Part IV

Future Challenges for China

From: China's Role in Asia and the World Economy - Fostering Stability and Growth,
FONDAD, December 2003, www.fondad.org

16

Financial Challenges in China

Xie Ping

Thinking about the future role of China and the reform of its financial sector, I would like to say something about the issue of non-performing loans. This is a very hot topic inside the central bank, and it raises intense discussions. How can we settle the problem of non-performing loans of the big four banks? Some people say the government should pay the bill and transfer the non-performing loans to the asset management corporations. But this has not yet been decided because lately something has changed. China's big four state-owned commercial banks had a very good performance last year.

Why did they perform well? First, total loans have increased by 14.14 percent last year. Second, because the deposit interest rate is much lower than the loan interest rate.

The big four banks were very profitable last year. They increased their lending by nearly one trillion Chinese yuan and were able to write off a lot of bad loans. So the Ministry of Finance said: 'You can continue to use your own profits to write off your bad loans.' If the Bank of China, the Industrial and Commercial Bank of China, and the China Construction Bank can maintain this rate in writing off bad loans in the next five to seven years, maybe they can solve the problem themselves. The presidents of these three big banks have declared that their banks will become publicly listed companies in the next three to five years, and they see a promising future for their banks. However, another big bank, the Agricultural Bank of China, has some problems.

The central bank and the government are confused about how to

From: China's Role in Asia and the World Economy - Fostering Stability and Growth, FONDAD, December 2003, www.fondad.org

deal with the non-performing loans. We continue to give some preferential policies to commercial banks in order to cut non-performing loan transfers. We also continue to give some subsidies and we maintain a big spread so that the banks themselves can reduce the non-performing loans in the next five or seven years.

Another challenge for the future is capital account liberalisation. We have no timetable, nor do we have a very clear target. This is, in fact, an odd situation because China's foreign reserves have accumulated dramatically after we entered the WTO and promoted the operation of foreign banks in China. If the capital account cannot be liberalised after 2006, it means that the costs of capital account liberalisation are very high.

For example, last year, some foreign banks issued foreign currency credit cards to Chinese citizens. Normally speaking, Citibank Shanghai cannot conduct this business, but the Citibank branch at Shanghai simply says: 'It is not our business, it is the branch of Citibank in Hong Kong conducting this business.' What happens is that the Hong Kong branch every month just ships the money to the Shanghai branch, and Citibank in Shanghai says, 'We are not in the foreign currency business, we are just acting as the agency for the Citibank in Hong Kong.' There are a lot of businesses like these.

This means that we are almost creating an open capital account, because Chinese citizens can use foreign currency credit cards. I can go to New York and buy anything I want – a hamburger or stocks on the New York stock exchange. This means that foreign banks can do much business. The information-technology is so advanced that it is very difficult, almost impossible to stop this business. Therefore, I believe that capital account liberalisation is inevitable and will be fulfilled much more quickly than we expect.

The third challenge for the future comes from the observation that you cannot have an independent monetary policy, a fixed exchange rate and free capital flows. Because if capital flows freely, and China wants to maintain an independent interest rate at the same time, you will have difficulty in keeping the exchange rate fixed. This is yet another very big challenge to the Chinese government and the central bank.

Currently, we have at most fixed exchange rates between the Hong Kong dollar, the Chinese yuan and the US dollar. But if China's exchange rate changes, we don't know what might happen in Hong Kong. So the central bank is very careful about the exchange rate regime.

The fourth challenge is the domestic government bond market. In China, we have a very big domestic government bond market, which consists not only of Treasury bills, but also of policy bank bonds. The central bank issued a lot of bonds in the last few years, which are almost like Treasury bills. We call this whole market the government bond market. Who buys the bonds? Mainly the big four banks. The big four banks bought almost two trillion yuan of government bonds in the last few years. Why did the big four make large profits? Because they bought government bonds, and the balance is increasing very quickly since we have a lot of foreign reserves. China has a lot of domestic savings too, which are held almost completely by the big four banks. They use the money to buy government bonds, and to make loans to households, state enterprises and the private sector. Mortgage loans have become important business in China, especially the last few years. The banks now have a good quality portfolio.

My last point with regard to the future financial challenges of China concerns the not clear agenda of domestic interest rate liberalisation. The banking deposit and the banking lending rates are still controlled by the central bank and there is no clear agenda yet of how to liberalise the deposit and the loan interest rates. It will require a discussion with a long-time horizon, which we have not had yet.

17

A Seven-Point Policy Proposal for Sequencing China's Financial Liberalisation

Masaru Yoshitomi

The Asian Policy Forum and the Asian Development Bank Institute have recently developed a risk-based approach to sequencing financial liberalisation and economic reform, as a part of its goal to explore appropriate development paradigms for post-crisis Asia.

Our approach sets pragmatic guidelines by identifying risk profiles for each step of specific liberalisation measures that may arise, and gauges these new risks in relation to overall systemic risk. In the case of China, we have developed a seven-point proposal[1] which gives top priority to restoring banking sector solvency through prompt resolution of large non-performing loans (NPLs) in the state-owned commercial banks (SOCBs).

Our first proposal is to substantially restructure the large state-owned enterprises (SOEs) and achieve successful privatisation. Second, we propose to stop the ever increasing NPLs by promoting market-based risk management, ownership diversification and clear property rights. Due to China's successful dual-track strategy for reform over the past quarter century, the ownership structure of SOCBs and SOEs has already been fundamentally changed, which

[1] ADBI, "Policy Proposals for Sequencing the PRC's Domestic and External Financial Liberalization", October 2002.

From: China's Role in Asia and the World Economy - Fostering Stability and Growth, FONDAD, December 2003, www.fondad.org

resulted in a very large accumulation of private savings and the development of strong entrepreneurship. Because re-capitalisation of the banks and establishing a minimum social safety net will require large fiscal commitments, it may be difficult to maintain fiscal sustainability. To avoid monetisation of the public debt, our third proposal therefore is that the central bank should be made independent from state interference, and that financial supervisory agencies should be given full independence to enforce legal, judicial, and prudential regulations over financial institutions

These first three points of our proposal should enable the Chinese authorities to effectively address the new risks entailed by domestic and external financial liberalisation. New risks arise because financial liberalisation expands both lenders' and borrowers' opportunities and may result in excessive risk-taking, particularly when coupled with an expansionary macroeconomic environment. Managing excessive risk-taking behaviour necessitates new institution building, which, however, generally tends to advance with a lag. Domestic financial liberalisation of interest rates should, in our view, be sequenced from lending to deposit rates and from long-term to short-term maturities. A carefully phased approach will provide banks with sufficient time to develop new profit-making opportunities compatible with their capabilities of managing such new risks – which is our fourth proposal. Relaxing domestic entry requirements for banking and other financial service industries would create a large number of new banks and also non-bank financial institutions who might engage in excessive risk-taking activities. Our fifth proposal therefore is that China develops an entry strategy which encourages reputable foreign participation, as a means of introducing better risk management skills and a credit culture to the domestic financial sector.

In our view, China should be cautious with opening the capital account. Given the current status of core institutions, further capital account opening, particularly for short-term, foreign currency denominated international capital movements, should not be on the short-run policy agenda. Ill-prepared capital account opening can exacerbate both maturity and currency mismatches, thereby increasing the possibility of twin financial crises (withdrawal of international liquidity, and domestic banking crisis). Such mismatches were the crux of the problem behind the Asian capital account crisis of 1997-1998. However, policymakers must also be

From: China's Role in Asia and the World Economy - Fostering Stability and Growth, FONDAD, December 2003, www.fondad.org

aware that domestic banking and financial services liberalisation (particularly via accelerated foreign bank entry, within the context of increasingly globalised financial markets and rapid financial products innovation) will speed up *de facto* capital account opening. This phenomenon underscores the need to speed up the establishment of the sound core institutions that would mitigate and better manage these double mismatches and twin crises – which is our sixth proposal.

When freer international capital flows are allowed, a more flexible exchange rate regime should be introduced to cope with the so-called "trilemma problem" of maintaining free capital flows, independent monetary policy, and a fixed exchange rate at the same time. Given the shallow nature of financial markets in China, large capital flows could easily translate into excessive volatility of China's exchange rate and domestic asset prices. Hence we propose a midway exchange rate regime between a free float and hard peg. Furthermore, because of the possibility of severe twin crises driven by currency depreciation and balance sheet deterioration over very short time spans, regional lender of last resort facilities should also be established with the help of China's active participation to prevent the collapse of exchange rates owing to a capital account crisis.

Thus, our seven-point policy proposal for China's financial liberalisation consists of (i) a strong banking system, (ii) robust core institutions, together with (iii) a flexible midway exchange rate regime combined with regional lender of last resort facilities, as well as (iv) sustainable macroeconomic policies, in a new era of domestic and external financial liberalisation after China's accession to the WTO.

18

The Future Role of China

Choong Young Ahn

I would like to talk about the Chinese economic profile and its impact on the regional as well as the global economy, by extending the time horizon two decades or even longer than that, say 25 years later.

Anytime I visit China, I see there exist 25 different countries of South Korean population size and varying from the peasant economy of the highland to the very sophisticated economy observable in Shanghai or in Shenyang. Therefore, the development literature describing China´s economic transformation process must be rewritten totally, dividing from the usual pattern of the stages of industrial growth.

I would like to make essentially five points.

China's Role in Continuing the East Asian Miracle

In China we can observe a true full-set economy from one province to another. Ranging from totally labour-intensive agricultural activities to all the way to send a mission to the moon, as well as building a Chinese colony in Mars, as China´s space scientists predicted. Therefore, to describe the future role of China, it must be perceived from very diverse and different perspectives from the normal wisdom we apply to a standard size of a country.

Because of the market size and labour-cost advantage, China is likely to grow at least 7 to 8 percent for another two decades or even more than that. Despite of what is going on in the world, and

From: China's Role in Asia and the World Economy - Fostering Stability and Growth, FONDAD, December 2003, www.fondad.org

irrespective of the outcome of the Iraqi War, China is likely to continue to grow. This has enormous implications for the region as well as for the global economy. In sum, China is going to change the economic landscape of not only East Asia but also of the entire world in the next two decades or so. According to a study done by the World Bank, China will nearly equal the GDP of the United States in terms of purchasing power parity in the next two decades or slightly longer than that. As a consequence, China is going to have an enormous impact on the global economic picture.

Observing the deepening and enlargement process of the European Union, which is extending its membership to ten additional countries by 2004, and observing the intended expansion of NAFTA to cover the entire Latin American region, East Asian dynamism will depend on how we can trigger intra-regional demand. In this context, I think the East Asian countries, especially the countries in North East Asia, are very fortunate to have a growing China, with such a great potential, as an immediate neighbour. This must be seen as a blessing rather than a threat, provided that these neighbouring countries are going to adjust their economic system and make sure it will be more competitive than before. I think that China is going to trigger the East Asian dynamism on a continuous basis so that we can continue to generate "the East Asian miracle" that we observed in the 1970s and 1980s.

As a result of joining the WTO in 2001, China can enjoy an additional 3 to 5 percent points of GDP higher than if it had not joined the WTO. The accession to WTO is a great blessing for China, which enables it to continue its own growth momentum and dynamism. However, it also provides a great challenge for China as a full member of the WTO. According to a KIEP study, China´s trade value will double within the next five years. In that sense, China is perhaps the greatest beneficiary of the WTO accession. A disturbing factor of China´s WTO accession is that China will become a more trade-oriented economy and that the trade disputes between China and its trading partners are likely to increase. For example, last year no country in the world was at the centre of more anti-dumping investigation than China. About a total of 18 cases were raised and in the same period there were 9 cases of anti-dumping measures imposed upon China´s export goods by various trading partners. Now that China is a full member of the WTO, a potential trade dispute should be resolved within the multilateral trading system. In this regard, I think that China should carry on the standardisation and harmonisation of its legal and regulatory framework so that a trade dispute could be resolved harmoniously and will not cause trouble. I really hope that the kind of trade disputes experienced in the last two years, like the case that happened between Korea and China, will be avoided by means of a very concerned private sector. The settlement mechanism, for example, that China and its trading partners may form could be a private level dispute settlement mechanism which carries on a candid dialogue and points out some early warning signals. I think China will take full advantage of the WTO membership and will make a maximum effort to avoid a potential trade dispute with its neighbouring countries.

A Stable Exchange Rate Regime

Talking about the exchange rate regime, a long-term goal of the exchange regime in China is to reach free exchangeability of the RMB. Of course, to open up the capital account a country needs to wait until it meets certain macroeconomic conditions such as a stable macroeconomic climate and a healthy financial system. It might take some time, even a long time before the maturity of the macroeconomic conditions can ensure the free exchangeability of the RMB, but in due course I believe a partially free exchange rate mechanism with RMB in the near future can be expected from China.

China should continue to work with a stable exchange rate system to avoid a potential competitive devaluation, the phenomenon that we experienced in the early 1990s and which triggered part of this Asian financial crisis. As China becomes more trade oriented and tries to accumulate a trade surplus while adjusting to a free exchange scheme, maybe we run into exchange rate volatility especially between the RMB and the Japanese yen and perhaps along with the Korean won. So the future role of China should be: how can we work together to ensure a stable exchange rate mechanism.

Capital-Intensive Industries

The third point I would like to raise is related to the overcapacity problem. China will continue to pursue its own version of import-substitution policy towards the extremely capital-intensive industries such as iron, steel, ship-building, semi-conductors and automobiles. Of course, the number of foreign companies may evolve in this process but the point I am raising is that because of the low-cost advantage China should be able to produce a low-price and high-quality product in these areas. But in a macroeconomic sense, this will cause what we call a deflationary pressure on the neighbouring economies and exert a downward pressure on the general price level. The point I want to make is that can we talk about a concerted investment strategy on the part of China on the long-term horizon, in ship-building, iron, steel and semi-conductors. However, Japan and Korea together already are capable of producing enough to supply world demand. So if China joins to meet the potential demand on China's domestic market, the already existing capital stock in these industries is likely to augment to such an extent that it may cause a global downward pressure on the price level. So Korea, China and Japan should work on an internal division of labour in these capital-intensive industries.

China and Japan Competing for Regional Hegemony

The next point I want to catch upon is the competition of free trade agreements (FTAs) engineered by China, Japan and Korea. In October 2001, at the ASEAN+3 meeting in Singapore, China proposed an FTA with ASEAN. That really surprised a number of East Asian economists. In response to China´s initiative, Japan also proposed an FTA with ASEAN, which generated FTAs with five key countries last year.

It seems to me that China and Japan are competing in concluding FTAs with ASEAN members. South Korea proposed the formation of an East Asian Free Trade Agreement. The question that I am putting out is: Are China and Japan struggling for the regional hegemonic leadership by proposing FTAs competitively to the ASEAN member economies? There is a very powerful overseas Chinese community in a number of the key ASEAN member countries ranging from Malaysia, Indonesia to Thailand, and those overseas Chinese businessmen are the early pioneers who brought the green field FDI in China. So there is a very strong relationship between the overseas Chinese business community and China. The regional economic leadership struggle between Japan and China could be very harmful for the East Asian integration process. Perhaps it could lead to a spaghetti bowl of FTAs deviating from the original purpose of facilitating intra-regional trade. We need to work on a truly cooperative basis rather than carry on with this regional leadership struggle.

Political Pluralism and Socialist Market Economy

A final point I would like to make is that China will continue to pursue its own version of the socialist market economy to achieve the welfare society upfront. However, to become a truly advanced nation by the year 2050 the fundamental question I have always in mind is: Can China realise its own version of a socialist market economy without political pluralism? In other words, I think that a multiparty system should come into the picture to ensure that the market economy and political pluralism can work together to represent the various interests of society segments.

As Fukuyama mentioned in his book *The End of History*, many believed that in the post-cold war period, the political democracy and the market economy should work side by side. I think that the future role of China, in the long term, depends on how China is going to combine the market economy and political democracy.