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Jukka Taskinen*

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Abstract

This study overviews the current state of the Chinese state enterprises and bank reforms. Transformation of command economy into market economy has until recently been relatively frictionless, at least in retrospective to other command economies. Recently economic growth has become sluggish which has been blamed on structural factors. Corporate governance reform is recognized as the next key issue of reforms. Despite the economic weight of state owned enterprises is diminishing, the financial sector is heavily linked to the SOE. The current economic woes result from the reckless lending practices, the money was given to those with political influence instead of those deserving. Now, the amount of bad debt is threatening the stability of the financial sector. Institutions required for effective corporate governance are emerging. However, the state wants to retain control over the former state owned enterprises, which hinders the proper functioning of the market. Piecemeal reforms do not appear to suffice and there are some serious doubts of the capacity to finance the reforms.

Keywords: China, Economic Reforms, State Owned Enterprises, Corporate Control

1 Introduction

China may well be the most successful transition country of all. While ex-communist countries in the former Soviet Union and Eastern Europe have seen economic growth stumble for various reasons, China has maintained high growth. China may also have an economic structure more apt to reforms than the Soviet Union. Nevertheless, cracks in this impressive façade of success have appeared in recent years as losses by state-owned enterprises (SOEs) have mounted. Marketisation, delayed SOE reforms and increased private sector competition are all seen as reasons for the poor performance of SOEs. Corporate governance reform is often prescribed as a way to resolve the problematic relationship between the banks and SOEs.

The very existence of a soft budget constraint can be interpreted as a corporate governance problem. In this paper, therefore we examine economic reforms in China to discern signs of possible hardening of budget constraints and changes in corporate governance.

So far, banks have been the most important source external finance, but their role in the future is not self-evident given the extent of their losses on bad SOE loans. China, therefore, may need to reform of both its banking sector and its large state-owned firms. Chinese state enterprises continue to absorb resources that could be used more productively elsewhere.

Politically, China's objective is to establish "socialist market economy with Chinese characteristics." Since 1994, China has reformed its tax, fiscal and foreign exchange regimes, and current reform effort is directed towards enterprise and banking sector reforms. Corporate control is still at an embryonic stage, and it is not clear what the future will bring.

In many respects, China is like other transition countries. The soft budget constraint (SBC), which emerged as a response to marketisation shock, eventually burdened the banking with bad debt. What is perhaps different is that savings rate in China has remained high. In its recent history, China has not had an inflationary shock big enough to wipe out savings. There has been a shift, however, in the saving and finance pattern: a shift of savings source from government to households and a shift of financing enterprises from state budget to financial sector, notably into a banking system.

2 Why is China different?

China arguably was in a better initial position for reforming its economy than other former socialist countries. China benefited from its underdeveloped position, the FSU and CEE suffered because of their heavy industry (Sachs and Woo 1994). China was well under way of developing a socialist economy based on heavy industry, but a rupture in the Sino-Soviet relationship in the 1950s led to a withdrawal of Soviet technical assistance, and industrial projects were not completed. Ironically, the lack of industrialisation left China with a large reserve of rural workers force available to shift into productive jobs in the industrial sector when the opportunity arrived. Favourable initial conditions and this absence of macroeconomic and structural distortions contributed to 7% annual growth in this decade. (Malo et al. 1997, 34) The incrementalist strategy applied by the Chinese was feasible because the state sector had not exhausted available resources at the beginning of reforms.

China has implemented dual-track reforms, creating coexisting market and planned socialist economies. Planned prices were adjusted gradually under the dual-track price system to correspond to market prices prevailing in the private sector. Liberalisation created new incentives for enterprises and workers to take advantage of the opportunities offered. Price liberalisation was followed by a parallel approach to enterprise reforms. While SOEs remained

in place, private and semi-private collective enterprises emerged. Foreign joint ventures and foreign direct investment also made significant inroads into China. Between 1979 and 1994, 210,000 projects were undertaken by foreigners, mostly overseas Chinese (Cao et al. 1997, 22).

China's economic reforms may appear haphazard and not carefully planned, and give the impression that the country's leaders had no clear idea of the correct course of reforms (Fan 1994, 104). Even so, the opposite is more likely. Reforms, after all, were advanced by a consensus on a need to move towards a market-based system. Paradoxically, a potential explanation for a rise of dynamic semi-private collective enterprises might lie in an attempt to create an ultimate socialist economy. An estimated 60% of party officers were eliminated in the purges during the Cultural Revolution, transferring decision-making power in practice to local communities. Although much of the economic growth was attributed to a tissue of small enterprises, they were not officially tolerated. As late as 1991, there were serious attempts to curb their operating freedom in favour of state sector. Only the threat of collapse of the tax base prevented authorities from acting.

3 Chinese enterprise sector

With over half of production controlled at the county or city/provincial level, the structure of the Chinese state sector differs considerably from other ex-command economies. The non-state sector includes a mixture of private and public enterprises, including the increasingly significant town and village enterprises (TVE). The difference between SOEs and collectively owned enterprises lies in property rights. By definition, an SOE is held by all the people, so the central government reserves the ultimate right to decide upon the allocation of residual cash flow or assets. In the case of collective enterprises controlled at local level, the central government is unable to intervene. Due to corporatisation an increasing number of enterprises are formed as joint ventures, joint stock companies. Joint ventures have often been formed of some divested part of SOEs with a foreign partner in order to attract foreign capital or technology (Qian 1995). Economic reforms have also long aimed at decentralising decision-making. Increasing decentralisation without changes in ownership rights of the SOE has given local governments increasing powers over resource allocation and income distribution (Fan and Xin 1998).

Table 1 Types of enterprise ownership in China

	SOEs	**Non-state owned enterprises**			
		Collectives		**Individual**	**Others**
	Public enterprises		**Private enterprises**		
Urban	Controlled by some level of government	District and neighborhood enterprises	Urban co-operatives	Urban individual	Private Joint stock Joint ventures
Rural	N/A	TVE	Rural co-operatives	Rural individual	

Source: Qian 1994

Because SOEs still hold many social responsibilities, the role of SOEs within the public sector remains vague. The Chinese constitution was amended in 1992, when Party Secretary General Jiang Zemin made an initiative on a development of the "socialist market economy" and provided a rudimentary outline for a modern enterprise sector by 2000. Future reforms

were to follow gradually (and, in fact, they have).The "iron rice bowl," a metaphor for the guaranteed livelihood provided by SOEs, was to be taken away. In 1997, Jiang announced the government had increased its efforts to smash the iron rice bowl (Hughs 1998).

To maintain growth, SOE restructuring heads the agenda today. This is understandable, given that the average SOE's debt-to-asset ratio is now estimated at around 90% (Fitch IBCA 1998a). China selected one thousand enterprises for reinvigorating during 1996-2000 to form the core of a future enterprise sector. China also decided to "let go" of the remaining SOEs through liquidation, reorganisation, merger, sale or bankruptcy. The second group comprises some 102,000 small and 15,000 medium to large SOEs. In 1993, SOEs employed some 80 million people, of which 15 million were officially estimated to be redundant.

Table 2 Dual-track transition of pricing system, % of prices

	1978	1985	1988	1990	1991	1992	1993
Agricultural prices							
Planned	94.3	37.0	24.0	31.0	22.2	12.5	10.3
Guided	0	23.0	19.0	27.0	20.0	N/A	7.0
Market	5.6	40.0	57.0	42.0	57.8	N/A	82.7
Retail prices							
Planned	97.4	47.0	28.9	30.0	20.9	17.9	12.2
Guided	N/A	19.0	21.8	25.0	10.3	7.1	4.2
Market	3.0	43.8	49.3	45.0	68.3	75.0	84.6

Price liberalisation has been seen as a key issue in facilitating efficient use of resources. Earlier piecemeal approach has been adopted for unwinding price control and liberalisation was initiated in the agricultural sector. The process has been extended gradually to the industrial and service sectors. Currently, the economy is almost entirely covered, save strategically important sectors. Under a dual-pricing scheme, SOEs were obliged to sell a part of their production below market prices. While such a pricing mechanism may hold back inflationary pressure, it may also lead to harmful side effects such as corruption and distorted profit (Shleifer and Vishny 1997). Currently, over 90% of the retail prices are determined by the market; competition in producer and consumer products in China is intense. Increasing competition is partly an outcome of reforms and the rapid growth of joint ventures and domestic enterprises (EAAU 1997).

Table 3 Significance of SOEs in China's economy

	1985	1990	1991	1992	1993	1994	1995	1996	1997
Total number of enterprises	358.7	417.1	418.9	408.0	459.0	465.2	510.4	506.4	496.1
Total number of SOE			75.4	74.1	80.6	79.7	87.7	87.0	85.0
Of which loss making (%)	9.6	27.6	25.8	23.4	30.3	30.9	33.8	35.9	37.0
SOE losses (billions RMB)	3.24	34.88	36.70	36.93	45.26	48.26	63.96	79.07	
Fixed assets as % of total	52.7	50.0	50.1	50.0	50.2	49.9	49.0	47.8	46.5
Value added as % of total	42.6	36.6	36.3	34.6	33.0	30.8	28.6	26.9	25.9
Employment as % of total	13.7	12.1	12.2	12.1	11.9	12.1	11.9	11.6	11.1
Indus. employment as % of total	45.5	38.9	39.3	39.0	38.1	36.2	35.7	33.5	31.1

Source: Statistical authorities of China 1997

Table 4 SOE industrial enterprises 1995

	Number	SOE %	Gross output	SOE %
Total	510.4	17.2	5494.6	47.1
Light industry	252.9	17.5	2349.0	35.0
Heavy industry	257.5	16.9	3145.6	56.2
Large	6.4	73.0	2182.8	72.9
Medium	16.6	66.2	907.7	58.4
Small	487.4	14.8	2404.2	19.5

Source: Statistical authorities of China 1997

Between 1985-95, the number of enterprises grew by 40% peaking at 510,000 in 1995. Of these, 17% were classified as SOEs. Further, SOEs compose a significant share of the large and medium-sized industrial enterprises, respectively accounting for 73% and 59% of gross output. In heavy industries, SOEs produce almost 60% of gross output, although they are outnumbered by non-SOE enterprises. Almost 40% of SOEs were loss-making in 1996, and overall losses amounted to renminbi RMB 80 billion (USD 9.6 billion). At the start of reforms, the share of loss-making SOEs fell, reaching a low point below 10% in 1985. The trend then reversed, so that between 1985 and 1996 the losses of SOEs increased 24 fold. These losses were initially explained by dual-track price controls that obliged SOEs to sell part of their production at below-market prices. This explanation became irrelevant in the latter half of the 1980s when prices were liberalised. Increasing competition offers another plausible explanation for increasing losses. These losses are possibly underestimates of the real losses, since most SOEs do not pay interest on their loans. Loans are typically rolled over and payable interest added to principal (Lardy 1997).

Table 5 Fiscal subsidies to loss-making SOEs, 1985-96

	1985	1990	1991	1992	1993	1994	1995	1996
RMB billions	50.7	57.9	51.0	44.5	41.1	36.6	32.8	33.7
Percent of budget expenditure	25	19	15	12	9	6	5	4
Percent of GDP	5.7	3.1	2.4	1.7	1.2	0.8	0.6	0.5

Source: Statistical authorities of China 1997

Subsidies peaked in 1990 at RMB 58 billion, but have since declined dramatically. Fiscal subsidies to SOEs appear small relative to GDP or budget. The central government has financed the budget deficit since 1994 by issuing bonds, so its reliance on central bank financing has all but disappeared. Subsidies appear modest relative to economy and would imply a small loss of efficiency. However, SOE losses have not been entirely covered by subsidies, so policy loans by banks were used as quasi-fiscal subsidies (Lardy 1997).

The Chinese government has been essentially forced to initiate SOE reforms. The plan initiated by Jiang involves three steps:

1. redefining the government's role as a shareholder with limited liability,
2. revitalising certain large- and medium-sized enterprises by allocating more decision rights to the management, and
3. selling small and medium-sized enterprises to private entities.

The Chinese authorities are painfully aware of the excessive indebtedness of SOEs, and favour mergers as the best form of privatising SOEs. (Jie and Jie 1995) The three formal channels for reducing indebtedness are known as the "30 x 3 plan." The plan includes:

1. RMB 30 billion fund for debt write-downs under bankruptcies and mergers,
2. RMB 30 billion for converting old policy loans to state equity shares, and
3. a quota for emission of 30 billion shares at the Shanghai and Shenzen stock exchanges.

Unfortunately, the flood of new shares together with the East Asian crisis spooked equity investors. Thus, stock market issuance will not necessarily become a substantial source of new capital for a while (IMF 1998, 99).

4 Corporate governance reform

China reformed its economy gradually over three decades. The private sector was allowed to emerge despite the prevailing radical socialist ideology, while SOEs were not modernised. Unlike in other ex-socialist countries, China never experienced a loss of production. Gradual liberalisation and opening of economy freed resources to more productive uses, which compensated for SOE inefficiency. The increasing focus on credit risk may now force a rethinking of links between SOE and state-owned banks and lead to a harder budget constraint, and a deficient governance mechanism is often blamed as the root of the current woes. The gaps in centralised decision-making create opportunities for local level collusion between management and employees and between local authorities and SOEs. Thus far, China has made timid experiments in ownership structures and enacted some basic company laws.

There are two generic forms of corporate control in market economies. An arm's length system gives the stock market central role. Here liquidity needs and the threat of hostile take-over play important roles. A control-oriented system, on the other hand, underscores a role of banks in monitoring enterprises. Typically, banks are thought to have longer-time horizons than market agents and ownership tends to be more concentrated. The governance structure also depends heavily on historical factors. For instance, Germany and Japan were capital-poor countries in the eve of industrialisation; their banks practically had to assume a role in outside funding. On the other hand, legal development shaped ownership structure in the United States. Table 6 summarises some of the differences between the two systems.

Arm's length finance also requires a higher degree of legal protection, so courts have an important role in control. In a control-oriented system, the mere protection of voting rights suffices.

Both systems share common features. For example, the control-oriented system overlaps with the arm's length system in the aspects related to a protection of minority shareholders (Shleifer and Vishny 1997; Modigliani et al. 1998). Concentration of ownership and legal

protection of investors may act as substitutes. Legal protection of investors correlates with a depth of capital markets and diversity of ownership (La Porta et al. 1996). Berglöf (1997) summarises the essence of corporate governance systems. It is the relative importance of markets and institutions in monitoring the use of funds, rather than their roles in the supply of funds, that distinguishes financial systems.

While neither system's superiority has been proven, the ability to capture long-term opportunities is frequently given as the main benefit of governance. However, a control-oriented system is slower at responding to price incentives, and this potentially could lead to a misallocation of resources. For example, a study covering Japanese firms shows (Hoshi et al. 1991) that investment decisions in firms with strong ties to banks depended much less on cash flows. Corporate governance is result of historical development, hence sudden changes to institutional environment may create harmful side effects. For instance, the South East Asian crisis may have been partly caused by a sudden change in corporate governance (Rajan and Zingales 1998). Local institutions were unprepared to deal with large amounts of arm's length capital once current account transactions were liberalised. A legal system defining investors and creditor rights is a prerequisite for capital markets.

Table 6 Characteristics of control-oriented and arm's length finance systems

	Type of financial system	
	Control-oriented	**Arm's length**
Share of control-oriented finance	High	Low
Financial markets	Small, less liquid	Large, highly liquid
Share of all firms listed in stock exchange	Small	Large
Ownership of debt and equity	Concentrated	Dispersed
Investor orientation	Control-oriented	Portfolio-oriented
Dominant agency conflict	Controlling vs. minority stakeholders	Shareholders vs. management
Role of board of directors	Limited	Important
Role of hostile take-overs	Very limited	Potentially important

The reform of ownership structure created a dual-track economy. Parts of the economy started to move to a market-based system. China's special localised socialism is embodied in its TVEs. TVE faced less principal-agent problems than centrally planned SOEs, because direct benefits created an incentive to monitor local management. In other words, TVEs have always faced a hard budget constraint, so they never have been in a position to cover their losses by borrowing (Cao et al. 1997). In addition to the soft budget constraint of SOEs, the rise of "hiding-revenue-in-local-economy" is the second failure of centralised control mechanism of SOE (Fan et al. 1997). A system of contracting budget pre-specified amounts of tax revenue to be transferred from local to central government. A system creates an incentive for local governments to conceal and redirect revenue from SOE to local development. Qian and Roland (1994) show that a hard budget constraint can be achieved with a combination fiscal decentralisation and monetary centralisation.

During the pre-reform period, corporations had virtually no autonomy. Enterprise autonomy was enhanced in 1993, when Deng Xiao Peng issued a 16-point programme on enterprise reforms. The programme was aimed at improving management autonomy, corporate

structure, price controls, tax legislation and social security arrangements. Management autonomy was improved in 1988 with the SOE Law, which assigned managers significant freedom in 14 functions, including production, pricing, independent sales, selection of supplier, investment, use of reserve funds, and hiring and firing of workers. The law, however, was rather general and did not insulate managers from political influence. Management autonomy was specified by Autonomous Management Rights Regulations in 1992, which made enterprises responsible for their profits and losses and clarified the legal responsibilities.

A corporate control vacuum is a consequence of fragmented and weakly defined SOE property rights. Asset stripping and consequent capital flight are indications of an urgent need to improve protection of private property. For example, capital flight from China has been estimated to account for up to 30% of capital being invested in China in the first half of the 1990s. Weakly defined property rights and lack of control give management larger autonomy than formally indicated. While state assumes an unlimited liability over SOEs, insiders are able to privatise assets and socialise liabilities.

Corporatisation and privatisation were viewed as ways of locking in the benefits from marketisation. A step towards facilitating corporatisation was achieved through enactment of the Company Law in 1993. The law defined concepts such as limited liability, share capital and separation of ownership from management (Lichtenstein 1993). Corporatisation has progressed slowly. By 1996, two years after the Company Law went into force, only an estimated 5% of SOEs had become corporations. The World Bank explained the slow changeover of SOEs is difficult because “Identification of an SOE’s investor… is often a difficult task. This is not simply a problem of tracing funds; it is a political economy problem of assigning property rights. The competing claimants - the government departments and agencies, including line bureaux and ministries - often cannot reach consensus as to who is the investor.” (World Bank 1997) A division of property and control rights between the ministries is overlapping and confusing, in which case no one is responsible for the “bottom line.”

A hardening budget constraint and definition of property rights should lead to an effective system of control. Although exit through bankruptcy is clearly an essential element, the Hungarian experience shows that overly strict bankruptcy legislation is also harmful to economy (Abel and Gatsinos 1993). The Chinese bankruptcy law came in force in 1988, but it has been applied infrequently. This is due in part to the prevalence of bankruptcies faked to cover asset stripping (Qian 1995, 227). The number of exits has shown a modest increase. There were 1,700 bankruptcies in 1994, 2,400 in 1995, and 6,300 in 1996. For SOEs, bankruptcies have grown in similar proportion: 100 in 1995 and 600 in 1996.

Governance issues are complicated in transition countries by the social responsibilities of SOEs. Non-economic objectives blended into the SOE agenda lead to conflicts of interest. SOEs controlled by politicians perform poorly because politicians maximise their non-economic objectives such as employment at the expense of profitability (Schleifer and Vishny 1994). A lack of clear identification of ownership, management’s responsibilities or responsibility for liabilities has led to a softening of the SOE budget constraint (World Bank 1997, 49). Budget subsidies and policy loans reflect of a soft budget constraint, which in China’s case has led to bad debt problems (Shumei and Schaffer 1998). Accumulation of non-performing debt, in turn, reflects the shift of financing from budgetary support to intermediation through the banking system.

The Chinese authorities are aware of the lack of mobility among SOE workers. SOE employees have been reluctant to leave because of non-transferability of pensions and lower wages offered by the private sector. Private sector enterprises have not been capable of offering

equivalent benefits. Measures to increase employee mobility have been initiated. For instance, in the northern Liaoning province in the heartland of Chinese heavy industry, laid-off workers are provided income support. The State Economic and Trade Commission (SETC) and ministry and finance have decided to shift from direct support of SOEs to indirect measures aimed at improving the business environment (Standard & Poor's 01/1999).

Asymmetric information offers an alternative explanation for an accumulation of bad debt. In an environment where creditors have less information than managers, poor projects are more likely to be financed. Another explanation for refinancing is the sunken cost nature of poor projects (Dewatripont and Maskin 1995). Political influence and poor information have been caused the soft budget constraint in Chinese SOEs. SOEs have little incentive to correct a situation when they can count on a bailout (Li and Liang 1998). When nominal owners have limited information about enterprises and corporate assets are effectively controlled by insiders, the possibilities for asset stripping, inappropriate allocation of capital, excessive wage increases etc. increase.

The Chinese enterprises have been allowed to issue shares and corporate bonds since the 1980s. Share issues have yet to create a significant source of alternative finance, however. It is estimated that 4-5% of large- and medium-sized SOEs have issued shares, and that, at most, 7-8% of total SOE share capital is held by the shareholding public. Typically, a privatisation sale has meant selling a 20-30% stake to the public. Small shareholders, however, are unlikely to increase their weight in corporate control due to a dispersed ownership structure (IMF 1998, 107). Share issues were seen as an attempt to reduce competition for bank loans and an attempt to reduce dependence on bank loans (IMF 1997, 31). In Russia, a voucher privatisation aiming at creating a liquid stock market failed, because it did not raise productivity (Sachs and Woo 1994).

The stock market has grown rapidly in China, hampered mainly by ownership limitations and the sheer size of the country. Nevertheless, stock markets have flourished in China. Enterprises can get listed in Shenzen or Shanghai exchanges, and two classes of shares are available. A shares are only for domestic investors and B shares for foreigners. As of the end of 1997, over 600 companies had listed A shares and over 100 companies B shares. Foreign ownership through B shares is still small, accounting for only 5% of the market capitalisation. Technically these shares are similar, but B shares trade at a discount. Restrictions on current account transactions and a lack of alternative savings forms may explain the lower price (Fernald and Rogers 1998).

There has been a debate on the most suitable system of the governance for the large SOE. Earlier, it was thought that the Chinese industrial structure might migrate towards a Korean-style Chaebol system. Advocates argued that the small size of many Chinese SOEs in comparison to their foreign competitors justified the Chaebol structure. However, the perceived ineffectiveness of Korean and Japanese conglomerates these days has strengthened the opposing argument, which says that Chinese industrial groups are already too diversified (IMF 1998, 126).

Whatever the case, it is clear that the public and private sectors are following diverging trends in governance. Private firms have created informal "bamboo networks" in response to the country's weak legal protection. These networks of control closely resemble Japanese keiretsu or Korean chaebol (Lehmann 1997, 117). The future direction of corporate control of SOEs, therefore, largely depends on government attitudes. There is no consensus for what is symbolised by the Chinese characters for "socialist market economy." There are also open questions regarding to the relationship between regional and central governments, between

industrial, financial and administrative control, between monolithic versus multiple share holding and so on (Morris 1995, 56). Such indications may mean that China envisions a strong interventionist model similar to that of Singapore or South Korea (EAAU 1997).

Banks have a central role in the Chinese economy, so naturally they could assume a role in monitoring. Given the Polish restructuring experience, non-governmental creditors should be allowed the initiative to undertake restructuring (Wijnberger 1997). On the other hand, it is argued that specialised state banks lack the skills needed for risk management. Thus, even if the staff is replaced, a legacy of planning gives a rise to financial market fragility, repeated banking upheavals and government bailouts (Berglöf 1995, 84). A Chinese policy aims at creating a "main-bank" system for the selected 300 enterprises considered to have "national interest." Here, banks and selected small and medium-sized enterprises sign a formal agreement. The main bank must "consider the long-term development of the enterprise, and support most of its reasonable funding needs, according to principles of commercial credit." The Chinese main-bank system differs from the German or Japanese system since the Chinese system does not require the banks to nominate members for a board of directors. Reciprocally SOE have to inform the bank of any significant event influencing their operation (World Bank 1997). In 1997, banks were made responsible for their lending. By the end of that year, there was already evidence that lending officers had become more cautious. In the beginning of 1998, the system of loan quotas was abolished and banks were allowed to make loan decisions based on balance sheet strength and perceived credit quality. The banks responded by scaling down most of their lending. In general, inexperience in credit risk analysis is a fundamental weakness of the banking system (Fitch IBCA 1998b).

Moral hazard and adverse selection are thus potential threats to reform in an environment of ailing financial institutions. There is an urgent need to recapitalise the Chinese banking system before the banks can be expected to assume their proper role in monitoring. One proposed way to fill the negative capital base has been a swap of central bank loans to the state banks for shares held by the government (JP Morgan 1998). Debt-for-equity swaps are used increasingly in China, because they are effective in diversifying ownership. On the other hand, they provide a cash flow relief that reduces the SOE manager's incentives to move ahead with the enterprise restructuring. Poland experienced a similar situation at the beginning of its reforms. State banks inherited large quantities of poor debt, and an enterprise-restructuring program threatened liquidity of the banking system. Swaps allowed the firms to restructure by reducing inherited debt burden. The lack of creditor protection, however, pushed banks to support bad enterprises at the expense of good ones (Balka 1997).

Many factors indicate the Chinese economy is headed towards a bank-centred system of corporate governance. Chinese SOEs lack capital and technology, which probably excludes a voucher privatisation. Chinese leadership has also voiced reluctance to the idea of extremely diffuse ownership. Many authors relate a development of a securities market to the maturity of legal institutions to enforce contracts, in particular rights of minority shareholders and foreign investors. The role of stock market and small shareholders will potentially remain limited in an immediate future. On the other hand, the evolving main-banking system may be more apt to monitor SOEs than an arm's length system. The Chinese plan to gravitate from a command economy to "market socialism" carries hazards. Partial reform are unable to weed out current problems (Dorn 1998). A state centred system of conglomerates leaves much room for crony capitalism and inefficiencies, hence a true divorce of a state and market should be completed. Moreover, conglomerate system generates low returns on capital, because insiders dominate corporate governance. Insider's private benefits depress their demand for productivity, which may prove out to be too low in the face of an ageing population (Gibson 1998).

5 The Chinese financial sector

In a socialist system, the role of banks was confined to executing the credit plan, i.e. the central bank's main monetary policy instrument. Compared to other socialist countries, China began economic reforms early. By the mid-1980s, the state had loosened its grip on the economy and the People's Bank of China (PBC) had embraced functions typical of a Western central bank. These reforms remained frail because banks were still obliged to make policy loans according to the credit plan. The Chinese banks began circumventing the rigid plan and credit rationing through investment trusts. Proliferation of investment trusts after 1986 made their supervision difficult.

The overheating of the economy between 1988-1991 forced a slow-down in the reform process. The Chinese economy is highly monetised, and inflation has remained at relatively modest level compared to monetary expansion. In 1994, the separation policy lending from commercial banking was the most central of the reforms though local branches specialised banks were still exposed to political pressure. Implementation of the credit plan became harder due to the various opportunities for bypassing regulation (Yusuf 1994).

Financial market liberalisation has been implemented gradually. Before reforms are initiated at the national level, reforms are tested in regional “laboratories” (Mehran et al. 1996). Abandoning the credit plan requires profound changes in the Chinese society, because of the complexity of interrelationship and spheres of influence. Note that the PBC and specialised banks have been under the direct influence of the central government and state council. Local governments have had a great impact on lending decisions of specialised banks, because supervision of the PCB's 2,400 branches has been close to impossible. Despite a tough policy stance in the centre, the local branches of the PBC have not been immune to political pressure. Often a local “big shot's” opinion has been favoured over the guidelines from the headquarters (Montes-Negret 1995). Dismantling the credit plan is thus requisite in hardening the budget constraint. The credit plan showed strong continuity until mid-1993, and funding of infrastructure projects was mandatory for specialised state banks.

The Chinese savings rate is high compared to other transition countries in Eastern Europe. In fact, the savings rate has remained high and stable regardless occasional bouts of inflation, and the high demand for money has been a crucial element in reigning in inflation. Similarly, government's share of overall savings has fallen steadily. In the 1980s, the government accounted for 43% of savings and households for 23%. The remainder came from the enterprise sector. In the 1990s, the picture has changed. The government's share plummeted to a puny 4%, while households increased their savings quota to 71%. The high savings rate also focused enterprise financing towards bank lending. Policy lending has become a substitute for state subventions coming out of the budget. Hence, China avoided large budget deficits during its transition. (Qian1995)

With the ascendance of a private and semi-private sector, the economic importance of SOEs has waned rapidly. In fact, without the drag caused by economic ties to specialised state banks, China might be able to grow its way out of trouble. Unfortunately, almost 70% of the loans to SOE are made by specialised state banks, which in 1996 held nearly 70% share of loans and deposits. The SOEs might thus destabilise the Chinese economy through the banking system. Presently, specialised banks have inherited a large stock of non-performing loans. A widely quoted estimate on non-performing loans has been 20-25% of the total loan stock. Currently the specialised banks have an urgent need to recapitalise, which may prove hard since their average pre-tax profit on assets is less than 1%.

Table 7 Structure of the Chinese banking sector, end-1996, RMB million

	Assets	Loans	Equity
State policy banks			
Agricultural Development Bank	712449	404218	13189
State Development Bank of China	280280	265223	31935
Import–Export Bank	21561	14429	2518
State-Owned Specialised Banks			
Industrial and Commercial Bank of China	3629566	1787490	94151
Bank of China	2427672	1207217	113995
China Construction Bank	2125301	1541413	45500
Agricultural Bank of China	1466946	894319	42158
Nation Wide Shareholding Banks			
Bank of Communications	397883	203570	21268
CITIC Industrial Bank	108670	50732	5497
China Investment Bank	57349	30714	2606
China Everbright Bank	47054	23546	2189
Hua Xia Bank	22652	10166	2870
Regional Shareholding Banks			
China Merchant Bank	92577	47395	5696
Guangdong Development Bank	79097	37638	2826
Shanghai Development Bank	64969	35195	2210
Shenzen Development Bank	30022	14317	2535
Fujian Industrial Bank	24361	1212	1862

Source: Fitch IBCA 1998a

Berglöf and Roland (1995) studied incentives of undercapitalised banks with poor loan portfolios and political pressure to refinance unprofitable firms. They found that due to government's propensity for bailouts, enterprises faced a soft budget constraint that gave rise to repeated bank bailouts. The soft budget constraint is a result of the tough recapitalisation policy. Bank managers fearing dismissal after recapitalisation have an incentive to roll over their bad debts. On the other hand, an overly soft recapitalisation programme encourages firms to take an overly tough stance to liquidation policy in an attempt to exaggerate their own recapitalisation requirement (Aghion et al. 1998). A hospital agency is never an optimal solution, because banks avoid bearing any cost associated with bad loans. A government that is able to commit itself to a once-and-for-all re-capitalisation of banks, may succeed in hardening the budget constraint. The soft budget constraint arises from a sunk-cost nature of bad projects, i.e. it is profitable to refinance *ex post* poor projects, which would *ex ante* be unprofitable (Berglöf and Roland 1997).

Signs of gradual hardening of the budget constraint are now appearing. For example, the central bank's agenda now includes restructuring of China's trust and investment companies, reducing the number of investment firms from 240 to 40. The first concrete sign of a harder budget constraint may have been the recent the declaration of bankruptcy by Guangdong International Trust and Investment Corporation (GITIC) . The government has also announced a plan to establish a hospital agency to deal with bad debt, whereby an asset management company will take on loans overdue by two years or more (Harding 1999). Intensifying banking competition should increase efficiency of financial intermediation over time and lead to a more diversified banking sector (Cheng and Cheng 1998).

There is increasing evidence since the beginning of 1998 of a toughening policy stance. The PBOC has now closed small banks on several occasions. The alleged reason for the bank closures has been negative value and poor management. The China Construction Bank was selected as an experimental case for solving the bad debt problem. According to this plan, banks are recapitalised by selling non-performing loans as government-backed securities. These measures may yet prove inadequate, because the estimates of the PBOC and outsiders differ substantially on the total amount of non-performing loans.

6 The future of China's banking and corporate systems

Having avoided a loss of production, China's transition to date appears highly successful. The country's smooth transition is explained by favourable initial conditions, sound policy, and a gradualist approach to reforms. In the beginning of reforms, Chinese resources appeared sufficient to justify the gradualist approach. However, China ultimately failed to deal with the marketisation shock. Price liberalisation and emergence of new competitors to SOEs pushed SOEs deep into the red, leading to an accumulation of bad debt. The fact that continuous accumulation of non-performing debt is tolerated is explained by a soft budget constraint; specifically, the lack of incentives among banks to impose stringent lending conditions. SOEs did not restructure to meet the market competition, because they didn't have to. Consequently, corporate governance tops the list of upcoming reforms.

State ownership failed to yield satisfactory results. However, the poor result were partly due to non-economic obligations. Now China has undertaken projects to dismantle previous system of social security, which impedes restructuring of SOEs. Similarly, new sources of funding are emerging. The number of Chinese SOEs listed in Shenzen and Shanghai stock exchanges is growing, but state seems willing to hold a voting majority in SOEs. There are various reasons to believe the stock market role in governance will remain limited. Weak legal protection of (minority) shareholders, geographically dispersed ownership and the authorities attitude all argue against seeking capitalisation from the stock market.

Asset swaps and sales of minority stakes do not diversify dramatically ownership structure. Most importantly, the voting majority in SOEs remains under state control. A mass privatisation would be a potential answer, but it also carries potential hazards. In an environment of weak legal protection and poor information, a sudden diversification of ownership base potentially transfers the control of enterprise assets to insiders. Against these facts, banks are better able to monitor SOEs. More frequently utilised debt-to-equity swaps automatically create a bank centred system. However, in an environment of uncertain property rights it is not clear whether recapitalisation through debt-to-equity swaps will succeed, although the enterprise would otherwise be healthy. If Chinese banks manage to establish a functioning system of control and supervision, the value of equity will rise and the banks will be able to sell their possessions at a profit. This will loosen their current financial straitjacket. On the other hand, swaps in unhealthy enterprises can not change the banks' situation significantly, so they may still have insufficient cash flow to pay interest on deposits.

Finally, it must be said that the sincere concern of the Chinese authorities is not in doubt. Despite a looming credit crunch, the GITIC was allowed to go bankrupt. This indicates that political will does exist to combat the soft budget constraint. The decision to cut down a number of ITICs and reorganise the branch network of the central bank are also steps towards centralising monetary policy and facilitating supervision of the banking industry. All these moves should help harden the budget constraint. However, the authorities have also chosen

to eliminate corrupt practises by making the penal code more severe. Such gestures do nothing to solve the fundamental problem of weak corporate governance. Recapitalising the banks and eventually corporatising specialised state banks are fundamental requirements to restore their incentives to monitor SOEs. China has chosen mixture of a sale of stocks and state bonds and securitised loan bonds to raise new capital for ailing financial institutions. There are some doubts on a feasibility of such a reform program. Not only are Chinese banks likely lack the skills to turn around poorly performing SOEs, but securitisation of loans may be difficult, given that there is no secondary market for loans.

China recognised correctly the need for reforms and thereafter took assertive steps towards resolving the corporate control problem. The doubts relate to the effectiveness of these measures. The fast decline of SOEs in terms of employment and value added might also imply that China could to grow its way to health. Indeed, SOEs are disappearing from the scene at increasing speed. However, high leverage with falling economic performance could create further difficulties in serving debt. The specialised state banks have directed most of their lending to SOEs, creating a mountain of a bad debt in the process. It is therefore impossible to predict whether the proposed programs are sufficient for filling the need for fresh capital. Even if the recapitalisation plans are effective, it is still dubious whether specialised state banks can redirect their lending to profitable enterprises. Estimates of the amount of non-performing debt vary, but it seems that the four specialised state banks are empty shells. While we have yet to read of bank runs, the risk of systemic collapse in the banking sector is not unthinkable. Bank deposits account for over half of GDP, so a collapse of the banking sector would wipe out the most household savings.

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Notes

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