THREAT OF BANK COLLAPSE IN CHINA

by

[redacted]
PGIP Class 2004

Unclassified thesis submitted to the Faculty
of the Joint Military Intelligence College
in partial fulfillment of the requirements for the degree of
Master of Science of Strategic Intelligence

July 2004

ABSTRACT

TITLE OF THESIS: Threat of Bank Collapse in China

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CLASS NO. PGIP 2004 **DATE**: July 2004

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This study examines the likelihood of bank collapse in China and the security implications of this phenomenon. Although it has long been established that bank-driven economic crises have inherent political effects, various political factors including China's dependence on economic growth for political legitimacy will likely make such a crisis extremely destabilizing. Moreover, China's particular economic development strategy has guaranteed that a bank crisis event will also have potent destabilizing effects in neighboring countries, relations between Taiwan and China, and many developing nations who have become dependent on Chinese growth for increased national revenue.

China's banking system is extremely fragile and highly unstable. An exploration of the current health of China's banks reveals that they exhibit nearly every instability indicator provided in the analytical framework used to evaluate the banks. In fact, a robust policy framework is what likely keeps the banks from having already collapsed. Although an ambitious reform effort is underway, this study assesses that its effect will be limited due to the time-limited aspects of its design and institutional challenges such as regime behavior and autonomous local elites.

This thesis argues that bank collapse in China has a high probability to occur in 2007, when reform-related, fiscal, and policy-limiting factors are likely to converge to create an implicit deadline for banking reform.

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CHAPTER 1

INTRODUCTION

Through a development strategy heavily dependent on stable economic growth for political stability, the Chinese Communist Party (CCP) has, in the last quarter-century, made China the sixth-largest economy in the world with an average annual rate of growth at about 9 percent GDP.[1] China is now the fastest-expanding market for U.S. exports and its demand for raw materials has helped to drive up global prices on commodities to multi-decade highs.[2] As much as this development trajectory has been remarkable, it also has been necessary in retaining the right to govern. Since the failure of Mao Tze-Tung to generate development and legitimacy through ideology, the CCP has turned to economic growth to buttress its political legitimacy and create the terms on which development can thrive.

Although a quarter-century of growth has managed to improve the economic circumstances of most Chinese and maintain the legitimacy of the CCP, this development strategy may be threatened by the terminal health of China's banking sector. China's overwhelmingly bank-dependent financial sector is already insolvent, and is only buoyed from collapse by a protective policy framework. The Economic Advisor to U.S. Pacific Command describes China's dire financial circumstances stating that its "impressive

[1]China is the world's sixth-largest economy at market exchange rate; measured on a purchasing power parity basis, China is the second-largest economy in the world.

[2]Bureau of East Asian and Pacific Affairs, U.S. State Department, *Background Note: China*, Report, March 2004, URL: <www.state.gov/r/pa/ei/bgn/18902.htm>, accessed 22 June 2004; Mark Gongloff, "Signs of Inflation. Or not." *CNN Money*, online ed., 15 June 2004, URL: <money.cnn.com/2004/06/14/markets/commodities>, accessed 22 June 2004.

economic superstructure . . . rests on financial quicksand."[3] China needs a healthy banking sector to maintain the strength of its economy and continue its current rate of growth. However, the depth of China's banking problems, coupled with institutional challenges is likely to overwhelm even the current reform program. As early as 2007, China may succumb to a critical bank collapse.

A bank collapse will not only have domestic economic and political repercussions, but international implications as well. Domestically, bank-driven economic instability, along with other impending political factors, will likely result in a bold challenge to the legitimacy of the CCP. Anticipating such a response as a result of economic crisis, the CCP could go so far as to pursue preemptive political reform to lessen the impending impact of a severe economic downturn. Internationally, per Alan Greenspan's own warnings, financial instability in China "would present a risk to the global economic outlook."[4] Among a wide-ranging set of possible implications, a financial shock created by the collapse of China's banks would most certainly have a tremendous impact in the economies of its regional neighbors, the political and economic outlook for developing countries which have profited greatly from China's economic growth, and the often-tense relationship between Taiwan and China.

[3]Leif Rosenberger, "Economic Development and Asian Security," paper presented at the 2003 Pacific Symposium, "Toward a Durable Regional Security Strategy," 25-27 March 2003 (Honolulu, HI: Asia-Pacific Center for Security Studies, 2003), photocopy, 3.

[4]Alan Greenspan, letter to Senator Richard Shelby (R-AL), subject: "QFR: Fragility of China's Financial System," 2 March 2004.

Chapter Summary

This study opens by examining past theoretical and empirical assertions that banks have an important role in the maturation of an economy. Inherent to their function in an economy, a healthy banking system will aid economic growth and development. On the other hand, a distressed banking sector often has a critical role in economic and political instability. Noting the challenge of monitoring such bank-related crisis, chapter 2 establishes a loose, subjective framework of instability indicators for analyzing the health of a banking sector.

Chapter 3 focuses on the evolution of China's current development trajectory, asserting that economic growth – driven by foreign investment and banking – has become central to the government's political legitimacy since the failure of Mao. China needs economic growth to maintain the party's monopoly on political power, exacerbating the political effects of any economic slowdown or collapse.

Given the unlikelihood of a rapid contraction of foreign investment in the near-term, chapter 4 examines closely the latter of the two growth drivers to find that China's banking system is in poor condition. The sector exhibits most of the microeconomic instability indicators established in the second chapter. Although the banking system has not yet collapsed due to a credible policy framework, its dysfunction has certainly affected the macroeconomic environment by fueling equity bubbles and a ballooning money supply.

Chapter 5 explains the current reform effort to improve governance and recapitalize the banks. Reflecting the innovation of China's technocratic elite, the strategy includes leveraging foreign investment and securities markets to improve governance, and diversifying sources of equity to lessen the requirements for a government sponsored-bailout.

That said, chapter 6 assesses that this strategy as stated is unlikely to succeed. China's strategy of foreign investment is driven by a policy framework that will likely force competition in 2007 before the domestic banks are ready. Additionally, upcoming fiscal obligations in the same year will likely limit the government's freedom to undergo recapitalization efforts and weaken the policy framework so critical in keeping the banks from immediate collapse. The convergence of both issues should pressure most of the reform plan to be completed by 2007. However, this will be extremely challenging to a regime that may find rapid, untested change difficult and strong opposition from local governments with a long history of autonomy.

This thesis concludes by discussing the domestic and international implications of a bank collapse. Domestically, economic distress due to bank failure will not only have political effects because of the party's reliance on economic growth for legitimacy, but the effects will be intensified by other political factors including the 2008 Olympic Games. China is unlikely to avoid these political effects without preemptive liberalization of its political sector. Unfortunately, the international implications of a banking collapse will be more difficult to preempt. A bank collapse in China will have significant regional repercussions for its neighboring countries and the relationship between China and Taiwan, as well as destabilize developing countries reliant on Chinese growth to keep their own fragile economies afloat.

CHAPTER 2

BANKS, ECONOMIC CRISIS, AND MONITORING

In perhaps the greatest challenge of development, countries like China must rely heavily upon their banking sector to drive successful economic development, and at the same time, acknowledge that it is the most fragile and crisis-prone piece of their economy. Indeed, banking sectors across the globe are notorious for sparking expensive economic crises with potentially regime-changing political ramifications. To the chagrin of the developing world, predicting when a banking sector will collapse to produce untenable economic effects is incredibly difficult. Present-day analytical methods largely help to assess the *potential*, vice the *timing* of these events. For China in particular, bank monitoring is a subjective art of analytical judgment based upon a balance of policies on one hand and instability indicators on the other.

Critical Role of Banks in Economic Development

Banks are the cornerstone in many country’s financial infrastructures. Although a bank’s full range of financial intermediation roles differs across countries, they almost always serve a central purpose of financing production at a scale unavailable to traditional sources of capital, and at a level of risk impossible to achieve by individual investors. Particularly after the Industrial Revolution and the advent of economies of scope, scale and technology, a company's need for capital has most always outpaced its own ability to acquire it through individual savings or socially-based partnerships. Banks have found their niche in meeting such capital requirements. As financial intermediaries, they accumulate capital for investment by pooling a diverse number of deposit holdings, and then provide funding to promising ventures by leveraging their intimate financial knowledge of lender. Because they pool capital from multiple depositors, they are able to meet capital needs better than an individual or community. Further given their specialization in lending, and special access to a company's records as the evaluator of a future enterprise, banks leverage this advantage to reduce information risks inherent to any lending transaction. On a national scale, the collective effect of such banking activities theoretically ensures that an economy allocates capital productively, sustains profitable enterprises, and generates new growth. Essentially, banks serve to get money to enterprises that will provide the highest rate of return (and away from poor performers), ensure good companies have enough working capital to continue progressing, and provide seed money for new business ventures. Some nations have built their financial infrastructure on this kind of bank-based system; namely, countries like Germany, Japan, and China. Others, like the U.S. or U.K. aggressively maintain and regulate a banking system, but rely much more upon a securities market-based system. Although the verdict is out on which system (or what kind of hybrid system) is intrinsically better in managing a nation's capital, banks have retained an important share of nearly every economy due to their historical precedent in financial systems and general effectiveness in meeting this market niche.

A voluminous amount of theoretical and empirical research has shown that banks play an influential role in how a nation's economy develops and the rate at which it grows. Theoretical and empirical research in the last half of the 20th century has closely examined the relationship between the financial sector of a country and economic growth.

Much of the current understanding of the role of banks and financial systems in development is underpinned by four seminal works in the late 1960s and early 1970s written by Rondo Cameron, Raymond Goldsmith, Ronald McKinnon, and Edward Shaw. In 1967, Cameron used subjective evaluations of 7 historical case studies in *Banking in the Early Stages of Industrialization* to illustrate the role of banking in positive economic growth.[1] He established a historical relationship between the development of banks and the process of industrialization. Goldsmith, in *Financial Structure and Economic Development* followed two years later with a seminal analysis of data from 35 countries to defend the relationship between economic growth and financial development.[2] 1973 gave rise to two important texts on this subject – McKinnon's *Money and Capital in Economic Development*, and Shaw's *Financial Deepening in Economic Development*.[3] Both texts served as major attempts to argue the fundamental importance in reforming financial infrastructure to generate development. As a matter of policy, both authors debunked a popular reliance on foreign aid and advocated competitive banking reform as a critical priority for sustainable development. Their work helped to show that banks are important for the financial discipline and domestic entrepreneurial development that makes economic growth sustainable.

[1]Rondo Cameron, *Banking in the Early Stages of Industrialization* (New York, NY: Oxford University Press, 1967).

[2]Raymond Goldsmith, *Financial Structure and Economic Development* (New Haven, CT: Yale University Press, 1969).

[3]Ronald McKinnon, *Money and Capital in Economic Development* (Washington, DC: Brookings Institution Press, 1973); Edward Shaw, *Financial Deepening in Economic Development* (New York: NY, Oxford University Press, 1973).

Among recent works that have added further depth to these influential texts, Robert King and Ross Levine contributed to a deeper understanding of financial sector effects with a notable 1993 empirical study. They analyzed data across 80 countries to further establish that the state of a nation's banking sector not only has a significant effect on economic growth, but also on the *rate* at which it grows.[4] Indeed, the state of a banking system is influential to a nation's economic progress – both in relation to its sustainability, as well as its pace.

Banks: Prone to Instability and Crisis

Unfortunately, the nature of banking services has proven that the sector is historically fragile, and prone to instability. The *Economist*, in its typically constrained hyperbole, goes as so far as to say in a recent survey:

> Banks have proved themselves to be the most hazardous economic institutions known to man. Breakdowns in banking lie at the center of most financial crises. And banks are unusually effective at spreading financial distress, once it starts, from one place to another.[5]

Banks are fragile because of the nature of their core business – to borrow money from their depositors in order to finance loans to other enterprises. Not only do they do so with the promise to pay out the full amount of any deposit from any depositor on demand, they also rely upon the loan recipients to pay according to their contract. As a result, banks

[4]Robert King and Ross Levine, "Finance and Growth: Schumpeter Might Be Right," *Quarterly Journal of Economics* 108, no. 3 (August 1993): 717-737.

[5]Clive Crook, "The Trouble With Banks," in "A Survey of Global Finance," *Economist*, 1 May 2003, URL: <www.economist.com/displayStory.cfm?Story_id=1730399>, accessed 27 April 2004.

are heavily reliant on their ability to manage risk between the depositors and loan-holders. Instability on either side can cause a bank to crash. Indeed, if enough depositors remove their funds from a bank simultaneously, the bank will fail. Alternatively, if enough firms default on their loan payments to meet the operating threshold of the bank, it can also fail.

In the former case of depositor-side failure, the most common cause of collapse is a run on deposits. A run on deposits is a mass withdrawal of funds by depositors, whether through a full accounting of the financial circumstances of the bank, or simply a panicked loss of confidence. Such runs often have a mob psychology-like momentum about them that is difficult to reverse. The individual depositor hopes the mob knows something that he does not, and follows its movement simply in fear he might be left behind. If the run generates enough market-wide panic, the effects of a run on one bank might spread to another, and so forth, thus leaving the entire sector in ruins. Such a run on deposits decimated U.S. banks after the New York Stock Exchange crash of 29 October 1929. The downward spiral generated by the bank run made the subsequent Great Depression the darkest economic downturn in U.S. history.

In the latter case of loan repayment failure, the consequences to the health of a bank depend on the overall scale of the non-performing loans. If enough firms fail to repay their loans, banks are forced to cut back lending to recoup capital, therefore reducing available funding for other businesses. This can create a downward spiral where banks cut financing, firms cut back on production, and as a result the firms lose scale-advantaged profitability – leading to another potential loan loss for the bank and so on. The collapse of a single bank, because it has fallen irreversibly into negative net worth, can have significant repercussions. Depending on the state of the economy, firms that have lost financing from bank collapse may not be able to find new sources of financing quickly enough to maintain a healthy state of operations. A domino effect of unstable firms and their respective banks can quickly result in an economic crisis.

A crisis in a banking sector can be devastating to a nation's economy. Table 2.1 outlines some of the findings of a seminal study examining banking crises from the late 1970s to the early 1990s. The findings show that the cost burden of a banking crisis can be catastrophic to a country's financial health. Given that only 7+ percent GDP growth is considered by most measures a phenomenal rate of growth, an unproductive transfer of even a few percent GDP in one year due to restructuring is a costly situation. Even a relatively short crisis may spike unemployment, cause drawdown on a nation's social welfare net, and have long-term consequences on increased public debt financing. In cases like Argentina and Chile, where the equivalent to 40-60 percent GDP was transferred to bail-out the financial system, the result can be fuel for social and political chaos. Table 2.1 further illustrates the diversity of banking crises. The range of national representation on the table suggests that no region or economic tier of states is invulnerable to bank sector troubles. Indeed, although Japan is one of the world's most powerful economies, it has so far expended over 20 percent of its GDP on restructuring as a result of a continuing banking crisis.[6]

[6]Patrick Honohan and Daniela Klingebiel, *Controlling the Fiscal Costs of Banking Crises*, World Bank Study, Working Paper No. 2441, September 2000.

TABLE 2.1
The Cost of a Banking Crisis, Selected Countries

Country	Period	Length (years)	Cost (% GDP)
Argentina	1980-1982	3	55.3
Chile	1981-1983	3	41.2
Israel	1977-1983	7	30.0
Cote d'Ivoire	1988-1991	4	25.0
Uruguay	1981-1984	4	31.2
Venezuela	1994-1995	2	18.0
Spain	1977-1985	9	16.8
Mexico	1995	1	13.5
Tanzania	1987	1	10.0
Finland	1991-1993	3	8.0
Sweden	1991	1	6.4
Norway	1987-1989	3	4.0
United States	1984-1991	8	3.2

Source: Gerald Caprio, Jr. and Daniela Klingebiel, *Bank Insolvencies: Cross Country Experience*, World Bank Study, Working Paper No. 1620, July 1996.

Bank-driven economic crises are an important security issue not only for their economic effects, but their political effects as well. Substantial theoretical and empirical work in comparative politics has been devoted to the study of how economic crises trigger political instability, or more particularly, regime change. As a cumulative body of work, the studies depart from one another greatly on the varied political outcomes to economic crisis, but they generally agree that economic crisis can produce critical political effects. A widely-discussed 1973 study by Guillermo O'Donnell, for instance, describes how economic crises created a political situation that led to the breakdown of democracy in Brazil and Argentina.[7] Another study by Ekkart Zimmermann expands academic scrutiny of this phenomenon to Europe in order to show that economic crisis

[7]Guillermo O'Donnell, *Modernization and Bureaucratic-Authoritarianism: Studies in South American Politics* (Berkeley, CA: Institute of International Studies, 1973).

does result in political volatility, but specific outcomes vary across countries.[8] Studies by Edward Epstein, John Markoff, and Silvio Duncan Baretta speak specifically to the relationship between economic crisis and political legitimacy in bureaucratic-authoritarian regimes – a very relevant topic to China. Markoff and Baretta explain that economic crises threaten the inherently fragile legitimacy of authoritarian, technocratic regimes, particularly for those that maintain their right to govern through economic success.[9] According to their study, crises spark new, opposing points of view in the national discourse for successful economic development, thus increasing the level of political conflict in the regime dynamic. Epstein examines four experiences in South America to show how bureaucratic-authoritarian regimes that rely on such economic success have found it therefore extremely difficult to maintain power in an economic crisis.[10] The expression of significant opposition in light of lost legitimacy resulted in promises for new presidential elections in the authoritarian regimes of Argentina and Uruguay, and new state gubernatorial elections in highly-decentralized Brazil.

The Challenge of Monitoring Bank-Driven Instability

Although the banks' influence on an economy is well established, and their fragility understood, the science of understanding and monitoring when bank duress

[8]Ekkart Zimmermann and Thomas Saalfeld, "Economic and Political Reactions to the World Economic Crisis of the 1930s in Six European Countries," *International Studies Quarterly* 32, no. 3 (September 1988): 305-334.

[9]John Markoff and Silvio R. Duncan Baretta, "Economic Crisis and Regime Change in Brazil: The 1960s and the 1980s," *Comparative Politics* 22, no. 4 (July 1990): 421-444.

[10]Edward C. Epstein, "Legitimacy, Institutionalization, and Opposition in Exclusionary Bureaucratic-Authoritarian Regimes: The Situation of the 1980s," *Comparative Politics* 17, no. 1 (October 1984): 37-54.

might cause systemic crisis is fundamentally imprecise. A run on deposits or lending crisis may destroy a bank, or a group of banks. But if the problems identified in these institutions are perceived as – and are eventually proven to be – limited to the banks affected, such shocks will probably not cause an economic crisis. And if the overall economic outlook is fair, companies will find new lenders and depositors will find new banks. That said, a nation's banks can also be entirely insolvent, but the economy relatively unaffected because of credible government backing through an aggressive policy framework. In another situation, the banks may not be under particular institutional duress, but be driven into a crisis spiral because of outside circumstances (e.g. political nationalization of assets). In light of this multivariable balance of influences, timing a future crisis is yet a function of luck. During what is now understood as the first economic sign of the East Asian Financial Crisis of 1997-98, one academic explains that even the U.S. President with his economic entourage had dismissed the critical event only as a "few glitches in the road" to prosperity.[11] The historical study of crises has lent a similarly inexact basis for judging future banking-related crisis. In a judicious survey that compared five different studies on banking crises, the author found wide variance in how each study made key judgements on economic crisis situations, including causality, timing, and its definition.[12] The study results suggest that effective crisis monitoring is ultimately a task of individual subjective judgement. Empirical measurements of critical financial and economic indicators alone are insufficient in

[11]Joseph E. Stiglitz, *Globalization and Its Discontents* (New York, NY: W. W. Norton & Co., 2002), 93.

[12]Edward J. Frydl, *The Length and Cost of Banking Crises*, International Monetary Fund Study, WP/99/30, March 1999.

determining the timing and proximity of a crisis. As economic phenomena, banking crises can have a "you know it when you see it" quality about them – when a nation is fully immersed in one, very few watchers will dispute it. But when and how exactly a nation falls into one is at best, an artful and subjective skill of mixing the policy environment with present indicators and future prospects, and then making the best judgment possible from them.

Indicators, when balanced with an analysis of a country banking policy, help to describe a banking system in terms of crisis risk. Indeed, a crisis monitoring framework is most like a see-saw between stabilizing policies and crisis indicators. Although neither side can by itself dictate the outcome, the overall difference in weight between the two sides provides perhaps the best analytical help for an observer. When executed well, banking policy can make a tremendous impact by limiting the influence of specific crisis indicators and countering market forces to stabilize a banking system. Alternatively, a series of increasingly weighty crisis indicators can overwhelm banking policy and plunge the economy into crisis. Of course, the analyst must recognize that this is a dynamic system. Relative to the specifics of the situation, policies will affect the intensity of crisis indicators, and vice-versa.

Where policies are fairly well-defined by specific government pronouncements, crisis indicators require more definition. Crisis indicators can be organized into two broad categories – microeconomic (poor banking operations) and macroeconomic (bad operating environment). Stefan Ingves, a high-level banking crisis expert at the International Monetary Fund, provides this useful structure and a set of basic indicators to analyze the *potential*, vice *imminence*, for crisis by examining risk aspects of bank duress.[13] A summary of these indicators are provided in Table 2.2. The value of using these indicators, in contrast to a statistical study of hard measures such as capital adequacy, asset quality, and earnings, is the emphasis that these place on a more complete qualitative/quantitative analysis of the banking sector. This is particularly true in a quantitative environment where national statistics, particularly those that negatively impact China's image as a booming economic force, are constantly challenged for their accuracy. This type of holistic analysis will produce a more accurate view on the challenges that a nation must contend with in order to ensure the stability of its banking system.

TABLE 2.2
Some Indicators for Financial Crisis

Microeconomic	Macroeconomic
Poor lending practices	Lending booms
Excessive risk taking	Hot money inflows
Poor governance	Equity bubbles
Weak regulation and supervision	Excess capacity/falling profitability
Excessive focus on market share, vice profits	Sharp slowdown in exports
Unproductive policy lending	Low investment growth
Insufficient skilled staff	Rising deficits
Poor transparency	Sharp changes in exchange rates
Insufficient policies for failing banks	Weak debt sustainability

Source: Stefan Ingves, Director, Monetary and Exchange Affairs Department, "Banking Crisis From an International Perspective," transcript of remarks delivered at *Seguro de Depósitos Sociedad Anónima* (SEDESA), Buenos Aires, 8 April 2003, URL: <www.imf.org/external/np/speeches/2003/040803.htm>, accessed 20 November 2003.

[13] Stefan Ingves, Director, Monetary and Exchange Affairs Department, "Banking Crisis From an International Perspective," transcript of remarks delivered at *Seguro de Depósitos Sociedad Anónima* (SEDESA), Buenos Aires, 8 April 2003, URL: <www.imf.org/external/np/speeches/2003/040803.htm>, accessed 20 November 2003.

Conclusions

Banks bear critical responsibility for the success and pace of economic development, but are also a major cause of economic instability. As a result, the success and failure of China's banking system will have substantial implications for the nation's economic and political future.

CHAPTER 3

LEGITIMACY THROUGH ECONOMIC GROWTH

The historical evolution of China's economic trajectory lends strength to the previous assertions that banks are critical to a nation's economic development. With the miserable failure of Chairman Mao's ideological development plans, China's leadership has turned to wealth generation for political legitimacy. By reestablishing foreign investment and creating an enormous banking sector, such legitimacy has been secure because of how these elements have generated an unprecedented record of economic growth.

Failure of Mao's Ideology-Driven Economic Development Strategy

From 1949 until 1976, the Chinese Communist Party (CCP) under Chairman Mao Tse-Tung governed under the legitimacy of his socialist ideology. Mao led the country on a moral crusade of class struggle to assert "that the will of the masses, once energized, could conquer all."[1] Whereas other revolutionaries may have emphasized Marxist bureaucratic planning, discipline, cadre training, and skilled industrialists; Mao favored modernization based on populism, the stirrings of the masses, an enthusiastic peasantry, and the skill of the politically indoctrinated.[2] Economic objectives could be achieved in the same manner that Mao had so far successfully met his political objectives; in that,

[1]John K. Fairbank and Edwin O. Reischauer, *China: Tradition and Transformation*, rev. ed. (Boston, MA: Houghton Mifflin Company, 1989), 514.

[2]Fairbank and Reischauer, 514-515.

ideologically-mobilized peasants could generate rapid economic advances.[3] Mao's seeds of charismatic discourse landed on fertile soil in China. Since the collapse of the last of China's dynastic kingdoms in 1911, the geographic area now known as China had disintegrated into a shifting patchwork of provincial warlords vying to maintain their landholdings, been ravaged by the Japanese invasion, and experienced a violent civil war with one of the parties still holding power on the island of Taiwan. Supported by a history of almost 50 years of political and economic chaos, Mao had a captivated audience in the vast heartland of China.

Mao found initial success with his ideologically driven strategy, but the success turned to failure when he pushed for bolder transformation through the Great Leap Forward (GLF) campaign of 1958 to 1962. Through national mobilization efforts led by enthusiastic party cadre, Mao's China developed economic and industrial infrastructure at a spectacular rate, and by 1957 had achieved the highest rate of industrial growth in underdeveloped Asia.[4] However, the socialist transformation was assessed to be increasingly unsustainable due to agricultural stagnation and bureaucratic inefficiencies. Under the pressure of slowing economic progress, Mao announced the GLF in 1958 to further mass-mobilize its vast peasantry to meet grandiose output targets in investment and industrialization. Rural manpower would be leveraged even further for capital investment projects across the nation. Heavy industrial output – specifically in iron production – would be decentralized to rural collectives. Output targets were to be formulated by political cadre who understood better the capacity of an enthusiastic

[3]Christopher Howe and others, *China's Economic Reform* (London: RoutledgeCurzon, 2003), 3.

[4]Fairbank and Reischauer, 503-507.

peasantry. Mao projected that the GLF would enable China to overtake the UK economically in 7 years, and the U.S. in 15 years.[5]

The GLF was a critical failure. Although the mobilization furthered expansive infrastructure growth in such sectors as transportation, irrigation, urban utilities, and telecommunications, the sheer rate of growth and general lack of expertise led to profound economic imbalances and quality problems. The production quality of rural iron and steel was poor. The broad shift in rural labor as a result of the GLF, misallocated agricultural resources, and gross negligence by party ideologues monitoring agricultural output, exacerbated massive crop failure. Although the numbers are highly debatable due to the lack of credible statistics in this period, approximately 25 million people probably died of starvation in the worst famine in recorded Chinese history.[6] Industrial output plummeted in 1961 by 38 percent, and a further 16 percent in 1962 when pragmatists began to emerge out of the state bureaucracy to reorient the economy and question Mao's strategy for development.[7] The workforce had gradually become less productive, disillusioned, and exhausted.

In a struggle to eliminate post-GLF opposition and its alternative discourse, Mao mobilized a "Cultural Revolution" – this time among students and Mao's ideological faithful – to purge the CCP of his critics and the intellectual elite, and eventually dismantle the party bureaucracy. In this new revolution, Mao's economic utopianism

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[5]Howe and others, 15.

[6]Gregory Chow, *China's Economic Transformation* (Malden, MA: Blackwell Publishers, 2002), 27.

[7]"The Great Leap Forward, 1958-60," under Chapter 5 in *China: A Country Study*, online edition (Washington, DC: Library of Congress, Federal Research Division, July 1987), URL: <lcweb2.loc.gov/frd/cs/cntoc.html>, accessed 11 July 2004.

became even more idealized. During the first phase of the revolution, Mao's army commander Lin Piao dismissed balanced and realistic planning for even higher military-focused targets than the GLF.[8] Mass rallies, propaganda, and parades further dominated China's social, political and economic landscape under the cult of personality that Mao had created. From about 1966 to 1969, Mao's revolutionary enthusiasm ravaged China's government bureaucracy and the educational institutions. Over a million of China's elite were tortured and killed in Mao's ideological exhortation for violent class struggle. Even until Mao's death in 1976, the reverberations of the Cultural Revolution could still be felt in Chinese society.[9]

The declining social and economic state of Mao's China was increasingly unacceptable. Output growth was at most zero in 1974, millions of peasants and intellectuals had perished in the two revolutionary campaigns alone, and living standards for most had remained static or were falling over Mao's leadership.[10] Additionally, the contrast between China's progress and that of its neighbors had become staggering. Although China may have outpaced the economies of Taiwan, Japan, and South Korea in 1957, by the late 1970s the nation had fallen far behind in development compared to the so-called Asian "tigers." The CCP clearly needed a new pathway for development.

[8]Howe and others, 4.

[9]Fairbank and Reischauer, 519.

[10]Howe and others, 6-11.

Deng's New Course: Legitimacy by Getting Rich

By late 1978 after the death of Mao, Deng Xiao-Ping had maneuvered to lead the CCP as a twice-exile under Mao. A party moderate who broke with Mao during the catastrophes of the GLF, Deng recognized the need to create a new course for the CCP – well-distanced from Mao's failed attempt to modernize China through revolutions, campaigns, and ideology. Mao's failure to improve China had put the CCP in a crisis of legitimacy that needed to be addressed, as put by one scholar below.

> the post-Mao leadership has no longer been sure that [Mao's] ideology can generate "legitimacy as believed," given its colossal failure in the past decades' practice. In fact, CCP's ideologically-based legitimacy was in serious crisis by the end of the Cultural Revolution. A strenuous task facing the post-Mao leadership was, therefore, to brace the fractured foundations of the regime's legitimacy.[11]

Deng quickly moved to repudiate Mao and reestablish legitimacy based on the success of economic reform. Deng had no "grand blueprint for social change," rather he believed that the success of socialism would be demonstrated by China's eventual economic prosperity.[12] On a course of incremental and pragmatic reform, Deng began a development trajectory that mixed market-oriented economics with China's socialism to generate wealth.

The success of Deng's reforms brought new-found legitimacy to the CCP as China's economy began to grow at an extraordinary rate. Although exact GDP figures for China are highly controversial, most scholars and economists agree that China's real GDP has probably grown about 9 percent a year, on average, since Deng's accession to

[11]Feng Chen, Economic *Transition and Political Legitimacy in Post-Mao China: Ideology and Reform* (New York: State University of New York Press, 1995), 18.

[12]Peter Nolan, *China at the Crossroads* (Cambridge, UK: Polity Press, 2004), 6-7.

party leadership in 1978.[13] If this figure is to be believed as credible, China's growth rate is easily the fastest of any country in the world over the same period. With China's GDP now at 1.27 trillion USD at market exchange rate (vice purchasing power parity), it ranks as the sixth-largest economy in the world.[14]

Leaders after Deng have held on to his legacy of legitimacy through economic growth, and it remains an important enabler for the regime's right to govern. Most scholars seem to agree that China's economy must sustain stable growth at the 7 to 8 percent range to ensure regime stability. At this rate, income rises in absolute terms year-on-year for the vast majority of the population, from the rural poor to the urban rich. It also generates employment opportunities to replace a sufficient share of jobs lost during recent waves of state-owned enterprise (SOE) layoffs. Indeed, a stable trend of expanding income and improving employment opportunities is critical to the population's acceptance of China's non-elected party leadership. Nicholas Lardy, a prominent China expert, argued in a recent text that China's political decisions in the global economy are motivated fundamentally from the CCP's need to retain political legitimacy through continued economic growth.[15] The *Economist* has gone so far as to label China as the

[13]See numerous studies by Thomas Rawski of the University of Pittsburgh for a thorough critique showing that China's GDP numbers are inconsistent with other published statistical series. A good summary of his analysis can be found in Thomas G. Rawski, "What's Happening to China's GDP Statistics?" *China Economic Review* 12, no. 4 (2001): 347-354.

[14]International Monetary Fund, *International Financial Statistics Database*, online ed., URL: <imfstatistics.org/imf/logon.aspx>, accessed 1 May 2004.

[15]Nicholas R. Lardy, *Integrating China into the Global Economy* (Washington, DC: Brookings Institution Press, 2002).

"bicycle economy" – referring to the country's need to keep the economy moving forward just to avoid a hard political fall.[16]

Deng's Economic "Legs": Foreign Direct Investment and Banking

Among Deng's many individual economic reforms since Mao, no two changes have been perhaps more important to China's growth than the reintroduction of foreign investment and the development of a banking system. China depends heavily on these two reforms for economic success. Foreign direct investment (FDI) provides China's economy with a major source of productivity and strategic direction. A vast banking system has provided the Chinese economy with the liquidity to fuel economic progress over the last two decades.

Foreign Direct Investment

A central theme in Mao's development policy was to ensure self-sufficiency. Foreign involvement in China's modernization, whether in the context of trade, investment, or borrowing, was expressly prohibited.[17] However, such an effort not only cut off a lucrative opportunity for China to generate wealth through leveraging its comparative labor advantage in the global economy, but it also forced China to modernize without the benefit of learned expertise or existing technology. China's status as a poor nation was exacerbated by its self-isolation.

[16]"Special Report, China's Economy: Is the Wakening Giant a Monster?" *Economist*, 15 February 2003, 63-65.

[17]Shyam J. Kamath, "Foreign Direct Investment in a Centrally Planned Developing Economy: The Chinese Case," *Economic Development and Cultural Change* 39, no. 1 (October 1990): 110.

In a sharp departure from Mao, Deng Xiao-Ping pursued a development route to explicitly rely upon foreign investment for strategic direction to China's development trajectory. That said, he also pursued foreign monies with careful discretion. Eschewing higher-volume, but highly unstable international capital flows such as portfolio equity and international bank lending, Deng adopted a restrictive policy environment to attract only FDI-sources of foreign financing.[18] Deng further created four Special Economic Zones (SEZs) to attract FDI, opened 14 ports specifically for foreign trade, entered into the World Bank and International Monetary Fund, and began developing a legal tradition in China to handle contracts.[19] Ignoring Mao's warnings that a reliance on foreign investment would lead to "dependent underdevelopment," Deng began integrating China's economy into the global production cycle to generate modernization and new business opportunities for China's economic future.[20]

Deng was right – FDI, particularly in joint-venture relationships with foreign counterparts, has come to provide vibrancy and growth in China's economy. One economic scholar assess that no country in the post-World War II period has expanded its share of global trade as rapidly as China.[21] Leveraged by global manufacturing companies wanting to exploit China's labor cost advantages, China has become the

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[18]FDI is a broad category of funds that encompasses any foreign monies which are registered with the government of China and invested in physical assets, whether it may be a factory, commercial office space, technology transfer, or joint-venture activity. As a result, this type of international capital is highly illiquid and highly stable. It is especially sought-after because it often exposes domestic industries to foreign best-practices, high technology, advanced management techniques, and global production networks.

[19]Fairbank and Reischauer, 532.

[20]For a broader discussion of the concerns of this development trajectory, see Friederich Wu, "External Borrowing and Foreign Aid in Post-Mao China's International Economy Policy," *Columbia Journal of World Business* 19 (Fall 1984): 53-61.

[21]Nicholas Lardy, "Sweet and Sour Deal," *Foreign Policy*, no. 129 (March/April 2002): 20.

world's mass-production center for items such as shoes, toys, and clothing. An improving skilled labor force has enabled Chinese joint-ventures to expand into more-lucrative reprocessing and re-export businesses. Essentially, foreign affiliates are now exporting sophisticated components from their home-country factories to China for further assembly alongside Chinese partners, and then re-exporting the finished products to global consumers. China's developing comparative advantages are making this type of cross-border enterprise extremely profitable – for both foreign companies seeking larger profit margins and Chinese companies needing to learn the "tricks of the trade" from the most successful global corporations. The scale of this overall production activity is substantial. China alone accounted for 90 and 37 percent of global production growth in 2002 and 2003, respectively.[22]

Dependency on FDI has entailed some cost. In a recent interview, current Premier Wen Jiabao stated that FDI in the form of joint ventures and wholly foreign-owned enterprises contributes to about 65 percent of China's total exports.[23] In such items such as electronic circuitry, the share has risen as high as 91 percent of total exports.[24] The extent at which China is depending on FDI for its export development and modernization is provoking caution among some China-watchers. Authors such as Peter Nolan have commented on China's vulnerability to the bursting of the FDI-bubble.[25]

[22]Guillermo Perry, *The External Environment for Latin American Countries*, World Bank Study, January 2004, 5.

[23]Wen Jiabao, Premier, China, unpublished transcript, interview by *Washington Post* Editors Leonard Downie Jr. and Philip Bennett, and *Washington Post* correspondents John Pomfret, Philip P. Pan, and Peter S. Goodman, 21 November 2003.

[24]United Nations Conference on Trade and Development, *World Investment Report 2002* (New York: United Nations, 2002), 162-163.

[25]Nolan, 24.

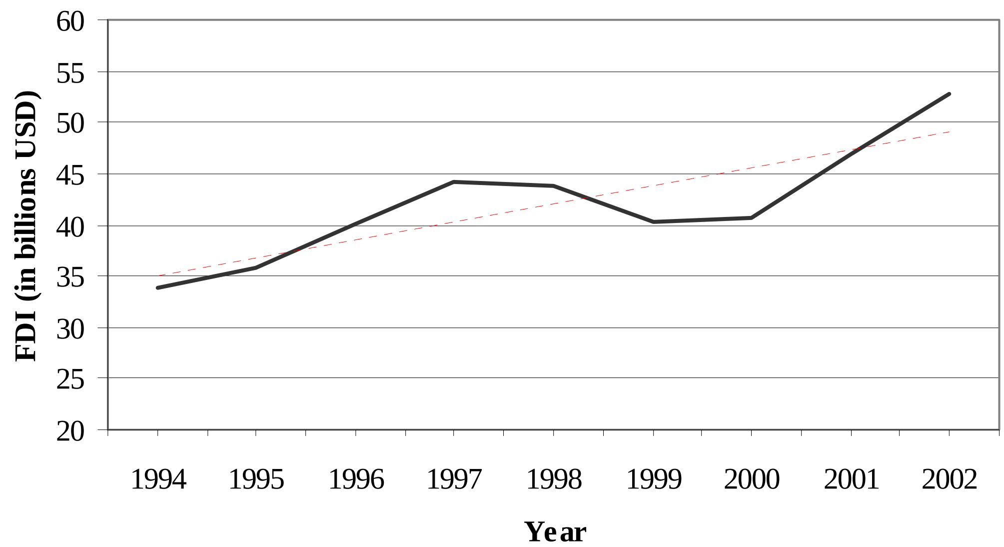
China's dependence on FDI is unlikely to be a significant destabilizing influence in the near future. The nature of FDI as a long-term, fairly permanent investment makes it relatively resistant to short-term volatility. Additionally, the flow of FDI to China has been shown to be incredibly consistent and robust, as illustrated by Figure 3.1. Whereas other nations continuously make efforts and compromises to attract flighty sources of FDI, China has largely brought in FDI *despite* challenging capital flow restrictions.[26] Despite an anemic global economic recovery in 2002 from the 2001 global recession, FDI inflows to China rose by 13 percent year-on-year to 52.7 billion USD.[27] In the context of tumultuous world capital flows, the 2002 statistical snapshot represents a profound measure of consistency to China's FDI. China achieved this investment growth despite a 22 percent reduction of FDI flows worldwide -- including a 79 percent drop in FDI to the U.S. alone.[28] In this context, Deng's FDI-reliant development trajectory for China looks very safe for the near future.

[26]Walden Bello, "China at 50: A Success Story," *Far Eastern Economic Review* 162, no. 41 (14 October 1999): 60.

[27]United Nations Conference on Trade and Development, *FDI Database*, online ed., 2003, URL: <www.unctad.org/Templates/Page.asp?intItemID=1923&lang=1>, accessed 1 May 2004.

[28]United Nations Conference on Trade and Development, *World Investment Report 2003* (New York: United Nations, 2003), 8; UNCTAD, *FDI Database*, 2003.

Figure 3.1 *FDI Inflows (1994 to 2002)*



Source: United Nations Conference on Trade and Development, *FDI Database*, online ed., 2003, URL: <www.unctad.org/Templates/Page.asp?intItemID=1923&lang=1>, accessed 1 May 2004.

Banking

During Mao's period of governance, China's banking system was collectivized into a central monobank based on the Soviet *Gosbank* system. The bank existed as an arm of the Ministry of Finance to provide short-term working capital to SOEs according to a strict central plan of output targets. Bank savings were not personal deposits, but forced savings of agricultural and industrial SOE profits and "financial contributions."[29] Its financial intermediation role was relatively simple – the bank distributed funds according to the stated requirements of the party. Under this system, SOEs had no other sources of financing. There were no financial markets or a competitive banking system.

[29]Wayne M. Morrison, "China's Economic Conditions," *CRS Issue Brief for Congress* IB98014 (Washington, DC: Congressional Research Service, Library of Congress, 29 May 2002), CRS-3.

In sum, China's monobank acted as the all-encompassing financing vehicle for Mao's ideology-based development strategy.

Although central to Mao's development plan, a banking system in such an arrangement fundamentally limited China's economic progress. By the late 1970s, government controls and output targets maintained relatively high levels of forced savings and investment, but the productivity of these funds was declining at an unacceptable rate.[30] Capital was distributed according to planned output goals, vice financial productivity measures, which in turn created an economic environment with little fiscal discipline. Indeed, any enterprise that wanted credit could obtain it from the bank by justifying it according to the central plan.[31] Not surprisingly, the economy was unsustainably inefficient. Total factor productivity, a measure of an economy's efficiency, fell at a rate of -0.78 percent each year from 1952 to 1978.[32]

Deng moved decisively to transform China's banking sector and create a capital environment where enterprises could flourish. In a decision that reflects familiarity with the modern discourse on the importance of financial systems, Deng partially liberalized the banking system to encourage development. The reforms were not to create a perfect market-oriented economy, but to provide enough of such an environment to fuel development. The monobank was split up and reorganized into state-owned banking entities. Enterprises were weaned off of budgetary grants to pursue growth through bank

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[30]Howe and others, 9.

[31]Dwight Heald Perkins, "Reforming China's Economic System," *Journal of Economic Literature* 26, no. 2 (June 1988): 617-618.

[32]Angus Maddison, *Chinese Economic Performance in the Long-Run* (Paris: OECD Development Centre, 1998), page 6 at URL: <www.eco.rug.nl/~Maddison/China_book/Chapter_3.pdf>, accessed 12 July 2004.

lending. Bank activity was broadened and financing expanded into longer-term loan arrangements. A general outline of these reforms is summarized below in the following table.

TABLE 3.1
Reforming the Banking System

Reform Period	Focus
1978-1984	Establish functional banking system
1984-1988	Establish central bank and specialized banks
1988-1991	Stabilization program to control inflation
1992-present	Deepen financial reform and commercialize state banks

Source: Donald D. Tong, *The Heart of Economic Reform* (Aldershot, UK: Ashgate Publishing Limited, 2002), 18-23.

In light of this reform trajectory, China's banking sector has become increasingly concentrated and predominant in domestic financing. Four Chinese banks now dominate the economic landscape – the Agricultural Bank of China (ABC), Bank of China (BOC), Industrial and Commercial Bank of China (ICBC), and the China Construction Bank (CCB). The four banks were created quickly after Deng's accession to diversify the central monobank into specialized issue areas. In 1979, ABC was created to handle rural banking and BOC established for foreign currency transactions. In 1984, ICBC was called upon to handle SOE banking and CCB was divested as an arm of the Ministry of Finance for long-term infrastructure projects. By the 1990s, although the banks had formally lost their policy functions, the banks have retained significant market share and clout as previous instruments of the state. Despite the introduction of joint-stock banks (public-private enterprises) and city commercial banks in the financial system, the so-called "big four" hold approximately 60 to 75 percent of the nation's banking assets.[33] They are a powerful force in the financial sector and provide the lion-share of the economy's financing. In 2000, the assets of just these four banks equaled 115 percent of China's entire GDP for the year.[34] This is hardly a surprise given the explosion in bank deposits seen as a result of Deng's reform activity. CNN estimates that between 1979 and 1999, savings had increased 220-fold from about 2.5 billion USD to 560 billion USD.[35]

By all accounts, China's financial system has actually become almost entirely bank-based. Financing via the state budget had ended almost completely by 1988. The market for private bond issue is negligible due to fixed interest rates in China. Furthermore, the stock market has often been more likened to a casino than a financial center. International sources of financing outside of FDI are still severely limited as a matter of monetary and state policy. In such a financing environment, banks have quickly become the premier source of financing in China's economy. Figure 3.2 illustrates the share of bank lending to total domestic financing from 2001 to 2003. The share of bank loans to all other sources of domestic liquidity had reached 76 percent in 2001 and 85 percent in 2003.

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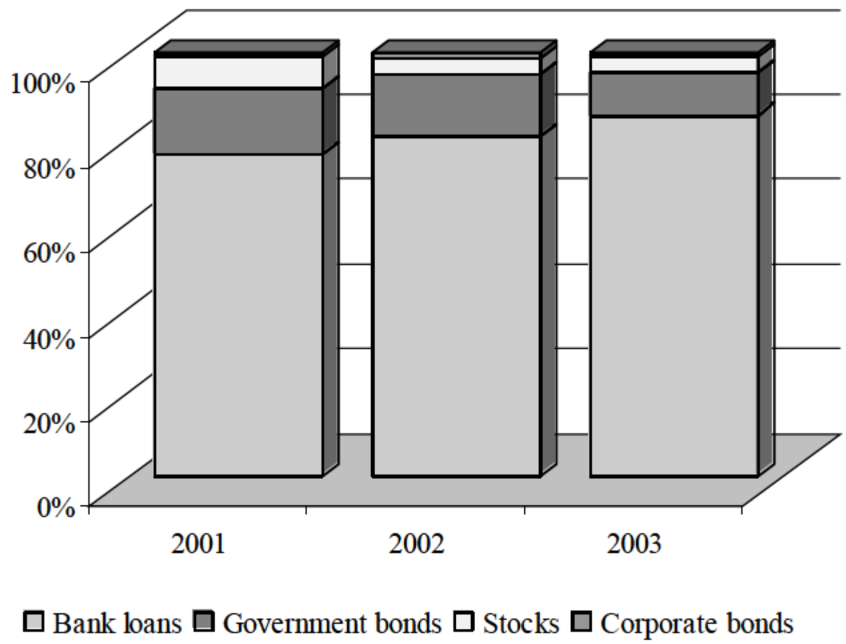
[33]The voracity of Chinese statistics is always a challenge. As a result, this number has a substantial range depending on how the figure is calculated. In similar periods, the *Economist* has stated 60 percent, while *Business Week* claims 70 percent, and *Far Eastern Economic Review* cites 75 percent.

[34]Nicholas R. Lardy, "China's Worsening Debts," *Financial Times*, online ed., 22 June 2001, URL: <search.ft.com/search/article.html?id=010622016856>, accessed 16 June 2004.

[35]Cheng Li, "Revolution Is No Dinner Party, But China's Reform Is," *CNN*, online ed., 1999, URL: <www.cnn.com/SPECIALS/1999/china.50/red.giant/communism/>, accessed 8 July 2004.

Figure 3.2 *Sources of Domestic Financing*



Source: People's Bank of China, *China Monetary Policy Report 2003*, Report, March 2004, 19.

This bank-based system has been fairly successful in meeting China's liquidity needs. More than 90 percent of China's investment-led growth has been financed by this banking system. Funding such investment primarily through this system (as opposed to financial markets or other instruments) has allowed companies to focus on long-term objectives and eschew short-term concerns such as share price fluctuations and shareholder issues. In China's particular case, this situation also allows the central government to have substantial management control over the direction and pace of the economy. Through total ownership of the major banks in China, the central party apparatus essentially controls the purse-strings of every major economic actor in the country.

That said, although domestic bank financing has proven its success as a means to fuel the pace of growth over the past two decades, it has over time, made China's domestic banks extremely frail. The accumulating consequences of this managed financing strategy have made China's most significant financing vehicle also its greatest liability. Unlike the FDI leg of Deng's modernization trajectory, China's banking system is of significant concern because of continued policy lending, excessive risk taking, poor governance, and problems in transparency and regulation.

Conclusions

In a new political environment where China is securing legitimacy on the basis of economic growth, the country has leveraged FDI and banking heavily to achieve phenomenal results. As much as these two "legs" have enabled China's past economic success, it is likely that they will also determine China's future economic trajectory. According to this study's assessment, it is highly unlikely that China's dependency on FDI will be destabilizing. FDI has been extremely reliable over past years, and the strategic nature of these types of investments makes short-term withdrawal extremely difficult.

China's dependence on its banking system is another matter altogether. As discussed, banks are notorious for sparking economic crisis, and in turn, political instability. In China's case, the banks make up the lion-share of its national financial resources. Additionally, the party's reliance on economic growth to generate political legitimacy only amplifies the liabilities inherent to a bank-reliant financial system. These factors alone should cause great caution to any China-watcher. Unfortunately, the current state of China's banking system reflects a situation where crisis is not only a cautionary consideration but likely an impending one.

CHAPTER 4

A FRAGILE BANKING SECTOR

China's banks are in a state of crisis. In the perspective of previous discussions that recognize the fundamental fragility of banks, and China's heavy dependence on its banking system to provide an environment where political legitimacy is generated by economic growth, this is an assertion of critical importance. Of particular concern is the sheer number of instability indicators exhibited in China's banking operations, or the so-called "microeconomic factors" referred to by Stefan Ingves. Counterbalanced by policy supports that include government backing of the banks, limited convertibility of the currency, and tightly-controlled interest rates, the banks have not yet failed. However, these policies are not unassailable. The banks are nonetheless managing to have a detrimental affect on the macroeconomic stability of the economy.

Unproductive Policy Lending

As legacies of central planning, China's banks are beset with the consequences of decades of directed policy lending. During Mao's monobank era and over the course of early bank reform, China's banking system was directed to make loans to selected industries, not on the basis of sound risk analysis and the financial viability of the project, but on the basis of party-derived social and political considerations. Inefficient state-owned enterprise (SOE) recipients managed to destroy wealth with negative net worth, but managed to stay viable through cheap, government-sponsored bank credit because they were an important source of local political power and served as critical elements of the state's welfare system. China's SOEs were proxies of the state to care for their work unit through lifetime employment, housing, health care, education, and other state-provided amenities. Profitability was subordinate to maintenance of these structures for political stability, and loans ended up being distributed without credible obligation that they would be paid back.

When the big four banks were divested from these original purposes through reform during the Deng era, they inherited the loans of the previous system. Unfortunately, the vast numbers of such loans were in non-repayment, and many of the SOEs still exist as critical enterprises. Estimates by China's leading official think-tank put current SOE assets at about 60 percent of the nation's total assets.[1] Unfortunately, they have not become any more profitable. A World Bank study claims that 51 percent are still money-losing ventures, with the statistic over 60 percent in the rust-belt provinces of the Northeast.[2] A combination of old non-performing loans (NPLs) and new lending to these SOEs has burdened the banks with a combined NPL to total loan ratio that is estimated between about 20 to 50 percent, depending on the source of the analysis.[3] Anywhere along this NPL range, the banks can be deemed technically insolvent. For comparison, the NPL ratio on all loans in the U.S. on 31 March 2004 was

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[1]Stephen Roach, "China – Determined to Slow," *Morgan Stanley Global Economic Forum*, 24 March 2004, URL: <www.morganstanley.com/GEFdata/digests/20040324-wed.html>, accessed 27 March 2004.

[2]William P. Mako and Chunlin Zhang, *Management of China's State-Owned Enterprises Portfolio: Lessons From International Experience*, World Bank Background Paper, 3 September 2003, 4.

[3]The NPL ratios of the banks are hotly contested between the international commercial banking sector and the Chinese government. Individual official NPL ratios for the big four banks are between 15 and 37 percent, but these figures is widely considered as extremely conservative due to loopholes in how NPLs are classified in China, as well as the government's attempts to manage the public perception of its banks. Standard and Poor's, an international credit-rating agency, provided its own analysis in 2004 estimating NPLs are likely to be as high as 50 percent of total loans.

1.09 percent.[4] At the NPL ratio of 45 percent, the Chinese government would likely have to spend upwards of 600 billion USD in a concerted 15+ year effort to get the ratio down to a manageable 5 percent.[5] Compared to the relatively small 160 billion USD that the U.S. Savings and Loan debacle of the 1980s through early 1990s cost the U.S. government, this is indeed an astronomical problem.[6]

It appears that the banking industry has not been able to completely shed these costly policy-driven lending habits. The banks continue to support "pillar industries" and are required to purchase allocations of infrastructure bonds.[7] Per the Commercial Bank law of 1994:

> After a transition period of unspecified direction, all banks are to operate as independent legal entities . . . . In the interim, however, they must lend according to the needs of the national economy, social developments, and the state's industrial policy as mandated by the State Council.[8]

As late as 2001, China's banks do not appear to be out of this so-called interim period. The big-four banks are still required to occasionally provide "social settlement" loans to support unemployed workers, and Agricultural Bank of China (ABC) is even now

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[4]Federal Reserve Bank of St. Louis, *Federal Reserve Economic Database II*, online ed., URL: <research.stlouisfed.org/fred2>, accessed 28 June 2004.

[5]Standard and Poor's, *China Financial Services Outlook 2004*, Study, November 2003, 9-10. Cited hereafter as S&P, *CFSO 2004*.

[6]Leif Rosenberger, "Economic Development and Asian Security," paper presented at the 2003 Pacific Symposium, "Toward a Durable Regional Security Strategy," 25-27 March 2003 (Honolulu, HI: Asia-Pacific Center for Security Studies, 2003), photocopy, 4.

[7]S&P, CFSO 2004, 14.

[8]Charles Wolf, Jr. and others, *Fault Lines in China's Economic Terrain*, a RAND Study, no. MR-1686-NA/SRF (Santa Monica, CA: The RAND Corporation, 2003), 126.

required to finance government-directed grain purchasing for rural development.[9] Under government pressure to expand financing for infrastructure investments and other projects to counteract an economic slowdown, all four banks have contributed considerable sums of money to the effort. Industrial and Commercial Bank of China (ICBC) committed over 20 percent of its long-term portfolio between 1999 and July 2000, and Bank of China (BOC), 45 percent of its new 1999 loans.[10] Such loan growth is deepening the banks' NPL plight with lending decisions still being made on political considerations rather than sustainable enterprise activity.

Continuing support for SOEs and other state priorities has distorted banking to profitable private enterprises. Due to the financial environment in place, the formal banking sector is less willing to lend to more profitable private enterprises. Private enterprises suffer from the weak accounting practices that plague most of China's companies, but unlike SOEs, they are not backed by the state to make up for the increased risk. Additionally, small loans are less profitable to banks in China’s fixed interest rate system. Since the cost of processing and administrating loans does not vary significantly between a large loan and a small one, margins are much more attractive on the processing of large SOE-style loans. Lastly, but perhaps most importantly, loans to the private sector that go bad can have political consequences. Depending on the

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[9]Victor Shih, "The Chinese Banking Sector: Current Conditions and Future Prospects," *Harvard Asia Quarterly* 5, no. 4 (Autumn 2001): 48.

[10]Shih, 47-48.

individual circumstances of the loan, the lender can be charged with "consorting with the private sector to embezzle the state."[11]

As a result, China's banking system is inefficiently allocating resources for high-growth entrepreneurial activity. In fact, small enterprise financing is most likely reliant on the savings of informal family or community networks, vice this banking system. This is no small matter given that in high-growth provinces such as Zhejiang (700 billion RMB revenue in 2002), 91 percent of the enterprises are privately owned.[12] The gap in what banks can provide and what these enterprises need shows up most visibly as a component of rising household savings deposits – from 8.2 percent in 1978 to 43.4 percent in 2000.[13] With banks unable to capitalize on the top tier of China's non-foreign direct investment (FDI) domestic growth, this is likely to further hurt already weak bank balances.

Excessive Risk Taking

The past and continuing policy-driven environment is likely to produce more unproductive loans because of excessive risk-taking. China's banking system is challenged by two widely described economic phenomena – moral hazard and too-big-to-fail (TBTF). Moral hazard refers to the reckless risk-taking behavior that beneficiaries to

[11]Wing Thye Woo, "What Are the Legitimate Worries About China's WTO Membership?" in *Dilemmas of China's Growth in the Twenty-First Century*, ed. Ligang Song (Canberra: Asia Pacific Press, 2002), 20.

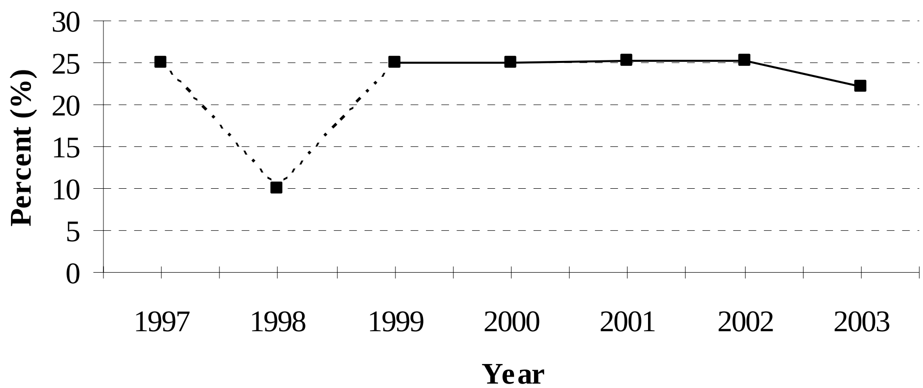
[12]Sameena Ahmad, "On the Capitalist Road" in "A Survey of Business in China," *Economist*, 20 March 2004, 16.

[13]Wolf, *Fault Lines in China's Economic Terrain*, 138; According to a May 1994 study by Liang-Yn Liu and Wing Thye Woo on Taiwan's saving behavior, increases seen in China's savings rate may also be related to the lack of bank financing for small-medium enterprises.

an insurance arrangement may exhibit because of the safety net the arrangement provides. In China, an unwritten policy of government deposit insurance, on top of several bailouts in recent years, has demonstrated that the government is willing to save banks that are in trouble. This informal policy has facilitated moral hazard behavior in bank lending. TBTF refers to a bank's willingness to take on more risk because its importance to the economy is such that the government will save it in case it fails. The fact that the four banks collectively own at least 60 percent of all banking assets fuels TBTF effects. The banking sector fully understands the critical importance each bank has to the stability of the nation. If one bank were to collapse, the entire economy would be at risk, and in turn the legitimacy of the Chinese Communist Party (CCP). They understand that the party would hardly allow that scenario.

China's banks are motivated by both phenomena to continue bad lending practices. The government has bailed out the banks three times in seven years – in 1998, 1999, and 2004 – for a total amount of over 2 trillion RMB. Despite aggressive policy and recapitalization measures to reduce NPL ratios over these years, they have remained fairly stubborn over the same period of years. Figure 4.1 presents the officially released NPL ratios from 1997 to 2003. Any close analysis of the official data reveals shortcomings in its fidelity. The 1998 NPL data appears vastly inconsistent with other out-years, and may be a result of a single-year methodology change. The lack of any fluctuation in the official statistics also suggests that the numbers are not fully accurate. Each government capital injection should have had at least a short-term effect on reducing overall NPL ratios. That said, given that publicly-released information on sensitive matters still tends to reflect conservative judgments along the general shape of the actual data, the flatness of the NPL curve defends the assertion that there has not been significant progress in reducing NPL activity.

Figure 4.1 *Official NPL Ratios*



Source: Guifen Pei and Sayuri Shirai, Habei and Keio Universities, *The Main Problems of China's Financial Industry and Asset Management Companies,* Study, 5 February 2004.

Furthermore, in a clear example of the risk-taking effects of moral hazard and TBTF, NPLs after 2002 are being eliminated not necessarily by reducing the numerator (amount of NPLs), but by substantially increasing the denominator (total loans) of the ratio.[14] This new lending boom suggests troublesome risk-taking behavior in an already investment-rich economic environment of diminishing gains, particularly given that banks are not demonstrating market-based lending practices. Because new NPLs will usually not show up in statistics for a number of years, it remains to be seen the extent of new NPL growth due to excessive banking risk. Moral hazard and TBTF are difficult problems for governments to deal with because they exacerbate existing banking

[14]Barry Naughton, "An Economic Bubble?" *China Leadership Monitor*, no. 9 (Winter 2004): 6-7, URL: <www.chinaleadershipmonitor.org/20041/bn.html>, accessed 10 June 2004

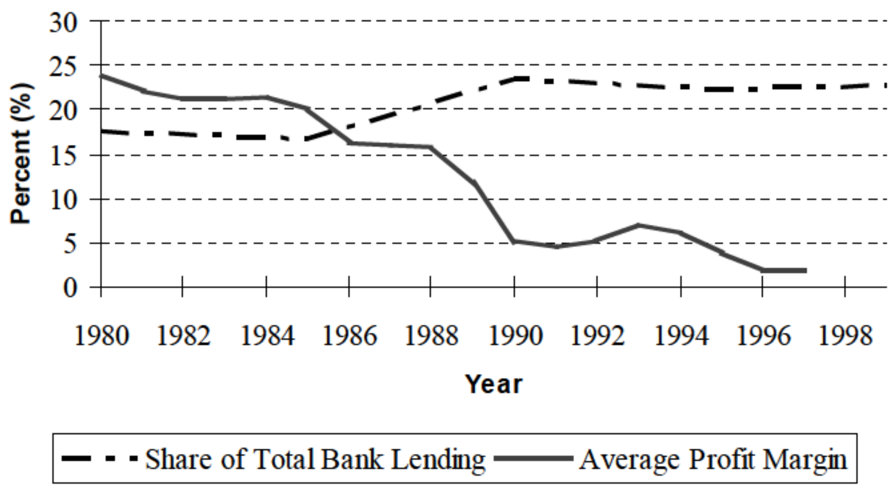
inefficiencies while at the same time challenging true reform. For the CCP, short-term, strong-arm tactics to reform banking behavior are likely to be judged as too costly. Continuing on with the status-quo does not look too much better.

Lack of Profit Sensitivity

In light of discussions about the continued domination of policy lending and risky lending behavior, there should be little surprise that China's banking sector does not perform financial intermediation based on sound economic fundamentals. Among several studies that have examined China's bank sensitivity to financial returns, one by James Laurenceson and Joseph Chai provides an especially provoking illustration of Chinese bank behavior from 1980 to 1999.[15] A summary is provided in Figure 4.2. This visual depiction of their data shows clearly that despite falling after-tax profits, industrial SOEs have continued to receive a large percentage of the banking sector's loans.

[15] James Laurenceson and Joseph C. H. Chai, *Financial Reform and Economic Development in China* (Cheltenham, UK: Edward Elgar Publishing Limited, 2003).

Figure 4.2 *Weak Profit-Driven Lending Behavior to Industrial SOEs*



Source: James Laurenceson and Joseph C. H. Chai, *Financial Reform and Economic Development in China* (Cheltenham, UK: Edward Elgar Publishing Limited, 2003, 33.

Such weak profit sensitivity does not portend well for the banks or China's broader economy. The banks risk ballooning NPLs if lending continues to ignore the balance sheets of the firms financed. Additionally, with financing available regardless of whether a company is destroying wealth or creating it, the motivation for China's enterprises to pursue profitable ventures is weakened.

Poor Governance

Independent, corporate governance of the banks is not yet a reality. Bank governance continues to reflect more the interests of the party, local autonomy, and state bureaucratization, than market orientation. Ranking bank managers are politically appointed by a personnel committee under the State Council. Creating possible conflict-of-interest issues between financial entities and their regulatory counterparts, top officials will shuffle between posts in banks, government supervisory bodies, and the corporate sector. In 2003, for instance, the President of BOC was appointed Chairman of the China Banking Regulatory Commission (supervisory body for the banking system), who was in turn replaced by Xiao Gang, previously the Deputy Governor, People's Bank of China (the central bank).[16] Wang Xuebing, former President of China Construction Bank (CCB), had come to his position via posts as the President of BOC and Vice Chairman, China Everbright Group. As a result of this kind of party-driven career progression, profits, modern management, and aggressive supervision are necessarily secondary to party patronage and loyalty. Unsurprisingly, governance and lending decisions never drift far from party interests. Javed Hamid of the International Finance Corporation describes Bank of Shanghai board meetings in 2001 as follows:

> The minutes of board meetings would be written before the board meeting. Decisions would be made on the basis of growth, not whether it would improve returns. Bank managers were like kings. . . . People were rewarded not on the basis of market criteria, but on how loyal they were to the party.[17]

Furthermore, career management by party selection inevitably affects the behavior of the entire banking enterprise. Middle managers serve as doers, or information links between

[16]Bank of China, "Xiao Gang Appointed Chairman and President of Bank of China," Press release, 2 April 2003, URL: <www.bank-of-china.com/english/c1news/2003/news2003_026.html>, accessed 22 June 2004.

[17]Sameena Ahmad, "Non-performing" in "A Survey of Business in China," *Economist*, 20 March 2004, 18. Cited hereafter as Ahmad, "Non-performing."

lenders and upper management, rather than entrepreneurial agents.[18] It is not profit-driven innovation that motivates the rank-and-file, but the need to maintain the party line.

Despite attempted reforms, it also appears that banks and their lending activities are often influenced heavily by local elites, to the chagrin of the central bureaucracy. A significant reform effort was made in the 1990s to wrestle control of bank branches away from local government leaders and make branch managers accountable to senior management of the bank. By maintaining administrative authority over local branches of state banks, local elites would leverage their influence to encourage funding based on local political priorities. Although administrative authority was formally shifted to the bank's immediate hierarchy through reform, it is highly unlikely that bank governance has become significantly more objective or centralized. Many bank managers are fairly isolated political appointees in a setting where local government elites are usually more powerful, higher-ranking party officials. Indeed, one recent investigation by China's State Auditing Commission has criticized banks for excessive lending to local governments.[19] In a more subtle presentation of the continued strength of local governments, ABC signed a 23 February 2004 agreement with the government of Zhejiang Province to alleviate local government funding shortages by financing its infrastructure plans.[20] In a sharp reversal of efforts to improve branch control through the

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[18]Kenneth Lieberthal and Geoffrey Lieberthal, "The Great Transition," *Harvard Business Review*, OnPoint Article Study, October 2003, 4.

[19]Economist Intelligence Unit, *China Country Report*, ed. Paul Cavey, March 2004, URL: <db.eiu.com/report_full.asp?valname=CRCNE301&title=Country+Report+China>, accessed 12 March 2004. Cited hereafter as EIU, *China Country Report*, March 2004.

[20]Zhang Dingmin, "Reform Helps Agricultural Bank Bolster Deposits," *China Daily*, online ed., 24 February 2004, URL: <211.147.20.16/bizchina/openews.shtml?id=632&cate=>, accessed 10 March 2004.

bank's hierarchy, the agreement also pledged that ABC would give the Zhejiang branch more autonomy to grant loans approved by relevant authorities. Even as late as 15 April 2004, *New York Times*' James Kynge quoted Chinese officials stating that local authorities were using their influence to extract loans from local banks to finance their projects.[21]

Such local effects are magnified due to the banking system's decentralized system of auditing and credit risk management. Audits and credit management activity is either wholly based on local accountability only, or at most is a secondary duty of the bank's administrative line of control. This is likely intentional, for it enables bank administrators to control information to superiors. In contrast to western banks, Chinese banks usually do not have an independent credit or auditing chief with a direct line of control over all of their subordinate officers to ensure standards are being met. As a result, bank branches are often run as small fiefdoms with conservative management.

The lack of adequate bank governance has tremendous effects on a credible monetary policy. In fully socialist, centrally-planned economies, central party monetary policies are heeded as mandatory top-down directives. In free-market societies where policies are implemented as a matter of law and regulatory supervision, banks promulgate them through their management chain. In China's case where the banks are neither fully instruments of a command economy, nor free market entities, there is little assurance in the normal mechanisms that encourage banks to operate in-step with one another. Indeed, in the first two months of 2004 when China's central bank was aggressively trying to

[21] James Kynge, "China's Economy Soars Despite Beijing's Curbs," *New York Times*, online ed., 23 February 2004, URL: <www.nytimes.com/financialtimes/business/FT1079420359660.htm>, accessed 24 February 2004.

slow down investment growth to sustainable levels, central government projects slowed to 12.1 percent growth whereas local government projects continued on at increases of 64.9 percent.[22] According to analysts familiar with the rise, the large difference reflects "local governments' disregard of the central government's macro-economic regulation strategies."[23]

Poor Transparency / Weak Regulation & Supervision

The banks' corporate governance arrangements also inform how information is reported and evaluated in China's regulatory and supervisory bodies. Under this governance structure, regulation and supervision is significantly weakened. Middle managers and local government elites have little personal incentive to report negative information that might undermine public targets or embarrass the party. In fact, the current desire of many Chinese enterprises to win state permission for an international stock market listing encourages the practice of inflating figures.

Recent attempts at ascertaining the accuracy of financing documentation have revealed egregious errors in reporting. A report issued in 2002 by the China Securities Regulatory Commission concluded that 1 in 10 listed companies in China's Shanghai-based stock market had doctored its books to win state listing approval and attract investment. In a February 2002 National Bureau of Statistics report, the government found no fewer than 60,000 violations of statistics regulations during a three-month

[22]Ling Huawei, "Behind Suspension of Bank Loans," *Caijing Magazine*, online ed., 5 May 2004, URL: <www.caijing.com.cn/english/2004/040505/040505behind.htm>, accessed 7 May 2004.

[23]Ling Huawei, "Behind Suspension of Bank Loans."

investigation in 2001.[24] In January 2004, a survey conducted by the Finance Ministry revealed that 159 firms had misstated profits by a combined 2.9 billion RMB.[25] A recent report by the State Administration of Foreign Exchange (SAFE) found that bank reporting irregularities were of such scale that it threatened the accuracy of national balance of payments data.[26] One bank failed to report 171 million USD in foreign-exchange transactions; another two managed to misreport a combined 252 million USD through accounting problems.

The role of corruption in affecting the transparency of information flow also cannot be overlooked. A 2003 China Banking Regulatory Commission investigation found cases of fraud and mismanagement at over 1000 offices of various financial institutions, including the misuse of 11.9 million RMB by an ABC branch office and 1.8 million RMB in false accounting by an ICBC branch.[27] In another case in 2002, the U.S. Comptroller of the Currency and China's central bank issued a combined 20 million USD fine on the New York Branch of BOC because of multiple counts of fraudulent activity.[28] As problematic as these reports are, the real dilemma for China's banking sector is not the depth of these transparency issues, but the asymmetrical information environment that it creates between banks, depositors, and lenders. Poor transparency causes tremendous

[24] James Kynge, "Report Casts Doubt Over Chinese Data," *Financial Times*, online ed., 28 February 2002, URL: <search.ft.com/s03/search/article.html?id=020228001817>, accessed 16 June 2004.

[25] Ahmad, "Non-performing," 19.

[26] "China Briefing: FOREX Regulator Exposes Misconduct," *Far Eastern Economic Review*, online ed., 11 March 2004, URL: <www.feer.com/articles/2004/0403_11/p024china.html>, accessed 25 May 2004.

[27] EIU, *China Country Report*, March 2004.

[28] U.S. Comptroller of the Currency, "Comptroller of Currency Fines Bank of China's New York Branch," Press release, 18 January 2002, URL: <hongkong.usconsulate.gov/uscn/others/2002/011801.htm>, accessed 28 May 2004.

challenges for banking operations. As a matter of providing loans, commercially viable banks must be able to evaluate the risk of the borrower using credible information. Alternatively, bank consumers will also evaluate their financial institution based on the information available to them. If either side of the banking relationship loses confidence in the credibility of its information, there is increased risk of bank failure.

Holding the System Together: Policy Supports

The heavy burden of bank crisis indicators seen in China – problematic policy lending, excessive risk taking, poor governance, lack of profit sensitivity, inadequate transparency and regulation – clearly reveals that the system is under considerable duress. Since bank liberalization began in 1979, the government has undertaken extensive efforts to maintain the viability of the banking system and its role in generating growth. The most critical of these have been in banking-related policy. Collectively, they have most likely kept China's banking system from massive collapse.

First, large central bank reserves and fairly low government debt has facilitated an unwritten policy of government-sponsored deposit insurance on bank loans to sprawling state enterprises. China's central bank currency reserves topped an extraordinary 444 billion USD in March 2004.[29] In early 2004, China demonstrated for the third time its commitment to back bank loans by unloading 45 billion USD of this reserve to improve liquidity at BOC and CCB. This kind of demonstrated commitment is perhaps the most valuable policy support for the banks, as it reduces perceived credit risk across all banks and minimizes the threat to held deposits. As long as the banks remain liquid with this

[29] "Emerging Market Indicators," *Economist*, 26 June 2004, 102.

kind of guaranteed capital, they can continue their services to the economy even under substantial duress.

Limited convertibility of China's currency restricts capital flight from domestic depositors, thus facilitating the stable reinvestment of wealth in the national economy. Because of limited convertibility, the Chinese economy is cushioned heavily from the worst effects of a run on deposits. Depositors cannot shift their money to international banks or foreign financial instruments. Furthermore, in such a bank-heavy financial structure with an inferior market for bonds and stocks, domestic deposits have essentially nowhere else to go except into cash holdings or physical investments. Federal Reserve Chairman Alan Greenspan refers to the importance of this policy support, explaining that given the high level of debt in China’s banking system, it can only operate if depositors have no incentive to pull out their money from it.[30]

Lastly, the central bank's control over interest rates reduces market competition between banks for financial activities, thus keeping even the weakest banks alive. Depositors cannot differentiate between banks in terms of rate of return. Combined, the latter two policy supports effectively creates a market environment where existing banks have a near-monopoly on deposits. This is critical in keeping China's banking system afloat.

These policy supports are at best, a teetering counterweight to the fundamental problems in China's banks as outlined earlier; and at worst, only supporting a deepening of China's banking woes. One of many problems this kind of banking see-saw can produce is the macroeconomic effects of such an arrangement.

[30] Alan Greenspan, letter to Senator Richard Shelby (R-AL), subject: "QFR: Fragility of China's Financial System," 2 March 2004.

Macroeconomic Results of China's Bank Weakness

Bank governance and regulation problems, in conjunction with the other exhibited instability indicators, can produce alarming macroeconomic effects. This is especially true in China's current macroeconomic situation as bank lending has recently exploded at an alarming pace. In 2003, lending expanded by 23 percent in the first half alone, and 47 percent of China's GDP was investment-related.[31] China's M2, a measurement of the total loans and deposits in the country's money supply, rose 20 percent in 2003 year-on-year.[32] On such an enormous scale of lending growth, it is impossible to maintain sustainable returns on such volume, even in advanced banking systems.

Banks are effectively generating more money in the financial system than can be used productively. As a result, companies are exhibiting profit-taking behavior by attempting to grow by inserting themselves in any market it can to generate revenue. China's leading appliance manufacturer is an illustrative example. Through cheap lending, Haier has tried to find revenue growth at all costs – for its China market, the company now has 96 categories of goods in 15,100 specifications.[33] Chinese mobile phone manufacturers have progressed similarly. Brian Modoff, a senior wireless analyst at Deutsche Bank, claims that 47 Chinese mobile phone brands sell over 800 models in their domestic market.[34] This type of growth strategy, in either appliances or mobile

[31] Naughton, 1; Sameena Ahmad, "Behind the Mask," in "A Survey of Business in China," *Economist*, 20 March 2004, 4. Cited hereafter as Ahmad, "Behind the Mask."

[32] Justin Lahart, "When China Slows," *CNN Money*, online ed., 16 January 2004, URL: <money.cnn.com/2004/01/16/markets/chinaslow>, accessed 15 February 2004.

[33] "Chinese Business: Haier's Purpose," *Economist*, 20 March 2004, 72.

[34] Brian T. Modoff, Senior Wireless Equipment Analyst, Deutsche Bank, unpublished transcript, interview by Kenneth N. Gilpin, 23 November 2003.

phones, would be commercially unviable in any developed banking environment. It is simply far too inefficient and wealth-destroying. One expert provides that the inefficiency and waste is such that it now takes about 7 USD of capital investment to produce only 1 USD of output in China (The top advanced countries maintain a ratio approximating 1:1).[35] Indeed, the anecdotal evidence highly suggests that banks are wasting money at an incredible rate by pouring loan growth into sectors which are already over-invested, creating equity bubbles.

Wasteful overinvestment bubbles are appearing broadly in several manufacturing-related sectors and perhaps most notably in the housing sector. Those sectors that cannot grow through diversity are going into oversupply. In manufacturing, capital expenditures in ferrous metals, machinery, and chemicals are up 176, 170, and 150 percent in 2004, year-on-year.[36] That said, approximately 90 percent of manufacturing goods are also in oversupply.[37] In housing, investment surged 32.3 percent in the first 11 months of 2003, year-on-year, generating at least 70 percent growth in new housing starts in a similar period.[38] However, one study estimates that only 330 of the 550 million square meters in construction completed in 2003 was ever sold.[39] Not surprisingly, vacancy rates are in

[35]Hugo Restall, "Examining Asia: China's Not Overheating, It's Wasting Capital," *Wall Street Journal*, Eastern Edition, 22 December 2003, Accessed via ProQuest, 7 January 2004.

[36]Denise Yam, Andy Xie, and Sharon Lam, "China: The Second Tightening Move," Morgan Stanley Global Economic Forum, 29 March 2004, URL: <www.morganstanley.com/GEFdata/digests/20040329-mon.html>, accessed 30 March 2004.

[37]Ahmad, "Behind the Mask," 4.

[38]Economist Intelligence Unit, *China Country Profile*, 2004/2005 Main Report, January 2004, URL: <db.eiu.com/report_full.asp?valname=CPCNE101&title=Country+Profile+China>, accessed 12 March 2004; Naughton, 2.

[39]Isaac Cheng and Virginia Hulme, "Time to Regroup," *China Business Review* 31, no. 3 (May/June 2004): 30.

the double digits in some cities. Anecdotally, a business traveler who has visited Shanghai yearly from 2001 to 2004 also suspects such a trend. This individual notes that current apartment growth is irrational – new apartments dot the Shanghai skyline everywhere, but at peak times in the evening, the majority of the living units are dark.[40] Andy Xie, a notable China expert, believes that rising housing investment is a function of speculative investments by local governments – they borrow massively over the value of their landholdings to build new infrastructure, hoping that the land will appreciate enough to pay off the debts.[41]

The up-and-down nature of money supply growth through lending booms and investment bubbles may cause economic instability on its own. In the long-term, this lending boom is likely to produce an even greater NPL load for the banking system. If NPLs continue to grow in conjunction with poor bank management, the scale could be such that a bank rescue would be impossible without a fiscal implosion. In the short-term, a high rate of money supply growth may produce inflationary effects and a lending crash if the economic instruments employed causes it to contract too quickly. Both instances would create disastrous problems for China's economy.

China's leadership is pursuing serious efforts to curb this money supply phenomenon. In Wen Jiabao's 5 March 2004 address to the National People's Congress (U.S. State of the Union equivalent), he made pointed claims to curb the "excessively broad scale of investment, the serious problem of haphazard investment and low-level,

[40]A source, regular business traveler to China, who wishes to remain anonymous, interview by the author, 16 March 2004.

[41]Andy Xie, "Asia Pacific: The Twin Bubbles," Morgan Stanley Global Economic Forum, 6 April 2004, URL: <www.morganstanley.com/GEFdata/digests/20040406-tue.html>, accessed 12 April 2004.

redundant construction in some industries and regions."[42] Among several actions, China has increased reserve rates three times in the previous eight months, suspended certain categories of loans, and implemented a highly intrusive bank inspection regime. As important as it is to control this lending boom, it is increasingly obvious that the roots of this problem must be dealt with immediately and decisively through broad, innovative bank reform.

Conclusions

Suggesting a bleak outlook for China's financial sector, nearly all of Ingves' microeconomic instability indicators are represented in China's banking system. Even more problematic are the macroeconomic effects that uncontrolled lending is causing in the economy. Fundamentally, it appears that without China's costly policy supports, the banks would probably have already failed.

That said, the policy supports also cannot be expected to continue successfully over the long-term without sustainable banking reform. The policy environment that has done such an admirable job by eliminating competition and backing the fiscal position of the banks is increasingly burdened and appears to be fueling further bad banking practices. At this rate, the policy supports will only last so long before the crisis indicators push banks to collapse. The status-quo is unacceptable for future growth prospects, and it appears that China's government understands this. An ambitious and wide-ranging reform plan currently is being pursued to transform bank behavior and recapitalize this massively insolvent banking system.

[42]Wen Jiabao, Address to the National People's Congress, CCTV, airdate 5 March 2004, viewed online, URL: <rtsp://real.cctv.com.cn/engchannel/column/56K/667040305.rm>, accessed 5 March 2004.

CHAPTER 5

A REFORM PLAN

Given the unacceptable condition of China's banks, the Chinese Communist Party (CCP) is pursuing a decisive and innovative reform plan for the banking sector. Although a Herculean effort, the plan is critical to China's continued economic growth and political legitimacy. The effort has two prongs that must be implemented simultaneously – a fundamental shift in banking behavior and massive bank recapitalization. Of these prongs, the most innovative reforms are to leverage foreign direct investment (FDI) to change banking behavior, and international stock market listings as a vehicle for recapitalization.

All together, it is hoped that this new reform effort will negate all six of the bank instability indicators seen in China's banking system – transparency, regulation, risk-taking, policy lending, governance, and profitability. Transparency will be improved by market discipline in the stock markets, along with foreign expertise gained in accounting and management. Regulation will be bolstered by foreign regulators in the international securities markets. Risk behavior will be mitigated and governance improved by strengthening bank independence via recapitalization, market discipline in the securities market, and strategic management assistance from foreign investors. Policy lending will be phased out and profit sensitivity increased with changes in ownership by securitization and FDI.

Hitting at the Cause: Changing Bank Behavior via Foreign Partnerships

Consistent with its overall FDI growth strategy, China is using the same FDI-driven model to reform bank behavior. The strategy is anchored by World Trade Organization (WTO) accession commitments to pace reform and a regulatory framework to encourage the world's best foreign banks to enter China in joint arrangements with a domestic partner. Ultimately, the CCP hopes that its FDI strategy for bank reform fundamentally changes governance, diversifies the sector, and gives reformers more legitimacy to pursue further improvements.

A Policy Environment to Attract FDI Relationships

China's strategy for bank reform is underpinned by its accession to the WTO and the leverage this action has given the CCP to enact rule-based changes in the sector. After 15 years of negotiations, China finally opened its own way to WTO accession by bringing to its bilateral WTO negotiations a set of comprehensive, specific, and unilateral commitments for free-market reform. Despite a tumultuous year of diplomatic gaffes between the U.S. and China, the two countries managed to sign an agreement on the accession of China to the WTO on 15 November 1999. Two years later after completing a final series of bilateral agreements on accession, and then concluding negotiations with the WTO thereafter, China entered the WTO on 11 December 2001. WTO accession was never a certainty in China's bureaucratic politics, and successful completion of negotiations was considered a victory for President Jiang Zemin and Premier Zhu Rongji.[1] Accession accomplished two important goals – it supported China's

[1] Joseph Fewsmith, "China and the WTO: The Politics Behind the Agreement," *NBR Analysis* 10, no. 5 (December 1999), URL: <www.nbr.org/publications/report.html>, accessed 30 June 2004.

nationalistic base in further establishing China as a world power, and it provided a statutory framework to be used as a vehicle for difficult modernization efforts. In light of China's center-periphery governance challenges and the amount of political capital often required to push management reform, the WTO agreement provides the CCP an indirect means to drive reforms with urgency. The Economist Intelligence Unit agrees in its recent China assessment, stating "Zhu Rongji appears to have viewed the WTO agreement as a tool with which to push through painful domestic reforms that might already stall."[2] The WTO created a hard timeline for structural reforms that the entire nation could rally behind as a matter of China's reputation on the global stage. In a sense, the WTO had become a way to impose a rule-based society linked to its reputation as a state – an interesting mix of *mianzi* (face) and law indeed.

The specific timeline for foreign bank entry was established in China's WTO commitments to liberalize its banking sector, but the progressive terms of entry have been further delineated through regulation. According to the WTO commitment timeline, beginning 11 December 2003, foreign banks are allowed to provide RMB services to Chinese companies; and on 11 December 2006, the entire sector will be opened to foreign banks.[3] On top of these commitments, the government promulgated State Council Order No. 340, "Regulation on Management of Foreign Invested Financial Institutions." Order No. 340 establishes foreign banking minimum asset and investment requirements such that market entry is limited to only the largest, most stable

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[2]Economist Intelligence Unit, *China Country Profile*, 2004/2005 Main Report, January 2004, URL: <db.eiu.com/report_full.asp?valname=CPCNE101&title=Country+Profile+China>, accessed 12 March 2004.

[3]U.S. Department of Commerce, *Banking and Other Financial Services*, Industry Fact Sheet, December 2001, URL: <www.mac.doc.gov/China/Docs/industryfactsheets/banking.html>, accessed 23 November 2003.

international banks. A series of licensing requirements promulgated by the CCP also imposes high costs to establish and expand branch networks unilaterally. Together, these regulations accomplish two goals: first, to ensure that only the most experienced and skilled banks are allowed initially to enter the marketplace; and second, to encourage FDI-type, joint-venture activity in China’s banking sector. China is careful to ensure that foreign monies serve only well-honed strategic, vice speculative, purposes. By ensuring that only the most capitalized banks enter the country, the regulatory framework helps to keep such speculative investors and unstable international banking entities out of China's market.

The aforementioned terms of entry are designed to encourage foreign banks to develop lucrative joint relationships with domestic banks when they enter the Chinese marketplace. The progressive terms to entry currently makes foreign-joint venture activity the only way to be the first into China’s banking sector. Where unilateral entry is nominally only possible after December 2006, joint-ventures can occur right now. Dangling a market of 1.2 billion people holding 1.3 trillion USD in estimated 2003 deposits, the CCP anticipates that the most competitive international banks are simply unwilling to wait until 2006 to establish their banking presence in China.[4] Additionally, the licensing requirements, not to mention the existing challenges of navigating a new marketplace, make unilateral entry cost-prohibitive. By design, any foreign bank investing in China will find it easier to enter the market under a joint-venture agreement.

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[4]Zhang Dingmin, "Reform Helps Agricultural Bank Bolster Deposits," *China Daily*, online ed., 24 February 2004, URL: <211.147.20.16/bizchina/openews.shtml?id=632&cate=>, accessed 10 March 2004.

The Benefits of FDI in the Banking Sector

The goals for FDI in China's banking sector mirror those for China's overall development strategy. Walter Hutchens, a professor at University of Maryland's business school demonstrates FDI behavior in China's securities market, stating, "China grants limited market access in exchange for capital, technology, and know-how that will help the country develop."[5] Essentially, FDI-led banking reform is no different. Through case-by-case State Council review of investment applications, China filters investment activity to favor foreign firms with strategic industry experience, rather than just financial resources.[6] The reason, similar to the purpose of the regulatory framework in place, is to dissuade purely financial investors and attract strategically-oriented firms that will transfer expertise and know-how to foreign banks. By allowing strategic foreign bank participation in the management of domestic banks, China gains in the long-run from management exposure to advanced skills and practices. Even more in future sole foreign ownership arrangements, China will eventually profit greatly from local employees hired and trained by western banks, which inevitably will rotate out into domestic banks as highly sought-after skilled managers. Aware of the modernization strategy taken by the most successful domestic banks in Southeast Asia, the CCP is willing to pursue this kind of strategy in order to secure long-term success. Additionally, such joint foreign-domestic bank activity exposes China's banks to revenue-attractive innovations such as credit cards. China's consumer culture is overwhelmingly dominated by bank debit cards,

[5]Walter Hutchens, "China's Securities Markets Open to Foreign Investment," *China Business Review* 29, no. 5 (September/October 2002): 36.

[6]Nicholas C. Howson and Lester Ross, "Foreign Minority Equity Investments in Chinese Commercial Banks," *China Business Review* 30, no. 4 (July/August 2003): 19.

as its experience with credit is yet immature. Consumer credit-oriented products require credit rating expertise and technology, both for which foreign banks have a tremendous competitive advantage over their Chinese counterparts. In developing such products, China is most eager to place its banks where they can best maximize their learning curve – as joint credit card partners with foreign banks.

This strategy also encourages simultaneously the diversification of banks away from the big-four, and more efficient banking to China's private and consumer sectors. China's foreign investment strategy inherently favors domestic banks which are agile, younger, and urban. A top China manager of a foreign credit institution explains, "The big four are dinosaurs. The winners are going to be the second-tier banks who tie up with foreign financial institutions."[7] Because of the sheer size of the big-four state-owned banks, it is unlikely that foreign investors will make concerted efforts to purchase such a costly stake in these banks for management control. Not only are the non-performing loans (NPLs) a significant deterrent, but the cost to purchase such a stake is also not worth the challenge of navigating the banks' legacy relationships with government and SOE leaders. Additionally, the primary focus of the more profitable smaller institutions is reliable consumer loans and products. In the big-four banks, consumer loans make up only about 10 percent of their portfolio, particularly as they are still saddled with the burden of keeping selected SOEs afloat.[8] Smaller banks, particularly those outside of more rural areas where local governments can leverage control, have little to none of these restrictions. As a result, these smaller banks will be the primary recipient of foreign

[7]David Murphy, "Creative Loans Leave Dinosaurs in the Dust," *Far Eastern Economic Review* 166, no. 2 (January 2004): 31.

[8]Murphy, 32.

expertise, and in turn, are likely to gain considerable market share from the resulting joint-ventures. As a whole, China's banking system will become more stable because of the increased competition and market balance shift away from the troubled big-four.

The Foreign and Domestic Reception to the FDI-Driven Reform Plan

Foreign companies are responding enthusiastically to China's reform plan. Table 5.1 outlines some of the major banking joint-ventures in China. Citigroup announced on 2 January 2003 that it would acquire a 5 percent stake in Shanghai Pudong Development Bank (SHPD) and take a seat on its Board of Directors.[9] By February 2004, it had brought in the majority of SHPD's senior staff, and provided the technological expertise to launch a joint credit card.[10] Citibank benefits by initiating a brand presence to bolster its forthcoming operations in China. Indeed, Citibank plans to move into its 240 million USD Shanghai headquarters in 2005.[11] That said, the future of joint-venture activity may be foreshadowed by the recent acquisition of Shenzhen Development Bank by Newbridge Capital. Newbridge Capital, highly regarded for its rehabilitation and reform of Korea First Bank, finalized negotiations for an 18 percent controlling stake in Shenzhen Development Bank on 31 May 2004.[12] It is the first time that a foreign company has been approved to take management control of a Chinese bank. China

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[9]Citigroup, "Citigroup and Shanghai Pudong Development Bank Form Strategic Alliance to Target China's Credit Card Market," Press Release, 2 January 2003, URL: <www.citigroup.com/citigroup/press/2003/030102a.htm>, accessed 15 February 2004.

[10]Economist Intelligence Unit, *China Country Report*, ed. Paul Cavey, March 2004, URL: <db.eiu.com/report_full.asp?valname=CRCNE301&title=Country+Report+China>, accessed 12 March 2004.

[11]Murphy, 31.

[12]Peter S. Goodman, "U.S. Firm to Control Chinese Bank," *Washington Post*, 1 June 2004, E1.

anticipates that Newbridge will continue its track record of successful bank reform by bringing into Shenzhen Bank a cadre of top-notch executives and western business practices.

TABLE 5.1
Notable Foreign Investments in Chinese Banks

% stake	Sponsor	Chinese Bank	Major product(s)
5 percent	Citigroup	Shanghai Pudong Dev. Bank	Credit cards
8 percent	HSBC	Bank of Shanghai	Credit cards
16 percent	HSBC	Fujian Industrial Bank	Credit cards, personal loans
5 percent	GIC	Fujian Industrial Bank	
4 percent	IFC	Fujian Industrial Bank	
7 percent	IFC	Bank of Shanghai	
15 percent	IFC	Nanjing City Comm. Bank	
20 percent	Newbridge	Shenzhen Dev. Bank	
5 percent	Newbridge	Minsheng Bank	

Source: Various media reporting.

China appears to be extremely pleased with the results of the strategy thus far. The China Banking Regulatory Commission (CBRC) has issued public statements praising foreign banks for impressive governance and regulatory improvements made at their respective invested bank.[13] And on 1 January 2004, the CBRC expanded these joint relationships by raising the ceiling for a single foreign investor in a Chinese bank from 15 percent to 20 percent, with a combined foreign investment ceiling of up to 25 percent.[14]

The success of this strategy has emboldened China's reformers who understand that the CCP needs to divest their ownership stake in the banks to fundamentally improve lending behavior. The CBRC appears to be leading such reform efforts. According to

[13]Louise do Rosario, "Preparing for the Competition," *Banker*, online ed., 3 March 2004, URL: <www.thebanker.com/news/fullstory.php/aid/1286/Preparing_for_the_competition.html>, accessed 20 March 2004.

[14]"Business News: Bank Investment Controls Loosened," *China Daily*, online ed., 8 December 2003, URL: <www.chinadaily.com.cn/en/doc/2003-12/08/content_288368.htm>, accessed 15 March 2004.

The Banker, the commission has issued public statements recommending that the banking sector welcome foreigners to "take top jobs at Chinese banks, such as chief financial officer and chief technical officer."[15] Taking the momentum of growing foreign management interaction with the banks even further, it released proposed guidelines in February 2004 to ban government investment in new banks and require new banks to establish operations with a foreign-invested partner.[16] This CBRC proposal is not necessarily a long-shot. In fact, the latter requirement was approved by the State Council in a previous CBRC action to require that two new domestic banks launch with qualified foreign investors at their side. If the State Council continues its support for the CBRC, the commission is likely to make tremendous inroads in establishing independent bank governance. By itself, the February 2004 guidelines suggest a phasing-out of the hand of government in banking affairs and the development of a foundation for a new group of banks without the legacy influences of the big-four. This second-generation of banks, with their foreign-trained personnel, would certainly be ideal successors to the present banking system.

Restoration Therapy: Bank Recapitalization

Simultaneous with management reform, China's banking sector requires a large capital injection in order to become truly independent. The banks have been saddled with the accumulating consequences of 20 years of bad lending, and cannot come out of this

[15]Louise do Rosario, "Preparing for the Competition."

[16]Olivia Chung, "Rules for Banks to Block State Access," *The Standard*, online ed., 16 February 2004, URL: <www.thestandard.com.hk/news_detail_frame.cfm?articleid=45260&intcatid=2>, accessed 20 February 2004.

financial situation without large injections of capital. As long as the banks have to rely upon the central government for assurance of liquidity, they are unlikely to exhibit independent behavior, and will likely continue down a spiral of moral hazard. In order to wean the banks off of government backing, the CCP will find it necessary to put them on a solvent financial footing that gives them a self-deterministic incentive to succeed. The efforts so far to improve liquidity are far-ranging, including NPL liquidation, fiscal concessions through tax breaks, expanded corporate bond issue allowances, and future international stock market listings. After all of these options are exhausted, the final recapitalization effort will likely be made by the Chinese government through targeted bailout activity.

Recapitalizating the banks is no small feat. Even accounting for three previous recapitalization efforts, Standard and Poor's cites the current cost of recapitalization at upwards of 600 billion USD.[17] An editor of the *China Business Review* estimates the cost at 500 billion USD, noting that official sources claim an expected outlay of approximately 447 billion USD.[18] None of these estimates include future NPL growth as a result of the current lending boom.

Bank Profits

The banks' current finances will not allow them to achieve independence through their own operating profits. Although their profits are rising, they are far from sufficient to restore capital positions and absorb credit losses. Limited in non-interest sources of

[17] Standard and Poor's, *China Financial Services Outlook 2004*, Study, November 2003, 9-10. Cited hereafter as S&P, *CFSO 2004*.

[18] Isaac Cheng, junior editor, *China Business Review*, interview by the author, 12 March 2004.

income, China's banks are heavily dependent on loan interest for profits. That said, Fitch Ratings calculates the average return on interest earnings in 2002 was just 3.5 percent, up from 3.2 percent in 2001 because of broad loan growth across all domestic banks.[19] Standard and Poor's presents a lower figure at 1.9 percent for both 2002 and 2001.[20] At both return figures, the profit margin to write off loan losses from their NPL burden is marginal. Even if the banks decide to improve their balance sheets with everything they have, China's problem loans (NPLs and impaired off-balance sheet assets combined) are at conservative estimates, more than three times, and at liberal estimates, more than seven times the paid-in capital of the entire banking sector.[21]

China has made fiscal concessions to the banks in order to support even this small effort to eliminate NPLs. Problem loans can be written off earnings before tax, and the overall tax rate for banking revenue has been reduced from 8 percent in 2001 to 5 percent in 2003.[22] The concessions have been accepted wholeheartedly – China Construction Bank (CCB) used 99 percent of its 2003 operating profits to dispose of bad assets and Industrial and Commercial Bank set away 60 percent for similar debt relief.

Liquidation of NPL Assets

Liquidation of collateral linked with NPLs has only had limited success. In 1999, four Asset Management Companies (AMCs) – one for each of the big-four banks – were

[19]Fitch Ratings, *Chinese Banks: Review and Outlook*, Special Report, 19 December 2003, 2.

[20]S&P, *CFSO 2004*, 45.

[21]S&P, *CFSO 2004*, 12.

[22]Ling Huawei, "China State-owned Banks Prepare for Listing," *Caijing Magazine*, online ed., 26 December 2003, URL: <www.caijing.com.cn/english/2003/1220/1220ch-state.htm>, accessed 14 June 2004.

set up to recover and liquidate 170 billion USD (16-25 percent total loans) of NPLs. In various arrangements with international investment banks such as Morgan Stanley and Goldman Sachs over the last five years, the AMCs have repackaged and auctioned off only about 36 percent of the assets, at a 20 percent recovery rate.[23] It is likely that this 20 percent recovery rate will be significantly less when eventually factored into the total NPL share transferred to the AMCs. The disposals have been arranged to repackage the highest-quality assets first. After five years, the vast remainder of the NPL portfolio contains assets unlikely to command much value.

Corporate Bond Issues

Corporate bond issue is another avenue being explored for revenue growth. Throughout most of China's modernization, corporate bonds were discouraged in favor of government T-bonds. Moreover, the banks' ability to issue bonds was virtually non-existent. Since late 2003, China has reversed course to develop a functioning corporate bond market. To create the basis for this market, the government has begun selling T-bonds to create a yield curve.[24] In December 2003, the CBRC unveiled a plan to allow commercial banks to issue subordinate bonds as second-tiered capital.[25] China's banks are responding to this new market opportunity. The big-four are reportedly making preparations to issue a combined 300 billion RMB in corporate bonds in early 2004.[26]

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[23]KPMG Hong Kong, "In Brief," *BankNotes*, 30 January 2004, 2.

[24]Cheng interview.

[25]Ling, "China's State-Owned Banks Prepare for Listing."

[26]KPMG Hong Kong, "In the News," *BankNotes*, 6 February 2004, 1.

Supported by the World Bank, it appears that further development of China's commercial bond market is continuing.[27] It is a welcome source of income.

International Stock Listings

The most risky, but intriguing means of recapitalization may be the use of international securities markets. Of all the strategies to restore liquidity, this one has brought the most press coverage in Chinese business media outlets. Banks are being encouraged to seek out capital through stock listings in international markets such as New York and Hong Kong. But in China's still-managed economic system, it will be up to the assessment of the CCP whether and when any of the banks will list. The government appears to be using stock listings to encourage reform by controlling it as a carrot to high-performers who have improved governance and their capital position. That said, listings will not be without risk. The banks might find a rude awakening as to the ruthlessness of reform via market, particularly if their listings are timed after the current frenzy for Chinese stocks has ebbed and investors' attitude more critical to the individual health of each enterprise.

International securities markets have been specifically targeted for bank listings in order to serve these reform objectives. Although domestic securities exchanges exist in China, Nicholas Lardy explains that, relative to China's economy, the exchanges are "quite small," and show "no signs of becoming a significant source of funds for the

[27] Asia Society, "Investing in China's Capital Markets: Where Will WTO-Sparked Reforms Lead?" *Conference Proceedings*, 9 May 2002 (New York, NY: Asia Society, 2002), 26. Cited hereafter as Asia Society *Conference Proceedings*.

Chinese corporate sector in the future" due to poor structural issues.[28] They are simply less attractive in their ability to raise funds as well as reform governance. International markets, however, are a substantial source of equity. Particularly in light of the extraordinary demand that international markets have for Chinese stocks, current listings are generating huge initial public offerings (IPOs) and considerable returns. As one measure, the Bank of New York's China index, a portfolio of 25 Chinese companies traded in New York City, is up 59 percent in 2003.[29] Provided in Table 5.2 is a selection of IPOs listed in the Hong Kong and New York exchanges. This IPO list is not exhaustive, but provides a glimpse of why international listings look so attractive from a capital perspective. Since December 2003, retail demand for Chinese IPOs has been extraordinary – even China Green, a rather common fruit and vegetable processing company, managed to close its IPO with retail demand at over 1600 to 1. As the table suggests, Chinese firms are attempting to capitalize on this energetic demand by pursuing listings quickly before there is a change in market psychology on Chinese stocks.

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[28]Asia Society *Conference Proceedings*, 15.

[29]"Chinese Life Insurance: Off With a Bang," *Economist*, online ed., 18 December 2003, URL: <www.economist.com/research/articlesBySubject/displayStory.cfm?story_ID=2304369&subjectid=348960>, accessed 30 June 2004.

TABLE 5.2
Recent Chinese IPOs

Company	Market	IPO date	Amount Raised (USD)	Retail Demand (subscribed)
Ping An	HK	Jun 2004	1.8 billion	58:1
China Green	HK	Jan 2004	25 million	1604:1
China Life	HK, NYSE	Dec 2003	3 billion	170:1 (NYSE)
Great Wall Auto.	HK	Dec 2003	194 million	680:1
PICC	HK	Nov 2003	693 million	136:1
BOC (Hong Kong)	HK	Jul 2002	2.9 billion	6:1
China Unicom	HK, NYSE	Jun 2000	4.9 billion	4:1 (both)

Source: Various media reporting.

Indeed, the success of these IPOs has generated high interest in the banking sector to join in China's current listing frenzy.

By controlling access to these markets, the CCP is decidedly dangling the listing privilege to motivate rapid reform from the banks themselves. Banks understand that the market timing for a lucrative listing is right now while Chinese stocks are hot, and that waiting too long could cost them needed equity. Without having to resort to heavy-handed tactics, the party has found a way to reform bank operations at a steady pace. Bank of China (BOC) and CCB has lead the big-four in reform. Motivated by a possible listing in 2005, BOC has undergone significant reforms to win listing privilege and prepare itself for the international markets. It is pursuing five or six foreign partners to improve governance, and has hired foreign consulting companies to modernize its operations – PricewaterhouseCoopers for annual reports that meet international standards, Boston Consulting Group for operations overhaul, and Hewitt Associates for a modern, competitive human-resources system based on performance.[30] CCB, looking forward to

[30]"Bank of China: Foreign Strategic Investors to be Selected in Restructuring," *Wall Street Journal*, 2 July 2004, accessed via ProQuest, 3 July 2004; Kathy Chen and Lora Western, "Bank of China to Restructure Before Share Offering," *Wall Street Journal*, 31 March 2004, accessed via ProQuest, 4 April 2004.

a listing approval and IPO this year, is undergoing broad restructuring to split the company into a holding group and joint-stock entity.[31] The joint-stock entity will account for about 90 percent of CCB's assets for listing in both Hong Kong and New York simultaneously.[32]

Due to strong precedent set by previous listings, the government anticipates that the effects of market discipline will improve bank governance and transparency. China Life's listing, and the resulting commitment to reform, is a pertinent illustration. A vast pre-IPO restructuring of China Life made it the largest listing in the world in 2003. Upon its NYSE listing, China Life's Chairman and President was quoted stating that U.S. supervision over its corporate governance and transparency practices would be valuable to the company's reputation and continuing reforms.[33] To China Life's benefit, and the precedent that it creates for other corporations, this is most certainly true. In April 2004, only months after its IPO, the company is coming under fire from its investors and the U.S. Securities and Exchange Commission (SEC) for corporate governance and transparency problems.[34] Indeed, the market will demand improvement in listed firms.

As China Life is learning, the government's strategy to capitalize the banks with stock market listings has risks. Accessing international capital flows for the first time via

[31]"China Advances Plan to List State Banks," *Wall Street Journal*, 10 June 2004, C5.

[32]Ling Huawei, "China Construction Bank Ready for Restructuring," *Caijing Magazine*, online ed., 2 March 2004, URL: <www.caijing.com.cn/english/2004/040220/040220ccb.htm>, accessed 15 March 2004.

[33]Li Shufeng and Kang Weiping, "The World's Largest IPO in 2003," *Caijing Magazine*, online ed., 23 December 2003, URL: <www.caijing.com.cn/english/2003/1220/1220ipo.htm>, accessed 24 March 2004.

[34]Francesco Guerrera and Richard McGregor, "Chinese Majors Under Fire On Disclosure," *Financial Times*, online ed., 29 April 2004, URL: <search.ft.com/s03/search/article.html?id =040429000722>, accessed 12 May 2004.

securities exchanges provides valuable carrots, but also substantial sticks. Strong entities will be rewarded with a flood of capital; but if listed banks are not sufficiently competitive, the markets will also eventually punish them. As a result, the exact arrangements made for listing – particularly the percentage of total shares to be floated on the market, and astute market timing – will be critical issues for the government to manage. If the percentage of shares listed is too small, the IPO is likely to be unattractive to investors and market discipline non-motivating to the bank. If the percentage is too large, the bank will be exposed to severe market shocks, potentially leading to insolvency if investors decide to sell-off shares due to problems in the bank. Per the issue of market timing, BOC's IPO for 2005 might come at the end of the current market frenzy to buy Chinese stocks, and the other two banks may simply be too late to take full advantage of floating securities on international exchanges. The current exuberance for Chinese stocks is being compared to the irrational buying of U.S. technology stocks in the late-1990s. If investors begin to lose confidence in Chinese stocks and the market crashes due to widespread selling proximate to a bank's IPO timing, it could spell disaster. All said, the listing of CCB later in 2004 will be a market event to be carefully watched, for it will establish precedent and the possible risk environment for the remainder of the three big-four banks.

Direct Government Bailouts

When all else fails, China will likely have to fill in the gaps with targeted bailouts. The challenge is to structure them in such a way that they are truly prudent. China's last bailout towards only two of the big-four banks reveals reasonable progress in the structuring of these actions. In 2004, China committed 45 billion USD of its foreign exchange reserves to reduce NPLs at CCB and BOC only, thus distinguishing their recent performance from the remainder of the big-four. The selectivity of government support is an important first step for reducing the effects of moral hazard and too-big-to-fail behavior.

Another challenge will be to execute these bailouts with due speed while it is still fiscally possible to do so. Indeed, there may be almost 600 billion USD in NPLs in the system to purge. Given China's current 444 billion USD currency reserve holdings and relatively benign debt situation (cumulatively about 25 percent GDP), China can afford to expand its debt in external markets to pay down most of the banks' debts.[35] It should be noted that China's debt – at 25 percent GDP – is relatively low in comparison to the 60 percent cumulative debt generally seen in developed countries. With a rapidly growing GDP, as well as the practice of stretching costs over a period of many years using currently low-interest government bond issues, China retains fair capacity to take on new debt in a sustainable manner.

Conclusions

China's use of various instruments such as FDI and the international stock market to reduce the effects of instability indicators illustrates a reform plan that is dynamic, ambitious, and innovative. Unfortunately, this plan will not be allowed unlimited time to impact China's banking system as it also has severe time constraints. Although the policy framework for FDI is successfully attracting foreign partners to reform China's banks, it

[35]Emerging Market Indicators," *Economist*, 26 June 2004, 102; Chi Lo, "Bank Reform," *China Business Review* 31, no. 2 (March/April 2004): 32.

also relies upon the creation of a new competitive dynamic in 2007 to attract these partners. Government bailout relief will be constrained by external factors coming online in the next few years, such as the upcoming costs of pension reform and future debt restructuring. Indeed, the structure of this reform plan suggests that it will only have the next couple of years to make a truly dramatic impact on the banking sector.

CHAPTER 6

TIME CONSTRAINTS TO DERAIL SUCCESS OF THE REFORM PLAN

According to China's reform plan, the reliance on a limited policy-driven investment framework and a fiscal position to afford massive bank recapitalization necessarily creates a limited timeline for reform. In order to attract immediate foreign investment and cull the beneficial effects of foreign bank entry, the Chinese Communist Party (CCP) has held firm to its World Trade Organization (WTO) statutory requirement to liberalize fully the sector on 11 November 2006. However, attracting investment in this manner also obliges the government to accept the detrimental effects of foreign bank entry beginning in 2007. Because of the government's impending fiscal situation and debt schedule, it is likely that the strength of China's policy to back the banks, as well as its capacity to perform recapitalizations, will wane in 2007. Foreign competition, a weak fiscal position, and the erosion of a policy of government backing will make 2007 a critical deadline for stable and sustainable banking reform.

Such time-dependent pressures will make it unlikely that China can, in only two years, accomplish the full array of changes necessary for a capitalized, disciplined banking sector. Not only is a two-year reform timeline difficult given the extent of improvements needed in the banking sector, but it will be even more challenging for a regime unused to a rapid rate of untested reform and one hampered by local governments unlikely to fully endorse the plan.

Key Constraint 1: Foreign Bank Competition in 2007

In 2007, the full effects of liberal foreign bank entry will begin to manifest itself in China's economy. As one of China's statutory WTO commitments, its full banking liberalization date is 11 November 2006. If by 2007 the banks are liquid, competitive, and independent, this strategy will have proven its brilliance as a method of reform. It is highly unlikely that foreign competition, under the regulations already in place, would necessarily affect the stability of China's economy. Most likely, some loan and skilled labor displacement will take place towards unilaterally-operating foreign banks as they expand their market share. However, the regulations for establishing foreign bank networks are such that domestic banks should be able to stay one step ahead of their foreign competitors by more quickly establishing market share in less-saturated markets outside of the major cities.

If by 2007 the domestic banks remain in their current state of financial weakness, the competition will probably create disastrous consequences for China's banking sector. The threat of large-scale displacement of profitable loans and skilled employees from insolvent state banks to well-operated foreign banks is a very likely one. Because of China's policy support to ban currency trading on the capital account, capital outflows from the banks had previously been restricted because domestic monies essentially had nowhere else to go. The full introduction of international banks to the market in 2007 will open an avenue for depositors to move their funds away from weak domestic banks to international banks with high reputability for their global coverage, stability, and diverse financial instruments. Such a capital outflow from domestic banks to their international competitors would create a scenario where state banks are left to hold an unfavorable portfolio of state-owned enterprise (SOE)-type loans. In turn, the risk of the banks going illiquid under the burden of bad loans would rise. Illiquidity caused by this scenario would force an emergency government bailout or risk bank collapse.

Whether by an overt announcement or a debilitating regulatory framework, scaling back the date for allowing foreign banks full access to RMB-denominated services is unlikely. Retreating from such a public WTO commitment will have consequences not only with international investors and within the WTO body, but also in China's strategy to leverage foreign bank expertise for domestic bank reform. Extending the deadline a year would also crowd a busy 2007, which is already mired in important commitments that will have to be closely monitored. Even in a quasi-market environment like China, it cannot be ruled out that the markets in 2007 would not punish this kind of news with adverse effects in China's securities and foreign direct investment (FDI) arrangements. With bank liquidity likely linked to international securities listings, such an announcement would bring serious doubt to the banks' financial state of health, and in turn, their share price. In light of China's sensitivities in creating a credible diplomatic image as a world power, withdrawing from this commitment would be embarrassing to the CCP. As to consequences in the WTO framework, the U.S. has certainly made its position known that it will pursue enforcement of each commitment outlined in its U.S.-China bilateral WTO agreement.[1] In a speech by the U.S. Trade Representative during a period of intense congressional discussions about China's status

[1]The U.S.-China bilateral WTO agreement essentially covers a great deal of China's final WTO accession agreement. As pertinent to this discussion, it does include specific reference to the dates when China has agreed to allow foreign banks local currency businesses. For a summary of the agreement, see Office of Public Liaison, The White House, "Summary of U.S. China Bilateral WTO Agreement," Press Release, 17 November 1999, URL: <www.uschina.org/public/991115a.html>, accessed 10 February 2004.

as a trading partner and prospective entry into the WTO, Ambassador Barshefsky claimed of China's bilateral commitments to the U.S.:

> Each commitment is specific, detailed, and fully enforceable -- through our own trade laws, WTO dispute settlement, periodic multilateral review of China's adherence, multilateral pressure from all 136 WTO members, and other mechanisms such as the special anti-dumping rules and anti-import surge remedies. We are already preparing, with the President's most recent budget request, for the largest enforcement effort ever devoted to a trade agreement.[2]

Indeed, there are a number of pathways for international recourse if China decides to withdraw one of its WTO accession commitments. China appears to understand this, as it has made considerable efforts to defend publicly its progress in meeting these commitments. Ultimately, China's dependence on its bank reform strategy might be the largest factor in eschewing this kind of behavior. The CCP sees foreign entry into the banking sector as key to its reform efforts. Scaling back on the entry timeline may break critical momentum in reforming the banks through joint-venture activities and bring doubt to the market partners that China is so jealous to guard. Lastly, having to push management of this entry timeline into the following year would heavily tax China's central government. Given China's need to closely manage reform centrally, having to oversee foreign bank entry and preparations for the Summer 2008 Olympic Games simultaneously is an unlikely scenario.

[2]Ambassador Charlene Barshefsky, U.S. Trade Representative, "China's WTO Accession in American Postwar Strategy," transcript of remarks delivered to the Bretton Woods Committee, Washington, DC, 16 May 2000.

Key Constraint 2: Fiscal Limitations in 2007

China's ability to recapitalize the banking sector is directly related to its ability to afford such an effort. Each bank bailout in 1998, 1999, and 2004 was accomplished with little overall fiscal detriment due to China's strong economic position during each bailout. China's high growth, low debt servicing costs, low total debt accumulation, and no other major fiscal outlays assisted bank bailout financing tremendously. With China's future debt schedule and near-term fiscal responsibilities; however, this ideal environment cannot be guaranteed much longer. Particularly as 2007 approaches, China's debt situation may be such that a total recapitalization-type bailout will bear unsustainable costs to its fiscal position. A loss of fiscal capacity to afford a bailout also will affect China's ability to lend legitimacy to its policy of backing bank liquidity. This is a critical policy measure that has helped defend the banks against harmful market effects. Losing legitimacy in this policy area will have a sharp effect on consumer confidence regarding promised bank loans and held deposits.

According to an insightful study by economist Chi Lo, China's current debt structure is designed to lock in the costs of current debt only until 2007.[3] His study recognizes that between 2007 and 2008, China's current 229.5 billion USD bond issuances will completely turn over. This is ultimately an issue because the cost of China's debt is linked to the interest assessed on it – presently a low 4 percent on average. If typical interest rate cycles expose the new issuances to a much higher interest rate (say, 10-12 percent according to pre-1997 coupons) in 2007, China's combined accumulated debt might become prohibitively expensive in a very rapid fashion. A potential 6 to 8

[3]Chi Lo, "Bank Reform," *China Business Review* 31, no. 2 (March/April 2004): 32.

percent jump in new servicing on a 229.5 billion USD portion of China's debt in 2007 could challenge funding for reform priorities.

Swelling deficits could create similar fiscal effects. For approximately six years, China has been spending in deficit to boost domestic demand. As a result, China's debt skyrocketed 250 percent from 1997 to 2002. Although the jump has resulted in current total debt at a supportable 25 percent of GDP, the pace of deficit spending had raised concerns from top CCP officials. In April 2002, China's Finance Minister stated very directly:

> The fiscal situation is grim. Revenue is growing too slow and expenditure is growing too fast. Not enough money is being collected and too much is being spent.[4]

It appears that the need for China's pump-priming has fallen greatly as a result of the current phenomenon of ballooning bank lending. As a result, CCP officials have indicated that it would cease bond issues for economic stabilization purposes starting 2004.[5] That said, China's swelling deficit problem is far from full resolution. Fundamentally, the central government is falling into debt as a result of a weak tax system. Despite what should be a lucrative period of tax revenue growth between 1978 and 1998, China's government income as percentage of GDP has actually dropped from 32 percent to only 12 percent in 10 years.[6] The central government's inability to raise tax

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[4] Mark O'Neill, "Beijing Heavy Spending Alert," *South China Morning Post*, 17 April 2002, accessed via LexisNexis, 20 March 2004.

[5] Isaac Cheng and Virginia Hulme, "Time to Regroup," *China Business Review* 31, no. 3 (May/June 2004): 35.

[6] William Gamble, "The Middle Kingdom Runs Dry: Tax Evasion in China," *Foreign Affairs* 79, no. 6 (November/December 2000): 16.

revenue from obstinate local governments has actually required it to raise 60 percent of its operating revenue in 1999 from debt issuances.[7] As a result, the phenomenon of rising debt is unlikely to disappear simply from the reduction of fiscal pump-priming. A growing deficit curve from continually weak tax revenue will make for a challenging 2007 fiscal position.

Additionally, the cost of unfunded pensions are likely to start weighing the government's fiscal bottom-line. Economist Yiping Huang estimates that unfunded pension liabilities total up to 600 billion USD.[8] With the pension deficit expanding as a result of a growing elderly population, pension reform will likely require a larger fiscal outlay than bank recapitalization. And like bank recapitalization, if pension costs are not recapitalized with some haste, the long-term economic, political, and social ramifications will be unsustainable and irreparable. Although the timing of this outlay is unknown, it will most likely affect the fiscal position of the government probably within this decade. The importance of this social safety net in China's socialist system forces it to loom large on the CCP's political radar.

The most important effect of a constrained fiscal position will be an erosion of the government's legitimacy in sustaining a policy support to back bank lending. This support has been critical in keeping the banks liquid. A lift on government support on liquidity at state banks increases the likelihood of a bank run in the weakest banks, potentially sparking a more widespread bank collapse. International credit rating agencies have widely publicized the importance of this policy, thus making this a highly-

[7]Gamble, 20.

[8]Mark Clifford, "China's Deficit Is the Least of its Financial Worries," *Business Week*, 6 May 2002, accessed via LexisNexis, 9 January 2004; Cheng and Hulme, 34.

monitored issue. Standard and Poor's, for instance, explicitly provided in its 2004 bank assessment that current Chinese bank ratings are largely a reflection of the government's unwavering backing of assets; their stand-alone credit profiles would be "significantly lower" than their given rating.[9] Highly publicized reports such as these affect market psychology in such a way that a change in this policy will likely produce a quick, high-velocity reaction in the banking sector. Indeed, in a banking system where liquidity is largely a function of government support, a loss of credibility in this policy will be catastrophic.

Between the time-sensitive factors of foreign bank entry and fiscal constraints, the latter's full impact is more challenging to forecast. The contemporary economic environment will affect the intensity of these aforementioned factors in assailing China's fiscal position, and in turn, its ability to bail out or back emergency provisions for the banks. If 2007 brings low interest rates for bond issues, controlled deficits, a significant upturn in China's fundamentally weak tax revenue, three previously consecutive years of 9+ percent GDP growth, or a strong combination of the four, this factor may not be as nearly critical to 2007. That said, the challenge for China will be to counteract actively an impending fiscal crunch, not simply to manage passively negative effects or assume a trend-line of future growth. Only maintaining the current course will most certainly result in an untenable fiscal situation. The problematic state of China's tax system, deficit growth, and considerations that international bond prices may increase have made this time-sensitive factor more likely to impact China than not.

[9] Standard and Poor's, *China Financial Services Outlook 2004*, Study, November 2003, 8.

An Unacceptably Short Timeline for Reform

These two time-limiting factors will put incredible pressure on the CCP to make the banks competitive within the next two years. When foreign bank entry in RMB-denominated activity occurs starting 2007, China's banks will need an independent governance structure and strong revenue position to compete despite inevitable loan displacement toward international banks. Also by 2007, the banks must be adequately capitalized in order to guard against the potential that the government's tight fiscal position will undermine its policy to back bank liquidity.

The chance that China will be able to strengthen sufficiently the banks before 2007 is a possible, but unlikely prospect. Joint-venture activity will need to expand rapidly and unhindered by local elites and regulatory regimes. Stock market listings will have to be decisive with a share listing that encompasses a healthy percentage of total enterprise equity. The China Banking Regulatory Commission will also need to have the full support of the State Council to eliminate state control of the banks, improve independent banking operations, and reorganize hopeless banks. Lastly, a pre-2007 program of targeted, strategic government bailouts would have to be implemented across those banks showing reform progress. Unfortunately, not only would the success of such an ambitious and far-reaching program be unprecedented, but China has two fundamental challenges unique to its particular development trajectory. CCP leadership will have to overcome the psychological challenge of pursuing rapid, untested change. The party will also have to curb heavily the influence of local governments in bank behavior. The latter provides exceptional challenges, as local governments have demonstrated precedent for derailing central government reforms.

Wary Resistance to Rapid, Untested Change

Contemporary memories of Mao's disastrous campaigns for swift reform have made the CCP wary of rapid change. One of Deng Xiao-Ping's most famous quotes has become "*mozhe shitou guo he*" (to cross the river by feeling for the stones), underlying the position that reform is an incremental activity achieved through a series of pragmatic experiments. FDI was only fully adopted on a national scale after it was assessed that the special economic zones were a success; the use of securities markets for capital slowly broadened only after a controlled experiment was conducted with listings on a new exchange in Shanghai; and banking reform might be more accurately seen as a continuous process begun in 1979. Fundamentally, the reform plan as stated will cause the central and local governments to lose influence over a critical instrument of state control and absorb what will be an unprecedented amount of debt from restructuring costs. Because of the enormous uncertainty of how these changes will affect the ability of the CCP to govern, accomplishing this plan in two years will be a phenomenal psychological challenge due to the history of contemporary reform.

The Challenge of Reducing Local Autonomy

Major problems such as banking governance and limited fiscal capacity are exacerbated by China's autonomous local governments. This study has touched briefly on many instances where local elites have completely spurned central government reform efforts. In one example, reform efforts in the 1990s to wrest control of branch banks away from local government leaders had not apparently reduced their influence in lending. In another, local governments have continued to grow investment projects up 65 percent, despite central bank attempts to slow down investment growth in early 2004. In other instances, China's fiscal capacity to recapitalize the banks has been constrained by an inability to raise tax revenue from resistant local governments. Indeed, at the chagrin of central government reformers, it appears that local governments have been unsupportive in establishing an independent banking system. The local elites are apt to challenge any reforms that will generate unemployment and weaken their legitimacy.[10] Given the role of local bank branches in buoying unprofitable, but labor-heavy SOEs owned by local governments, ceasing such lending activity through reform is a major issue of concern for local elites. Lastly, although of perhaps lesser scale, previous discussions in this study have suggested that control of the branches has also enabled local governments to enrich themselves with speculative investments and corruption.

Resistance from local elites will be incredibly difficult, if not impossible to eliminate – local autonomy is a phenomenon with a long historical precedent. Over four centuries of history, China's central authorities have generally respected and co-opted local elites, instead of conquering them per many Western historical traditions. The diversity of China's cultural geography, vastness of its physical geography, as well as its relationally-oriented Confucian tradition, has made the conservation of these local ties a necessary challenge. Over each dynastic cycle even as early as the Zhou Dynasty (770 to 221 B.C.), tribal and familial ties in local governance have been largely conserved and leveraged for effective governance. Even as early as the early 1900s with the fall of the Manchus, the geography known as contemporary China was governed wholly by loose coalitions of local elites and their militias. In light of China's lack of experience as a

[10]Richard Newfarmer and Dana M. Liu, "China's Race with Globalization," *China Business Review* 25, no. 4 (July/August 1998): 9.

centrally ordered state, the prospect that the CCP can eliminate local tampering in bank lending and fix the tax system in two years is grim. One study by Tung Chen-Yuan reviews how difficult this type of action is – in promulgating economic reforms in the 1980s and 1990s, the CCP found their efforts constantly derailed because of resistance from local elites.[11] The resulting compromises have forced the central government into fiscal sharing arrangements that remain unsustainable.

Conclusions

This assessment concludes that the two-year timeframe for reform created by China's current plan will be insufficient for credible and lasting reform. On such a tight deadline, this broad-reaching and complex restructuring plan may be an impossible management task for a party which is uncomfortable with untested and rapid reforms and a local elite likely to resist them. If the banks do fail as this assessment forecasts, the implications of subsequent economic distress may be substantial, both domestically and internationally.

[11]Tung Chen-Yuan, "China's Fiscal Predicament," *American Asian Review* 21, no. 1 (Spring 2003): 25-53.

CHAPTER 7

CONCLUSION: IMPLICATIONS OF A BANK COLLAPSE IN CHINA

According to a considerable body of theoretical and empirical study on the relationship between economic crisis and political instability, the economic effect of a bank collapse is always likely to render domestic political effects. In the case of China, where this study has also established that the governing regime has tied their political legitimacy to economic growth, a collapse in the banking system and the resulting economic crisis will likely manifest not only political effects, but political *crisis*. Although the banks could fail today given the indicators for collapse so prevalent in the banking sector, the timing of this event might be more convincingly assessed for 2007 when the time-sensitive implications of the current bank reform plan are extrapolated outward. If such a collapse occurs on the suggested timing, it will have particularly acute domestic effect on the current regime because of the political environment in which it will occur. It will also likely have substantial economic and security ramifications on regional investment partners (including Taiwan) and certain developing nations.

Domestic Implications of Bank Collapse in China

The legitimacy trap created by Deng Xiao-Ping to rest the Chinese Communist Party's (CCP's) legitimacy on economic growth will, by itself, generate a degree of political instability in the case of a massive banking collapse. A bureaucratic-authoritarian regime like the CCP that is dependent on economic growth for political legitimacy will probably be challenged, at minimum, within the party by advocates of alternate perspectives on development if China's fragile banks finally sink under the weight of their own insolvency. That said, the outlook of the political environment where this challenge is likely to occur is also bleak. China's political environment, a significant determinant of the magnitude of any crisis, will exacerbate the political instability already inherent to China's particular economic challenge.

China's political environment in the years leading to 2007 and 2008 is especially troublesome. Unfunded pensions are increasingly becoming a political liability. In March 2002, tens of thousands of unemployed workers protested in the industrial rustbelt of the Northeast over issues such as non-payment of welfare benefits and low severance pay, making these the largest protests since 1989.[1] The country is also facing a severe employment problem. An official Chinese newspaper explains that between 2003 and 2020, 15 million *new* job seekers will enter the market each year.[2] Even at a blistering 7 percent growth in GDP, with employment elasticity remaining at a historical 50 percent, the unemployment rate could rise past 10 percent by 2007 – doubling the rate in only two to three years.[3] Perhaps most critically, the lead-up to the 2008 Beijing Olympic Games will fuel the confidence of protesters and dissidents likely to leverage what will be a unique political setting.

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[1]"Asia-Pacific: Chinese Oil Workers in Massive Protest," *BBC News*, online ed., 13 March 2002, URL: <news.bbc.co.uk/2/hi/asia-pacific/1870936.stm>, accessed 13 December 2003; Rupert Wingfield-Hayes, "Chinese Labour Protests Spread," *BBC News*, online ed., 18 March 2002, URL: <news.bbc.co.uk/2/hi/asia-pacific/1879463.stm>, accessed 13 December 2003.

[2]"National News: For Workers, Parting is Painful," *China Daily*, online ed., 2 February 2004, URL: <www.chinadaily.com.cn/en/doc/2004-02/02/content_302178.htm>, accessed 13 March 2004.

[3]Ray Brooks and Ran Tao, *China's Labor Market Performance and Challenges*, IMF Study, Working Paper WP/03/210, November 2003, 3.

Intense international scrutiny will make the Olympic Games and its year long run-up a vulnerable political period for the CCP. International press coverage is often overwhelming for even the most prepared cities, and the 21,500 members of the world's media expected in-country to cover the 2004 Athens Olympic Games is only likely to increase for China in 2008. With the privileges of exposure that the party will eagerly capitalize upon to increase China's international standing, also comes tremendous responsibility. The Olympics are the world's largest and most famous avenue to brand a nation to the world. In such opportunity, China's government will be heavily restrained to tread carefully and avoid harsh crackdown tactics, as to not tarnish a political and economic image that will last for decades to come.

Perhaps more important is the precedent that the 1988 Seoul Olympic Games has set for potential dissidents inside China, in Hong Kong, or in Taiwan. Easily remembered by many Chinese who watched the Seoul Games in their childhood, the Seoul Games revealed that an autocratic government could be challenged, and won over, through protest activity supported and fueled by unwavering international media coverage. Moreover, historical accounts of the event have widely attributed the timing of South Korea's democracy to the effects generated by the 1988 Olympic Games.[4] These historical "lessons-learned" may embolden dissident movements and influence the timing of coordinated protest efforts against the regime.

If the banks collapse in 2007 as suggested, unfunded pensions, unemployment, and the opportunity of the Olympic Games will increase the magnitude of a likely

[4]Bruce Cummings, *Korea's Place in the Sun: A Modern History* (New York, NY: W. W. Norton & Company, 1997), 332-333; Don Oberdorfer, *The Two Koreas* (Reading, MA: Addison-Wesley, 1997), 161-172.

political crisis. Invigorated also by the use of internet communications to assist dissident coordination, the intersection of the aforementioned variables could spark political unrest on an untenable scale. Such an intersection would be unprecedented in contemporary China, even in light of the social unrest, bleak job picture, and economic crisis that has often been credited in driving the 1989 Tiananmen Square massacre.[5]

According to INSEAD professor Jonathan Story, China may be able to minimize a great deal of this type of political unrest by co-opting the dissidents and preemptively liberalizing the political norms of China's communist regime before 2007.[6] There is some likelihood to this proposition, if the CCP recognizes the impending political and economic scenario. It is possible that the party would allow the political system to evolve towards a more democratic model on the basis of maintaining stability. Chinese Premier Wen Jiabao himself recently stated:

> Our development over the past years has proven that stability is of vital importance for China. As premier of this country, I think the most important issue for me is to ensure stability and development.[7]

Per Premier Wen's own statement to ensure stability, one of the domestic implications of an *impending* bank collapse may be increased liberalization of China's communist

[5]Victor Shih, Assistant Professor of Political Science, Northwestern University, e-mail interview by author, 26 May 2004; David Chater, "China: Boom and Bust?" *Global Investor*, September 2004, 21.

[6]Jonathan Story, Professor of International Political Economy, INSEAD, "What China's Transformation Means for Business, Markets and the New World Order," lecture presented at the SAIS China Forum, Washington, DC, 22 April 2004.

[7]Wen Jiabao, Premier, China, unpublished transcript, interview by *Washington Post* Editors Leonard Downie Jr. and Philip Bennett, and *Washington Post* correspondents John Pomfret, Philip P. Pan, and Peter S. Goodman, 21 November 2003.

political system. This would be a dramatic change in China's development trajectory indeed.

International Implications of Bank Collapse in China

Regardless of the outcome of China's domestic political situation, a bank collapse will almost certainly have direct ramifications internationally – particularly on China's regional foreign direct investment (FDI) partners and developing nations dependent on primary commodity exports for growth. Internationally, acute security concerns of an economic downturn in China exist most likely in the China-Taiwan relationship and developing nations most exposed to commodity price shocks.

Integration Effects of China's FDI Strategy and Implications on International Partners

China's FDI development strategy has encouraged Chinese integration into the global economy by participating in the production processes of multinational corporations. Although this has been most true with regional companies which can more easily leverage their geography to use China as a reprocessing and re-export hub for their products, efficiencies in global transportation networks have enabled this type of production migration to begin occurring from anywhere in the world. Indeed, information technology component exports to China from regional companies in Japan, South Korea, and Taiwan for reprocessing and re-export accounts for 40 percent of

China's total imports.[8] China is now South Korea's largest export market.[9] The trade is so critical to Korea's export-reliant economy that it would have likely sunk into recession in 2003 if not for expanding trade with China.[10] With regard to Japan's share of imports in China, this accounts for about 32 percent of Japan's total export growth in the second-half of 2003.[11] Like Korea, this is no small statistic – Japan's long-awaited economic rebound in 2003 is in large part driven by increased export growth caused by efficiencies from using China as a manufacturing hub. Apart from the phenomenon of regional integration, the global effects are growing. Nearly 80 percent of the Fortune 500 companies are now currently invested in Chinese joint-ventures.[12] The top ten of these alone accounted for 152.4 billion USD in 2001 revenue. Table 7.1 provides a revenue-based snapshot of these international firms and their investments. For the most part, the listed companies represent the most lucrative, high-growth sectors of the global economy – automobiles, telecommunications, and technology. Many of these multinational companies began joint-ventures in China to focus almost solely on the domestic market, but increasing quality and skill from Chinese manufacturers are enabling several to begin leveraging China as an export hub. Honda is building an automotive factory devoted

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[8]Customs General Administration of the People's Republic of China, *China Customs Statistics Yearbook 2004* (Hong Kong: Goodwill China Business Information, 2004), CD-ROM.

[9]"Business: China Emerges as Biggest Export Market of S. Korea," *People's Daily*, online ed., 14 November 2002, URL: <english.peopledaily.com.cn/200211/14/eng20021114_106790.shtml>, accessed 9 July 2004.

[10]Moon Ihlwan and Dexter Roberts, "Korea's China Play," *Business Week*, online ed., 29 March 2004, URL: <www.businessweek.com/magazine/content/04_13/b3876012.htm>, accessed 3 April 2004.

[11]Stephen Roach, "Asia's Recovery Void," *Morgan Stanley Global Economic Forum*, 26 March 2004, URL: <www.morganstanley.com/GEFdata/digests/20040326-fri.html>, accessed 30 March 2004.

[12]United Nations Conference on Trade and Development, *World Investment Report 2001* (New York: United Nations, 2001), 26.

specifically for exports; Volkswagen has also indicated that it will begin exporting from China as well.[13]

Table 7.1
Top 10 Foreign Companies in China (by JV revenue), 2001§

Foreign Investor	Joint Venture(s)	JV revenue (bil. USD)
Volkswagen (Germany)	Shanghai Volkswagen	28.7
	Shanghai Sac Volkswagen	15.9
	Fay-Volkswagen	15.8
Motorola (U.S.)	Motorola (Tianjin) Electronics	31.3
Ericsson (Sweden)	Nanjing Ericsson Communications	9.9
General Motors (U.S.)	Shanghai GM	8.8
Siemens (Germany)	Shanghai Siemens Mobile	7.7
Honda (Japan)	Guangzhou Honda	7.5
IBM (U.S.)	International Information Products	7.2
Nokia (Finland)	Dongguan Nokia Mobile	6.8
Alcatel (France)	Shanghai Bell Telephone Equip. Mfg.	6.5
Sinar Mas (Indonesia)	Sinar Mas Pulp and Paper	6.3

§*Excludes Chinese joint ventures with special administrative regions*
Source: Ministry of Foreign Trade and Economic Cooperation, *2002 Yearbook of China's Foreign Economic Relations and Trade* (Beijing, China: China Foreign Economic Relations and Trade Publishing House, 2002), 799.

Despite what appears to be a strong integration trend in China's economic development, some recent scholarship has warned that the full extent of this phenomenon has yet to be realized. An empirical April 2004 study conducted by the International Monetary Fund concluded:

> China's emergence will eventually represent a larger shock to world factor endowments and to the global economy than previous integration episodes, potentially implying a major impact on certain sectors and regions.[14]

[13]"The Rich Hit The Road," *Economist*, 19 June 2004, 60.

[14]International Monetary Fund, *World Economic Outlook*, Study, WEOEA0012004, April 2004, 86.

At the moment of future bank failure, the extent of China's integration will help determine the regional and global implications of economic crisis in China. The magnitude of integration even at present already assures that bank failure in China will produce adverse effects at multiple levels. Due to the relatively slower progression of non-regional foreign firms in establishing integrated processes in China, the effects of a Chinese bank collapse in the short-term future is unlikely to be a critical event for multinational firms. There should be little doubt that the resulting losses will erode the financial balance sheets for a wide range of international enterprises. However, the share of a company's investment in China relative to the total volume of its global operations is not yet such that instability in China is likely to cause massive adverse effects in these firms. That said, the effects on regional firms and their home nation economies are more likely to be severe due to the extent of economic integration already achieved between these nations.

As regional and highly-integrated neighbors, Japan and South Korea will bear high costs in the case of an economic crisis in China. A major think-tank in Korea has warned that rapidly expanding trade volume with China makes Korea's economy extremely vulnerable to any slowdown in China's economy.[15] Even if the economy slows to an annual growth rate of 5-6 percent GDP, Korea's exports will shrink immediately by an estimated 5 billion USD, or 0.3 percent GDP.[16] With Japan's much heralded

[15]Yang Sung-jin, "Dangerous liaison?" *Banker*, online ed., 3 May 2004, URL: <www. thebanker.com/news/fullstory.php/aid/1529/Dangerous_liaison_.html>, accessed 20 May 2004.

[16]Kim Jae-kyoung, "Korea on Alert over 'China Shock,'" *Korea Times*, online ed., 16 May 2004, URL: <times.hankooki.com/lpage/special/200405/kt2004051614075211440.htm>, accessed 20 May 2004.

economic rebound accounting for a meager 2.7 percent growth in GDP in 2003, a collapse in China's economy would likely easily erase such gains.

In Taiwan, where production integration with China is most pronounced, the economic and political ramifications of an economic collapse in China are considerable. Both economies participate in an information technology production cycle that forces them to be reliant on one another for growth. Taiwan sends 33 percent of its total exports to China for further manufacturing; in fact, Taiwanese computer companies made over 40 percent of their product in China in 1999.[17] As a result, Taiwanese firms account for 70 percent of China's total output in information technology hardware.[18] China and Taiwan are integrated so closely that even the slightest market effect in one affects the other. For instance, when China announced in late-April 2004 that it intended to restrain growth in 2004, Taiwan's stock exchange reacted immediately to the negative news by losing 14 percent of its total value in only 10 days.[19]

In light of an often-tense political and military relationship between the two nations, damaged economic linkages as a result of distress in China's domestic economy will also have strategic security implications. According to a widely-cited political theory that interdependence produces a greater likelihood of peace between state actors, economic integration between Taiwan and China appears to have aided stability in this

[17]Nicholas Lardy, "Sweet and Sour Deal," *Foreign Policy*, no. 129 (March/April 2002): 21; James K. Glassman, "A Bull in China's Shop," *Washington Post*, 15 February 2004, URL: <www.washingtonpost.com/ac2/wp-dyn?pagename=article&contentId=A41504-2004Feb14&notFound=true>. Accessed on 16 February 2004.

[18]Lardy, 21.

[19]Dan Nystedt and Sabrina Kuo, "As China Goes, So Goes Taiwan," *Wall Street Journal*, Eastern Edition, 6 May 2004, C14.

bilateral relationship by increasing the economic cost of war.[20] If integration between these two states were to unravel as a result of economic distress, it is possible that the potential for conflict would increase. Such concern has made this issue a primary area of current monitoring for high-level crisis watchers such as the economic advisor to U.S. Pacific Command and the surveillance division at the World Bank.[21]

China's Commodity Demand and its Effect on Developing Countries

A downturn in China's economy may have political and economic repercussions in developing countries heavily dependent on primary commodity exports. China's thirst for commodities to feed its growing investments and manufacturing has been a great benefit to many developing nations; however, such dependence on China's demand has made these nations vulnerable to the effects of a negative price spike in the event of an economic crash in China.

International commodity prices have been driven up by Chinese demand. Chinese growth currently accounts for the consumption of about 50 percent of the world's cement, 30 percent of its coal, and 25 percent of its iron and steel.[22] China's growing consumption of oil is no less substantial. A senior economist at SG Economic Research

[20]Such complex interdependence theory asserts that multidisciplinary interactions between states (economic, social, and political connections) raises the cost of war sufficiently that military force becomes less of a viable means to project power between such entities. Keohane and Nye have written extensively on complex interdependence theory. For a broader treatment, see Robert O. Keohane and Joseph S. Nye, *Power and Interdependence: World Politics in Transition* (Boston, MA: Little, Brown and Co., 1977).

[21]Leif Rosenberger, Economic Advisor to Commander, U.S. PACOM, telephone interview by the author, 30 January 2004; A source, senior economist in the Surveillance Operations Division, World Bank, who wishes to remain anonymous, interview by the author, 2 June 2004.

[22]Economist Intelligence Unit, *China Country Report*, ed. Paul Cavey, March 2004, URL: <db.eiu.com/report_full.asp?valname=CRCNE301&title=Country+Report+ China>, accessed 12 March 2004.

assessed that China would account for 50 percent of new global oil demand in 2003.[23] In spring 2004, the price of oil spiked to nearly 42 USD a barrel, the highest price in over two decades.[24] International spot prices on steel scrap also rose in the spring of 2004 to 340 USD/ton – up almost 300 percent year-on-year.[25] Steel scrap, a preferred source of steel, has become valuable enough to intensify global criminal smuggling of metals stripped and stolen from public infrastructure. A recent *Wall Street Journal* article highlighted China's effects on a diverse array of commodities prices due to its role in the global production process. A few of the notable trends are listed in Table 7.2 below.

Table 7.2
China's Effect on Commodity Prices (Jan to Mar 2004)

Commodity	Price increase (%)
Copper	93.5
Soybeans	74.5
Silver	51.2
Platinum	50

Source: Peter A. McKay, "Shortages Fuel Commodity Prices," *Wall Street Journal*, 18 March 2004, C1.

China's demand has been a revenue engine in developing countries, particularly in Africa, which are dependent on the export of a narrow range of primary commodities for a large share of their GDP. Table 7.3 points out the relationship of primary commodity exports to the GDP of several African nations. The data (like all statistics for Africa), as well as the age of the statistics, warrants due caution. However, it remains a

[23]Phillip Day, "China's Appetite for Oil Helps To Keep Gasoline Prices High," *Wall Street Journal*, Eastern Edition, 22 October 2003, C16.

[24]"Demand From China Blamed For Oil Shock," *Far Eastern Economic Review* 167, no. 22 (3 June 2004): 28.

[25]James Brooke, "Asian Scavengers Feed China's Hunger for Steel," *New York Times*, online ed., 11 June 2004, URL: <www.nytimes.com/2004/06/11/business/worldbusiness/11scrap.html>, accessed 11 June 2004.

useful illustration of the general extent of dependence that some nations may have on a small band of commodities. The table also helps to demonstrate how increased prices in China might have such a considerable revenue affect on a nation's GDP. In Zambia, for instance, copper comprised 88 percent of the nation's total commodity exports in 1990. Per Table 7.2, China's strong demand for copper has nearly doubled the market price for the commodity in three months, resulting in a presumable windfall for the Zambian government and its copper producers. Likewise, Angola, Congo, and Nigeria are benefiting greatly from oil revenue growth not seen in years as a result of increased price pressure from Chinese demand.

Table 7.3
Dependence on Primary Commodities in Selected African Countries, 1990

Country	Commodity (% total exports)	Exports as a share of GDP (%)
Angola	Oil (93)	39
Congo	Oil (85)	51
Mauritania	Iron (55)	46
Nigeria	Oil (96)	43
Zambia	Copper (88)	36

Source: Angus Deaton, "Commodity Prices and Growth in Africa," *Journal of Economic Perspectives* 13, no. 3 (Summer 1999): 26.

Although high prices may provide an immediate revenue boon in these aforementioned countries, their dependency on a narrow band of commodities also creates tremendous political and economic risk in case of price shocks to those commodities. Indeed, one recent World Bank study recognizes that a large price shock phenomenon in a commodity export-dependent country will severely affect economic growth, and can increase the risk of reversed development, a failed state, or worst, civil war.[26] Indeed, large downward price spikes can have a dramatic effect on a poor country dependent on revenue from these commodities to maintain sustenance, to fund improved infrastructure, and to finance public projects essential for social stability. Given the unsustainable levels of debt and lack of income diversification in many of these nations, lost revenues are not easily replaced, often resulting in failed projects and political duress to governments likely already strained by weak legitimacy.

A devastating price shock in the commodities markets is certain if China's economy is exposed to a liquidity crisis as a result of adverse bank effects. Just as prices have been driven up at the speed of China's economic ascent, prices are likely to drop at a speed relative to any decline in its economic trajectory. Although the precise impact that this will have on commodity export-dependent nations will vary depending on the individual political, social, and economic circumstances, it is likely that the commodity reverberations of an economic crash in China will be felt, in some way, in all of these nations. Acute security effects are most likely to be seen in situations of failing states and regimes with low political legitimacy.

Final Conclusions

China's insolvent banking system may fail in the next three years. As a result of the likely political backdrop to this event, bank failure may produce violent and unpredictable unrest only avoidable perhaps by preemptive political liberalization. Regardless of the domestic outcome of such an event, a bank collapse will also probably have harmful effects on regional partners such as Japan and South Korea, stress the

[26] Paul Collier and others, *Breaking the Conflict Trap* (Washington, DC: World Bank, 2003).

relationship between China and Taiwan, and create political and economic instability in developing countries reliant on China's roaring demand for their economic growth. Having taken a "blind eye" approach to the long-standing problems in its banking system, China will soon have to face the consequences of relatively ineffective reform over the last two decades. That said, it is unfortunate that the international community is also likely to suffer due to the terminal economic health of one of its most populace members.

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