China’s Domestic Debts. Will They Interfere with Financial Sector Liberalization and WTO Commitments? Issues and Strategies.

Pieter Bottelier
Adjunct Lecturer, John F. Kennedy School of Government
Harvard University
To be presented at the Conference on Financial Sector Reform in China
September 11-13, 2001
China’s Domestic Debts. Will They Interfere with Financial Sector Liberalization and WTO Commitments? Issues and Strategies.


Pieter Bottelier

Abstract. WTO membership increases the urgency of many domestic reforms, particularly in the financial sector. China’s contingent and implicit domestic debts are very large and still growing. Most are related to the country’s economic transition. The approach that was taken by the government’s four Asset Management Companies to non-performing loan clean-up in 1999 and 2000 is questionable and should not be repeated. State banks should play a larger role in absorbing their own accumulated losses. China should leverage its external financial strength for domestic financial clean-up. The exchange rate may appreciate which would be helpful in this process. A large and growing proportion of state assets is held in the form of non-tradable shares in partially privatized state companies. To protect the solvency of the government, many of these shares will have to be made tradable and sold in the next 5-10 years. Further strengthening of the fiscal system along with rapid and sound development of domestic capital markets is essential. Breaking-up some or all of the four large state-owned commercial banks into smaller units would facilitate their restructuring and eventual privatization. China may slip in the implementation of some WTO commitments, because the timetables for adjustment in the financial sector are extremely tight.

Introduction

In this paper I will review financial sector reform issues and relevant facts primarily from the angle of state debt and public finances in general. I will discuss the size and composition of the state’s external and internal debt (formal, contingent and implicit; guaranteed and non-guaranteed), strategies for the absorption of bad debt in the system, the role of stock exchanges in this process, and the solvency of the state. At the end I will propose elements of a new strategy for the restructuring and re-capitalization of the four large state-owned commercial banks\(^1\) (SOCB) which together account for over 70 percent of total banking system assets.

A healthy financial sector (including sound corporate financial structures) is essential for sustaining high and efficient growth as the economy opens up further under the commitments that China has made to WTO partners. China’s financial sector has to overcome many problems before it can be given a clean bill of health. Many state-owned

\(^1\) In order of their balance sheet total: ICBC, CCB, BOC, ABC.
corporate clients (SOE) of state-owned commercial banks remain inefficient and/or seriously under-capitalized. Although loans to non-state firms and private borrowers are rapidly increasing as a proportion of total state bank lending, recent central bank statistics indicate that loans to SOEs still accounted for more than 50 percent of their total loan portfolio at the end of 2000. A large proportion of the SOE loan portfolio is non-performing (NPL). There is little information on the quality of outstanding loans to non-state borrowers.

WTO membership increases the urgency of both SOE- and financial sector reform. Five years after accession, foreign banks are entitled to full “national treatment”\(^2\), while all restrictions on the kind of customers they may serve, domestic currency transactions, and geographical location should be lifted. Two years after accession, foreign banks should be able to conduct local currency business with Chinese corporate customers. There is a risk that China may not be able to meet all WTO commitments on timetables that are part of agreed accession terms.

The most urgent debt problem that needs to be resolved in the context of WTO commitments is the NPL problem of the SOCBs. This is not a formal state debt, but a contingent debt. Without an implicit government guarantee of SOCB deposits (a large proportion of which has been used to finance NPLs) those banks, and with them China’s financial system, would collapse. The implicit guarantee represents the state’s contingent NPL debt. Resolution of this problem is a complex and time consuming process involving change in many areas of government policy.

As owner of the state banks, the state is responsible for their re-capitalization in accordance with internationally agreed capital adequacy and accounting standards. Without adequate re-capitalization (and many related structural reforms) of these banks, it will not be possible to meet WTO commitments. The precise magnitude of the state’s contingent NPL debt is not known, but, as will be discussed later, it is very large in both absolute and relative terms. The financial accounts of the four large SOCBs have thus far not been audited according to international standards. BOC is the only one of the four that publishes consolidated accounts for all of its national and international holdings and operations. It is more difficult to assess the overall financial condition of the other three. While precise numbers cannot be provided, it is clear that all four remain seriously under-capitalized. This is true in spite of the Rmb 270 billion bank restructuring bonds that were issued by the Ministry of Finance (MOF) in 1998 and the subsequent re-capitalization through NPL purchases at par totaling Rmb1.4 trillion by Asset Management Companies (AMCs).\(^3\)

\(^2\) I.e. there should be no distinction between entry- or prudential requirements for foreign and domestic banks.

\(^3\) MOF’s 1998 bank restructuring bonds were financed from excess reserves held by the SOCBs with the Central Bank. This form of re-capitalization differs from the subsequent re-capitalization through the purchase of NPLs at par by the AMCs in the sense that the latter approach adds to the net stock of public debt while the former didn’t. If full re-capitalization at a capital adequacy ratio of 8 percent had been undertaken at the end of 2000, additional financial resources of at least US$200 billion would have been needed. In the May 2001 bulletin of the Global Markets Research of Deutsche Bank in Hong Kong, Jun Ma
Unfortunately, after more than 15 years of SOE- and bank reform in China, the stock of NPLs appears to be still growing. For a variety of social, political and accounting reasons, it is not possible for China to “freeze” the NPL problem immediately, as is often recommended. The best that can be planned for is a very rapid reduction in the rate at which the NPL stock is growing. There is, however, a point of no-return beyond which a deep crisis (or reversal of liberalization policies) will become unavoidable. This is not a fixed point that can be calculated ex-ante, except in a model under highly restrictive assumptions. There are no indications that this point has been reached. Once the NPL problem has peaked, which should happen within the next 3 years, comprehensive once-for-all solutions (such as e.g. a massive government bond issue to re-capitalize the banks) become possible in principle. Other avenues toward re-capitalization should be pursued as well, as will be discussed.

A major issue in the NPL clean-up process is the distribution of costs among the various stakeholders - the government (central and local), banks, SOEs, Chinese citizens (in particular tax payers), owners of bank deposit, shareholders and foreign creditors. Burden sharing will not be voluntary. Through its policies and actions, the central government will be the main arbiter of outcomes in this process. There will often be conflicting pressures on the government and struggles between stakeholders to shift the burden as much as possible to others. The massive financial clean-up task that lies ahead will not only require financial and economic expertise, but also great political skill and leadership.

An overall strategy for financial sector reform has not yet emerged. There are many indications of movement in the right direction, but there are also apparent contradictions in the government’s strategy and areas of policy uncertainty. I am unable to answer the question in the title of this paper with confidence. What is certain, however, is that the timetable for adjustment to WTO requirements is extremely tight and that there is virtually no room for policy mistakes. The fact that China is entering WTO at a time of great international economic uncertainty and possibly recession, increases both the urgency and the difficulty of the reforms that lie ahead. Because of the enormous complexity of the challenge, China should formulate a convincing overall strategy – a road map - for financial sector reform.

**NPLs, AMCs and debt/equity conversions**

One indication that the stock of NPLs is still expanding is the fact that the growth in lending to non-state borrowers accounts for only about half of the growth in total lending.\(^4\) Although precise numbers are not available, it is possible that even the rate of growth of the NPL stock has not abated much\(^5\). Most state bank managers in China are

---

\(^4\) The total SOCB outstanding loan portfolio as a percentage of GDP grew from 66 percent in 1996 to 115 percent in 2000. During that same period, the share of lending by all state banks to the non-state sector increased from 40 to 48 percent.

\(^5\) Nicholas Lardy estimates in a recent article in the Financial Times (June 22, 2001) that the increase in the stock of NPLs in 2000 was of the order of RMB 400 billion, or about 4 percent of GDP. I believe that this
fully aware of the urgent need to correct the market distortions and SOE behavioral problems that underlie the NPL problem. However, political commitment to accelerated SOE reform appears to have wavered in recent years, as the magnitude of social disruption due to lay-offs (in the absence of adequate social safety nets) became apparent.

Financial sector reforms in China have traditionally lagged behind market reforms in the real economy. This is partly due to the fact that, at the political level, the issues were not well understood until recently, but also because it was convenient to delay financial sector reforms as long as banks and other financial institutions could be shielded from international competition and norms. Many in the leadership did not begin to appreciate the risks associated with a weak banking system, inadequate supervision, and poor corporate governance until the Asian Financial Crisis of 1997/8. This crisis, together with the final stages of WTO-entry negotiations with the U.S. in 1999 forced many of the issues into the open. Not only did financial sector reform and concerns about inadequate corporate governance move center stage, but significant changes in industrial policy were made as well.6

From the time that the fiscal burden of supporting loss-making state-owned enterprises (SOEs) was shifted from the budget to the four main SOCBs in the mid-1980s, until the macroeconomic policy reforms of the mid-1990s, SOCBs served as financial agents of the government and as “dustbins” of the reform process. This permitted preserving full employment in cities and kept alive the illusion that China could avoid the pain of reform. In a more positive vein, China’s incrementalist approach to reform bought time for people and institutions to adjust to the emerging realities of a market economy while incomes were growing and social stability was preserved. Meanwhile, accumulating financial losses in the state banks could be easily hidden and did not seem to hurt anybody. The day of reckoning could be postponed, perhaps indefinitely, it seemed.

If China’s fiscal system had been stronger it might have been possible for the state banks to build larger reserves against future losses. This did not happen, in part because MOF – owner of the banks on behalf of the state - for many years limited provisioning by state banks to 1 percent of their assets. For budget reasons, MOF had to maximize tax revenues from state banks. Budget considerations were in direct conflict with key financial system reform requirements. An implication is that the performance of China’s state budget has been consistently weaker than official numbers indicate while taxable state bank profits were systematically overstated. MOF’s policy has recently changed. The 1 percent provisioning restriction was lifted and the banks are now encouraged to absorb more losses themselves. At the same time, efforts are being made to increase the profitability of the state banks through internal restructuring and (business) tax

---

6 South Korea’s Cheabol structure appears to have served as a model for China’s new industrial policy announced in President Jiang Zemin’s speech at the opening of the 15th Party Congress in September, 1997 – 3 months before the South Korean financial crisis broke. The model appears to have been quietly dropped from China’s plan.
reductions. This big change in approach to loss absorption was made possible by an improving fiscal revenue performance.

Nonetheless, China’s tendency to present a rosier picture of state finances than is economically justified has not yet been relegated to the past. This is illustrated by the fact that the recent purchase of NPLs – totaling Rmb 1.4 trillion (about US$170 billion) since the process started in 1999 - by the four newly created state-owned AMCs is not shown as a budget expenditure or as additional sovereign debt. The reason for this is probably that NPL purchases were made after the State Economic and Trade Commission had authorized parallel debt/equity conversions at par between the AMCs and their SOE debtors. This created the (false) impression that AMC liabilities were fully backed by AMC assets and that there was no change in MOF’s net financial position. (Implications of this unorthodox approach to financial restructuring will be discussed later.)

Financial markets were at once shocked and pleased when Liu Mingkang, the President of Bank of China (BOC), the most prestigious, most international and third largest of the SOCBs publicly announced in May 2001 that the bank’s NPL portfolio amounted to 28.8 percent of assets at the end of 2000. BOC is ahead of the other three in internal management and administrative reforms, and in financial restructuring. It is preparing for a domestic bond issue and for an IPO in Hong Kong for its consolidated and separately incorporated international holdings. In preparation for this listing and partial privatization of (mostly Hong Kong-based) international holdings – a first for China’s SOCBs and a breakthrough of enormous importance if the IPO is successful – it has to present a reliable balance sheet.

Liu Mingkang’ s announcement came as a shock, because the stock of BOC’s NPLs was far larger that anyone in official position in China had previously admitted or even hinted at. He was praised because of his initiative and forthrightness. BOC had already transferred a significant amount of NPLs – Rmb267.4 billion, or about 8 percent of assets - to its AMC (Dongfan) since 1999. Given BOC’s balance sheet total of Rmb3,430 billion at the end of 2000, it is easy to calculate that BOC’s stock of NPLs must have accounted for about 40 percent of assets before the transfer started. Since BOC is generally thought to be financially the strongest of the four large SOCBs, their aggregate stock of remaining NPLs plus the Rmb1.4 trillion that was transferred to the AMCs in 1999 and early 2000 (in exchange for interest bearing AMC bonds), may be of the order of 40-45 percent of their combined assets.

If the stock of NPLs could be frozen now, the Chinese economy would have to deal with a combined NPL/AMC portfolio of the order of US$490-550 billion equivalent. Assuming an average recovery rate of 20 percent (which may be optimistic in light of the reported 9 percent recovery rate achieved by AMCs so far), the total accumulated loss that will have to be covered in one way or another amounts to some US$390-440 billion.

---

8 According to their balance sheets, combined SOCB assets amounted to a little over Rmb10 trillion (US$ 1.22 trillion) at the end of 2000.
(around 40 percent of GDP). Few countries have ever had to deal with losses of such magnitude. Unfortunately, the stock of NPLs owned by the four SOCBs cannot be frozen immediately. Moreover, the loss estimate does not include irrecoverable losses accumulated elsewhere in the public financial system (including for example rural credit cooperatives) which could amount to another 7-9 percent of GDP. This would bring the estimate of total irrecoverable losses in the state financial sector to US$450-510 billion (45 – 50 percent of GDP). The absorption of losses of this magnitude will take many years. All avenues will have to be pursued, including debt/equity conversions, new bond and share issues, as well as write-offs against reserves or future provisionings.

The AMC program is supposed to have taken care of the stock of NPLs that had accumulated up to the end of 1996. No comprehensive plan for post-1996 NPLs has been announced, but greater emphasis appears has been placed on loss absorption by the banks themselves, which is a desirable shift. There are no indications that the government intends to use the four existing state-owned AMCs beyond the Rmb1.4 trillion of NPLs that has already been transferred to their accounts and converted into equity. This is encouraging, because the approach that has been followed to NPL clean-up (through AMC purchases at par) and simultaneous SOCB re-capitalization, is highly questionable from a reform perspective. The approach amounts to little more than a complex set of accounting transactions that do not add up to real economic reform.

There are three important problems with the AMC approach to NPL clean-up that has been followed thus far:

1. The bonds issued by the AMCs to compensate the state banks for the NPLs purchased – at par – are not formally guaranteed by MOF; yet the transaction is regarded as a re-capitalization of the state banks. China cannot have it both ways. If the NPL/bond conversion is to be regarded as re-capitalization, MOF has to guarantee the bonds and add the amount (Rmb 1.4 trillion) to domestic state debt or state debt guarantees.

2. Debt/equity conversions between AMCs and SOEs at par can easily lead to the undesirable result that the accounts of participating, but poorly performing SOEs, suggest renewed creditworthiness for state bank loans, thus continuing the vicious circle. According to case studies by Edward Steinfeld (see footnote 7) this is in fact what happened.

3. The AMC transactions so far have done nothing to induce a healthier credit culture or behavioral changes in SOEs in China. They may in fact have had a perverse effect in some cases. Ultimately, sustainable economic reform has to rest to solid micro-foundations and behavioral change. When the AMC program was

---

9 Obviously, equity shares issued to the AMCs under this program are not tradable at their issue price. The AMCs have been given ten years to dispose of their newly acquired assets through auctions, negotiated sales, etc. The initial recovery rate is reported to have averaged only about 9 percent. Some AMCs have already conducted international “road shows” in preparation for the sale abroad of some of their assets.
first announced in 1999, many observers believed that it was the key to serious final-stage SOE and financial sector reform. They were wrong.

**The role of stock exchanges and capital markets in NPL clean-up**

The massive NPL/AMC portfolio cleaning-up process that lies ahead represents a large tax on society, except for that portion of the portfolio that can be sold commercially or converted into tradable securities. China’s stock exchanges will have to play a major role in the loss absorption process through debt/equity conversions. This is one of the reasons why the rapid and sound development of China’s stock exchanges (including Hong Kong) and other capital markets, is absolutely critical.

The government should also encourage private (both domestic and foreign) investment companies to actively participate in the NPL/AMC clean-up process. There has been little private sector activity of this kind so far. Naturally, private companies will only be able to purchase NPLs at an *up-front* discount rather than *at par*, like the state-owned AMCs did. Up-front discounts for NPL sales would force the SOCBs and their owner (the state) to recognize losses immediately, which is precisely what the government has been trying to avoid so far. The discount on limited asset sales by AMCs so far is reported to have averaged 91 percent. MOF has accepted responsibility for ultimate AMC losses, but legally this does not amount to the same thing a formal guarantee for AMC bonds.

It has been suggested by some that the NPL/AMC portfolio is so large relative to the size of the Chinese economy that it will not be possible to absorb all losses within a reasonable period of time, unless the government opens up the possibility for state bank deposit holders to voluntarily convert part of their deposits into equity. This would be a very unorthodox approach to bank re-capitalization, but it is worth exploring under what circumstances it might be a legitimate option. The bulk of all deposits in SOCBs (about 70 percent of about Rmb 7 trillion - US$850 billion) is owned by private individuals and close to 10 percent of that amount is held in foreign currency (mostly US$) accounts. The potential of voluntary SOCB debt/equity swaps may therefore be significant. Any such voluntary conversions at discounted share prices would presumably require government compensation to the depositors.

Voluntary debt/equity conversions will be easier to arrange when there is confidence in the stock markets and when share prices are stable or rising. Ongoing efforts by China’s Securities Regulatory Commission (CSRC) to improve the quality and transparency of new listings, corporate governance, accounting- and auditing standards, as well as trading supervision on the Shanghai and Shenzhen stock exchanges, are critical in this regard. Good progress is being made, but many problems remain. With respect to share prices, the government faces a dilemma and a potential conflict of interest. As majority shareholder in most listed companies¹⁰, the government naturally has an interest in high share prices, but as market regulator and supervisor of the financial system (through the

---

¹⁰ The government owns an average of 67 percent of the 1151 companies that were listed on the Shanghai and Shenzhen stock exchanges in August 2001. It also owns majority shares in Chinese companies listed in Hong Kong (H shares and red chips).
regulatory agencies), it has to ensure that there is confidence in its ability and willingness to set and enforce high governance standards. The actual situation with regard to share prices and governance standards (for listed companies and for the stock exchanges themselves) remains fraught with anomalies\(^{11}\) and potential conflict.

**NPLs in the broader context of state finances**

Daunting as the NPL/AMC clean-up task may be, it is not the only domestic debt challenge facing the government. China’s formal, contingent and implicit sovereign state debt is much larger than is commonly realized. It consists of the following three components:\(^{12}\)

A. **Registered central government debt and debt guarantees (46 percent of GDP):**

1. Sovereign domestic bond debt – about 14 percent of GDP (soon rising to 16 percent);
2. Sovereign external debt – about 7 percent of GDP (China’s total external debt amounts to about 16 percent of GDP);
3. Domestic bonds issued by AMCs and State Policy banks – 14 and 11 percent of GDP respectively.\(^{13}\)

B. **Contingent NPL debt (37 - 44 percent of GDP):**

This is the estimated NPL portfolio that remains on the books of all state banks after the transfer of Rmb 1.4 trillion to AMCs in 1999 and 2000.

C. **Unfunded future state pension obligations (45 – 95 percent of GDP):**

This is mostly long- and very long-term debt. It should only be included to the extent it is not covered by future pension contributions or payroll deductions, which is presently the whole of the estimated amount. The present value of this implicit state debt is sensitive to many uncertain factors and therefore hard to calculate. Estimates based on current state pension system regulations and parameters range from 45 – 95 percent of GDP.

\(^{11}\) For example, due to currency inconvertibility (for capital account transactions) and other factors, A shares in Shanghai and Shenzhen often trade at a multiple of the value of corresponding H shares in Hong Kong in the same Chinese companies. The average P/E ratio of A shares came down from about 56 in April to 40 in August 2001 which is still very high. After the opening of the B-share market to local investors in February 2001, the average P/E ratio and turnover rate of B shares increased suddenly and dramatically, but still remained far below the rates for corresponding A shares in the same companies.

\(^{12}\) The magnitudes indicated (as GDP shares) are based on official data when available and on author estimates.

\(^{13}\) I include AMC bonds in this category (even though there is no formal MOF guarantee) because these bonds could otherwise not serve to re-capitalize the state banks. State Policy Bank bonds (also without formal MOF guarantee) are included, because it seems inconceivable that the government would permit any default on these bonds.
The above list does not include the debt of lower level governments or state corporations (other than the NPL portfolio). Nor is allowance made for the need to strengthen the capital base of SOEs. Most Chinese SOEs are severely under-capitalized. Debt/equity ratios of 7-10 (higher than corresponding ratios for Korean Cheabols before the financial crisis of 1997/98) are not uncommon. Such high ratios are dangerous in an open market economy, because of the extreme vulnerability of corporate finances to interest rate fluctuations. If China wishes to adequately capitalize SOEs for their future role in an open economy or to make them privatizable, large additional financial resources will be needed. Most of these resources will have to be borrowed or financed from the sale of state assets. A rough estimate of the present value of the funds that may be required for this purpose is 5-7 percent of GDP. This is not “debt” in a legal sense or even implicit debt, but it does represent a significant claim on future public resources related to the fact that China is preparing to become an open market economy.

The above numbers and comments suggest that the overall financial situation of the Chinese state is much less sanguine than is usually suggested in official reports. The unfunded state pension debt presents enormous social and political challenges, but the payment of this debt can be spread out over a very long period. China has so far not succeeded in getting the new mandatory two-pillar national pension scheme for urban workers to function as designed. The accumulation of funds from payroll deductions against future individual account (pillar-2) liabilities, falls far short of requirements. The state (central and lower level governments) is unavoidably the debtor of last resort in this. In an effort to reduce pillar-2 and other social security funding problems, the government recently announced that 10 percent of the proceeds of new IPOs for SOE would be paid into the newly established National Social Security Fund. This is another illustration of the important role envisaged for stock exchanges in the gradual resolution of China’s domestic debt problems.

**Leveraging China’s external financial strength for domestic financial clean-up**

The contrast between China’s external financial strength on the one hand – a stable currency supported by an unusually strong balance of payments and high international reserves – and the weakness of its domestic fiscal and financial system on the other, is striking. Without its considerable external financial strength China’s economy would quickly become extremely vulnerable. Maintaining external financial strength during economic transition is imperative for China.

---

14 It is not clear if the Government plans to reserve 10 percent of a proceeds of new IPOs for this purpose or if it plans to sell additional shares amounting to 10 percent of the IPO. The latter approach would be preferable, because it avoids the impression that the initial purchasers of IPO shares have to share the burden of the Government’s social security obligations.

15 China’s balance of payments has shown both current and capital account surpluses in most years since 1994. Official reserves amounted to about US$ 190 billion in August 2001 – more than 11 months import equivalent. In light of this great external financial strength and current balance of payments prospects, China’s currency is more likely to appreciate than depreciate in the coming years.
The Government has to find ways to leverage external financial strength to help resolve domestic financial weakness. External debt is at present the least of China’s financial worries. China can afford to borrow more abroad for domestic re-capitalization purposes. In addition, external share (or NPL/AMC) sales reduce the claim on domestic financial resources. These avenues will undoubtedly be pursued with vigor in the years ahead. In this context, a further appreciation of the Rmb against the US$, as seems indicated by China’s continued large balance of payments surpluses, would also help (see footnote 15).

Fortunately, there are important synergies between China’s pressing domestic financial needs and incentives to improve accounting, auditing and governance standards. China cannot expect to access foreign stock exchanges for the listing of a substantial number of SOEs that are to be privatized, unless disclosure and governance standards are adjusted to international norms. The dynamics of the reform process itself may contribute to the solution of China’s domestic financial problems as long as a strong growth momentum is maintained. Exchange rate appreciation could boost the reform process, provided a strong balance of payments can be maintained. Helpful synergies may also lie in the gradual integration of the A en B share markets domestically (as is already happening) and in the gradual reduction of capital account restrictions (growing currency convertibility). Once full currency convertibility has been achieved (which may taken another decade or more), mobilization of foreign financial resources for domestic investment and debt clean-up will be easier than it is at present.

**Is the Chinese state solvent?**

States are solvent as long as they can pay their bills and service their debt on time. Solvent states may face liquidity problems that can be solved through borrowing, asset sales or additional taxation. Technically, states cannot go bankrupt like corporations, but in practice they (especially smaller countries, as the recent Asian financial crisis has amply demonstrated) can come close to it. Under present economic conditions there is no risk that China’s central government would be unable to meet its external financial obligations. The situation is different and more complex with regard to the state’s domestic financial obligations. Some components of the Chinese state, including state-owned corporations and lower level governments, have defaulted on part of their financial obligations (sometimes external as in the case of GITIC, but usually internal - wages, pensions, local suppliers and/or utilities). Local government budget problems intensified in poor areas after the fiscal reforms of 1994\(^{16}\).

In principle the central government can make good on unmet financial obligations of components of the state - and is doing so in a limited way for social security obligations – but it is understandably concerned about perverse and adverse consequences if it did so indiscriminately. Moral hazard problems and the risk of inflation are obvious. The Chinese government appears to have no inclination whatsoever to use the inflation tax as

---

\(^{16}\) This deterioration is mainly due to the fact that the Central Government has so far been unable to generate the re-distributable fiscal resources of about 10 percent of total revenues that were projected when the 1994 tax reforms were introduced.
part of the solution of its domestic debt problems. Mild inflation will probably not be resisted, provided it does not threaten social stability. Should the domestic financial problems of the Chinese state become unmanageable, high inflation will probably become unavoidable. This could lead to serious social instability and spell disaster for the regime. Protecting the solvency of the state is obviously critical.

The solvency of the central government for domestic financial obligations is apparently not in doubt. Otherwise there would be a run on deposits in state banks and state bonds would sell at a deep discount. Doubts about the solvency of the government can quickly lead to acute liquidity problems and thus provoke a financial crisis. It is therefore essential for the authorities to avoid that such doubts arise. This explains why on the few occasions that local bank branches ran into acute liquidity problems, the center never hesitated to transfer additional cash to such branches immediately.

Government officials often make the point that there is no reason to worry about the solvency of the state, because state assets are alleged to exceed state liabilities by a large margin. To demonstrate this in a comprehensive national balance sheet of assets and liabilities for the Chinese state as a whole, including state-owned companies and lower level governments, would be very difficult. Many of the state’s assets, such as land and buildings, are not liquid or are encumbered in various, often non-transparent ways. It is moreover doubtful that a balance sheet for the state as a whole, even if it could be constructed, would conclusively demonstrate solvency or the lack thereof. It is perhaps more useful to focus on the central government as the most important agent of the state.

In normal circumstances, central governments do not have to own or use assets to protect their solvency, except, in some cases (e.g. state-mandated social security systems). In a growing economy, normal financial obligations of the government, including debt service, can usually be financed from current revenues and modest increases in the stock of debt. Like other transition economies, however, China is a special case. A large part of the central government’s financial obligations is related to the country’s economic transition. This “transition debt” includes the bonds issued by state-owned AMCs, part of the long term debt of the three state-owned Policy Banks, the NPL portfolio that remains on the books of state banks, part of the state’s unfunded pension liabilities, and re-capitalization needs of SOEs owned by the central government. Against these transition-related liabilities, the government has transition-related assets such as the shares it owns in listed SOEs, SOEs that are to be listed or sold, other marketable assets, net foreign investments, and expected proceeds from NPL/AMC sales.

It is of interest to compare transition-related liabilities to the value of the assets that the government could use to finance such liabilities outside the normal budget. A highly

---

17 For example, the national balance sheet of state assets and liabilities for Japan, one of only a few countries generating such information, shows a large net-deficit. Even though its international sovereign debt was last year downgraded by at least one major rating agency, the Japanese state is not considered insolvent.
simplified balance sheet of transition debt and transition assets might approximately look as follows:\textsuperscript{18}:

<table>
<thead>
<tr>
<th>Central Govt. Liabilities</th>
<th>(Rmb billion)</th>
<th>Central Govt. Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMC bonds ..................</td>
<td>1,400</td>
<td>Market value of govt-owned</td>
</tr>
<tr>
<td>Policy Bank bonds ..........</td>
<td>500</td>
<td>shares in listed SOEs........ 3,600</td>
</tr>
<tr>
<td>NPLs (remaining) ..........</td>
<td>3,300</td>
<td>Market value of SOEs to be listed in next 5 years ............ 2,300</td>
</tr>
<tr>
<td>SOE re-capitalization needs ....</td>
<td>1,200</td>
<td>Other marketable assets ...... 400</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Net foreign assets ........... 1,500</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Proceeds of NPL/AMC sales.... 400</td>
</tr>
<tr>
<td>Estimated present value ....</td>
<td>4,300</td>
<td>Estimated present value...... 6,300</td>
</tr>
</tbody>
</table>

Note: Estimated present value of the unfunded pension debt: at least Rmb 4,500

This simple overview suggests that the capacity of the central government to finance the non-pension “transition debt” is adequate, provided asset markets don’t collapse and provided the government is willing to sell a large proportion of the assets it holds. Another important proviso is that the stock of NPLs does not continue to grow much bigger. To protect the solvency of the government, a large part of the currently non-tradable shares in partially privatized SOEs will have to be made tradable in the years ahead. This has major implications for the domestic and Hong Kong stock exchanges. One of the most important conclusions of the analysis is that the value of state-owned shares in partially privatized SOEs constitutes a significant element in the protection of the solvency of the central government.

If the pension debt is included, there is technically a solvency problem. Clearly this huge implicit state debt is pivotal in the overall public finance picture. Since the pension debt can be paid over a very long period, it need not cause undue financial pressures in the near-term future. Moreover, it is possible to change the design and the parameters of the pension system such that the present value of unfunded future liabilities is reduced, or matched by future revenue flows.\textsuperscript{19} Pension benefits may have to be further reduced and

\textsuperscript{18} It should be emphasized that these are at best rough approximations for illustrative purposes only. The numbers are based on various sources and author estimates. For the sake of simplicity point estimates are given rather than ranges. The valuation of non-tradable Government shares is based on August 2001 market values at the stock exchanges of Shanghai, Shenzhen, and Hong Kong. The proportion of the Hong Kong stock exchange capitalization accounted for by mainland companies (H shares and red chips) is about 26 percent at present and projected to rise to 35 percent after the proposed share issues by China Telecom, Unicom, China Aluminium and Bank of China. Modest amounts of Chinese shares trade at other stock exchanges – mainly New York. The Chinese government owns on average about 67 percent of listed SOEs. These Government shares are at present non-tradable.

\textsuperscript{19} The ongoing pilot pension reform project in Liaoning Province may provide useful guidance on pension system design and parameters.
new revenue sources may have to be identified and earmarked for the pension fund to protect the solvency of the state.

Since a large proportion (over 70 percent) of marketable assets of the central government is in the form of shares in SOEs that are or will be listed on stock exchanges, the behavior of those markets and their capacity to absorb the sale of government-owned shares without market disruption, is critical for managing overall public finances. The government will obviously have to be careful that the additional sale of shares in listed SOEs does not unduly depress asset prices. Should that be perceived as a serious risk, the securitization of assets may be employed as a technique to defer share sales until a later date and finance “transition debt” with bonds in the meantime. This underlines the critical importance of promoting the development of domestic debt markets in parallel.

The financial tightrope that China will have to walk in the coming years presents enormous challenges. Successful resolution of the “transition debt” problem requires sound fiscal development as well as rapid and sound domestic capital market development. Avoiding a stock exchange collapse while building confidence in the market is critical to solve financial problems of the past and to help finance future corporate investments. The dynamics of China’s reform processes suggest that the government’s current majority ownership in listed companies will gradually change to minority ownership as result of emerging financial pressures. At the same time the relative importance of the state banks in the overall financial system will gradually diminish, while the share of bank deposits in total financial assets will similarly decline.

**Constraints on the pace of new IPOs and government share sales**

The need for a further rapid expansion of the Chinese stock exchanges has to balanced against the equally urgent need for institutional improvements, greater stability in the markets, and protection of the deposit base in the SOCBs. These factors limit the rate and the volume of new IPOs. Another important factor, of course, is the limited supply of quality SOEs with audited accounts that meet the (rising) standards of Shanghai, Shenzhen, or Hong Kong. The Chinese government cannot afford to create a situation in which deposits in the state banks would be drawn down overly rapidly (for share

20 The combined market capitalization of the Shanghai and Shenzhen stock exchanges (including the value of Government-owned non-tradable shares in 1151 listed companies) rose from virtually nil ten years ago to well over US$580 billion in August 2001. This is an astonishingly rapid expansion by any standard. Since such a large proportion of the shares is not tradable, however, a comparison with the Hong Kong stock exchange (valued at about US$550 billion) hides as much as it reveals. Another factor that makes comparison difficult is that P/E ratios in Shanghai and Shenzhen are substantially higher than in Hong Kong, even for shares in the same mainland SOEs. If P/E ratios and share prices (for the same companies) in Shanghai and Shenzhen were about the same as in Hong Kong, the combined market capitalization of the two mainland stock exchanges would be considerably smaller than that of Hong Kong.

21 By the standards of most developed countries, the stock exchanges of Shanghai and Shenzhen were opened prematurely (in 1990 and 1991 respectively) in the sense that trading started before a proper legal and regulatory framework had been established. There has been much improvement in the meantime, but disclosure, supervision and transparency standards are not yet comparable to those in most developed countries. A Trust Law was recently enacted. A mutual fund law and an investment law are under preparation.
purchases or other purposes), because those deposits are critical for the protection of the liquidity of the state banks under current circumstances. The deposit base remains very large relative to other financial assets in the country and a very large proportion of it (about 70 percent) is accounted for by private depositors.

The main constraints on expanding equity markets in China does not lie on the demand, but on the supply side. There is a shortage of high quality companies to be listed. CSRC has to make every effort to ensure that new listings meet adequate standards. On average during the past 12 months, 10 new companies were listed on the domestic exchanges. Only one company was de-listed, but others may follow under new, more stringent regulations issued recently by CSRC. On the demand side, the government is preparing a scheme that would allow qualified foreign institutional investors to buy limited amounts of A shares. This would amount to a partial liberalization of the capital account which is consistent with WTO commitments. Under current conditions, it is unlikely that foreign investors would buy large blocks of existing A shares, since they are generally overpriced. It is possible, however, that well priced IPOs would be facilitated by this move and that the rate of new listings could be increased if supply is available.

The supply of equities in non-state enterprises has been very small so far, but may increase rapidly if and when the government proceeds with a plan to open a second Board in Shenzhen for private enterprises, particularly in the high-tech sectors. Plans for such a Board have been delayed for a number of reasons, including fear that market instability would be too great.

**Restructuring the four large SOCBs**

In accordance with WTO provisions, it is likely that many new private banks – both foreign and domestic - will enter China’s domestic market over the next 3-5 years. This will increase competition for quality borrowers, deposits and financial services and thus enhance financial sector reform and modernization. However, the market share of the four large SOCBs is likely to remain dominant during this period. For the overall reform effort it is therefore of great importance to select a strategy for those banks that is fully consistent with sector requirements.

Because of their size (all four are among the fifty largest banks in the world in terms of assets), their large number of branches, large number of staff (ICBC, the largest of the four, had some 500,000 staff a year ago), and relatively poorly developed management information systems, they are extremely difficult to manage. It may be advisable to break some or all of them up into smaller units that could reform at unequal speeds, depending on their location and management capability. This approach would facilitate re-capitalization and privatization. NPLs that remain on the balance sheets of the four large SOCBs could be centralized in a non-bank holding company. Smaller state banks located

---

22 Even if there is a further delay in establishing a new Board for private enterprises in Shenzhen, it would make sense to consider consolidating the existing stock exchanges of Shanghai and Shenzhen into one exchange.
in areas where competition from foreign and private domestic banks is likely to intensify could be equipped with adequate capital, management and staff first.

Smaller state banks may enjoy less national prestige and have less market power, but they will be easier to privatize than very large, unmanageable banks. It will also be easier to enforce quality standards through banking supervision. BOC is the first of the four that is preparing for the listing (in Hong Kong) of its consolidated international holdings. Like in the case of SOEs, the government will undoubtedly wish to retain a majority share in the listed company, at least initially. A successful BOC IPO will be a breakthrough of great importance and set the stage for follow-up IPOs by other state commercial banks. The other three large ones (ICBC, ABC, CBC) do not have significant international holdings. Once their balance sheets are substantially cleaned up, further re-capitalization through privatization may become a realistic and attractive option, especially if the units to be listed, or offered for partnership in direct negotiations, are smaller units.

The franchise value of domestic branch networks of state banks, even smaller units, could be considerable. Some foreign banks or new private domestic banks interested in retail banking in China, may find it more attractive to buy into an existing branch network, than having to build one from scratch. Franchise value is a resource that could be exploited in financial sector reform. This asset would be easier to mobilize for regional branch networks than for national ones. Potential franchise values are not included in the balance of central government assets and liabilities in the preceding section of this paper.

Washington, D.C. 29 September, 2001