

Reforming China's Banking System: Gradualism, its Impact, and Implications

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Abstract

This paper argues that China's attempts at banking system restructuring may best be compared to the experiences of the Eastern European economies, due to both the scale of the NPL problem and the path that China has taken during its financial transition. A comparison with the internal and external alternatives for bank restructuring in the presence of constrained capital, and based on the recontracting of non-performing debt arrangements, suggests that China has given preference to those methods that allow it to defer—that is, allow a more gradualist recognition of—the costs associated with banking system recapitalisation. That this choice may entail a higher level of cost than would a more rapid recognition of losses and recapitalisation of the banking system, may suggest that such a preference has been based on pragmatic consideration of the greater ability to fund such losses in the future, or upon the perceived macroeconomic benefits of a more gradualist approach. However, such an approach is more likely based on recognition that China currently lacks either the budgetary or debt accumulation capacity to enable a more rapid resolution of the NPL problem within its state-owned banking system.

Key words: China, non performing loans (NPLs), state-owned commercial banks (SOCBs), bank restructuring, budget constraint, optimal policy

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1.0 Introduction

This paper examines China's choices in restructuring its state-owned commercial banks (SOCBs) as part of the process of resolving the non-performing loan (NPL) problems associated with decades of policy-based lending. The paper begins with discussion of the level of NPLs relative to GDP or total loans for a range of Asian and Eastern European countries and China's experiences with managing its NPLs. Such a discussion allows the similarity between China's constraints and experiences to those of the Eastern European transition economies to be highlighted rather than, for example, comparing China's experiences to those of the Asian crisis countries or Japan. In part, this reflects that the core of China's banking system remains state-owned (or majority-owned by the state), and has been maintained as such over China's extended transition. The discussion then turns to the methods available for the reform and restructuring of banking systems in crisis, based on the experiences of the Eastern European transition economies. The paper then moves to consider the financial reform options that the Chinese government has actually chosen and used on its banking sector in light of the options suggested by the transition bank reform experiences of the Eastern European Countries (EEC). This leads into discussion of the apparent rationale for these choices, the benefits and costs potentially associated with China's banking system reforms, and whether the choices made are optimal or more likely budget constrained. A brief summary completes the paper.

2.0 China's financial transition: Asian or Eastern European in character?

2.1 The need for restructuring and recapitalisation of China's state-owned banking system

The absence or presence of a systemic banking sector crisis in China is open to debate, largely due to extensive explicit and implicit government support of the system (McIver, 2005). Those that suggest that China has had, or will have, a banking sector crisis point to the continued presence of an unsupportable level of NPLs on the balance sheets of the SOCBs, and the likelihood for further NPLs to accumulate due to non commercial lending practices at these institutions (Economist Intelligence Unit, 1999 and 2001; Lardy, 1998, 1999, 2000 and 2001; Cockerill, 2001; Bottelier, 2002; Clifford, 2002; and DaCosta and Foo, 2002). This assessment is very much based on western concepts of the operation of a bank and the danger posed by NPLs to the ability of the banking system to perform its core functions (McIver, 2005). Alternative perspectives on this issue, consider such factors as the role of continuing government support for the SOCBs, and the assets of the state available to cover losses associated with the NPLs (He, 2002; Fan, 2003; Lin, 2003; and Gordon, 2003). To this may be added the continuing development role played by the

SOCBs, suggesting that their performance be judged other than purely on commercial criteria (Laurenceson and Chai, 2001). However, China's attempts to recapitalise its banking system, and the level of funds required for its SOCBs to be recapitalised to levels conducive to operation as commercial banks, are consistent with a state of financial crisis (McIver, 2005). Regardless of the view accepted, the estimated peak ratio of China's NPLs to GDP suggest that the costs of restructuring of China's banking system has provided, and will continue to provide, a significant drain on the resources of the state over an extended period as evidenced in the data presented in Table 1.¹

Table 1: NPLs as a per cent of GDP for Asian banking sector distress countries (2001), and NPLs as a per cent of total loans for Eastern European transition economies (1991)

Country (2001)	NPLs (% of GDP)	Country (1991)	NPLs (% of loans)
China	44-55	China ¹	53-67
Malaysia	36-48	Hungary	50
Thailand	36-41	Poland	40
Taiwan	20-27	Czech and Slovak Federation	55
Japan	25-26	Bulgaria	44
Indonesia	11-14	Romania	37
South Korea	7-14		
Philippines	9-13		

Note: ¹ Figure for China refers to 2001.

Source: Berger, Nast and Raubach (2002), Exhibit 1–The burden in Asia, p. 140, Thorne (1993), p. 16, and author estimates.

2.2 China's financial transition and similarities to Eastern European and Asian experiences

As indicated by the data in Table 1, China's NPL problem is thought to be large relative to that of most other Asian countries experiencing banking sector distress. Indeed China's NPL to GDP ratio stands out clearly in terms of its magnitude relative to most of the countries affected by the Asian Crisis of the late 1990s, and even against that of Japan following its banking sector crisis over the latter decades of the 1900s. It is also the case that, in contrast to China, most of the Asian countries with banking system crises listed in Table 1 had these problems emerge via the private sector. This relates to such problems as: moral hazard and overinvestment in the presence of implicit government guarantees over debts of private sector financial intermediaries (Krugman,

¹ Dornbusch and Giavazzi (1999, p. 44), estimated that the ratio of NPLs to loans was between 50 and 70 per cent in 1999 putting the peak at this stage. However, as theirs is derived explicitly from a range of estimates, the peak NPL to loans ratio for China for 2001 is based on the NPL to GDP ratio produced by Berger, Nast and Raubach (2002).

1998); excessive borrowing by the non-bank private sector due to euphoria regarding the success of economic reform (McKinnon and Pill, 1998); panic by foreign investors (Radelet and Sachs, 1998); and the emergence of awareness amongst investors of the fundamental problems associated with banking and corporate debt in these countries (Corsetti, Pesenti, and Roubini, 1998).²

The similarity of both the time over which China and Japan have been attempting to address their NPL problems and the absolute size of this problem in each country may lead some to suggest that the Japanese experience is particularly relevant to the study of the Chinese NPL problem. The Japanese experience is undoubtedly informative, suggesting that more rapid resolution may be appropriate, and is similar to the extent that there is heavy government involvement in addressing the NPL problem. However, significant differences exist between the banking systems and NPL problems of the two countries. These differences in the Japanese case relative to that of China include: the sale of NPLs to Japan's AMC (the RCC) at a fraction of book value, the relatively small amount of assets transferred in association with the NPLs, the slower rate at which NPLs have been disposed of, use of bank merger, nationalisation, and bank sale to foreigners, all nationalised banks were later privatised, and Japan has experienced a prolonged phase of recession and limited economic growth.³ This suggests that we may better look elsewhere for a model of bank restructuring better matched to the Chinese case.

In terms of the share of NPLs in total loans, the data presented in Table 1 highlights the similarity of the magnitude of China's NPL problem in the early 2000s with that of the Eastern European transition economies in the early 1990s. This suggests that while high, the ratio of NPLs to loans in China is not exceptional in the context of an economy in its transition from a planned to a more market-based system.

As well as the order of magnitude of the problem, other aspects of China's path through financial transition are not inconsistent with those of transition economies that have faced a systemic crisis

² Much of this was reflected in the collapse of property market bubbles in a number of the Asian economies.

³ Qian (1994, p. 41) reaches similar conclusions on the limitations of the Japanese experience as a guide for China's banking reform, suggesting that flexibility of institutions and an ability to adapt rather than copy are the main lessons. What is clear from the Japanese experience in the 1990s vis-à-vis that of America during the 1930s, for example, is that where government assistance is provided in the absence of market discipline, limited incentives exist for banks to avoid transference of risk to the government, or to engage in long-run risk management (Calomiris and Mason, 2003, especially p. 31). Kane and Klingebiel (2004) provide a detailed account of the experiences of a range of recent banking crisis countries.

in their banking sector.⁴ Specifically, China's financial transition process is similar to that of the former socialist countries of Eastern Europe, in that it has:

- restructured its banking system from a state-owned mono-banking structure to a commercially-oriented system
- been associated with an inheritance by the newly commercialised banking system of a large stock of policy-based NPLs
- required that restructuring of the financial sector be undertaken at the same time as restructuring of the state-owned enterprise (SOE) sector.

Also similar to the Eastern European economies are the major factors behind the accumulation of China's NPLs to the levels indicated in Table 1. These include extensive policy lending during the command economy period, poor and deteriorating financial performance of a significant portion of the SOE sector (Bonin and Huang, 2001, pp. 199-200), and the lack of a true bank credit culture at the SOCBs (OECD, 2000, p. 87). These features have frequently been observed in socialist transition economies, where the dominance of the state sector and, particularly, public ownership of both the SOCBs and SOEs, is associated with a lack of financial discipline in SOEs; a soft-budget constraint exists (Kornai, 1992; Li, 1992).

However, in contrast to many of the former socialist countries of Eastern Europe, China has taken a gradualist approach to economic transition, especially with regard to the evolving legal, regulatory and institutional arrangements associated with reform and restructuring of its banking system. It is also unique in several other respects:

- that its transition process has not been associated with a significant and rapid decline in GDP
- although NPL ratios are high in its banking system, it has not suffered from a collapse in the credit-creation ability of the banking and financial systems.

Indeed, both growth in GDP and lending have remained positive and generally strong over the transition period (McIver, 2005).

3.0 Recapitalisation of banking systems

3.1 Factors influencing the cost of restructuring

Recapitalisation of China's banking system at a level sufficient to cover the existing stock of NPLs must be viewed as a medium-term process due to its complexity. Recapitalisation approaches

⁴ See, for example, Catte and Mastropasqua (1993), Borish, Long and Noël (1996), and Šević (1999), on the bank recapitalisation and restructuring experiences of the Eastern European transition economies.

available to the government in the case of such a significant intervention will differ with respect to the mix of direct capital injection, asset purchase and asset rehabilitation that may be chosen (Saunders and Sommariva, 1993; Borish, Long and Noël, 1996; Claessens, Klingebiel and Laeven, 2001; Calomiris, Klingebiel and Laeven, 2003 and 2004). However, in all cases the mix of approaches chosen will determine the expected present value of net government expenditure (outlays less recoveries), and thus can be seen to require strategic management at both the systemic and individual bank levels (Enoch, Garcia, and Sundararajan, 2001; Honohan and Klingebiel, 2003).

While the expected present value of net government expenditure may seem to be a core issue in bank recapitalisation, there is a range of factors—institutional, political, economic and cultural—that will determine the restructuring model chosen by policy-makers, and thus the resulting trade-off between efficiency and income distribution effects. The scale and extent of the banking crisis also impacts on the appropriateness of restructuring alternatives. Small-scale crises may be managed via internal restructuring processes such as recapitalisation and the rescheduling of problem loans, on the understanding that the banking system will expand with growth in the economy. Thus, internally-generated capital may provide adequate resources with which to rebuild bank balance sheets over time, while not precluding continued growth in lending. Large-scale crises will often demand government-sponsored external restructuring, due to the lack of sufficient resources within the banking sector to provide for future expansion and the support of economic growth (Saunders and Sommariva, 1993, p 956). These alternatives are explored in more detail in the next section.

3.2 Alternatives for the restructuring of the banking system in transition economies

A number of alternative approaches are available to bankers when dealing with the restructuring and management of non-performing loans. These approaches may be divided into legal remedies, based on the use of bankruptcy and liquidation laws, and remedies based on the recontracting of the non-performing debt arrangements (Saunders and Sommariva, 1993, p. 935). However, China faces difficulties in restructuring many of its SOEs that are associated with substantial NPLs. Public bankruptcy costs are likely to be high and procedures inefficient for SOCBs attempting recovery via bankruptcy due to the inadequacies of the legal bankruptcy framework (CMS Cameron McKenna, 2001). Even where the court process itself is quite fast, it will often take a long time for the local government to decide on the bankruptcy route and to secure the debt write-off. It is also often difficult to liquidate assets under current arrangements which are often associated

with unrealistically high valuations. Delays in bankruptcy filing and then bankruptcy proceedings may lead to asset stripping by existing management. This results where increased asset wastage and agency costs are associated with delayed bankruptcy proceedings as managers are provided with an incentive to dissipate assets before these are claimed by the firm's creditors (ie, managers seek to transfer firm assets to themselves or related parties). This suggests a focus on methods that are based on the recontracting of non-performing debt arrangements.

Saunders and Sommariva (1993, pp. 937-950) identify eight alternative models for the restructuring of banks in transition economies particularly suited to banks that are capital and reserve constrained (as it may be argued is the case of China). These models, which are based primarily on the recontracting of the non-performing debt arrangements, their mode of operation, and their potential advantages and disadvantages are summarised in Table 2.

Table 2: Alternative models for bank restructuring

Restructuring alternative	Operation	Potential advantages	Potential disadvantages
<i>Internal</i>			
Recapitalisation	Involves a substantial injection of new equity capital onto the balance sheet of the bank, usually supplied by either the government (or an agency of the government) or an external agency	<p>Allows bank to make new loans, reducing credit constraints on development</p> <p>Reduces incentives for managers to undertake high risk activities/gamble in order to regain lost bank capital</p> <p>Can provide preferred equity stakes to external financing agencies to encourage their taking of a stake in the bank</p> <p>Bank continues as a going concern, avoiding costs of liquidation/bankruptcy</p> <p>May encourage new depositors/reduce risk premium required by depositors</p>	<p>Potentially softens budget constraint of firms in financial difficulty, including the provision of new doubtful loans to poor quality firms</p> <p>May increase state control over the bank where it provides significant funding</p> <p>Preferred stakes may cap upside exposure to bank and loan assets</p>
Loan hospital	The bank maintains the problem loans on-balance sheet, but segregates a portion of these loans to receive special monitoring and allocates these a separate management team	<p>Increases resources allocated to the problem loans</p> <p>Provides a training ground in which to develop staff skill in the identification and workout of problem loans</p>	<p>Requires that a work-out plan for problem borrowers be developed and adhered to</p> <p>Lack of existing expertise within banking organisations in transition economy banking systems</p> <p>May require design of appropriate incentive system to ensure remuneration of management encourages maximisation of the PV of the debt portfolio</p>

Table 2: Alternative models for bank restructuring (continued)

Restructuring alternative	Operation	Potential advantages	Potential disadvantages
<i>Internal</i>			
Debt-for-debt exchange	Requires revision of loan contract after negotiations between parties, often leading to: reductions in the interest rate, reductions in bank seniority over collateral, extension of maturity on debt contracts, relaxation of loan covenants, partial pay-down of loan, issue of new credit to debtor, and replacement of management of the financially distressed firm	Provides greater flexibility than is available in the case of liquidation/bankruptcy Avoids transactions costs associated with liquidation/bankruptcy Maintains business value as a going concern, enhancing the value of assets By reducing the number of parties involved in negotiations, it increases the predictability of outcomes for the bank	In the presence of insoluble problems for the firm due to demand and cost factors, this may only delay rather than prevent closure of the firm Potential need for soft loans/government guarantees by banks prior to entry into negotiations to ensure bank willingness to engage in loan restructuring
Equity-for-debt swap	Bank negotiates with the management of the loss-making enterprise on the taking of an equity position in enterprises associated with non-performing loans, in exchange for forgiveness of the debt (or a component of the debt).	Subordination of bank claims to other creditors, potentially reducing the cost of trade finance and other non-bank non-secured finance. May allow the bank to exercise control over/to influence investment and strategic decisions.	The bank's role as both a debt and an equity holder poses considerable conflicts of interest, and may provide incentives to provide higher levels of financial support to the financially distressed firm. By increasing ownership concentration, there may be an increase in monopoly power in the economy with a result loss of efficiency and the deterrence of new entrants.
<i>External</i>			
Good-bank-bad-bank structure	Create a specialised subsidiary, the 'bad' bank, into which the non-performing loan assets are placed—a carve-out of a component of the bank balance sheet.	Improves liquidity of 'good' bank and its ability to make new loans. By improving the balance sheet of the 'good' bank its stability is improved. Allows non-performing assets to be packaged to investors looking for higher risk assets. Allows provision of incentives to managers of the 'bad' bank to align management and state objectives.	In the presence of state ownership of the bank, requires additions to bank capital to allow non-performing loans to be written down to market value prior to carve-out and transfer of loans to the 'bad' bank. May require external financing. May require pooling of state assets with non-performing loan assets to improve saleability of debt portfolio. Does not prevent the writing of new loans to enterprises associated with non-performing loans.

Table 2: Alternative models for bank restructuring (continued)

Restructuring alternative	Operation	Potential advantages	Potential disadvantages
<i>External</i>			
Government restructuring institution	Government establishes special-purpose vehicles charged with the responsibility of resolving and rearranging the banks' non-performing loans. Can use liquidation and merger, via deposit transfer or purchase and assumption of assets, as means to pool assets and/or liabilities of banks.	Recognises errors in design of current banking system, and potential removal/reduction of inefficiencies. Centralisation of monitoring and management functions of bad loan assets. Bundling of assets to enhance sale value. May avoid fire sale situation via continued funding of agency. May assist in privatisation of financial institutions.	Diseconomies of scale due to the size of the pool of non-performing bank assets. Political pressure for rapid reform may lead to fire sale of assets. Government agency takeover of assets may increase centralised control of industrial and financial sectors.
Loan sale/swap	Banks write-down loans to market value, then rearrange/swap loans amongst themselves.	Assists in the development of an inter-bank market in corporate debt, and the future development of secondary markets for this debt. May allow banks to diversify their bad loan portfolios.	Does not resolve the underlying problem of non-performance of the loan portfolio. Secondary cash market for debt requires long-term development.
Government bond/bank loan swap	Carve-out of loans and transfer to government in exchange for government bonds/securities.	Transparent process Cleans up balance sheet.	Banks must hold bonds in the presence of illiquid bond markets. Low coupon interest rates will impact on bank earnings Creation of additional deficit in fiscal budget. Government may not be a suitable/skilled liquidator due to a lack of expertise in personnel charged with the task.

Source: Derived from Saunders and Sommariva, 1993, pp. 937-950.

4.0 Reforming China's four large SOCBs

4.1 Methods used in China's reform and recapitalisation process

Since 1996 China's government has taken a number of steps to improve the soundness of its banking sector and, in particular, the financial integrity of the four large SOCBs that still account for the bulk of the total assets of the banking sector. Some of these strategies are behavioural, including a greater exposure to market forces and improvements to corporate governance in the

banking sector itself (Moreno 2002, p. 2; OECD, 2000, p. 14).⁵ However, the high level of exposure to bad debts in the balance sheets of the four national SOCBs has been a major obstacle in the path of these banks becoming true commercial banks. This has required that significant funding and changes to the balance sheets of the SOCBs be enacted as important elements of the Chinese reforms. Table 3 provides a summary on which of the alternative models for bank restructuring outlined in Table 2 have been applied in the Chinese case.

From Table 3 it is apparent that a number of internal and external methods have been used, and still are being used, to resolve the problems associated with the level of NPLs held by the four national SOCBs. However, the use of Government restructuring agencies in the form of the AMCs, and the internal loan hospital approach, are the dominant methods being used to manage NPLs. Recapitalisation of the banks has also been an initial requirement in China's management of its SOCBs' NPLs, with a 1998 RMB 270 billion (USD 32.9 billion) injection of capital taking place.⁶ From Table 3 it is apparent that while a range of both of internal and external alternatives have been used to restructure the SOCBs by China's authorities there has been a preference for internal restructuring methods. Of the four internal restructuring alternatives available, three have been chosen—recapitalisation, loan hospital and equity-for-debt swaps (although the latter is evident only to a minor degree). Of the external approaches available, that of the government restructuring agency is the only alternative for which there is clear evidence (the creation of the four national AMCs associated with each of the SOCBs).

In terms of the quantitative importance of the methods chosen, government restructuring agencies, in the form of the AMCs, and the internal loan hospital approach are the dominant methods. However, write-offs of NPLs using internally-generated funds, as under the loan hospital approach, will actually account for the removal of more NPLs from the SOCBs balance sheets than did, for example, the 1999 to 2000 NPL asset transfer to the AMCs.⁷

⁵ These behavioural factors include: a requirement for the use of commercial standards in the allocation of credit, the planning for partial listing of the SOCBs on mainland China's stock markets, the introduction of governing boards, and a requirement for audits to be conducted by approved accounting firms.

⁶ Questions regarding the adequacy of the initial recapitalisation were raised at the time with suggestions that further injections of capital would be required by each of the SOCBs (Hu, B., 2003, p. 6), as has clearly been the case.

⁷ This may be seen in the level of write-offs of NPLs that the SOCBs have achieved since 2000.

Table 3: Bank restructuring processes used in China's bank reform

Restructuring alternative	Application	Results
<i>Internal</i>		
Recapitalisation	1998 RMB 270 billion (USD 32.9 billion) recapitalisation of the SOCBs by the central government. 2003 (USD 45 billion) quasi-recapitalisation of two banks	Enabled the banks to initially meet/approach the eight per cent capital adequacy ratio required under the Basle Agreement (Lardy, 2000, p. 12; Huang and Xu, 2000, p. 17). Additional recapitalisation will be required to ensure the SOCBs balance sheet strength and stability.
Loan hospital	Strong evidence of use of this method by national SOCBs, especially BOC, ICBC and CCB.	Improved internal monitoring and use of bankruptcy by BOC, ICBC and CCB apparent from annual reports. Presence of Asset Disposal Committee in BOC. Sales by ICBC and CCB of components of their NPL portfolios to national and international consortia.
Equity-for-debt swap	Not apparent between SOCBs and SOEs.	
Debt-for-debt exchange	Not apparent.	
<i>External</i>		
Good-bank-bad-bank structure	No. Use of Government restructuring institution.	
Government restructuring institution	Transfer of a large amount (around RMB 1.4 trillion) of NPLs from the SOCBs' balance sheets to an associated set of AMC. At the core of the management of the problem of large state-owned enterprises with substantial NPLs. Equity-debt swaps are an associated component. Selected company NPLs have been chosen by the government and AMCs as the basis of equity-for-debt swaps between AMCs and SOEs as apart of the process associated with the transfer of NPLs from SOCBs. AMCs have taken a total book value of equity of RMB 405 billion in enterprises selected 'jointly' by the government and the AMCs via these debt-equity swaps.	Financially more significant than recapitalisation and important to the reforms. Bundling of assets has been used to enhance sale value. Ten-year horizon for AMCs may avoid fire sale situation. However, AMCs appear to be underfunded. The Ministry of Finance has provided 10 billion Yuan to each of these companies as capital, a relatively small contribution given the level of assets each is required to manage. May assist in privatisation of financial institutions by strengthening the balance sheets and credit ratings of the four national SOCBs. The value of the NPLs exchanged for equity under equity-for-debt swaps varies considerably by asset management corporation, with the swap representing 3.6 per cent of the NPLs carved out for Great Wall, 23.9 per cent for Orient, 27 per cent for Huarong, and 41.4 per cent for Cinda (Ma and Fung, 2002, pp. 13-14).
Loan sale/swap	Not apparent.	
Government bond/bank loan swap	No. However, government ownership of AMCs and an implied guarantee of AMC debt by the MoF effectively suggest aspects of this method.	

Recapitalisation of the banks was also an initial requirement in the Chinese authorities' management of these NPLs, with a RMB 270 billion (USD 32.9 billion) injection of capital taking

place in 1998. That this was inadequate even at the time, was quickly reflected in suggestions that further injections of capital would be required by each of the SOCBs (eg, Hu, B., 2003, p. 6). That this has not occurred until recently, in the form of a quasi-recapitalisation via an injection of capital of USD 45 billion (approximately RMB 372 billion) into BOC and CCB in January 2004, split evenly between the two banks, reflects a desire by the authorities for their SOCBs to internally manage the write-off a substantial component of their NPLs.

4.2 Impact of the choice of methods in the recapitalisation process: Deferral

With the exception of recapitalisation, which has to date only been partial, and applied more fully to BOC and CCB than to ICBC and ABC, it is apparent that the Chinese government has chosen to emphasise restructuring methods that allow for delay in the full recognition or settlement of losses associated with the NPLs of the SOCBs—again suggesting a gradualist approach to the recognition and resolution of the NPL problem. This is particularly the case with the emphasis that has been placed on the loan hospital and government restructuring agency (AMC) approaches to restructuring. The latter approach has been financed through the issue of bonds backed by the MoF, deferring full settlement on losses associated with the management of the NPLs, and a large central government budgetary balance impact, until maturity of the AMC bonds. The deferral arises because of the replacement of NPLs in the SOCBs' balance sheets with the AMC bonds. To some extent the original recapitalisation, funded through fiscal bonds, has also allowed for a spreading over time of the budgetary impact of the cost of this component of NPL resolution.

5.0 An optimal strategy?

5.1 Potential costs and benefits of a gradualist approach

As China is taking a gradualist approach in reform of its banking sector, that is an accommodating approach to the NPL problem in the shorter term, the fiscal costs may be higher than if the NPL problem were immediately resolved. This reflects the moral hazard effects of the provision of implicit guarantees on SOCB held debt, debt relief via equity-for-debt swap for financially distressed SOEs, and the potential for further recapitalisation of the SOCBs. For example, Honohan and Klingebiel (2003, Table 5, p. 1553), provide estimates of the average cost of taking individual accommodating approaches during financial crises. Their estimates, which assume that no other forms of accommodation are in place, put the cost of provision of blanket guarantees at 2.9 per cent of GDP, that of forbearance on debt at 4.1 per cent of GDP, and that of repeated recapitalisation at 6.3 per cent of GDP. As China displays aspects of all these forms of accommodation in its approach to the resolution of the NPL problem at the SOCBs, the potential

for considerable additional cost of NPL resolution is clearly high. Thus, an important issue to address is why the government would choose a potentially higher-cost strategy in the presence of low reported government debt levels and large reserves of foreign exchange.⁸

It may be argued that the higher likely costs of an accommodating approach to NPL management must be traded off against the greater ability of the Chinese government to fund rehabilitation in the longer term. This enhancement of capacity over the longer term is due to a rapidly increasing level of GDP and reductions in the SOE share of national output as the non state-owned sector grows. The latter provides potential for a gradual improvement in the level of tax receipts, and the capacity for the government to better fund losses that are recognised on the NPLs without placing immediate strain on its budget. It has also been argued that the macroeconomic benefits of a gradualist approach may make it a preferred option. However, before accepting the argument that a gradualist approach has resulted due to it being an optimal choice, closer consideration of the ability of China's government to fund bank rehabilitation is suggested.

5.2. China's fiscal capacity to fund more rapid NPL resolution

The gradualist approach to recognition of the policy basis of many of the NPLs held by the SOCBs, and a failure to remove all NPLs generated on this basis from the SOCBs' balance sheets, may suggest an inability on the part of China's central government to fund the additional debt required to achieve this outcome. Ignoring issue costs, the estimates contained in the previous section suggest that an increase in debt funding sufficient to recapitalise the SOCBs to international standards would increase the official public debt-to-GDP ratio from its current level of little more than 30 to between 50 and 70 per cent of GDP. While these levels of direct explicit liability are not high by international standards, China also possesses relatively high levels of both direct implicit and contingent explicit and implicit liabilities that, through conversion to direct liabilities, would significantly increase its debt-to-GDP ratio.⁹

⁸ China's foreign debt-to-GDP ratio measured just over 16 per cent as of the end of 2001 (Fan, 2003, p. 148). Explicit fiscal debt (recognised internal debt) to GDP also stood at around 16 per cent of GDP as of 2001 (Lin, 2003, p. 84). China's foreign exchange reserves stood at just over USD 408 billion at end of 2003 prior to the recent transfer of USD 45 billion to further recapitalise BOC and CCB, providing sufficient funds to cover the cost of all but the most pessimistic of the above estimates of the potential cost to resolve China's state banks' NPL problem.

⁹ Polackova (1998) provides both a discussion of these alternative forms of government fiscal liability and a methodology for their measurement. Direct explicit liabilities include both the public debt and government budget, while direct implicit liabilities include such obligations as future pension and social security liabilities. Contingent explicit liabilities encompass the obligations of state-guaranteed institutions, including deposit insurance. Contingent implicit liabilities may exist due to foreign credit received by the domestic corporate and financial sectors, banking failures, and obligations accumulated by local governments. The latter category is clearly of greater significance in the presence of state ownership or control of the corporate, banking, and financial institutions.

For example, Fan (2003, p. 149) places the ratio of national comprehensive liabilities-to-GDP at 72 per cent at the end of 2002, excluding social security debt liabilities. Jia (2003, p. 15) estimates that the value of broad-based government debt represents about 91 per cent of GDP as of 2000. Hu (Hu, F., 2003, p. 15) suggests that the inclusion of estimated unfunded pension liabilities on top of the liabilities from NPLs generated by the SOCBs would increase the estimate of the liabilities-to-GDP ratio to around 135 per cent. Lin (2003, p. 74) reports upper estimates of the level of the total explicit plus implicit debt-to-GDP ratio for China to be of the order of 150 per cent of GDP. Although direct implicit liabilities in the form of social security and pension obligations to current and former employees of SOEs comprise the largest component of these liabilities (Fan, 2003, p. 149; Lin, 2003, pp. 91-92), they may be considered to be of a relatively long-term nature (Jia, 2003, p. 17).¹⁰ Of more immediate concern is a need to recognise components of China's contingent liabilities that will require the provision of additional funding in the short-to-medium term. This includes the shortfall between the value of the AMC bonds held by the SOCBs, which will mature in 2009-2010, and the value of funds likely to be recovered on the NPLs behind these bonds. To this must be added accrued, and hence unpaid, interest on the bonds that is owed to the SOCBs. Although no official estimates on total accrued interest owing from the AMCs is available, the recovery rates on NPLs and equity-for-debts swaps to this date (see below), suggest the presence of a contingent debt in excess of the RMB 1,168 billion of the face value of bonds issued by the AMCs, or that a minimum of ten per cent of the value of (2003) GDP in additional debt or budget outlays will potentially be required to fund this shortfall.

The large increases in the level of China's debt and its debt-to-GDP ratio suggested by the need to recapitalise the banking and financial systems is of concern, because China's ability to service debt payments from its fiscal revenues is severely restricted. Additionally, China has increasingly become dependent on debt issue to fund budget deficits during the most recent phase of financial and economic reform, which has been increasing as a share of GDP (Table 4).

The ability of China's Central Government to raise revenues via taxation is poor, reflecting the devolvement of responsibility for collection to lower levels of government, widespread tax avoidance/evasion, and the provision of widespread tax relief (Deng and Smyth, 2000, pp. 398-399). A further complication for China is a high reliance on extra-budgetary revenues at the central and local government levels, in the forms of inefficient and ad hoc levies, charges, and fees (Deng

and Smyth, 2000; Eckaus, 2003). Attempts to enforce transfer of these forms of revenues, so as to allow management by the central government, may reduce local government incentives to collect such revenues. This would exacerbate the current revenue problem and increase the rate at which government debt is required to increase to fund budget deficits (Lin, 2003, p. 84).

Table 4: Budget deficit as a percentage of GDP, 1995-2004

Year	Budget deficit/ GDP	Year	Budget deficit/ GDP
1995	-1.0	2000	-2.8
1996	-0.8	2001	-2.6
1997	-0.8	2002	-2.9
1998	-1.2	2003	-2.4
1999	-2.1	2004	-1.3

Source: Calculated from data sourced from DataStream.

Prohibitions on borrowing from PBoC enacted in 1994 have been associated with an increased reliance on the issuance of public debt to fund the fiscal deficit (Gao, 2003, p. 4). The value of new debt issuance in 2001 equated to 24.4 per cent of national government, and 79.8 per cent of central government, budgetary expenditures, while repayment of principal and interest equated to 23.4 per cent of central government revenues in the same year (Jia, 2003, p. 15). For example, figures included in draft budget estimates for 2002 suggested that 43 per cent of the value of new debt to be issued would have been required to service interest and principal payments on existing debt (Lin, 2003, p. 86). The issue of additional debt to fund settlement of liabilities associated with the NPLs in the banking system would have a significant impact on the share of revenues required to service debt payments, and thus reduce flexibility in other key expenditure areas. It may reasonably be concluded that it is only in the presence of rapid growth in GDP, and hence significant accompanying growth in government revenues, that a continuation of recent rates of growth in the level of government debts will be sustainable,¹¹ and that the capacity to service increases in debt to fund write-offs of existing and new NPL losses is limited.¹² This suggests that

¹⁰ Offsetting these long-term liabilities are the long-term assets held by the state, including SOEs and their associated assets and all land. State balance sheets put the value of assets associated with the SOEs at more than RMB 9 trillion in 2001 and at RMB 9.9 trillion at the end of 2002 (Lin, 2003, pp. 94-95; Fan, 2003, p. 149).

¹¹ Lin (2003, p. 84) records that between 1994 and 2001 explicit fiscal debt increased in level from five to 16.3 per cent of GDP.

¹² Lardy (2000, p. 15) draws the conclusion that funding to adequately recapitalise the SOCBs exceeds the fiscal capacity of the government through a similar argument to that given above, although presenting data covering earlier periods. See also OECD (2000, p. 12) regarding the implications of fiscal constraints for China's ability to fund

a gradualist approach to financial sector reform may also be seen as necessary (or broadly optimal) given fiscal constraints, rather than just a reflection of the perceived requirement to match the underlying pace of reform in the real economy.¹³

6.0 Conclusions

A brief review of the level of NPLs relative to GDP and total loans, consideration of China's move from a mono-bank structure to a multi-institution sector still largely under control of the state, and restructuring of the banking system in the presence of severe capital constraints, was completed. From this it was decided that the Chinese pattern of bank financial reform and bank restructuring had greater parallels with the Eastern European experiences than with those of the Asian economies (including Japan). This supported an analysis of the alternative methods for the restructuring of banking systems (internal and external to the banks), based on the Eastern European restructuring experiences—based primarily on the recontracting of the non-performing debt arrangements.

While both internal arrangements—recapitalisation, loan hospital, debt-for-debt, and equity-for-debt-swap—and external arrangements—good-bank-bad-bank restructure, use of a government restructuring institution (an AMC), government bond-bank loan swap, and loan sale/swap—are available for restructuring of banking systems, the Chinese authorities have focussed on a relatively small set of these options. A clear preference has been displayed for internal arrangements—recapitalisation, loan hospital, and equity-for-debt-swap—compared to external arrangements—primarily the use of a government restructuring institution (an AMC) in China's case. That the methods chosen for restructuring allow some deferral of the budgetary cost of bank restructuring has been suggested as having been a primary criterion in China's case.

An inability to immediately fund the cost of restructuring and recapitalisation of the SOCBs, due to inadequate budgetary resources and the scale of the NPL problem, appear to be driving factors in China's choice of a gradualist approach to financial reform and the bank restructuring methods chosen. Thus, China has largely chosen methods that allow it to defer and to limit budgetary outlays to restructure the SOCBs, especially the use of internal methods such as the loan hospital

additional outlays on debt repayments. Gao (2003) also discusses the nature of China's current problems with low taxation revenues and rapidly accumulating debt and debt-service levels, and the need for China to constrain continued rapid expansion of its debt.

¹³ An alternative but complementary argument put forward by Dwight (2004), suggests that from a public finance perspective the continued creation of NPLs has allowed the Chinese government to provide loss-making SOEs with additional subsidies while limiting demands on taxation-based resources and reducing the excess burden of taxes.

which entails significant write-offs of policy-based loans by the SOCBs, for pragmatic reasons. This is also the case with the use of the AMCs, which have been funded largely via the issue of government-backed bonds at low interest. These bonds and funds made available from PBoC loans made to the AMCs were used to purchase stocks of pre-1996 NPLs from the SOCBs. Many of the factors relating to soft budget constraints and lack of corporate governance are still present. Weaknesses in the legal system and lack of enforceability of property rights still present major impediments to the China's SOCBs. The continued presence of government in the areas of financing and the appointment of SOE managers, and in the management of the disposal of NPLs may retard the reform process. The role of local government as supervisors of centrally owned SOEs, suggests that local employment and development issues may take precedence over efficiency and profitability (eg, see Watanabe, 2000).

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This has allowed higher levels of state-owned employment to be supported over an extended period than would have been possible via use of subsidies or low interest rate loans.

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