ability to function as real commercial banks. Specifically, these banks were made responsible for their profits and losses, and it was required that they maintain an 8 per cent capital adequacy ratio (none have met the requirement yet). Moreover, the law banned the PBC from financing government budget deficits by printing money (deficits have to be financed by the sale of bonds), and from making loans to the various levels of central and local government agencies. The laws also gave power to the PBC to implement monetary policy and exercise financial supervision over the other financial institutions.

These reform measures have given rise to a new type of banking institution (the so-called "share-ownership commercial banks"),²⁷ and helped bring the economy to a "soft landing" by reducing inflation to below 7 per cent, and removing some of the structural impediments and inefficiencies in the system. In March 1995, the National People's Congress (NPC) promulgated the Central Bank Law, which provided the PBC with legal authority to exercise financial supervision over other financial institutions. Two months later the NPC passed the Commercial Bank Law on May 10, requiring the state banks to meet capital adequacy standards, besides imposing a much clearer system for classifying loans that brought commercial banking practices closer to those in the West. However, neither the reforms nor the *Central Bank Law*, the *Commercial Bank Law* and the *Negotiable Instrument Law* of 1995 transformed the PBC into a truly independent central bank. That is, although the PBC has become more independent of the local and provincial governments, and, like the US Federal Reserve, can set the reserve requirements of the banks, can buy and sell bonds and set the discount rate and regulate the money supply, it nevertheless still had to operate under the

watchful eye of the State Council. As in the past, all important bank decisions regarding the money supply, interest rates or exchange rates still have to be approved by the State Council. In the light of this, Premier Zhu Rongji's claims that politically directed lending will end by the year 2001 sound unduly optimistic.

Rather, the pervasive influence of the State Council, the PBC's huge and procrastinating *nomenklatura*, and its weak supervisory and disclosure framework, not to mention the meddling by recalcitrant political bosses, will continue to prevent it from exercising real discretion. Unlike an autonomous central bank, the PBC is in no position to perform independent credit-risk analysis, or to evaluate bank performance on the basis of normal commercial criteria. Nicholas Lardy notes that "China's largest banks are not subject to independent audits. Three of China's four largest banks do not even report their consolidated financial results, meaning that losses can be buried in subsidiary firms. Nonperforming loans are classified by more lenient standards than the international norm, impairing the value of the data in measuring bank performance" (Lardy 1998a, 79). Suffice it to note that weak bank supervision combined with ineffective prudential regulation will continue to make it easier for the obstinate Communist party insiders, influential provincial and local bosses, and those with the ubiquitous *guanxi* connections to determine ingeniously who gets access to credit, besides channeling funds to themselves and their cronies through fraud, corruption and other lending irregularities. Although China's recent high-publicity anti-corruption campaigns have witnessed the arrest of several high-profile businessmen and bank executives, evidence also indicates that criminal financial activities, cronyism and favoritism continue to be rampant, and in fact may have worsened since the new laws were introduced.

At present, China's banking sector as a whole is not commercially viable, and certainly is unable to function effectively in the area of financial intermediation. Not only is China's banking system burdened with a huge build-up of non-performing loans conservatively estimated at US\$200 billion, or roughly 25 per cent of the country's total GDP; the profitability of the Chinese banks is one of the lowest in Asia. Dobson (1998, 133) notes that "in 1995 China recorded 8.6 per cent of returns on equity and 0.31 per cent on the return on assets. With the exception of Korea and Japan, these figures were lower than in most of the developing countries in Asia." However, under pressure from international financial markets for greater transparency the usually stoic Dai Xianglong, the Governor of PBC, admitted (in January 1999) with uncharacteristic candor that the share of non-performing loans in the portfolios of China's four largest state-owned banks had increased from 20 per cent at the year-end of 1994 to 25 per cent at the year-end of 1997 (Lardy 1998a, 83). Yet it is important to note that, given the lack of transparency and full disclosure of the banking system, the total volume of non-performing loans remains unclear. Not only do Chinese

authorities not release official data; prior to 1998, Chinese banks used a loan classification system based on actual loan performance that divided non-performing loans into three types: “overdue,” “doubtful” and “bad.” This approach underestimated non-performing loans, as it did not include highly risky loans that were not yet overdue. In 1998, China adopted the international standard loan classification system, which consists of five categories: normal (pass), special mention, substandard, doubtful and loss (unrecoverable). Reclassification of loans using the international standard was completed in the four large state banks in July 1999. On the basis of the new system, and on the internationally recognized 8 per cent capital adequacy standard, China’s four state-owned commercial banks were found to have a negative net worth, and are basically insolvent.

The deterioration of bank balance-sheets is the direct result of what Nicholas Lardy has termed “China’s unfinished economic revolution.” Specifically, the reforms have not only failed to fundamentally restructure the country’s 300,000-odd ailing cash cows – the SOEs (state-owned enterprises)²⁸ – but have further exacerbated the problem by continuing to maintain the life-support system of this ruinous vestige of Maoist central planning through the provision of large (if not extravagant) doses of subsidies. According to Janos Kornai (1992), the failure of the SOEs is rooted fundamentally in the “soft-budget constraint.” That is, while the managers of an SOE may be given reason to desire profit-generating performance levels, they cannot be similarly motivated to act with vigilance against losses so long as they enjoy an unwritten bankruptcy insurance policy from the state. Given such insurance, managers have been tempted to expand into new lines of production if they believe, despite the sizeable risks, that such actions will pay off with profits. The lure of a possible favorable outcome dominates decision-making, because the downside (i.e. potential losses) is cushioned by the state.

Yet, on the other hand, the SOEs are still the primary providers of employment in the urban areas, and care for the basic needs of their workers, from housing and medical expenses to pensions. Concentrated in the “rust-belt” in the north-east, but present in virtually every production sector, ranging from steel mills to coal plants and factories making machines, electronics or chemicals, the majority of these firms are loss-making, and depend on government subsidies for survival. While the SOE sector accounts for a shrinking share of GDP, it continues to absorb a disproportionately large share of bank credit. According to Lardy, direct and indirect subsidies to the SOEs and the banking system may now be costing the country some 10 per cent of its GDP. It is these so-called concessionary indirect “soft credits” or “policy loans” from state banks to SOEs, implicitly guaranteed by the government (as well as granted under preferential terms) that have over time reduced the banks to little more than conduits for cheap credit to the SOEs. It is no surprise that borrowing by the SOEs (measured by the value of loans outstanding) has increased 40-fold between 1978 and the end of 1997.

Yet the unwieldy SOEs' insatiable appetite for subsidized credit is not reflected in their poor performance. Currently, SOEs account for less than 30 per cent of the industrial output, compared to 80 per cent fifteen years ago; yet they consume almost 75 per cent of national industrial investment.²⁹ Factory-capacity utilization rates for major industrial products of SOEs have fallen below 60 per cent, while the industrial SOEs' profits have declined precipitously from 6 per cent of GDP to less than 1 per cent in the past decade.³⁰ While asset-stripping (the illegal transfer of state assets to non-state ownership), and the customary practice by the central, provincial and even local governments of conveniently saddling the SOEs with excessive social responsibilities (including the responsibility of providing cradle-to-grave services to the estimated 112.4 million SOE workers),³¹ have taken a toll on performance, Lardy notes that the major reason for the SOEs' moribund performance is the lack of fundamental change in ownership and in corporate governance. Besides overproducing an array of unwanted goods, a growing number of SOEs have been losing money. Approximately 50 per cent perennially incur net losses, compared with one-third just a decade ago. As of October 1997 roughly 46 per cent of SOEs were in the red, and the losses of these enterprises made up 57 per cent of the total. Indeed, available data show that a growing number of SOEs have accumulated unmanageable debt-to-equity ratios of between 400 per cent and 700 per cent.³² In effect, the majority of the SOEs, unable to amortize their debt, through reckless borrowing have zero or negative net worth today. They have not only made themselves technically insolvent, but have also left the banking sector hopelessly burdened with large portfolios of non-performing – indeed, non-redeemable – loans.³³ It is important to note that the bulk of the banks' SOE loans are still performing only because of government guarantees to banks and government subsidies to SOEs. Were these to cease, interest payments for SOEs would cease, rendering the banks illiquid. Asia's financial crisis illustrates the fact that in an economic slowdown the highly leveraged SOEs have the potential to create major liquidity problems for the banks. A domestic banking crisis could push China into a deep recession, and could eventually force the government to devalue the currency. The cost of bank bailouts under such conditions would be astronomical.

Yet if by tomorrow the SOEs were miraculously to honor all their financial obligations, the banks' position would continue to remain weak. This is because, like those of Thailand, Malaysia, South Korea, Japan and Indonesia (to name just a few), Chinese banks have played a lead role in creating "asset bubbles," especially in the volatile real estate and construction sectors (Ramo 1998, 64–75). During the early to mid-1990s, when "a casino mentality"³⁴ gripped the country, banks and other financial institutions imprudently funded massive property developments throughout China. First-class office spaces, luxury villas, ostentatious townhouses and apartments sprang up almost overnight, not only in major cities like Beijing, Shanghai and

Shenzhen, but also in the many smaller provincial and coastal county towns (Tse 2000). Perhaps nowhere was the transformation as stunning as in Shanghai. The so-called “Shanghai bubble” transformed this once drab city into one of the world’s glamor metropolises. By the end of 1995 Shanghai boasted over a thousand skyscrapers (including some one hundred five-star hotels), about 13.5 million square feet of office space in 1997 (an unprecedented five times the 2.7 million square feet in 1994), and a “hot” real-estate market that was adding stock at a faster rate than New York city (Lardy 1998a; Ramo 1998). However, the boom was relatively short-lived. By late 1996 the bubble had burst, in large part because of inefficient allocation of resources and overcapacity. By the first quarter of 1999, some 350 million square meters of office space stood empty, and real-estate prices slid to below 50 per cent (Pomfret 1999, A21). Tse (2000, 167) notes that “between the end of 1994 and the end of 1997, prime central business district office rents (monthly) had fallen from their peak of US\$73 per square meter to nearer \$28 in the middle of 1998 in Shanghai.” For many banks and their subsidiaries, such as the free-wheeling ITICs and SOEs, with heavy exposure to real-estate construction and speculation, this has meant a further deterioration in their balance-sheets.³⁵ However, for an increasing number it has meant bankruptcy. The collapse of the country’s second largest financial-trust company, the Guangdong International Trust and Investment Corporation (GITIC), in October 1998 sent an ominous signal. The GITIC had to declare bankruptcy when it was revealed that its debt totaled \$4.4 billion, compared to only \$2.9 billion in assets. In October 1998, the government announced the closure of GITIC, sending shock waves to Hong Kong, where many banks claimed they had lent to GITIC because the Guangdong provincial government had guaranteed the loans.³⁶ In early November 1998 two more ITICs, the Dalian International Trust and Investment Corporation and the Guangzhou International Trust and Investment Corporation, failed to make foreign debt repayments on the due date.

Explaining China’s resilience

One of the ironies of Asia’s financial crises: why did China, beset with many of the same fatal flaws that sent the dynamo Asian economies crashing like dominoes, survive the crisis with barely a bruise? In other words, what explains China’s remarkable immunity to the “Asian flu”?

First, China’s economic soft landing amid the general financial turmoil prevented “economic overheating . . . this laid a foundation for resistance to external shocks” (Song 1998, 105). Second, in December 1996 China agreed to Article 8 of the IMF and permitted full convertibility of the yuan for current-account transactions. Thus, unlike the currencies of virtually all other Asian economies directly affected by the financial turmoil, the RMB is

not convertible for capital account transactions.³⁷ Instead, it is only convertible on the current account (that is, an official documentation of a legitimate trade or other approved transaction is required to change money). This partial convertibility of the RMB makes it extremely difficult for speculators to take any short position against the RMB or to place large leveraged bets for or against the currency – since there is no forward market that speculators can use to attack the RMB. As a further precaution against speculators taking short positions on the RMB, on October 30, 1996, the State Administration for Exchange Control (SAEC) issued regulations to prevent foreign exchange under capital accounts from entering exchange settlements under current accounts. Chinese depositors were no longer allowed to convert their RMB deposits and purchase financial assets denominated in foreign currencies, while foreigners were legally barred from purchasing RMB-denominated shares. Also, the PBC, by requiring everyone to buy or sell foreign exchange or foreign-currency-denominated financial assets to enter the exchange market operating through designated banks, has inadvertently gave itself greater flexibility in responding to balance-of-payments problems. This is because the foreign-exchange market is not open to any purchase of foreign exchange for capital account transactions. Large RMB spot transactions require the pre-approval of the State Administration for Foreign Exchange (SAFE). In fact, without the approval of SAFE, trading of foreign currency by businesses and individuals is illegal in China. The SAFE approval requirements and related limitations on foreign participation in PRC equity markets have translated into low levels of portfolio investment. Also, in early July 1997, the Supervisory Commission on Securities Transactions (SCST) prohibited margin trading of overseas futures and foreign exchange in order to eliminate high-risk speculation and violations by Chinese enterprises in overseas markets. Finally, the Chinese authorities significantly intensified enforcement of exchange and capital controls, and moved to reduce circumvention. These measures involved enhanced screening of capital account transactions and increased documentation and verification requirements on current transactions to demonstrate that the transactions are in fact legitimate current transactions rather than disguised capital transactions.

The combination of these measures has made China less vulnerable to contagion and domestic or externally driven speculative attacks. To illustrate a case in point: to stem the outflows of the country's hard currency amid rumors that China would devalue its currency to match the depreciation in other regional currencies, the Chinese government took dramatic measures to intensify enforcement of exchange and capital controls. In early September 1998, SAFE ordered Chinese bank branches to cease trading hard currency from September 30, 1998. After that date, only the headquarters of the banks would be allowed to engage in foreign-currency trading. In October 1998, the central government announced that, as of December 1,

1998, all foreign-exchange swap centers (which acted as the official channel for foreign enterprises to adjust their foreign-exchange requirements) would be closed. In June 1999, the authorities restricted overseas yuan transactions by prohibiting domestic banks from accepting inward remittances in domestic currency. Moreover, in order to prevent smuggling of foreign currencies, the government (in August 1999) implemented a new rule requiring Chinese banks to obtain approval from SAFE before they could be issued exit permits for foreign currency leaving China in amounts exceeding US\$4,000 for Chinese citizens and US\$10,000 for non-Chinese citizens (Zheng 2001, 59–60).

Third, as the earlier chapters have shown, in the pre-crisis high-performing Asian economies, a mix of pegged exchange rates, heavy sterilization and no capital controls to discourage liquid short-term flows encouraged heavy external borrowing – in particular, of ever-increasing amounts of “hot money” in the form of short-term credits. Within a short period of time such practices not only created an excessive exposure to foreign-exchange risk in both the financial and corporate sectors (the result of growing mismatches in the structure of lending and borrowing), but also had negative effects on foreign direct investment and portfolio investment – which sharply declined in share in total private capital flows. However, in mid-1997 approximately 70 per cent of capital flows to China were in the form of FDI. An estimated US\$200 billion, this was at almost twice the level of China’s officially reported foreign borrowing (Lardy 1998a). FDI, with their much longer-term maturities and manageable debt-service ratios (given their relatively little exposure to private debt denominated in foreign currency) are far more stable and less susceptible to sudden reversals in direction due to negative monetary shock or investor panic. This, coupled with the fact that Hong Kong accounts for over half China’s foreign direct investment, made China less vulnerable to a speculation-led liquidity crisis.³⁸ In addition, more than 60 per cent of the foreign direct investment is supplied in kind, in the form of equipment and materials. As a result, the capital inflows have not created excess demand or generated substantial inflationary pressure (Jinping 1998, 298–99). Equally important, China’s massive geographic size and market potential allowed it to keep capital accounts closed and still enjoy sustained inflows of FDI.

Fourth, China, unlike pre-crisis Thailand, South Korea, Indonesia or Malaysia, was not heavily burdened with short-term debt liabilities. As was noted earlier, approximately 90 per cent of China’s external debt is medium- to long-term – the bulk of these debts taking the form of direct investments, mostly in joint ventures, that are highly illiquid and difficult to withdraw quickly.³⁹ In addition, China (unlike its Asian neighbors) does not have a banking and financial system with substantial foreign debts denominated in foreign currencies. By contrast, nearly all South Korea’s external exposure was in so-called portfolio form (mostly bank debts and bonds), some two-thirds of it short-term. Thus, in the case of China, foreign lenders could not

call in their loans every three to six months. Such relative stability greatly reduced the possibility of an immediate banking crisis. Also, China has less capitalization through the stock market and less foreign equity investment to be repatriated by nervous investors if market sentiments change. Finally, since the banks in the PRC are state-owned, their bad debts are simply government debts, not private debts. Moreover, the country's bad debts in the banking system are denominated in RMB and not US dollars. Considering the fact that the taxation ability of the central government is about one-half of that in the developed countries, the burden of servicing the government debts as a share of the government budgetary expenditure is still comparable to that of other countries and still manageable. These strengths gave China a greater breathing space to make the necessary policy adjustments during the crisis.

Fifth, China's total foreign trade has been growing rapidly, from US\$21 billion in 1978 to US\$325 billion in 1997. China's merchandise export volume reached US\$182.7 billion in 1997, with a trade surplus of US\$40 billion (Zheng 2001, 65). Not surprisingly, China has experienced trade and current-account surpluses since 1994. China's healthy current-account surpluses (some \$30 billion) and massive trade surpluses, and a formidable "war chest" in foreign-exchange reserves (totaling some \$150 billion in mid-1999 and second in size only to that of Japan) reduced the pressure to devalue the currency or raise interest rates. Moreover, in mid-1997, China had substantial foreign-exchange reserves relative to short-term debts: thus there was no overhang of short-term debt that could not be repaid easily out of foreign-exchange reserves when debt was not rolled over. While there was an outflow of direct foreign investment, the foreign assets remained sufficiently in place that foreign-exchange reserves were not threatened with depletion. During the period January to June 1998, although export growth was slowing, import growth was declining even more.

Sixth, unlike most hard-hit Asian economies, China did not suffer from significant exchange-rate misalignment. As was noted earlier, after depreciating in the early 1990s, the RMB has appreciated considerably in recent years in real terms. Even after the 1997 devaluations of its neighbors, a change of merely 10 per cent could return the RMB to its pre-1994 value in trade-weighted terms.⁴⁰ Yet, as will be discussed later, if the other Asian currencies sink lower, China's trade competitiveness will follow, especially in the absence of concomitant productivity growth (Song 1998). Yet it is important to note that China's export growth may not be adversely affected by devaluations elsewhere in Asia. Not only does China export a more diverse range of products, but its labor costs are below the average for the Asian region. Regional devaluations may reduce the labor-cost differential relative to China, but may not eliminate it. In industries such as textiles and garments, Southeast Asia is unlikely to take away significant market share from China.

And, seventh, the sheer size and diversity of the Chinese economy helped it better to withstand the crisis. Because China's domestic market is huge, the Chinese industries (in relative terms) are less dependent on world markets. Exports as a share of GDP are lower for China than for most of the crisis-affected Asian economies. In smaller economies, firms tend to rely excessively on exports and/or concentrate on a relatively narrow range of industries. In contrast, China's size and diversity has allowed for the development of a highly varied export structure. This enabled China to remain competitive in labor-intensive industries, while still developing its high-technology industries.

The challenges ahead

In China, a key precondition for a financial crisis – a fragile, if not largely insolvent, banking sector – already exists. This makes a domestic banking crisis the most serious threat to macroeconomic stability. Thus the problems in the banking and financial sectors and within the SOEs need to be resolved expeditiously. Specifically, the banks must be further re-capitalized and opened to competition (to increase their holdings of commercially viable, performing loans) and their prudential supervision strengthened. It is very unlikely that a significant portion of the loans to the SOEs will ever be repaid. Given this, the central dilemma facing the Chinese leadership is how to phase out the loss-making SOEs without precipitating massive unemployment. Ultimately the SOEs must be restructured through either hard-budget constraints, downsizing or outright closure. Since such measures have the potential to displace millions of workers who rely on the SOEs not only for employment, but for medical, housing and education benefits, it is important to begin the reform process before a crisis hits.⁴¹ And the notion of a crisis of internal makings is not far-fetched. For example, should the government's willingness to bail out even one Chinese bank come into doubt, or when savers lose confidence in the government's implicit guarantee of their bank deposits, millions of ordinary Chinese could potentially pull their deposits out of banks, including banks that were previously sound but would become unsound as a result. The authorities are well aware that the availability of alternative financial assets would tempt depositors to withdraw their funds from bank savings accounts, thus exposing the insolvency of much of the banking system. The fact that China's banks rely heavily on savings deposits of households (the household share in total domestic saving increased from 24 per cent in 1979 to above 70 per cent in 1997), the resulting bank run would have disastrous consequences (Huang 1999). Among other things, a bank run would force a large number of SOEs to close abruptly.⁴²

In the area of SOE reform, prior to the Asian crisis, the Chinese authorities tended to favor the Korean model. That is, there was strong ideological

support for retaining state ownership in key strategic industries, and support for *chaebol*-type conglomerates. The leadership believed that taking advantage of economies of scale (through firm mergers and industry consolidation) would increase efficiency to address the problems facing the SOEs. Indeed, the creation of such conglomerates was seen as a short-cut method of reforming (or restructuring) the SOEs. The financial crisis in general, and the massive failures of *chaebols* in particular, vividly demonstrated that “big” is not necessarily “better,” and that the Korean model was no panacea.

During the Ninth Party Congress in April 1998 China’s leaders candidly acknowledged the daunting economic challenges the country faced. The highlight of the Congress was when Premier Zhu Rongji sternly announced that the problems associated with money-losing SOEs and failing banks will be solved within three years through an accelerated program of “grasping the large and letting go the small.” This strategy, which tries to retain some key aspects of the Korean model, implies that the government would select large SOEs in strategic sectors for restructuring, while “dumping,” by way of closure, privatization and mergers of smaller enterprises that were either bankrupt or had limited potential. Specifically, the basic thrust is to divest small, non-strategic companies completely and to restructure the larger ones through mergers, public ownership, hard budget constraints, or other means. The prospect of bankruptcy or the shutting down of loss-making firms is not excluded, although the government will probably apply such measures only if all other means have failed. It is hoped that the reforms will establish a modern enterprise system based on a clear separation of the state’s ownership of enterprises from their management. However, progress has been slow. Some small and medium-sized firms have undergone *de facto* privatization (or privatization in the form of management buyouts and the sale of shares to employees), and some SOEs have reduced excess capacity and overstaffing. The authorities have also experimented with ways to develop and strengthen the social safety nets in order to protect workers adversely affected by the reforms. Yet formidable challenges remain. As Zheng (2001, 70) notes:

in a rush to “dump” the losers, local government officials often hastily put their SOEs up for sale, sometimes at bargain-basement rates. It was reported that 1,078 small and medium-sized SOEs located in 13 cities of Heilongjiang province, with a total of 320,000 employees, were offered for sale at a trade fair in 1998. Some provincial government officials even attempted to give away some of the troubled companies for free. Liaoning province, home to 10 per cent of China’s SOEs tried to sell off 1,500 of its unwanted companies through a promotional tour of major southern cities . . . this rush of sales of the SOEs prompted Premier Zhu to order a halt in late 1998. Zhu accused local government officials of misunderstanding the SOE reform.

No doubt, the leadership of the PRC is aware that the creation of a modern financial system is essential if China is to achieve the central goal of

its economic reform program: improving the efficiency with which capital is allocated and utilized. Without doubt, the most critical step in improving efficiency of resource allocation and utilization is the creation of a modern banking system. As was noted earlier, the reasons for this are straightforward. First, with their share of financial intermediation totaling some nine-tenths, China's financial system revolves around banks. And second, the development of capital markets obviously depends on a strong commercially-oriented banking system to process payments and act as custodians. Since early 1998, in the area of bank reform, state-owned commercial banks have been deepening their operations and management systems, merging the provincial banks with provincial city branches, and improving loan classification and provisioning regulations. For example, banks have been given freedom to appraise investment projects independently, using international risk-management and prudential norms. Also, the business practices of banks are being improved by the classification of non-performing loans according to international standards, the adoption of international accounting standards, and the publication of consolidated accounts, including the accounts of subsidiaries, so that portfolios can be assessed properly.

Cognizant of the fact that the ratio of non-performing loans in South Korea was 17 per cent on the eve of the crisis, Governor Dai and other reform-minded officials of the PBC were quick to point out that only 5 to 6 per cent of the loans are unrecoverable. However, keeping in mind that the so-called problem loans in China are not clearly recognized on banks' balance-sheets (thereby making the scale of uncovered losses a major source of uncertainty), most analysts (including those in the IMF), are of the view that some 50 per cent of the borrowers are already in default, and that a similar percentage of the loans are non-redeemable.⁴³ The government has borrowed heavily to recapitalize banks and take non-performing loans off their books. In August 1998, the government provided a one-time capital injection of RMB270 billion (US\$33 billion) in a bank recapitalization program (financed by Treasury-bond issues) to bring the banks up to international adequacy standards, in particular, enabling them to meet the 8 per cent capital adequacy ratio required under the Basle Agreement.⁴⁴ Clearly, this is a step in the right direction. China needs to create a capital market to supplement the role of banks in the allocation of capital. Bonds can serve as a more effective instrument than bank loans in providing long-term capital for infrastructure and other projects with long gestation periods. Moreover, equity markets can supplement bank financing for enterprises, thereby enabling them to achieve a more balanced financing structure. Yet it is also important to note that much more in the shape of both funds and strengthening of the supervisory and regulatory framework is needed.⁴⁵

Since early 1999, debt-restructuring has become an important priority. Over the past three years, the state banks have written off some RMB126.1 billion (US\$15.3 billion) in non-performing loans to SOEs (State Statistical

Bureau 2001). However, these debt write-offs have been very small in comparison to the amount of bad debt currently in the hands of the SOEs. To deal with this problem, between April and October 1999, the four state-owned banks each established an asset management corporation (AMC) – modeled largely after the US Resolution Trust Corporation. The task of the AMCs is to clean up the non-performing loans of the big four state-owned banks by literally taking over the loans, and to assess the credit expansion of banks by asset–liability ratios rather than through the centrally directed credit plan. Each AMC received RMB10 billion from the state budget as registration capital to cover current operating expenses. Since their creation, the AMCs have taken over bad debts from the major state banks, using a variety of restructuring methods to gain the best returns possible. However, restructuring has mainly taken place via debt–equity swaps, although asset sales, asset leasing, debt write-offs and asset rearrangements have also been concurrently employed. Although created to deal with the RMB1 trillion in non-performing loans (which is slightly less than half of the estimated bad loans of Chinese banks), by November 1999 the four AMCs had together purchased RMB1,393.9 billion (US\$168.3 billion) worth of bad assets from the state banks. This was followed by arrangements to swap debt for equity in SOEs with bad debts (State Statistical Bureau 2001). However, limited progress has been made in this area – in large part because AMCs do not have the authority to override the concerns of local governments or to effectively restructure SOEs with bad debts, including the right to appoint new managers or liquidate failing enterprises. Not surprisingly, as an IMF (2000) report notes, “the AMCs’ activities to date have largely been book-keeping transactions . . . A key element to the success of the AMC strategy will be to ensure restructuring of the enterprises in which the AMCs become stakeholders . . . the AMCs need to be provided with the skills and incentives to discharge their responsibilities, and to ensure that their financial positions are soundly based.”⁴⁶

The government has also taken action to turn the four major state-owned banks into independent commercial institutions. Most importantly, these banks are to be given decision-making authority over their financial activities and bear responsibility for their own risks, profits and losses. Finally, the PBC has increased the number of pilot cities for RMB business of foreign banks, approving Shenzhen City to be the second city where the foreign banks are permitted to open RMB business. Foreign banks now enjoy the same status with China-invested banks as members of the national interbank transaction market and are free to choose transaction counterparts to conduct bond dealings and bond repos. Foreign banks are also encouraged to provide consortium loans with China-invested banks. By August 1999, 25 foreign banks have been permitted to run RMB business. In early 2000, the PBC canceled the regional restrictions on foreign banks, allowing them to establish branches in all central cities (Fanzhang and Zhong

2000, 15–22). The authorities have also taken steps to reform the non-bank financial institutions. A number of institutions have been closed down, most notably GITIC, China's second largest trust and investment company. In December 1998, the National People's Congress promulgated the Securities Law to punish illegal financial activities.

Starting in 2000 the Chinese government has introduced a number of additional measures to strengthen risk management. These include:

- 1 Reducing risk exposure by making loans only against collateral. Banks must assess borrower creditworthiness, and loans to a single borrower must not exceed 10 per cent of bank capital.
- 2 The reorganization of the PBC's local branches along regional lines to reduce political interference in lending decisions by provincial and municipal authorities. Specifically, the People's Bank of China canceled 30 provincial branch banks and then established nine regional branches – each with jurisdiction over several provinces and municipalities.⁴⁷ The nine branches are to be directly supervised by Beijing, which will hold them responsible for implementing monetary policy, collecting financial information, supervising foreign-exchange activities and overseeing clearing and payment settlement in their respective geographic regions. In other words, the People's Bank will now operate more like a central bank, along lines similar to those of the US Federal Reserve System. Moreover, individuals and non-bank organizations may not interfere in bank operations. Commercial banks may not give unsecured loans to related parties or provide secured loans on preferential terms.
- 3 The establishment of a risk-management system for the banks and the phasing out of mandatory lending quotas.
- 4 Tightening supervision over banks and other financial institutions such as insurance companies and brokerages.

Despite these reforms, China still has a long way to go. It is important to recognize that the implementation of such an ambitious reform agenda is by no means guaranteed. Specifically, will the political and economic strains of a quasi-Leninist state push the reformers to backtrack? Consider for example the double-entendre: Although, Premier Zhu Rongji in 1998 abolished the so-called "credit plan" (which regulated annual bank lending by quotas and ceilings), and allowed the banks to make loans on the basis of stringent standards of accountability and creditworthiness, in 1999 the government once again ordered these banks to help fund the economic stimulus with loans to SOEs – loans that will very probably never be repaid. Or will the government take the other easy way out: through a competitive devaluation of the currency, rather than via the more prudent (and painful) reforms designed to increase productivity via internally generated efficiencies. Although, during the height of the crisis, Chinese leaders from President Jiang Zemin and Premier Zhu Rongji to Foreign Minister Tang Jiaxuan, Foreign Trade Minister Shi Guangsheng, Finance Minister Xiang Huaicheng

and PBC Governor Xianglong, together with other senior officials, repeatedly stated that the *renminbi* would not be devalued, the pressures for competitive devaluation are quite real.

First, although China received much praise for not devaluing the RMB during the crisis, the price paid has been declining international competitiveness and growing balance of payments pressure. The deep currency devaluations elsewhere in Asia, coupled with the overall economic slowdown, and in particular the continuing sluggishness of the Japanese economy, is having an adverse impact on China's export competitiveness.⁴⁸ Exports are crucial to China's economic growth and employment – and the crisis-affected countries account for about 60 per cent of China's merchandise exports. While it is true that the fall in the Korean won has had little impact on China's exports, because Korean products are more capital- and technology-intensive, there is little doubt that the commodity mix of China's exports (dominated by labor-intensive products) has been hurt (and will continue to suffer) through competitive devaluations in Indonesia, Thailand, Malaysia and the Philippines.⁴⁹ Few economists now believe that the current policy of nominally pegging the value of the RMB to the US dollar is the optimal exchange-rate policy for China. Rather, most agree that a managed float or some kind of basket peg in which non-dollar currencies, in particular the yen, receive a significant weight would be preferable. It is estimated that a modest 5 per cent real depreciation of the RMB would increase China's trade surplus by around US\$20 billion (Noland 1999). Will this push China to move to a new exchange-rate policy by devaluing the RMB and re-establishing its competitiveness? An early conventional account has so far proved to be incorrect:

Although the Chinese government announced that the RMB would not be devalued, there are strong doubts. Chinese leaders and economists agree that an RMB devaluation would have little effect on China's exports, but may cause a regional currency depreciation cycle, which would hurt the recovery of affected economies. But, there is a price to be paid to maintain the RMB value. Though devaluation may do little to improve exports, it would adversely affect imports . . . With a large foreign exchange reserve and trade surplus, the Chinese government probably has enough financial wherewithal to maintain the RMB exchange rate at least until early 2000, if not beyond.⁵⁰

And second, can the Chinese government carry out the necessary “deep” restructuring challenges in the banking and SOE sector without maintaining the growth-rates of the critical 8 to 9 per cent? It should be noted that even respectable growth rates of 6 per cent and 7 per cent may not be sufficient. Even an 8 per cent growth-rate is barely sufficient to maintain the much-cherished cradle-to-grave “iron rice bowl” for those with jobs, let alone to generate employment for the swelling and increasingly impatient urban labor force. Indeed, unemployment has been increasing, and the imperative to

maintain aggregate demand to absorb displaced labor and new entrants into the workforce is great. No doubt, for most of 1999, the government was preoccupied with reviving the sluggish economy. It slashed interest rates twice, in January and June, bringing the rate for a one-year deposit down to 2.25 per cent, and embarked on a Keynesian-style 100 billion yuan (US\$12 billion) public spending program, funded by issuing a record volume of Treasury Bonds. No doubt, such public works programs will help create employment in the short term. Yet, in order to provide continued stimulus to output growth, public investment must not only remain at a high level, but must continue to grow steadily. Given China's relatively low level of tax revenue and undeveloped bond market, financing further large-scale investment surges will be difficult.

The big question is how China will balance the conflicting concerns. Will Beijing's recognition of its regional responsibility (not to devalue) prompt it to continue to rely on fiscal and monetary tools to stimulate domestic demand, or will domestic economic and political pressures take precedence, forcing devaluation in order to increase exports? While devaluation could re-ignite financial market turmoil and another round of competitive devaluations, it is important to note that RMB devaluation is an easy way to stimulate China's slowing economy. After all, relaxation of lending, by itself, is unlikely to boost the economy, given the large volume of non-performing loans. Also, lower infrastructure and labor costs and the greatly improved regulatory and supervisory banking systems in Southeast Asia and South Korea may result in FDI bypassing China. Indeed, investment capital originating from Hong Kong, Taiwan, Singapore and Japan has fallen sharply. Their combined share of total FDI in China has shrunk to 45 per cent in 1998 from 68 per cent in 1994 (J. Leung 1999, 32).

Finally, another concern is whether China's accession to the WTO in December 2001 will adversely affect the viability of the financial sector. China has committed to eliminating non-tariff barriers and to reducing tariffs significantly, as well as to opening a number of sectors to foreign investment, including the financial sector. Over the long term, the country's adherence to WTO commitments should lead to significant efficiency gains and higher consumer choice. However, during the initial years, accession to the WTO will pose several challenges in key sectors such as agriculture, manufacturing, banking, insurance and telecommunications. Moreover, WTO obligations will require the government to reform further its laws and regulations to (1) honor the immediate obligations of being a WTO member, (2) accord equal treatment to domestic and foreign enterprises as required by the national treatment clause, and (3) improve the legal framework and the supervisory and regulatory systems to cope with a more competitive environment.

The impact of liberalizing foreign entry in the domestic banking sector and the granting of a number of RMB-dealing licenses to foreign banks to

encourage competition will not be felt for some time. Foreign banks initially will be allowed only to provide foreign-currency services to Chinese clients. They may provide local-currency services to Chinese enterprises within two years of accession, and the full range of banking services to all Chinese clients within five years of accession. No doubt, foreign bank entry will put tremendous pressure on domestic bank profits. WTO accession will also affect banks through its impact on manufacturing and services. Finally, WTO accession will place unprecedented competitive pressure on the SOEs and their products, as many SOEs are not in a position to compete effectively with foreign firms.

Notes

- 1 On the trade account, much-depreciated currencies and plummeting incomes in Southeast Asia hurt China's exports. On the capital account, foreign investment dried up, particularly from Hong Kong, China's main source of foreign investment.
- 2 See ADB (Asian Development Bank) 1999, 5. It is important to note that the official PRC figure for 1998 GDP measured in current *yuan* is 7.95 trillion. Measured in US dollars, using the IMF's average exchange rate for 1998 (8.28 *yuan* = \$1), China's 1998 GDP was \$961 billion.
- 3 In 1997 foreign direct investment rose for the seventh consecutive year to reach US\$45.3 billion. This is in addition to the US\$16 billion in debt and equity offerings China raised in international markets. Moreover, official holdings of foreign exchange reserves increased in 1997, reaching US\$140 billion by year-end, second in size only to Japan. Data compiled from Government of China (GoC, 1998), and Foreign Broadcast Information Service, *China Daily Report*, March 12, 1998.
- 4 China's nominal exchange rate *vis-à-vis* the US dollar (RMB8.3 to the dollar) has been virtually unchanged since early 1995. Encouraging Chinese currency stability was critical at the height of the Asian crisis, since a devaluation of the *yuan* could have set off a wave of additional competitive devaluations and a further downward economic spiral in the region. Also, in sharp contrast, by late 1997, in US\$ terms, the Indonesian *rupiah* was worth only one-fifth of its June 1997 value, while the Thai *baht* and the Korean *won* lost around half their former values. The Philippines *peso* and the Malaysian *ringgit* fell some 40 per cent below pre-crisis values.
- 5 For an excellent overview, see Lardy (1994; 1998); Economy and Oksenberg (1999).
- 6 While it is recognized that decentralization has been key to China's post-reform economic dynamism, it has also brought about serious side-effects – making China inflation-prone as a result of persistent budget deficits and excessive monetary expansion at the local levels. According to Dobson (1998, 131), “the decentralization of decision-making power from the central government to regional and local governments has weakened the central government's capacity

- for conducting macroeconomic policy. It has also become difficult for central monetary and fiscal authorities to monitor the performance and behavior of economic agents, creating moral hazard problems in a variety of areas. Speculative and reckless investments by financial subsidiaries of provincial and local governments have increased the risk exposure of the Chinese financial sector.”
- 7 By March 1956, over 90 per cent of peasants were in collectives, and by 1957, almost all were in advanced producers' collectives (Howe 1978). Unlike what happened under the collectivized system, under the household responsibility system farmland is contracted out to individual families, who enjoy autonomy in regard to the production and marketing of crops. After paying (either in cash or kind) taxes to the government and contract fees to the village (which still owns the land), the family is largely free to consume or sell what it produces. Land contracts that in 1995 had been set at fifteen years were extended for another thirty years in 1999 in order to give farming families more stability in planning their production and investment. This was supported by a policy to enlarge private plots and to purchase a fixed proportion (around 20 per cent) of the harvest at above market prices. For an excellent overview, see J. Y. Lin (1992).
 - 8 Guojia Tongji Ju (GTJ), 1998, 345.
 - 9 Data are taken from Nath and Tao (1998) and Guojia Tongji Ju (1993, 46). Also see Brugger and Reglar (1994).
 - 10 TVEs can be classified into two types. The first, the collectively owned enterprises (township-run or village-run enterprises) are owned by the local government and operate like holding companies, reinvesting profits in existing or new ventures, including local infrastructure. The second, and more recently developed, type is much closer to private enterprise, in that most are controlled, if not informally owned, by an individual. Nevertheless, both types maintain close fiscal ties to the local and provincial governments.
 - 11 In contrast, the SOEs had the advantage of captive markets and government support, but also remained subject to heavy government intervention, state pricing and the obligation to provide social support services.
 - 12 At the time the official rate of the RMB was 5.8 RMB per US dollar, versus the 8.7 RMB per dollar at the swap center.
 - 13 For a discussion of how China's pre-emptive devaluation contributed to the Asian financial crisis, see Corsetti, Pesenti and Roubini (1998).
 - 14 The tax change meant that exporters could claim a refund of the VAT paid on inputs.
 - 15 Data compiled from World Bank (1999a; 1996); IMF (1997) and State Statistical Bureau (1997) (*Zhongguo Jinrong Nianjian*).
 - 16 The bilateral trade deficit of the United States with China has grown every year since 1985. The Department of Commerce estimates that the trade gap grew by 15 per cent, reaching an all-time high of US\$57 billion, in 1998. This is only a few billion less than the deficit registered with Japan, the United States's largest trade-deficit partner. See Lardy (1999, 1–8); Fung and Lau (1997) and various issues of *Jinrong Shibao*, China's leading financial newspaper.
 - 17 This is sharp contrast to Indonesia with a debt/GDP ratio at 59.7 per cent and a debt-service ratio at 36.8 per cent, with short-term debt making up 25 per cent of the total debt in 1996. Similarly, Thailand in 1996 had a debt/GDP ratio at

- 50.3 per cent and a debt-service ratio at 11.5 per cent, with short-term debt making up 41.4 per cent of the total debt. World Bank (1998b, 1–20).
- 18 Data are taken from *China Statistical Yearbook*. (1997). The international poverty line as measured by the World Bank is based on US\$1-a-day. A recent World Bank (1998a, 3), study reports that “in absolute terms, the number of poor decreased by more than one-half in China since mid-1980.” Also see Hu and Khan (1997), Stiglitz (1998) and Li and Loconto (1998).
- 19 In Asia, once it became evident that many borrowers lacked the ability to repay their loans, depositors lost confidence in their banks’ ability to meet their obligations, resulting in a “run on the banks.” This, combined with the fact that most banks were highly leveraged, made them highly vulnerable to sudden bouts of instability.
- 20 See *The Economist* (1998, 65–7); Lardy (1998; 1998a).
- 21 Most notably, while the banking and financial reforms have strengthened the system’s ability to mobilize savings, they have been largely unsuccessful in promoting the efficient use and allocation of these savings. For details, see Xu (1998).
- 22 In 1997, two overseas banks, the Hong Kong and Shanghai Banking Corp. and the Industrial Bank of Japan, were allowed to conduct local currency services in the Shanghai Pudong New Zone.
- 23 According to Lardy (1998), in the mid-1990s banks still accounted for 90 per cent of China’s financial intermediation. Also, Yabuki and Harner (1998, 174–6) note that “Chinese banks are massive not only in terms of assets but also in terms of physical presence and people. The banks complicated, multi-tier organizational system extends from Beijing to the lowest districts and townships and villages throughout China. In 1996, the Industrial and Commercial Bank of China employed a total of 565,955 persons, including 121,140 at the township and village level in 38,219 branches, sub-branches and offices nationwide.” The Agricultural Bank of China employed 538,780 in 65,870 branches, sub-branches and offices nationwide. The total employment of China’s state-owned commercial banks, policy banks and the People’s Bank of China at year-end 1996 was 1,915,947 persons in 157,365 branches, sub-branches and offices nationwide. Suffice it to note the enormous scale and scope of the banking operations make efficiency, accountability and risk control exceedingly difficult, it not impossible.
- 24 Local government is a broad category used here to imply the intermediate levels (county and municipal) as well as township and village government.
- 25 According to one school of thought, Deng Xiaoping often sided with the local and regional governments because he used them as a counterweight to the more conservative central ministries. For details, see Shirk (1993).
- 26 As commercial enterprises, these banks will now have to bear the responsibility for any losses incurred in their operations.
- 27 In the “share-ownership commercial banks,” various levels of government, Chinese institutions and, in rare cases, private individuals are permitted to hold shares.
- 28 Before reforms, China’s industrial economy resembled that of the former Soviet Union. SOEs accounted for 78 per cent of all industrial output, almost all urban employment and 91 per cent of investments in fixed assets. Of the estimated 300,000 SOEs, roughly 5,000 to 6,000 are regarded as “large-scale.” The rest are either “medium” or “small.”

- 29 This sharp decline is due in large part to the fact that since 1978 Beijing has allowed the non-state sector to compete with SOEs.
- 30 According to Naughton (1998, 275), "Overall, industrial SOE profits sank to 45 billion yuan in 1997 (after deducting losses), or only 0.6 per cent of GDP."
- 31 This figure is for 1996 (*China Statistical Yearbook* 1997).
- 32 Broadman (1999) and World Bank (1997a).
- 33 According to Steinfeld (1998, 40), "In 1997, total net assets of the banking system were listed officially at RMB317 billion, less than 20 per cent of the estimated value of non-performing loans in the system."
- 34 I owe this term to Gao Xiqing, vice-chairman of the China Securities Regulatory Commission.
- 35 Non-bank financial institutions such as the ITICs are sponsored by individual provinces to help them raise capital overseas, bypassing the supervision of central authorities. For many of the ITICs the value of their speculative overseas equities and real-estate investments collapsed during the Asian crisis.
- 36 GITIC is not the only major financial company to collapse. In early 1999, Hainan Development Bank also collapsed under a mountain of bad debt.
- 37 Capital-account convertibility can be broadly defined as the freedom from quantitative controls, taxes and subsidies that affect capital-account transactions between residents and non-residents. Examples of such transactions include all credit transactions between residents and non-residents, including trade and non-trade-related credits and deposit transactions, and transactions in securities and other negotiable financial claims.
- 38 Zheng (2001, 62) notes that "by the end of July 1998, among the 314,533 overseas funded projects registered in Mainland China, 174,880 (55.6 per cent) were tied to Hong Kong investors."
- 39 Song (1998, 105–6) notes that "China had only a moderate level of foreign debt (US\$131 billion) by the end of 1997, compared with its capacity for repayment. Judged by the measures of debt service ratio (12 per cent), liability ratio (14 per cent) and foreign debt ratio (74 per cent) for 1997, China's foreign debt is at a moderate level."
- 40 Song (1998, 106) notes that "the yuan closed at 8.2796 yuan per US dollar at the end of 1997, representing an appreciation from the rate of 8.7 yuan per US dollar which was in place when the unified system was introduced in 1994."
- 41 Some have suggested that the government could use fiscal stimulus by spending funds on infrastructure and residential housing to revive domestic demand and soak up unemployment.
- 42 As Zheng (2001, 68) notes, "about two-thirds of the SOEs are losing money and 90 per cent of the bad loans by China's state banks are with SOEs."
- 43 Reuters News Service, "Full Text: China's Central Bank Governor's Speech January 27, 1999." Lardy (1998, 115–17), notes that the share of non-performing loans that is accounted for by the most impaired categories of loans has increased. Specifically, the sum of the share of loans that are outstanding to firms that have already gone through bankruptcy and been liquidated without the bank recovering their loans, the so-called "dead loans," and loans that are two years or more overdue (i.e. "doubtful loans") increased by at least half between the end of 1994 and the end of 1997.

- 44 Because the bond issue has no budgetary implications, it effectively shifts these costs to future years. There is also the question as to whether the sum is large enough to permit a sound separation of good and bad debts.
- 45 According to “Moody’s Investor Service estimates, China needs RMB1,000 billion, or 12 per cent of its GDP, to clean up the bad loans (Rosario 1999, 93).
- 46 IMF. 2000g. IMF Concludes Article IV Consultation with China, *Public Information Notice*, No. 00/71, September 1.
- 47 The nine regional “mega-branches” and their jurisdictions include: Shenyang (Liaoning, Jilin and Heilongjiang provinces), Tianjin (Tianjin municipality, Hebei and Shanxi provinces and Inner Mongolia), Jinan (Shandong and Henan provinces), Nanjing (Jiangsu and Anhui provinces), Shanghai (Shanghai municipality, Zhejiang and Fujian provinces), Guangzhou (Guangzhou and Hainan provinces and the region of Guangxi), Wuhan (Jiangxi, Hubei and Hunan provinces), Chengdu (Sichuan, Guizhou and Yunnan provinces and Tibet) and Xi’an (Shaanxi, Gansu and Qinghai provinces and the regions of Ningxia and Xinjiang).
- 48 In the first three months of 1999, total exports dropped nearly 8 per cent from the same period a year earlier, while imports rose 11.5 per cent. As a result, the first-quarter trade surplus narrowed to US\$4.3 billion, down 60 per cent from the preceding year. For details, see J. Leung (1999, 31).
- 49 China’s exports grew by just 0.5 per cent in 1998, compared with 20.9 per cent the year before. Forecasts point to further export declines in 1999–2000.
- 50 Brookings Institution Policy Brief (1999).