

# **Coping with Financial Vulnerabilities in China: Lessons from Japan and Prospects for Future Reform**

Zhengyuan YANG

Graduate School for International Development and Cooperation, Hiroshima University

Kamiyama 1-5-1, Higashi Hiroshima 739-8529

Email [yzy@ipc.hiroshima-u.ac.jp](mailto:yzy@ipc.hiroshima-u.ac.jp)

## **1. Introduction**

Since the onset of the financial crisis in East Asia in 1997, China has caught the attention not only for its critical foreign exchange policy but also for the uncertainty and vulnerabilities in its financial system dominated by the state-owned commercial banks. Careful observation of the economy may lead one to conclude that the Chinese economy is not immune to the crisis. Growth and foreign direct investment slowed significantly in 1998 and there is no sign of recovery in the first half of 1999. There exists a dualism in the China's financial system. While state-owned enterprises obtain financing mainly from state-owned commercial banks, the rapid growing non-state-owned part of the production sector has difficulties to access the financial facilities in the state-owned commercial banks. The inefficiency in the state-owned enterprises and the heavy intervention on the lending decisions of state-owned commercial banks by the administrative authorities have caused a serious nonperforming loan problem. This paper intends to analyze the causes of financial vulnerabilities in the China's state-owned commercial banks and to give some policy suggestions drawing from the experiences of Japan. The remaining parts of the paper are organized as follows: Section 2 of the paper describes the vulnerabilities in and causes of China's State-owned Banking System. Section 3 reviews Japan's experiences and discusses what lessons China shall learn from Japan's experiences. Section 4 concludes by providing some future perspectives for solving the financial vulnerabilities in China's financial system.

## **2. Financial Vulnerabilities in the China's State-owned Banking System**

### **2.1 Financial Vulnerabilities**

There exist serious vulnerabilities in the China's financial system, especially in its banking sector. The financial vulnerabilities manifest themselves in the following ways. First, the nonperforming loans have increased to a dangerous level. In 1997, the proportion of nonperforming loans was 24 percent for the four state-owned commercial banks, including 6 percent bad debts and 18 percent overdue loans (Dai, 1998; CCER, 1998). Other estimates given by foreign observers ranged from 20% to upwards of 35%. The problem of nonperforming loans in China is by any measure immense. The exact magnitude of the problem is hard to know because of the lack of transparency in accounting practices of China's banks.

Second, all the state banks are significantly under-capitalized, illustrating the banks' fragility in sound

operation and lack of capacities in dealing with asset losses. Table 1 shows that the state-owned specialized banks started off, in 1985, with sufficient capital to meet the 8% ratio required according to the Basle standards. However, capital adequacy has eroded steadily in three of the four state-owned commercial banks, with only the Bank of China displaying some increases in capital adequacy, at least up to 1992. After 1992, there is substantial further worsening in capital adequacy ratios. In 1996 the capital adequacy ratios for all four state-owned financial banks was significantly lower than the 8 percent that is required by China's Commercial Bank Law.

Third, all state-owned commercial banks operated inefficiently. The annual circulation rate of bank loans was very low and fell consistently in the 1990s from 1.32 in 1993 to 1.07 in 1996 for the four state-owned commercial banks.<sup>1</sup> The average profit-to-net asset ratio was 5.6 percent in 1996. This net profit rate could turn out to be a net loss if the uncollected interest payments were not counted as revenues. In 1996, the four bank only collected about 60% of the due interest payments (Li, 1998).

**Table 1** Capital Adequate Ratios of Major Banks

Year	Industrial-Commercial Bank	Agricultural Bank	Bank of Construction	Bank of China
1985	10.00%	12.60%	n.a.	4.40%
1986	8.90%	11.80%	n.a.	5.40%
1987	9.10%	10.70%	n.a.	4.30%
1988	7.20%	9.90%	9.20%	5.60%
1989	7.40%	8.80%	8.20%	7.00%
1990	6.80%	7.40%	7.50%	6.70%
1991	6.70%	6.50%	6.50%	6.60%
1992	6.60%	6.30%	6.50%	7.90%
1996	4.35%	3.49%	4.81%	4.84%

Source: Data compiled from PBOC, Almanac of Finance and Banking in China, various years; Zhao Wenjie. (1996), Monetary Policies and Transmission Mechanism in China [Zhongguo Huobi Zhengce Chuandao Jizhi]; Du Xuncheng. (1996), Financial Innovation during Economic Transformation [Jingji Zhuanxingzhong de Jinrong Chuangxin]

Finally, there is a rising trend in the gap between bank deposit and loan.<sup>2</sup> It might due to (1) the weakening economy and rising real interest rates (2) the reluctance to make loans on the banks' side or (3) tightening of monetary policy through credit control. More fundamentally, the reason of such a phenomenon may be that there were serious inefficiencies in the banking sector. Between 1992 and 1996, there were two years, 1994 and 1995, when domestic financial sector's increased debt was greater than its increased assets (Li, Y, 1998). New deposits were thus wasted either to support those nonperforming loans that would never be repaid or to cover the increasing costs of bank operation. Such a banking system is not sustainable.

## 2.2. Causes of the Problems: Financial Liberalization in Retrospective

The creation and development of these vulnerabilities were closely associated with the interaction between real and financial sectors and the unsuccessful financial liberalization process in China. The route of the fund allocation during the pre-reform period was almost exclusively governed by the state plans. The People's Bank of China, the central bank in China, was a subordinate body of the Department

of Finance at that time. Its role was to provide supplementary working capital to the state-owned enterprises. Reforms introduced aimed to distinguish budget and banking financing of investment in an attempt to improve the efficiency of capital utilization. While the policy-oriented investment would continue to be covered by government funding, other financial needs including those by the state-owned enterprises would be met through the banking sector on a commercial basis.<sup>3</sup>

In 1978, only 24 percent of the total provision of funds (for both fixed assets and working capital) were supplied through the state-banking sector. This proportion rose to 88 percent in 1997. These changes are the root of the weakening in the financial system. First, even though the reform policies introduced intended to establish a truly independent central bank and purely commercial state-owned commercial banks, this has never been achieved. Since the close connection between state-owned commercial banks and local governments, banks' lending decisions can hardly be free from administrative intervention.

At the same time, the government fiscal capacity declined relatively during the reform period. The share of budget revenues in GDP fell from 31.2 percent in 1978 to 10.8 percent in 1996. The government thus routinely sought resources from the state-owned commercial banks to support the projects and activities that should otherwise be covered by the state budget. This is an implicit transfer of the government budget to the commercial banks' balance sheets. Notwithstanding decreased fiscal revenues, fiscal subsidies have fallen both as a share of GDP and that of the government budget. Table 2 shows the picture of implicit transfer of budget/policy loans in China. Data in the Table 2 provide a very misleading picture. Although explicit fiscal subsidies have fallen in real terms, governmental support of state-owned enterprises has not. It has merely been shifted to the banks in the form of policy loans. The main categories of policy-oriented lending include (1) loans for investment in fixed assets of basic industry and infrastructure; (2) loans for working capital for purchase of agricultural products and import/export activities; and (3) loans for agricultural production, poverty alleviation, regional development and research activities. Even after the creation of three policy banks in 1994, the state-owned commercial banks continued to be burdened with policy loans. In the 1990s, these policy-oriented loans accounted for about 35 percent of total loans made by the state banks. The repayment rates of the policy loans were often extremely low due to poor management and abuse (Institute of Economics, 1998). If losses of policy loans were accounted, China's budget deficit would be much higher than the officially reported figure of around 2 percent.

**Table 2** Losses of Industrial State Owned Enterprises and Fiscal Subsidies to All Loss Making State Owned Enterprises

	total losses (RMB billions)	Fiscal subsidies (RMB billions)	fiscal subsidies % of GDP	fiscal subsidies % of budget
1990	62.8	57.9	3.1	19
1991	66.7	51	2.4	15
1992	66.9	44.5	1.7	12
1993	74.3	41.1	1.2	9
1994	81.8	36.6	0.8	6
1995	104.9	32.8	0.6	5
1996	132.1	33.7	0.5	4

Source: Lardy, Nicholas. (1998), *China's Unfinished Economic Revolution*: Washington DC, Brookings 35-37

State-owned enterprises in China rely heavily on bank loans for their financing need. In fact, many new state-owned enterprises were built using exclusively bank loans.<sup>4</sup> The debt-to-equity ratio rose quickly from 19 percent in 1980 to 79 percent in 1994. Combined with inefficiency in the state-owned enterprises, this caused great difficulties for enterprise operation. In 1997, for instance, the total real interest income from the bank loans was 361.4 billion yuan, about eight times the total profit of the state-owned industrial enterprises.

On the part of the enterprises, reforms were not yet successful in eliminating the 'soft budget' problems. Managers and employees of the state-owned enterprises not only lacked incentive to run the firms efficiently but also have felt no pressures to repay the bank loans as "both banks and enterprises are owned by the state". The state banks became the victims of their loans to the state-owned enterprises. The government, for stability reasons, does not want to see closures of state-owned enterprises. Consequently, the banks not only failed to recover the old loans but were also forced to make new loans. State-owned banks do not worry, as they feel that they are not responsible for the deteriorating balance sheet caused by lending decisions influenced by administrative interventions. This created a moral hazard problem and further weakened the state-banking sector.

### **2.3 Unsuccessful financial liberalization**

The preceding part has described how government administrative intervention on the state commercial banking system and transferring of government deficit budget to state commercial banks' balance sheet lead to a financially weakened banking system. A further implication of the situation is that attempts at incremental liberalization often fail. When the overall financial system is liberalized, there is a large outflow of funds from the state banking system. This creates liquidity shortages and generally leads the government to regain control over the financial system. Depositors looking for higher interest rates, i.e. looking to escape the increasing implicit taxation that is rapidly becoming confiscatory, move funds into informal, risky channels. These episodes are particularly likely to occur when liberalization intersects with accelerating inflation (as occurred, for example, in 1985, 1988, and 1992-93). Disintermediation creates a liquidity crisis in the banking system, to which the government responds in three ways. The central bank injects reserves into the commercial banks; administrative restrictions on non-bank financial institutions (formal and informal, legal and illegal) are tightened; and ultimately the deposit rate is increased, typically to the rate of inflation for term deposits. At this point, the implicit tax on the banking system is at its maximum. Deposit rates are high while lending rates are low. The implicit subsidies received through increased central bank lending are insufficient to offset the implicit taxation in the interest rate differential.

The high implicit tax on the banking system sustains the large and persistent presence of "irregular" financial institutions despite of government's attempts to restrain their development. Extra-budgetary funds are large, and are managed by government agencies so that they won't have to pay the punitive taxes levied on funds that go through the banking system.<sup>5</sup> For example, the growth of various Trust and Investment Companies (TICs) in China can be understood as the attempt to avoid punitive taxation on the banking system. Many of the TICs have been established by state banks: 181 of 394 authorized TICs in September 1995 were associated with the specialized (commercial) banks. Many of the others are subordinate to local governments. The TICs provide convenient outlets for bank money to avoid regulatory strictures and seek out higher returns than are available through regulated lending. As we will see in

the next paragraph such funds are frequently channeled into the stock markets.

Attempts to develop the capital markets faltered after 1992. Concerned about the rapid drain of funds from the banking system, and an acute funds shortage in 1992-93, Vice-Premier Zhu Rongji at that time, in charge of economic policy, adopted a series of measures to restrict the operation of bank subsidiaries. These policies caused the relative shrinkage of the stock market. However, while these policies retarded capital market development, they were quite effective in restraining the excessive growth of aggregate demand, which was building up during 1993. Adoption of restrictive credit policies turned out to be essential and effective. Inflation accelerated to a peak annual rate of 28% during 1994, but began to come down shortly thereafter. By May 1997, the consumer price index had come down to under a 3% annual growth rate. Macroeconomic stabilization—a “soft landing”—was achieved, but at the cost of aborting the ongoing financial liberalization, in particular the development of capital markets. If sustained, though, macroeconomic stability will prepare the ground for further financial reform, under more favorable conditions.

Because of the unsuccessful financial liberalization attempts, banking sector continue to assume its central role in providing state-owned enterprises with financing and thus kept on being haunted by the nonperforming loan problem.

### **3. Lessons from the Japanese Experiences**

#### **3.1 Slow responses of Japan in dealing of its financial problem**

Japan represents the second largest economy in the world. It has experienced serious financial disruptions in the process of liberalizing its financial system starting from mid-1970s. In dealing with disruptions during the financial liberalization process, Japan's case has suggested the heavy cost of slow actions. Japan's disruption manifested after the collapse of asset prices (equity and land) in the early 90s. Japan's financial system deteriorated with huge nonperforming loans. For the first time since 1950, Japan was forced to abandon the policy of no failure of financial institutions and use deposit insurance funds to close a number of insolvent institutions over the 1991-1995 period.<sup>6</sup> The insolvencies depleted the reserves of the deposit insurance agency and made the Deposit Insurance Corporation *de facto* insolvent.<sup>7</sup>

After a hurry of legislative actions in June 1996, Prime Minister Hashimoto's call for a “Big Bang” approach to financial reform in November 1996, and another set of financial reforms in the spring of 1997, the Japanese situation appeared to stabilize with some signs of recovery. Official estimates of nonperforming loans declined from \$500 billion in 1995 to \$300 billion in 1996 and the economy appeared to be on the road to recovery. A series of financial scandals in the securities industry, the failure of a large insurance company, the failure of several securities companies including Yamaichi Securities — the fourth largest securities company in Japan, and the failure of several large regional and city banks reversed the trend and the Japanese financial system deteriorated further in the last part of 1997.

As of early 1998, the Japanese situation has not improved. On January 12, 1997 the Ministry of Finance officially acknowledged what outsiders had been maintaining for years that the nonperforming loan problem was far larger than previous official estimates. The Ministry announced that in the six months to September 30, 1997 problem bank loans totaled ¥76.7 trillion and acknowledged the estimate

did not include problem loans at credit cooperatives, insurance companies, and other institutions nor did it reflect the impact of collapsing financial systems in other Asian countries since September 30.

There are some indications that the regulatory authorities are willing to depart from the traditional Japanese financial regime by allowing insolvent institutions to fail, strengthening financial regulation and supervision, and calling for public funds to be used to solve the financial crisis. Much of this falls under the heading of “prompt corrective action”.

### **3.2 Some issues relevant to financial vulnerabilities: A comparison of Japan and China**

#### ***3.2.1 Deposit Guarantees and Moral Hazard:***

Deposit guarantees possess significant moral hazard and failure to modify the deposit guarantee system in the face of financial liberalization creates a fundamental flaw that will make the financial system inefficient and unstable. Deposit guarantees eliminate deposit discipline and encourage risk taking on the part of depository institutions while at the same time, liberalization enhances the ability to manage and assume risk. The outcome is imprudent loan and investment portfolio behavior on the part of depository institutions.

Deposit guarantees were pervasive in Japan, formed an important component of the mutual support system between financial institutions, politicians, and the Ministry of Finance as well as being complicated by the existence of a large postal savings system (Cargill, 1993). Cargill, Hutchison, and Ito (1997) discuss how these guarantees contributed to Japan’s bubble economy in the second half of the 1980s and persist to misallocate financial resources in the 1990s.

Thus, deposit guarantees while desirable at some level to protect small depositors and limit contagion, possess moral hazard. Moral hazard becomes an important element in portfolio management as liberalization enhances the ability of financial institutions to assume and manage risk. Deposit guarantees at a minimum need to be reduced if liberalization is to proceed smoothly. Post-bubble economic, political, and regulatory conditions rendered the “no failure” norm inoperable, yet no coherent substitute was in place to address the serious problems facing Japanese banks. Policymakers in Japan struggled against political and bureaucratic inertia to move in the direction to establish a framework governing bank risk regulation, failed bank resolutions, and bank recapitalizations. First, a system of prompt corrective action based on objective criteria was instituted to deal with financial institutions in failing health.<sup>8</sup> Second, another bill enacted in 1996 conferred upon regulators the authority to initiate corporate reorganization or bankruptcy procedures with respect to financial institutions to deal with insolvencies in a more formal and timely manner.<sup>9</sup>

These measures show that regulators will allow and even force insolvent banks to exit the market — a major departure from past Japanese financial practices. In order to prepare for this eventuality, other bills raised deposit insurance premiums<sup>10</sup> and established two public collection agencies<sup>11</sup> for the recovery of assets of failed institutions. In view of the seriousness of the financial situation and the inadequacy of past disclosure practices, however, the government guaranteed all deposits (including those above the statutory payoff limit of ¥10 million) through fiscal year 2000.

In China, there is also an implicit deposit guarantee. Unlike Japan’s case, guarantee on deposit is simply because that major commercial banks are owned by the state. The safety of deposits is thus depending on the ability of the government to tax and issue debts. This reflects in the over-confidence of depositors in the nation’s banking system despite the severe non-performing loan problem within the state-

owned commercial banks. On the banks' side, the moral hazard takes the form of lending under political pressures rather than commercial considerations. Savings are channeled to low inefficient investment in such an institutional setting thus creating a typical shallow economy with emphasis on the quantity of investment<sup>12</sup> while productivity of investment has been overlooked. This in the short run can lead to a macroeconomic growth due to an increasing investment but in the long run will cause a structural problem, as the increased supply does not match the demand qualitatively. Banking supervision in China is far from being adequate. Moral hazard and rent seeking activities at the microeconomic level is widespread. All these problems lead to the nonperforming loan problem in China's state-owned commercial banks.

### **3.2.2. Agency Problems:**

The subsidy inherent in deposit guarantees, the political relationships between regulatory authorities and those institutions benefiting from deposit guarantees and the time inconsistency of short-run discretionary decision making combined together provided incentives for regulatory authorities to adopt policies that were a mixture of delay, forgiveness and forbearance in dealing with troubled financial institutions. The failure to deal decisively with troubled financial institutions by adopting policies that rely on an expected return to favorable economic conditions (lower interest rates, increased interest rate spreads between cost of funds and return on assets, and/or recovered asset prices) had aggravated the problems in the financial sector. It had increased the moral hazard problem, reduced the efficiency of the financial sector, reduced the credibility of the regulatory authority, and ultimately increased the amount of funds that will be required to deal with the troubled financial institutions.

The Ministry of Finance in Japan had followed the steps in first denying, then understating the problem and then following up with a series of policies that were firmly based on forgiveness and forbearance. One explanation points out that regulating authorities are captured by financial institutions they are supposed to supervise. Financial institutions are usually places where regulating staffs acquire employment after retirement. In this way, financial institutions attempt to buy off regulating authorities and to hold back policy changes unfavorable to them (Aoki, 1988).

In China's case, the agency problem is also severe. State bank as the major creditor has failed to enforce the debt contract. In a market economy, debts play an important role in corporate governance through bankruptcy threat. Nevertheless, this is not a case in China. Rather, bankruptcy has been widely used by enterprises and local governments as a way to write off debts instead of disciplining managers (ICBC Bankruptcy Research Group, 1997). Second reason for the creditor failure is that the incentive system of state banks is not adequately structured. Managers of state banks in China care for only accounting numbers rather than the real value of the bank asset. This is because their careers and private benefits all depend only on the accounting numbers rather than the real value of assets. Third reason is that some central government agencies (such as the State Economic and Trade Commission and the State Commission for Restructuring the Economic System) have biases towards debtors against creditors because their delegated task is to "invigorate SOEs (state-owned enterprises)" rather than "take care of SOBs (state-owned banks)". As the bank lending cannot be made on a sound commercial base free from political influence, there is a problem of who should be responsible for the resulting nonperforming loan. Consequently, finding out a solution to the problem has been slow. Ownership of the state banks continues to be expressed in vague and inconsistent ways that do not provide bank managers with adequate incentives for making appropriate loan decision.

Agency problems have prevented regulating authorities from carrying out a prompt solution for the nonperforming problem once it have occurred. To design an incentive-compatible rules for corporate governance and establish effective institutions to ensure their implementation is essential to the solution of agency problems.

### **3.2.3 Lack of Transparency**

The lack of transparency in financial system has at least two dimensions. First, it makes it difficult to assess the condition of financial institutions and large nonfinancial corporations; and second, it enhances the potential for regulatory authorities, financial institutions, and businesses to engage in mutual support, restrain competition, perpetuate insularity, and conceal the real cost of government failure in the financial system. In general, the lack of transparency provides misleading information to the regulatory authorities, understates the degree of balance sheet deterioration, enhances the moral hazard problem, and contributes to delay response to dealing with troubled institutions. Lack of transparency in all dimensions is a major characteristic of Japanese financial regime. The government long restraining policies on the bond and stock markets in favor of intermediation through banks has established a financial structure in which corporate enterprises rely on borrowings from banks for their external financing. As a result disclosure of information to the public was not a common practice for corporate enterprises in Japan as their main financial sources were the borrowing from financial institutions especially banks rather than from bond and stock market. Furthermore, the stock market has been trivialized by eliminating its role as a market for corporate control. The rules and customs serving this purpose include mutual long-term shareholding and issuance of new shares to existing shareholders at par value. This elevated the role of banks to monitor credit risk through a system of long term “customer relationships” that relied on institutional knowledge rather than open public disclosure.

The lack of transparency has been a serious problem in Japan. Resistance to publishing meaningful statistics on the condition of banks and nonfinancial corporations makes it difficult to assess risk exposure and hence increases the potential for contagion. Lack of transparency makes regulatory credibility more difficult to sustain, easier to loose, and increases the potential for delay, forgiveness, and forbearance in dealing with troubled institutions.

Transparency problem is also serious in China. The problem is due to both of a lack of past practices in providing information to the market participants and a lack of a strict accounting rule to address the nonperforming loan problem. First, classification procedures are much more lenient than international standards. “Past due loans” are those not paid by the extended due date, “doubtful loans” are past due for greater than two years, or after the project in question has been canceled, and “bad debt” is still unpaid after the borrower has gone bankrupt and undergone liquidation. Bad loans, according to international standards, are those with interest or principal past due for more than 180 days, while in china, the principal must be past due by greater than two years. Classification internationally is based on risk assessment, while in China it is based on the payment status of principal. A five-year bullet loan<sup>13</sup> could be nonperforming for seven years before classified as “doubtful” and could not be declared as “bad debt”. Chinese banks, contrary to international practice, only classify the loan past due, not all loans to the company, and only the portion of the principal past due, not the total loan. Other questionable practices exist as well, but these practices clearly show that reported percentages of nonperforming loans are most probably understated (Lardy, 1998).

Authorities have made some efforts to increase the transparency in the state-owned banking sector by



separating policy and specialized state-owned commercial banks to encourage operating on commercial principles. The separating of policy and commercial banks would greatly relieve the market participants to explain the financial information of the commercial banks. But in practice it had ignored two vital points: (1) the policy banks did not take on the previously made policy loans of the specialized banks, leaving them with hurting balance sheets and unable to operate on commercial principles, and (2) the specialized state-owned banks are themselves the main source of funds for the policy banks, and were obligated to purchase bonds issued by policy banks.

#### **3.2.4 Public funding:**

Japan has been reluctant to call for public funding. The 1996 bailout of the *jusen* or housing loan companies in Japan used a relatively small sum of public funds (¥6 trillion), but was met with such intense public criticism that politicians have been reluctant to go to the public for additional funding. However, the situation has changed as Japan's financial system deteriorated further in late 1997. In December Japan announced that it intended to sell ¥10 trillion in bonds with the proceeds combined with as much as ¥20 trillion loans to the Resolution and Collection Bank. The pooled funds would then be used to bail out the nation's banks; however, many questions remain as to how the funds are to be utilized, especially as to whether Japan is ready to impose serious market discipline on troubled financial institutions.

In Japan, the public is clearly unfavorable to the use of taxpayer funds to deal with insolvent institutions and nonperforming loans. The financial regimes in Japan systems have been designed to limit household access to support high savings and provide funds to the business sector to support industrialization. In the past, high rates of economic growth compensated the household sector for limited access, but in recent times, lower and unstable economic growth provides little offset. In addition, there is widespread consensus among the public that the financial system has been designed and regulated to primarily serve the interests of the government, financial institutions, and the business sector. The bad debt problems of the 1990s revealed numerous examples of unethical and illegal activities<sup>14</sup>. Consequently, the public in Japan opposes the use of taxpayer funds to solve the financial problems and the political leaders have been reluctant to make a case for public funding.

In China, deteriorating government fiscal position and inefficient tax-collecting system make it difficult to solve the nonperforming loan problem by resorting to tax revenues. However, relative low government debt to GDP ratio opens the possibility to strengthen the under capitalized state-owned commercial banks by issuing government bond. The government has raised 270 billion yuan through issuance of treasury bonds to increase the adequate ratios to 8 percent for state commercial banks in 1998. Such practices encountered less resistance than that in Japan as the political decision processes are quite different in the two countries<sup>15</sup>.

The comparison and contrast with Japan is made easy as China like Japan has a bank-dominated financial system in which the hand of government is heavy. China and Japan have exhibited similar problems of insolvent financial institutions, nonperforming loans, and a financial and regulatory structure increasingly incompatible with current economic and technological forces. Above comparisons show that there exist in both Japan and China similar microeconomic reasons for financial troubles in their banking sectors. A major difference between Japan and China is that major banks in China are owned by state, bailout of them does not have as much as political resistances as in Japan.

### **3.3 Lessons that China should draw from Japan's experiences:**

China's state commercial banks have been making loans to inefficient and loss-making state owned enterprises because of the administrative intervention. Japan's banking problems rooted in loans made to *jusen* and housing companies when they competed each other for the market share after the financial liberalization initiating in the middle 1970s. Despite of the difference in origination of nonperforming loan problems in two countries, they share one thing in common that without solving the nonperforming loans the banking systems, which is a stock problem, banks' lending decisions, which are flow problems, will be severely affected. The most important difference between the banking problems of Japan and China is that the problems in Japan have partially caused and largely compounded a deepening recession, while in China robust growth continues. It is imperative that Chinese authorities can learn the lessons of Japan to heart before it is too late.

The chief similarities between the Chinese and Japanese banking situation are the overly rapid expansion of credit, the soaring debt to equity ratios of enterprises, the mounting nonperforming loans, inadequate capital. Furthermore, both systems had induced loans be made on criteria other than the profitability of the ventures. Japanese rapid expansion of credit in the late 80's and soaring real estate values are mirrored in what happened in the mid 1990's Chinese economy when there was a speculation on real assets and stock.

In Japan, "to facilitate the implementation of industrial policy, the Ministry of Finance (MOF) tightly regulated Japanese banks throughout much of the last four decades. In return, banks were ensured that the ministry would not allow them to fail. In this collusive environment, banks had no incentive to develop a proper appreciation of risk analysis and risk management, and MOF was not motivated to exercise appropriate supervisory functions" (Ito, 1998). Similarly, in China policy loans were the vehicle for carrying out the state's industrial policy and failure of banks and state-owned enterprises were simply not options that can be easily adopted. This also created a severe moral hazard because bank and state-owned enterprise managers knew that they would not be held accountable for losses. Hard budget constraints did not exist in either case, and the legacy of those decisions is hurting Japan still, and may start to adversely affect China in the near future.

It is argued that the only way for Japan to start growing again would be to cut back on loans considerably, to raise rates for risky clients and to allow inefficient companies to go bankruptcy or be taken over by new owners (Alexander, 1998). Facing difficulties in gaining a public consensus to use public fund in solving the bad loan problem in the banking sector, price-keeping operations (PKOs)<sup>16</sup> had been taken as an attempt to prop up the market so that the inadequacy of the banks' capital was not exposed. Frequent PKOs have had the effect of holding the stock market above its natural clearing level and this has had the unfortunate consequence of inhibiting the issue of new equity. PKOs, as an easy solution seen by MOF to the inadequate capital base in the banking sector, had kept the stock market above its natural equilibrium level. It had prevented the proper function of the equity market, As a result, companies were not able to attract sufficient investment to rebuild their base of equity and a recovery of the economy was inhibited.

The implicit message to China is that reform of the banking system, if done properly, will be quite painful in the short run, but that it will prevent a lot worse agony in the long run. Japan's prolonged and deepening recession is a case study in what happens if banking reforms are put off for too long. While it is correct in positing that reforms must not be delayed, an important differences between Japan and China is that China's banks are state owned and hence cannot be nationalized. State commercial banks in China have access to capital based on the ability of the state to tax and issue debt. Considering the

size of the state commercial bank, closure of any bank will cause a panic in the economy and is out of range of the policy choices. A prompt solution of the nonperforming loan problem in China may require the freezing of the existing nonperforming loans and make new loans on a commercial base. However, this solution may cause financial difficulties for the state-owned enterprises, so it would be better to liberalize the capital markets for the state-owned enterprises to have alternative sources of funding. In any case, the policy loans made must be written off and the implicit government debt must become explicit.

Nonperforming loans associated with the collapse of a bubble economy and pessimistic expectations on the future economic performance, which make a rapid recovery of asset prices less possible could explain the weakening balance sheet of Japanese banks. With the changing of authorities' stance from a "no failure" norm to a "prompt corrective action" norm, banks are trying hard to improve their financial health. This has adversely affected their lending attitude and is a major cause for the credit crunch. Exacerbating moral hazard problems and putting off painful but necessary restructuring, the Bank of Japan, the government-run Japan Development Bank, and other governmental agencies have stepped in to fill the gap, making loans and buying commercial paper. This is directly analogous to the policy lending of Chinese banks and the soft budget constraints they cause. The main lesson China can learn from Japan is what not to do. If China does not actually reform the lending practices of its banks and the operating procedures of the State-owned enterprises, it will have to recapitalize repeatedly as new lendings are made on non-economic criteria.

The ongoing agency problems within the banks undermine what would otherwise be an obvious avenue of approach to enterprise restructuring, which is to have the banks play a greatly enhanced role as monitors of newly restructured enterprise management groups. Clearly, the banks are important stakeholders in China's corporations. Most SOEs rely on the banks for virtually the totality of their external financing. Moreover, banks provide substantial amounts of long-term capital, which strengthens the argument for long-term links between banks and enterprises, including the formation of financial groups. Obviously this gives the banks a potentially strong role in disciplining enterprise behavior, since enterprises have limited alternative sources of finance. In recognition of the large stake banks hold currently in State-owned enterprises, banks should be encouraged to put representatives on Boards of Directors, and the current prohibition of banks holding equity should be relaxed (though not eliminated). Banks should be allowed to hold small equity stakes, perhaps for limited periods (up to two years) as part of restructuring efforts. This would help banks gain experience, provide better incentives, and prepare banks for a more active monitoring role in the future. But such measures can only provide a small incremental benefit under current conditions. In addition, it is essential that the government move quickly and decisively to restructure the banks themselves. Enterprise restructuring without bank restructuring is unlikely, in the long run, to be successful. Control over financial enterprises ought also to be restructured, and the role of government ownership reduced.

### **3.4 Policy response of China to the nonperforming problems:**

The Japanese experiences of slow responses prolonged recession resulting in "corrective action" has shown the cost of delaying major reforms. In early 1998, Chinese authorities announced an ambitious reform program, including completion of reforms of the banks and the state-owned enterprises within three years. Small and medium enterprises are to be liberalized through bankruptcy, selling, merging and share holding, the government will focus on restructuring and efficiency improvement of only 1000

large enterprises in key industries.

In the banking sector, first, commercial banks are required to run transactions on purely commercial basis. Regional headquarters of the People's Bank of China are to be established replacing the provincial branches to ensure minimum disturbance from local officials. At the same time, the central bank also tightened supervision and regulation of banks and other financial institutions (Lardy, 1998). Second, controls over credit quotas are to be abolished. Total loans of commercial banks are determined accordingly to an asset-to-liability ratio management system. But the guidance credit quota will remain in place. Commercial banks will also be given more room in setting their own interest rates. The financial authorities are set to achieve the objective of commercialization of banks and marketization of interest rate. Third, the central bank has lowered the interest rates on the central bank loans six times since early 1996. This gave the state-owned enterprises a total annual saving on interest payment of 190 billion yuan. Fourth, the central government also committed substantial funds to finance write-offs of enterprises' bad debts. And fifth, international practices have been introduced to the banking sector, including the accounting method and bank assessment system. A new scheme for classifying five types of nonperforming loans, which is consistent with the international standards, has been introduced in 1998. All these measures were designed to tickle the underlying causes of nonperforming loans mentioned in the previous part.

#### **4. Future Perspective:**

It is difficult to predict how the financial vulnerabilities in China will develop in the future. Japan's experiences has shown how heavy cost the economy have to pay if neglecting calls to liberalize the domestic financial system, dispose of nonperforming loans, reduce government credit allocation, improve monitoring and supervision, and impose penalties for failure. Japan's experience has shown that most of important changes have been in response to external pressure rather than an internal political decision to recognize the shortcomings of the previous financial regime. What would be the external and internal pressure for China? Political stability has the highest priority in the policy makers' mind in China. The internal pressure for China to liberalize its financial system would be most probably come from the consideration that a delay in liberalization would cause a severe financial crisis that negatively affects the political stability. On the other hand, a rapid liberalization is also not desirable since it will do harm to the state power as it hurts the vested group in the country. WTO negotiation has showed that, like in Japan, external pressure would probably play an important role in pressing the Chinese government to liberalize its financial system.

Though the Japanese experiences suggest that a prompt solution to financial system fragility is desirable. The Asian financial crisis brings difficulties to financial reform in China while demonstrating the urgency for change. The Chinese economy is losing growth momentum both because external shock from neighboring countries and from internal austerity programs introduced in the earlier years (Song, 1998). To retain a relatively high growth rate, the government seeks stimulation from fiscal and monetary measures through dramatic increases in investment. This encourages the overruling of commercial considerations by administrative instructions, in order to lift the growth rate of GDP and exports, and thus undermines the reform efforts in the financial sector. If economic growth slides, the triangular debts between state-owned enterprises, and thus nonperforming loans of the banks, would again accumulate quickly. An economy with slow growth also has limited ability to offer new jobs. This creates further

difficulties for restructuring enterprises.

Given all the vulnerabilities and weakness of China's financial and banking system, the main engine keeping the inefficient banks running is the ever growing household deposits. Between 1990 and 1996, household deposits grew at 33 percent per annum. This growth was made possible by two factors, one is the lack of alternative financial investment opportunities as the market for equity and debts are underdeveloped, bank deposits was the only major option left for households and the other is household still confident about the safety of the state banks. The growth of household deposits has already started to slow down (only about 20 percent in 1997), and this trend is likely to continue. China's GDP growth and thus household income growth will fall somewhat given the adverse external shock. Observing the closure of banks and other financial institutions and introduction of non-state banks, the public may increasingly recognize the importance of risk assessment. The markets for equity and debt will develop rapidly in China and more options will be available for financial investment.

The financial vulnerabilities of Chinese financial system will not turn to a crisis for the time being. However, if the current high proportion of nonperforming loans, low circulation rate and high deposit-loan gap remain, a significant slow down in growth of the deposits may well trigger a domestic financial crisis. To avert such a crisis, financial reform needs to be pushed forward more quickly. The eventual successfulness of China's financial reform depends on addressing of three questions: (1) how to improve the financial institutions financial position. (2) how to stop the creation of new inefficiency? and (3) how to transform the state-owned banks into independent commercial banks?

The outcome of the financial liberalization will, therefore, be largely depend on changes in other sectors, especially reform of the state-owned enterprises and the public finance system. Otherwise non-performing loans will not stop accumulating. Nonperforming loans should be transferred or written off in a proper way to avoid the moral hazard problem. Further development of non-bank financial institutions, especially market for debt and equity, is not only useful for diversifying financial risks but also helpful in offering competition to inefficient banking sector. However, drawing from the Japanese experience in late 1980s, authorities should establish a sound supervision system before the competition can be encouraged. Otherwise, fierce competition together with an inadequate supervision will make financial institutions to increase portfolio risk to counteract the competitive risk they are facing.

## Endnote

<sup>1</sup>The ratio achieved in many Southeast Asian economies before the crisis was around 3 (Li, 1998).

<sup>2</sup>In 1995, the total gap was 291 billion yuan for all state commercial banks, this was increased to 744 billion yuan in 1996 and 810 billion yuan in the first half of 1998 (Li, 1998).

<sup>3</sup>This was implemented under the "loan for grant" reform in 1983 and 1984 (Ma, 1997).

<sup>4</sup>One may raise the question that if these firms were truly state-owned because the state had not invest a single cent, they were considered to be state-owned enterprises only owing to the fact that state had helped them get loans from commercial banks. This practice of state was normally not carried out for firms other than state-owned.

<sup>5</sup>Note that bank deposits owned by enterprises and organizations never enjoy the inflation protection that household deposits receive

<sup>6</sup>Deposit Insurance Corporation (DIC), a special corporation, was established under the Deposit Insurance Law (Law No. 34 of 1971) with capital contributed by the Ministry of Finance (MOF), the Bank of Japan (BOJ), and private financial institutions. The statutory payoff limit has been increased several times and is currently ¥10 million per depositor. In addition, deposits at agricultural cooperatives are protected under a separate statute. Deposits

in a postal savings system are also covered by an explicit guarantee.

<sup>7</sup>Since its inception, the DIC was poorly funded, understaffed, and largely subsumed within the operations of the BOJ. The deposit insurance fund has never been used to pay off depositors of a failed institution. And although there were Japanese bank failures in the 1970s and 1980s, the deposit insurance fund was not utilized until 1992, when the DIC provided financial assistance to facilitate a rescue merger for a small failed bank (DIC, 1998; Federation of Bankers Associations of Japan, 1994).

<sup>8</sup>Banking Law, article 26; Banking Law Enforcement Order No.10 of March 21, 1982, as amended, articles 21-2, 21-3. The prompt corrective action regime took effect in April 1998.

<sup>9</sup>Bill to Implement Special Procedures for Reorganizing Financial Institutions, Law No. 95 of 1996.

<sup>10</sup>Bill to Amend the Deposit Insurance Law, Law No. 96 of 1996.

<sup>11</sup>Two public collection agencies are Housing Loan Administration Corp. (HLAC) and Resolution and Collection Bank (RCB). The HLAC was established under the Special Measures Law to Promote the Resolution of the Assets and Liabilities of the *Jusen* Companies, Law No. 93 of 1996. The RCB was established under the Bill to Amend the Deposit Insurance Law, Law No. 96 of 1996.

<sup>12</sup>The financial deepening approach, pioneered by McKinnon (1973) and Shaw (1973), has been used to study economic development (Fry 1988, King and Levine 1993, Saint-Paul 1992, Greenwood and Jovanovic 1990). It argues that the shortage of such financial resources as domestic saving, foreign investment and bank loan is not the crucial constraint in growth and productivity, but rather institutional rigidities such as government imposed interest rate ceiling that led to inefficiencies in investment.

<sup>13</sup>A bank term loan that calls for no amortization.

<sup>14</sup>For example, securities firms had given guarantees of high positive rates of return to favored investors on their equity portfolio as in the case of Nomura Securities VIP list. [“The Weekly Post Special 3: TWP Obtains Confidential Document from Nomura Security Fraud Case”, *The Weekly Post* (Japan), July 14, 1997 website]. Large banks introduced crooked clients to subsidiary banks or credit cooperatives in order to keep questionable loans off their own books (“HLAC Plans to Sue Four Banks that Got *Jusen* to Make Risky Loans”, *Japan Digest*, January 26, 1998, p.1). Ministry of Finance officials gave banks advance warning of “surprise” inspections in exchange for lavish entertainment and other favors (“MOF Bribery Scandal Reveals Backroom Financial Deals”, *Nikkei Net*, January 27, 1998 website)

<sup>15</sup>In other words, the socialization of the losses in the financial system in China can be taken out relatively easy because of the less democratic political decision making process. Nevertheless, such a advantage, though in the short-run can ensure a prompt solution in the long-run can turn into the root of future wrong decisions.

<sup>16</sup>Typically, PKOs are carried out by the MOF ordering that funds in publicly-controlled accounts (such as public pension or postal life insurance) be used to make share purchases, indiscriminate of underlying value, while it also directly or indirectly restricts the flow of new issues into the market.

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