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China's "Triangle of Woes" and Its Impact on Financial Stability

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Abstract

The purpose of this paper is to apply Dean's (2001) model of the 'Asian governance triangle' to assess the symbiosis relationships among the Chinese government finance, state-owned enterprises (SOEs) and the banking system in China. According to Dean, the relationship as a whole is fragile and unhealthy. This is because crises of such character are interdependent and contagious in that crisis in any one corner could readily lead to crises in the others. However, China has so far managed to avoid a financial crisis, which according to Dean (2001), is due to three reasons. Firstly, China remains willing to pour public funds into its SOEs and banks. Partly, as a result, hundreds of millions of ordinary Chinese people keep adding to their bank deposits, which enable the banks to sustain their flow of non-repayable loans to the SOEs. Secondly, China remains shielded from the crisis by its holding of massive foreign exchange reserves. Finally, the financial system is well protected by its exchange and capital controls. However, over the years, a series of reforms of its SOEs and banking system has severed the symbiosis relationships through the introduction of banking and corporate governance in the system. Any disruption of the gradual approach towards the reforms by hastily adopting a flexible exchange rate and free capital flows would do more harm than benefit China in the long run.

JEL Classification: O16

Key words: China, corporate governance, banking governance, banking reforms, government finance, state-owned enterprises, state-owned banks

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The adoption of open door policy since 1978 has been followed by a series of economic reforms for the last two decades or so. However, the financial sector, in particular the banking system is still the weakest part of the economic structure of the Chinese economy. Equally weak is the state-owned enterprises, which have undergone several drastic changes over the years are still making losses, albeit with slight improvement in recent years. Government finances, on the other hand still needs a major revamp before a healthy balance sheet can be presented. The three entities which represent the three core pillars of the Chinese economy are somehow intertwined such that any changes in one entity will have significant repercussion on the other. The symbiotic relationship among these three entities has been called by Dean (2001) as the "Asian Governance Triangle" or "Triangle of Woes."

The fragile financial structure emerging in China at any time may contribute to financial instabilities, which under certain circumstances might bring about a financial collapse. In particular, the big state-owned Chinese banks have been on the verge of bankruptcy and previously technically insolvent, only supported by the Chinese government working as a tacit guarantor for the banks and people's continued confidence in these banks. Furthermore, the banking problem has become more acute basically due to massive lending to the faltering state-owned enterprises (SOEs), which has been the contributing factor in a huge build-up of non-performing loans (NPLs) and subsequent financial problems for the banks. In addition, the Chinese government official budget deficits combined with hidden liabilities, such as unfunded pensions, have caused more concerns on the overall stability of the Chinese economy.

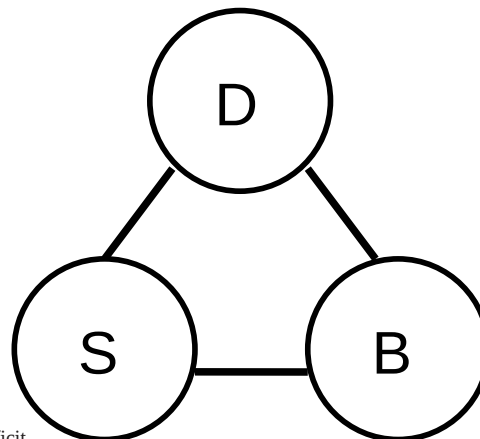
The purpose of this paper is to apply Dean's (2001) model of the 'Asian governance triangle' to assess the symbiosis relationships among the Chinese government finance, state-owned enterprises (SOEs) and the banking system in China. After the Introduction, the second section explains the "Asian governance triangle" and its symbiotic relationships. This is followed the next section by examining each constituent of the triangle. The fourth section attempts to extend the Dean's model to reflect the evolutionary changes of the governance structure. The last section alerts

that any disruption of the gradual approach towards the reforms by hastily adopting a flexible exchange rate and free capital flows would do more harm than benefit China in the long run.

2. The “Asian Governance Triangle” and Its Symbiotic Relationships

Dean (2001) has delineated certain characteristics of what he refers to as “Asian Governance Triangle” (AGT) involving a three-way symbiosis between government, finance and industry. Figure 1.1 depicts the government’s fiscal deficit (*D*), at the top of the triangle. This feeds in to the banks (*B*), at the bottom right corner and then to the SOEs (*S*) at the bottom left. This is, as dubbed by Dean, China’s ‘triangle of woes’. He stresses that each corner of the triangle is vulnerable to a crisis on its own account. For instance, a crisis at corner *D* could erupt if the government would not be able to finance its deficit by selling bonds or printing money. A crisis at corner *B* could also happen if people lost confidence in the banks and started withdrawing deposits (or if deposits stopped growing), and finally a possible crisis at the SOE (*S*) corner can be provoked by overwhelming losses.

Figure 1 - The “Asian Governance Triangle”



D: Government budget deficit
B: Banks
S: State-owned enterprises
Adapted from Dean (2001)

Dean emphasizes that crises arising from the AGT are interdependent and contagious. Crisis in any one corner could therefore readily lead to crises in the others. A crisis at *D* could result in the termination of the government bond interest paid to banks, government subsidies to SOEs, or to both. Were banks cut off from government bond

income, they would likely find themselves unable to retain deposits. The crisis would have spread from *D* to *B*. Or if subsidies to SOEs ceased, the banks would likely find themselves hard-put to earn loan revenues, and again the fiscal crisis would spread to *B*. Similarly, crises at the *B* or *S* corners might spread to the *D* corner; if banks or SOEs were the initial source of crisis, the resulting rise in subsidy spending might so bloat the government deficit as to cause a crisis there too (Dean, 2001).

In China, Dean argues, this internal fragility (SOEs, banks and fiscal deficit) is obvious. Experiences in other countries in the last decade have show that internal fragility causes financial crises. For instance, Latin America's international debt crisis in 1982-89 had much to do with fiscal deficits (Bowe and Dean, 1997; Dean, 1998); Mexico's crisis of 1994-95 had much to do with bad banking; and East Asia's crisis of 1997-98 had much to do with an unhealthy symbiosis between bad banking and loss-making enterprises with weak corporate governance. But in each of these cases, internal fragility led to a crisis on the countries' external capital accounts, a crisis that manifested itself most dramatically as a collapse in their currencies' external values. Hence, the internal problems became a full-blown crisis with catastrophic real consequences only after they turned into external problems.

However, China has so far managed to avoid a financial crisis, which according to Dean (2001), is due to three reasons. Firstly, China remains willing to pour public funds into the SOEs and the banks. Partly, as a result, hundreds of millions of ordinary Chinese people keep adding to their bank deposits, deposits that enable the banks to sustain their flow of non-repayable loans to the SOEs. Basically, most Chinese people have no where else to hold their savings, except as cash. Secondly, China remains shielded from crisis by the structure of its external balance sheet. China has massive foreign exchange reserves and relatively long-term foreign liabilities. The proportion of short-term debt is low enough for it to be easily repaid out of foreign exchange reserves should external creditors decide not to roll it over. Thirdly, China remains shielded by capital controls. This is an effective tool in preventing massive 'capital flight' usually with an ensuing currency crisis.

2.1 *The AGT and its Symbiotic Relationships*

In the pre-reform period, the allocation of funds to the SOEs was almost exclusively handled by the state plans. The People's Bank of China (PBoC) acted only as an auxiliary in providing supplementary working capital to SOEs. In a bid to improve the efficiency of capital utilization, reforms were introduced to achieve a clear division of labor between the budget and the banks in investments financing (Qian, 1994). While policy-oriented items would continue to be covered by government funding, other capital requirements, including those of SOEs, would be channeled through the banking sector on commercial terms. This stemmed from the 'loan for grant' reform of 1983-84, in which the SOEs would rely heavily on bank loans for capital inputs; subsequently 90% of enterprise borrowings were from the state banks (Li, 1998). According to Lardy (1998:83), at the end of 1995 exposure to SOEs was high as 83% of all loans from the state-owned commercial banks (SOCBs), and 90% of all lending for fixed investments by the Industrial and Commercial Bank of China (ICBC) were to SOEs. This shows a marked shift in capital allocation for the SOEs, given that in 1978, only 24% of the total provision of funds (for both fixed assets and working capital) was supplied through the state banking sector (Huang and Yang, 1998).

The SOEs' performance worsened rapidly during the 1990s. In 1996, about half of the SOEs lost money, and the state sector as a whole made a net loss of RMB 38 billion (Huang and Yang, 1998). The debt-equity ratio of the SOEs rose dramatically from 23% in 1980 to 440% in 1998, following the 'loan for grant' reform (Bartel & Huang, 2000). Rapid accumulation of enterprise debts is not a problem in itself, but it may lead to significant financial distress if net earnings do not cover the increasingly larger interest payments. The enterprise reforms succeeded in expanding autonomy and providing incentives but failed to establish a governance system for monitoring and enforcing responsibility. State-ownership was maintained, loss-making SOEs were rarely liquidated and redundant workers were usually not dismissed.

As a consequence of inefficiency, SOEs' financial performance has deteriorated during the reform period (see Table1). Their liability to assets ratios have grown and return on assets declined, while their losses have increased. Government subsidies peaked in 1989, but since then the government has been unable to cover SOE losses

due to a weak fiscal position, and increasingly the banking system and involuntary enterprise credits (triangular debt)¹ have made good the shortfall (Perkins, 1999).

Table 1 - Financial Performance of SOEs and Government Subsidies

	Losses of industrial SOEs (1)	Ratio of liabilities to assets of SOEs	Return on assets of industrial SOEs	Government subsidies to loss- making SOEs (2)
Year	RMB billion		%	RMB billion
1986	5.5	0.187*	19.9	32.5
1987	6.1	na	19.7	37.6
1988	8.2	na	20.2	44.6
1989	18.0	na	17.5	59.9
1990	34.9	na	12.9	57.9
1991	36.7	na	12.3	51.0
1992	36.9	na	12.4	44.5
1993	45.3	0.646	12.9	41.1
1994	48.3	0.652	12.5	36.6
1995	54.1	0.622	09.3	32.8

Note: na means not available

* from 1980 data.

Sources: (1) State Statistical Bureau, 1996b and previous years, *China Statistical Yearbook*, China Statistical Publishing House, Beijing; (2) State Statistical Bureau, 1996a and previous years, *Yearbook of China's Public Finance*, China Statistical Publishing House, Beijing

Adapted from Perkins (1999)

The financial deficits of the SOEs had direct fiscal implications. The revenue capacity of the fiscal system declined significantly during the reform period. The share of fiscal revenues to GDP decreased from above 30% in the early 1980s to 12% in the late 1990s (Bartel and Huang, 2000). This was partly an expected outcome due to the ‘tax for profit’ reform by which the government no longer directly collected enterprise profits and partly an unexpected consequence of the government’s inability to enforce tax collection upon the newly growing non-state sectors. However, the government could not refrain completely from intervening in enterprise activities, especially from subsidizing loss-making SOEs. In doing so, the government sought financial resources from the commercial banks in the form of policy loans, which accounted for about 35-40% of total bank loans in the 1990s (see Table 2).

¹ The problem occurs because one state enterprise (a manufacturer) owes a second state enterprise (a supplier). The second state enterprise owes money to a third state enterprise (a bank). In this example the second enterprise cannot pay its debt to the third enterprise because it cannot collect from the first enterprise. The first enterprise cannot earn money because it makes goods that no one wants. Since all enterprises are owned by the same entity, the state, it appears that the state owes money to itself. The problem is that the inefficient first enterprise continues to function despite the fact that it is inefficiently using resources.

Table 2 - Policy Loans in China 1991-1996 (RMB 100 million)

<i>Policy loans</i>	<i>1991</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>
Investment in fixed assets	1,906.5	1,959.0	2,735.9	3,896.0	5,382.1	6,631.2
Purchase of agricultural products	1,874.2	1,857.4	2,272.1	3,144.5	3,589.7	3,695.6
Purchase of products for export	1,791.5	2,145.8	2,594.4	2,890.6	3,266.3	3,745.5
State bank agricultural loans	1,209.5	1,448.7	1,720.2	1,554.1	1,921.6	2,367.8
Policy loans total	6,781.7	7,410.9	9,322.6	11,485.2	14,159.7	16,440.1
Total loans by state banks	18,044.1	21,615.5	26,461.1	32,441.3	39,393.6	47,434.7
Proportion of policy loans (%)	37.6	34.3	35.2	35.4	35.9	34.7

Source: Institute of Economics (1998)

Adapted from Huang & Yang (1998)

The official fiscal deficit was around 1% of GDP, which is healthy and sustainable by international experience. However, if the policy loans were regarded as implicit budget expenditures in the 1990s, the implied fiscal deficits would be as high as 25% of the GDP (see Table 3). In addition, projects financed by policy loans usually have high default rates (Bartel and Huang, 2000).

Table 2.3 - Official and Implied Fiscal Deficits 1990-1998

	Fiscal revenue (RMB b)	Revenue/GDP (%)	Fiscal expenditure (RMB b)	Official deficit/GDP (%)	Policy loans (RMB b)	Implied deficit/GDP (% GDP)
1985	200.5	22.4	200.4	0.0	185.8	-20.7
1990	293.7	15.8	308.4	-0.8	545.9	-29.5
1991	314.9	14.6	338.7	-1.1	678.2	-31.4
1992	348.3	13.1	374.2	-1.0	741.1	-27.9
1993	434.9	12.6	464.2	-0.8	932.3	-26.9
1994	521.8	11.2	579.3	-1.2	1148.5	-24.6
1995	624.2	10.7	682.4	-1.0	1416.0	-24.2
1996	740.8	10.8	793.8	-0.8	1644.0	-24.0
1997	865.1	11.6	923.4	-0.8	1986.2	-26.6
1998	985.3	12.4	1077.1	-1.2	na	na

Notes: the last column gives the total implied deficits including both official fiscal deficits and policy loans. Na. represents data not available

Sources: SSB (various years)

Adapted from Bartel and Huang (2000).

To safeguard social stability, the government did not want to see inefficient SOEs closed. The state banks became the victims of this behaviour. The banks, therefore, not only failed to recover old loans but were also forced to extend new ones. This created a moral hazard problem and further weakened the state banking sector (Huang and Yang, 1998).

The objective of the state-owned bank reform was to build a well functioning two-tier bank system with the central bank responsible for financial supervision and monetary

policy, and the commercial banks responsible for the allocation of capital. In 1983, the People's Bank of China (PBoC) officially became the central bank. A large state banking system was gradually built on four pillar SOCBs, namely the Agricultural Bank of China (ABC), the Industrial and Commercial Bank of China (ICBC), the Bank of China (BoC) and the China Construction Bank (CCB). These four major banks accounted for about 70% of domestic credit and held over 70% of household deposits (Lardy, 1998). However, the intention of the reform policies was to establish a truly independent central bank and purely commercial state-owned banks, but this turned out to be a long process which has not yet completed. Furthermore, since the local governments appointed the managers of the SOCBs, bank lending decisions could hardly avoid administrative intervention. Finally, as a result of the banks lending to the SOEs there has been a significant accumulation of NPLs in China's financial system (see Table 4).

Table 4 - Reported NPLs in Chinese Financial System 2003-2004

	as of	USD billion	NPL ratio (% of total loans)	% of GDP ⁽¹⁾
State-owned Commercial Banks	Dec-03	232	20	17
Joint Stock Commercial Banks	Mar-04	23	7	2
Policy Banks	Jun-03	19	18	1
Credit cooperatives	Mar-04	60	30	4
Banking system total	Dec-03	373	19	28
Asset management companies	Dec-03	107	-	8
Financial system total	Mar-04	480	-	36

Sources: Garcia-Herrero et al (2005) estimations based on official figures reported by Bofit (2004), Ernst & Young (2004), Ping (2003), and Pei Shirai (2004).

⁽¹⁾ June 2003 annual GDP

Adapted from Garcia-Herrero et al (2005)

Initially the government supported the SOEs; however this task was transferred to the banks after the 'loan for grant' reform of 1983-84. This paved the way for massive lending to the SOEs, which caused a deteriorating financial situation for the banks, especially during the 1990s. The government also continued to a certain extent its subsidies to the SOEs. The major input for funds for the banks was the Chinese people's deposits which ensured a flow of liquidity, given the continued confidence by the people in the banks. However, the system rested on shaky financial fundamentals due to the problem of the intertwined banks (growing NPLs) and government (guarantor of deposits, but worsening fiscal situation) and SOEs

(bleeding money due to inefficiency, and social and political considerations) which significantly exposed the structure to a systemic collapse if one of the entities fell.

3. The AGT's Constituents and Their Reforms

3.1 The 'B' of the Triangle - Chinese Banks

Since the opening up of the economy it has been the banks that have been almost wholly responsible for channelling the Chinese people's deposits achieved by very high savings rate into investments. And due to China's failure to develop healthy stock and bond markets, bank assets have grown to almost RMB 30 trillion in 2004, or 210% of GDP. In fact, this is the highest of any big economy, and to compare with other economies; India is at 170%, Brazil 160% and Mexico 100% (The Economist, 2005). However, the banks have managed these huge deposits from the Chinese people rather poorly; lending on government instructions to unprofitable projects and struggling SOEs has contributed to huge NPLs (Lardy, 1998). This practice has come to pose a threat to the whole of China's financial system. In addition, the investments made from the loans have been very unproductive. Already, China needs almost USD 5 of fresh capital to generate USD 1 of incremental output. This is a far worse ratio than Western countries and even India.

The health of the Chinese banking system has come under a spotlight since the beginning of the Asian financial crisis in 1997. In early 1998, the PBoC estimated the average proportion of the NPLs stood at 24% in the four SOCBs. This was much bigger than those NPL ratios of pre-crisis Thailand, South Korea, Indonesia, and Malaysia (Huang and Yang, 1998). But China maintained strong GDP growth in the following years without major financial instability. Furthermore, China's entry into the WTO in 2001 revived the anxieties about the sustainability of its banking system. China promised to grant, within 5 years after joining the WTO, foreign banks market access and to remove geographic and client restrictions. The WTO agreements became effective on February 1, 2002. Therefore, a better banking sector is needed in China mainly due to two reasons: firstly, overcome the macroeconomic threat posed by fragile and poorly run SOCBs. Secondly, improve the efficiency with which capital is allocated and utilized.

3.12 Banking Reforms

There are four steps in the institutional reform of the Chinese banking system. The first step was undertaken in 1984 when the mono-bank system was replaced with a multi-tiered one, in which central banking functions were separated from the rest. Four SOCBs were established. In 1994 the second step involved the creation of policy lending banks to take over from SOCBs projects for development purposes, thus separating commercial banking activities from those specially directed towards social and economic development. In 1995 a new Commercial Banking Law was also approved to regulate commercial banks. The third step was the strengthening of the institutional design of PBoC, with three main responsibilities: monetary stability, banking supervision, and the oversight of the payments system. The fourth step was the creation of the Chinese Banking Regulatory Commission (CBRC) in 2003, which separated the responsibilities for monetary policy and banking supervision (Garcia-Herrero et al, 2005). Apart from the institutional development of the Chinese banking system, the banking reform has been based upon three main pillars: bank restructuring, reduction of government interference in the system, and improved regulation and supervision.

Bank restructuring

The most pressing problems for Chinese banks have been poor asset quality and very low capitalization. As a result, the clean up of NPLs and recapitalization have been regarded as the most important areas of bank restructuring. This has led to the government injecting capital into the banks to reduce the NPL ratio. The first capital injection to the four SOCBs occurred in 1998 of the equivalent value of USD 33 billion. This was succeeded in 1999-2000 by the transfer of NPLs (at book value) of equivalent of USD 170 billion from the four SOCBs to the four newly created Asset Management Companies (AMCs).

AMCs were established in 1999 with the objective to improve state-owned banks' NPL ratio. Their task is mainly to collect NPLs, restructure them or convert them into equity. They issue bonds and borrowing from financial institutions to pay for the NPLs they receive. They are also in charge of restructuring SOEs and recommending companies for listing. By end-2005, the AMCs resolved 67% of assumed assets, almost six years after the start of the process, with a 21% cash recovery ratio

(Podpiera, 2006). However, the loans were bought at 50% of face value which implies that in practice that there has only been a 10.5% cash recovery rate of the nominal value (see Table 5)². This is quite off target with regard to the early projections of a 30-50% cash recovery rate. There are also suspicions that corruption and embezzlements have taken place within the AMCs, and that loans have been sold off very cheaply to friends and family of local AMC officials, and thus further decreasing the cash recovery rate (Tay, 2005). There has also been some fear the AMCs might actually increase NPLs as the parent banks view the AMCs as convenient outlets for future transfer of NPLs. In addition, the National Audit Office of the PRC reported that close to RMB 47 billion in spending by the AMCs has been used improperly. 191 officials have either been dismissed, demoted, received warnings or fined (Lianhe Zaobao, 2006). Anyhow, the government has set the end of 2006 as the deadline for the AMCs to work out all the NPLs.

Table 5 – AMCs’ Disposal of NPLs at March 2005

AMC	SOCB	Asset Transferred USD billions	Share of banks loans Outstanding (% at end-98)	NPL resolved	% NPL resolved	Cash recovery	% Cash recovery
Orient Asset Management	BoC	32.3	20.4	12.9	39.9	2.9	22.8
Great Wall Asset Management	ABC	41.8	24.6	25.8	61.8	2.7	10.4
Cinda Asset Management	CCB	45.0	21.7	18.56	41.2	6.2	33.6
Huarong Asset Management	ICBC	49.2	17.9	25.9	52.6	5.1	19.9
Total		168.3	20.7	83.2	49.4	16.9	20.6

Note: in USD billions at March-2005

Source: PBoC, CRBC, Annual reports, BIS working paper No. 115

Adapted from Garcia-Herrero et al, 2005

The second capital injection took place in December 2003 with USD 22.5 billion injected into the best performing SOCBs; CCB and BoC. These injections came from China’s official international reserves, through the transfer of rights of ownership of US government bonds. Due to certain restrictions, these could not be converted into RMB. Hence, the banks’ existing capital was used to write-off USD 23.4 billion of NPLs. This operation led to a very marginal increase in capitalization; however the asset quality improved substantially. Furthermore, in June 2004 the equivalent of USD 15.6 billion and 18.1 billion in NPLs were auctioned from CCB and BoC, respectively, to AMCs at 50% of face value.

² From March 2005

The third capital injection took place in April 2005, with USD 15 billion injected into ICBC. These funds were also taken from the official international reserves, and not converted into RMB. The restructuring continued in June 2005 with approval of an NPL disposal of USD 85.5 billion to AMCs and the issuance of USD 12.1 billion in subordinated debt. All in all, the Chinese government has injected more than USD 260 billion into its banks via straight handouts and by allowing the SOCBs to remove NPLs to the AMCs. To put it in perspective; this is about twice what South Korea spent to restructure its banks after the 1997-98 Asian financial crisis and about what America needs to bail out its savings and loans industry (The Economist, 2005).

The alarming high NPL ratio in China has been of great concern for the stability of the banking system. In total, an estimated of 20-24% of the 2004 GDP has been injected into the banking system as capital as a substitute of NPLs, amounting to over 110% of the SOCBs' capital in injections. Recent figures suggest that although the NPL ratio has decreased, this seems likely to be due to the growth of new loans (see Table 6). This is potentially a worrying trend, given Chinese banks' poor risk management and inadequate corporate governance practices. Nevertheless, the dismantling of the NPLs still remains one of the most pressing issues in order to secure better financial stability in China. However, there have been a lot uncertainties pertaining to the true extent of the NPLs, and there has often been a considerable discrepancy of estimates between unofficial estimates and the CBRC's official figures (Newsweek, 2005).

Table 6 – NPLs of The Big Four Chinese Banks 2002-2005

	2002	2003	2004	1Q2005	2Q2005	3Q2005	4Q2005
Asset share in the Chinese banking system	60.1%	58.0%	53.6%	-	53.6%	-	-
Average NPL ratio	26.2%	20.4%	15.6%	15%	10.1%	10.1%	10.4%

Note: end of period. The big four banks are China Construction Bank (CCB), Bank of China (BoC), Industrial and Commercial Bank of China (ICBC) and Agricultural Bank of China (ABC)
Sources: China Banking Regulatory Commission; Moody's Investors Service (2005)
Partially adapted from Ma (2006)

It is still too early to pass a judgment on the bank restructuring, however it seems that banks are subject to contradictory dictates from the authorities. For example the CBRC has threatened to fire bank managers if nonperforming loans in their portfolios

rise by 2% in a given year. Yet those seen as refusing loans to small and medium-size enterprises (a high-risk category of borrowers) face the wrath of the Central Bank (Newsweek, 2005).

Reduction of government intervention

In 1999 government interference in lending became illegal, at least in formal terms. Furthermore, interest rate liberalization has been regarded as important for Chinese banks to enhance the role of market forces in resource allocation. The approach towards the interest rate liberalization has been gradual, and is not yet completed.

Opening up to foreign competition

China has, under WTO's rule, pledged to fully open the Chinese banking system to foreign affiliates by the end of 2006. By then, foreign banks will be able to offer all banking services in local currency in all provinces and even to Chinese households. Previously, the foreign banks' operations in China have been limited to wholesale business and in few other areas. This sequencing in terms of entry of foreign banks adopted by the Chinese government has been able to avoid some of the problems observed in other countries, where a rapid entry of foreign banks has been associated with excessively rapid growth in overall bank lending fuelling speculative excesses (Ferri, 2005).

One of the main strategies in banking reform is to attract foreign strategic investors to buy minority stakes (see Table 7). There has been great interest among investors to get a piece of the Chinese banking industry. CCB had a successful listing on the Hong Kong stock exchange in October 2005, and BoC is set to be listed later in 2006. This fits well in to what appears to be the Chinese government's strategy of retaining control of the SOCBs through the majority of shares, yet list part of the shares on the stock exchange. An IPO (initial public offering) should, in addition to providing additional capital, increase the transparency of bank operations, enhance the standards of reporting, and increase the attention paid to bank operations. However, the role of strategic investors in domestic banks has been limited so far, as ownership regulations limit the share of a single foreign owner to 20%. However, this is consistent with the Chinese authorities' stated object to help develop and strengthen management systems in the local banks without allowing foreign control of major Chinese banks. On the

other hand, low ownership shares of foreign strategic investors in Chinese banks and their limited management involvement could weaken the incentives for foreign investors to take an active interest in the overall bank performance and make them focus on creating value only in narrow areas of cooperation (e.g. issuing credit cards) (Podpiera, 2006).

Table 7 - Announced Foreign Direct Investments in Chinese Banks

<i>Year</i>	<i>Target Banks</i>	<i>Strategic Investor</i>	<i>Equity Investment</i>
2006	Ningbo City Commercial Bank	OCBC	USD 70.6 m (12.2%)
2005	ICBC	Goldman Sachs-led consortium	USD 3,600 m (10%)
2005	Tianjin City Commercial Bank	Australia and New Zealand Bank	USD 110 m (20%)
2005	BoC	RBS/Temasek/UBS/ADB	USD 5,220 m (16.84%)
2005	CCB	BoA/Temasek	USD 3,966 m (14.1%)
2005	Bank of Communication	HSBC	USD 1,750 m (19.9%)
2005	Bohai Bank	Standard Chartered Bank	USD 123 m (19.9%)
2005	Huaxia Joint Stock Bank	Deutsche Bank/Pangaea	USD 454 m (20.9%)
2005	Hangzhou City Bank	Commonwealth Bank of Australia	USD 78 m (19.9%)
2005	Bank of Beijing	ING/IFC	USD 270 m (24.9%)
2004	Bank of Jinan	Commonwealth Bank of Australia	USD 17 m (11%)
2004	Xian City Commercial Bank	IFC/Bank of Nova Scotia	USD 6 m (5%)
2004	Shenzhen Development Bank	Newbridge Capital	USD 150 m (17.9%)
2004	Minsheng Bank	IFC/Temasek	USD 458 m (6.2%)
2004	Industrial Bank	Hang Seng Bank/IFC/GIC	USD 326 m (24.9%)
2002	Shanghai Pudong Development Bank	Citigroup	USD 73 m (5%)
2002	Nanjing City Commercial Bank	IFC	USD 27 (15%)
2002	China Everbright Bank	IFC	USD 19 (4.9%)
2002	Bank of Shanghai	IFC/HSBC/HK Shanghai Com Bank	USD 133 (13%)
Total			About USD 16.8 billion

Note: The year is the announcement date of the investment. Some announced deals are still pending regulatory approval. The sizes of investments in Bank of Communications and CCB are those before the latter's recent IPOs. The Bohai Bank is a new bank with Standard Chartered as one of its founding shareholders.

Sources: *Caijing Magazine*, No. 123 (2004) and No. 136 (2005); *The Asian Wall Street Journal*, 20 June 2005 and 27 January 2006; *The 21st Century Economic Report*, 24 August 2005; *The Financial News*, 7 and 9 September 2005.

Adapted from Ma (2006)

Regulation and supervision

The liberalization and restructuring measures have been accompanied by improvements in regulation, and especially with the establishment of the CBRC in 2003. The CBRC has enhanced transparency through reporting of individual bank data, including the NPLs. However, it is worth mentioning that foreign companies like Ernst & Young and S&P usually have had much higher estimates of NPLs than the official data (Newsweek, 2005). Other improvements from the CBRC have been the enhancement of the five-tier loan classification system³ which the banks had to comply with at the end of 2005. Secondly, capital adequacy ratio requirements have

³ The five-category loan classification means that commercial banks classify loans into five categories according to different degree of risk. The five categories are respectively Pass, Special Mention, Substandard, Doubtful, and Loss. This system is prevalent in America, Canada, Europe, and Southeast Asia as methods of classifying loans and controlling risks.

been introduced in compliance with Basel Core Principles for Effective Banking Supervision. These ratios will need to be fully complied with by banks in 2007.

3.2 The 'S' of triangle - Chinese State-owned Enterprises

At the beginning of China's reform period, almost 80% of the gross value of Chinese industrial output was produced by SOEs, and these firms dominated the urban economy. SOEs employed almost 80% of workers in the cities, and consumed most of the national savings in their capital investments. Although they were big, these enterprises were also clearly inefficient, and efforts to reform them began with Zhao Ziyang's experiments in Sichuan Province, even before the Third Plenum of the Eleventh Central Committee of the Communist Party of China (CCCPC) in December 1978 (Parker, 2002). Since then, SOE reform has been foremost in the policies of economic reform, and yet the problem of these enterprises continues to be intractable. Deng Xiaoping said that the SOEs were to be the cornerstone of China's "socialist market economy." However, according to Huang (2001), profits of SOEs declined significantly, especially after 1989. Once the cash cow of the central government, most SOEs were losing money by the mid-1990s, and absorbing large government subsidies as well as staggering amounts of loans that would never be repaid.

3.2.1 SOE reform – Corporate governance and Transformation

The SOE reform started out with the belief that the problems of the SOEs (poor performance, low profitability, and inferior competitiveness) could be solved through 'power-delegating' and 'profit-sharing' without changing the basic institutional framework of the SOEs. However, this approach saw limited achievements because of the unchanged institutional framework of the SOEs (Wu, 2005). Firstly, when the government reduced the administrative intervention in the SOEs, the government had to delegate more managerial power to the insiders of the enterprises. However, the insiders were not the real owners, and due to the system there was unchecked insider control with the potential of moral hazard. The only way for the government to control this was to strengthen supervision and intervention by government organs. Hence, it was back to square one.

Secondly, the lack of modern corporate governance practices (e.g. independent board of directors), but instead a 'factory director responsibility system' without a clearly

defined division of power and responsibility between the factory director and the party committee (supervisory body), also led to unchecked insider control and corruption.

The Third Plenary Session of the 14th CCCPC in November 1993 decided that deepening SOE reforms should “emphasize on the institutional innovation of enterprises”. This marked a shift in SOE reform strategy from ‘power-delegating’ and ‘profit-sharing’ to institutional innovation of enterprises. The “Company Law of the People’s Republic of China (PRC)”, 1993 went into effect on 1 July 1994. Then 100 SOEs were selected for pilot studies in corporatization. However, due to the lack of emphasis on using diversification of share ownership to restructure existing SOEs into real enterprises, most enterprises involved in the experiment simply converted themselves to wholly state-owned companies that were similar to modern corporations only in form. The Fourth Plenary Session of the 15th CCCPC in 1999 reiterated the requirements for corporatization, and consequently the large and medium-sized SOEs entered the period of establishing modern corporations according to internationally prevalent norms. Consequently, the corporatization of large and medium-sized SOEs after 1998 basically included three successive steps (Wu, 2005):

(1) The transfer of administrative functions of ministry-level institutions (“national industry corporations” and “group corporations” that belonged to central government and had had both administrative and enterprise functions), to “state bureaus” under the State Economic and Trade Commission, thus turning these national industry corporations and group operations into enterprises without administrative function.

(2) Previously usually one enterprise was set up in one industry or one sub-industry. But after 1998 the state broke up monopolies to promote competition by splitting and restructuring those enterprises. An example would be in the petroleum industry, with the creation of SINOPEC and CNPC (China National Petroleum Corporation).

(3) IPOs on domestic and overseas securities markets after asset restructuring

Two approaches were employed to convert the SOEs into real enterprises:

- Spin off noncore assets by splitting and remove redundant personnel by early retirement and recommendation for reemployment, and to restructure

the core assets for IPO. This approach proved more effective but took longer time.

- Carve out core assets from the original enterprise and restructure them for IPO, but to leave historical burdens such as noncore assets, nonperforming financial claims, and redundant personnel to the original enterprise to ensure the success of IPO. This approach took effect more quickly but it left more unresolved problems. However, China mainly employed this approach.

In addition, the Chinese government used *zhuada fangxiao* ('grasp the large and let go of the small' 抓大放小) approach to promote large-scale SOEs, which was reaffirmed at the Fifteenth Congress of the CPC (Communist Party of China) in September 1997. The centerpiece of the *zhuada* reforms is the promotion of a number of large state-owned enterprise groups (企业集团) including 120 groups known as the 'national team'. Running parallel with these reforms, in 1997 the government announced preferential support for 512 key large and medium enterprises, 74 of which were core members of the national team. While these 512 firms accounted for just 1% of all SOEs, they were responsible for 55% of assets, 60% of sales and 80% of taxes of the state industrial sector (CDBW, 14 January, cited in Sutherland 2001).

To maintain control by the government, corporatization usually left listed companies dominated by state-owned shares. The shareholder's rights of these controlling shares were usually exercised by wholly state-owned authorized investment institutions. The implications are that firstly, the directors, with the support of the authorized investment institution, dominated the board of directors. Furthermore, the chairman of a joint stock limited company is the legal representative under the Company Law of 1993. Hence, even when the listed companies that achieved diversification of share ownership were under the complete control of the state-owned authorized investment institution, it would still not have independent as required by a market economy. Secondly, using "remaining enterprises"⁴ that were formerly under the old system as

⁴ Restructuring for the SOEs was usually done by "carving out for IPO", i.e. state holding companies, state assets management companies, national industry corporations, and enterprise groups carved out their better-performing assets to set up joint stock limited companies for IPO financing. The assets and staff not carved out remained in the original enterprises, or authorized investment institutions, otherwise known as "remaining enterprises".

authorized investment institutions to control the listed companies was not conducive in transforming these companies into private business corporations (Wu, 2005).

The “remaining enterprises” were often stuck with the burden of assets, debts, staff, products, and other things not suitable to be carved out for IPO. This meant that many of them had the need to constantly obtain resources from their listed subsidiaries in order to survive. Moreover, because the “remaining enterprises” were usually the controlling shareholders of their listed subsidiaries, they also had the power to withdraw resources. Consequently, there were incidents where parent companies transferred money from their listed companies causing a ‘hollowing out’ effect. Furthermore, some authorized investment institutions stripped an enterprise of the high-quality assets, leaving debts with the group operations and then filed for bankruptcy. This put even more strain on the banks.

3.2.2 The State-owned Assets Supervision and Administration Commission (SASAC)

In April 2003 SASAC was established as both a regulatory body as well as the supervisory body representing government investment. As the investor, SASAC guides and pushes the reform and restructuring of SOEs, supervises the preservation and increment of the value of state-owned assets for enterprises under its supervision, enhances the management of state-owned assets, advances the establishment of modern enterprises system in SOEs, and perfects corporate governance, and propels the strategic adjustment of the structure and layout of the state economy (SASAC website). As a regulatory body, SASAC is responsible to dispatch supervisory panels to some large enterprises on behalf of the state and take charge of daily management of the supervisory panels. It also appoints and removes top executives of enterprises, and evaluates their performances through legal procedures, either grants rewards or inflicts punishments based on their performances; establishes corporate executives selection system, and perfects incentives and restraints system for corporate management. SASAC is also responsible to draft laws, administrative regulations of the management of the state-owned assets and draws up related rules; direct and supervise the management work of local state-owned assets according to law. SASACs at various local levels have also been established.

The SASAC has been rising in authority, self-confidence and resources (Naughton, 2005). However, there is also significant uncertainty and division of opinion caused by the SASAC's ambiguous mandate. The SASAC combines both the ownership and regulatory functions. While it struggles to assume ownership authority, it simultaneously carries out regulatory and other miscellaneous roles which were previously under the government bureaucracy. This state of affairs gives the SASAC a powerful and intrusive role that sometimes is resented and often provokes criticism. These views are often encapsulated in the adage that the SASAC has become "both mother-in-law and boss" (Naughton, 2005). The SASAC itself is a "special non-governmental organization under the State Council," which always has its documents countersigned by the Ministry of Finance to ensure that they are legally binding. The SASAC's legal position remains unclear because China has never been able to draft a law governing control of state-assets.

3.2.3 Assessment of Corporate Governance

Most state firms have re-organized under the company law over the years. They have diversified their ownership through sale of stock, although the state has remained the dominant shareholder in most cases. By the end of November 2003, 1,282 companies have listed on the Chinese stock exchanges, in either Shanghai or Shenzhen. A majority of these firms are large, state-controlled firms, converted from traditional SOEs. At the local level, hundreds of firms have been privatized; hundreds have been closed down or merged; and hundreds have been converted into corporations with diversified ownership. This vast process is still underway. However some problems have emerged.

Firstly, as SOEs converted into corporations, they have gained more autonomy from their bureaucratic superiors. This has enabled the companies to orient themselves more towards the market; however it has also paved the way for principal-agent problem, as managers have obtained unprecedented degree of power. Furthermore, the process of privatization has been dominated by insiders in the enterprises and in their immediate superior agencies. The result has been the serious problems of asset-stripping, and diversion of revenues. A major problem of corporate governance is that the current system does not provide adequate monitoring of incumbent managers. The

new “owners” of the SOEs, the central and local government SASAC have clearly targeted this problem. But it is not clear if they can effectively address it.

Secondly, there is the procedure of how managers are selected. In theory, the top manager of a corporation is selected by the board of directors which in turn, is supposed to represent the interests of the shareholders. But in most corporatized Chinese state firms, the government or a single government-controlled agency is the majority shareholder. The SASAC was established to take over the role of the CPC in terms of personnel selection. Yet, Naughton (2005) argues that the SASAC still must work close with the CPC in personnel matters, hence the result of this process is something that falls short of the kind of supervision of managers by shareholders that one expects in a market economy. While the CPC and SASAC are far less ideological than such bodies would have been in the past, and far more oriented towards business strategy and profitability, they are inevitably swayed by other considerations as well. These organizations themselves simply do not have the same incentives as the owners of a firm do in a market economy, and so they are not the most effective agencies to monitor and oversee managerial performance.

Finally, monitoring by banks over performance of state firms has been almost non-existent. In other economies, such as Japan, Korea, and Germany, the banks play an important role in monitoring managers and overall firm performance. Banks in those economies often have representatives on corporate boards, and sometimes have ownership stakes or cross-shareholding relationships. Most importantly, when firm performance falters, banks in those economies move in to protect their interests, and begin to restrict the freedom of operation of managers. In China, however, the state-owned banks are relatively weak. They do not have personnel or capabilities to exercise oversight over state industrial firms, nor do they have a strong legal position. Furthermore, in a bankruptcy case, banks have low precedence when residual claims are settled. As a result, banks are often forced to take large financial write-offs when firms are in trouble. China’s banks simply do not have the standing to exercise oversight and monitoring of state-run industrial corporations.

3.3 *The 'D' of the triangle - Chinese Government Fiscal Deficit*

China had shifted from using monetary policy to fiscal policy in October 1997 as the major tool to stimulate future economic growth because monetary policy was not working effectively arising from the fragmented money and capital markets. The deflation that occurred in China after the Asian financial crisis in 1997 slowed domestic consumption, exports, and foreign direct investments (FDI). The Chinese central government was obliged to play the key role of stimulating domestic demand through fiscal policies in order to sustain economic growth. Since the beginning of 1998, the Chinese government has drastically increased its expenditure and financed by issuing government debts and borrowing from bank. The use of fiscal policy to stimulate economic growth, however, has increased both the fiscal deficit and government debt in recent years. The deterioration of public finances in China has also been accompanied by the poor financial performance of the SOEs, whose profits in the early 1990s accounted for a significant proportion of total government revenue.

In 2004, China, however, ran a budget deficit of just 1.5% of GDP, compared with a deficit of 3.0% in 2002. The deficit is expected to fall to just 0.8% of GDP in 2005. The improving fiscal situation has allowed the government more space to consider a number of taxation and revenue reforms. Among the reforms that are likely to top the government's list of priorities are more spending on rural healthcare, and moves to scrap agricultural taxes. The improvement in the government's fiscal position since 2000 has been possible only as a result of tax reforms that were introduced in the mid-1990s. These reforms, which led to an increase in the proportion of total revenue coming from indirect taxation rather than levies on income, contributed to an increase in government revenue to 19.3% of GDP in 2004, compared with only 10.9% in 1996 (Business Monitor International, 2006).

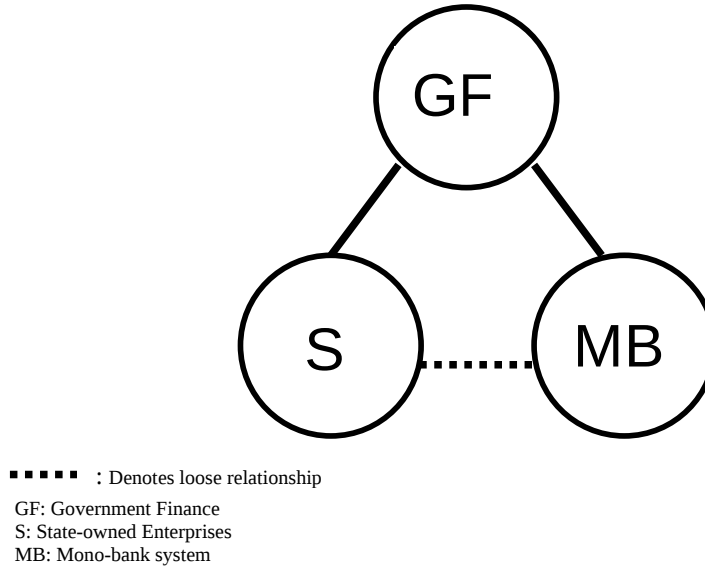
Overall, it would appear that China's public finance is in good shape. However, these figures do not take into account the hidden liabilities of the deficit. These liabilities pertain to unfunded pensions and remaining NPLs. For the latter, Agricultural Bank of China may require some RMB 800 billion to fully restore its balance sheets to health, while the tab for Guangdong Development Bank could run as high as RMB 50 billion (Ma, 2006). Furthermore, the city commercial bank sector may need additional

injections of some RMB 150 billion to clean up the balance sheets or fund their exit, while the structuring bill for the three policy banks may reach RMB 250 billion. For the unfunded pension funds this is not something of immediate concern. Within 15 years from 2006 the Chinese workforce will have peaked; and within 25 years the population in China will also have peaked. The current dependency ratio of three workers for one retiree today will be flipped in 25-30 years time (Anderson, 2005). Hence, the turnaround is predicted to be in 10-15 years, and it is not certain if the government will have the funds to bear the pension liability. On the other hand, no one really knows what the implicit pension liability is going to be. The Chinese government has not given any specific promises, other than it will contribute a fair share. However, if these liabilities are included, some estimates that the total debt to-GDP ratio in China could be approaching 100% of GDP (Business Monitor International, 2006).

4. Beyond Dean's "Asian Governance Triangle"

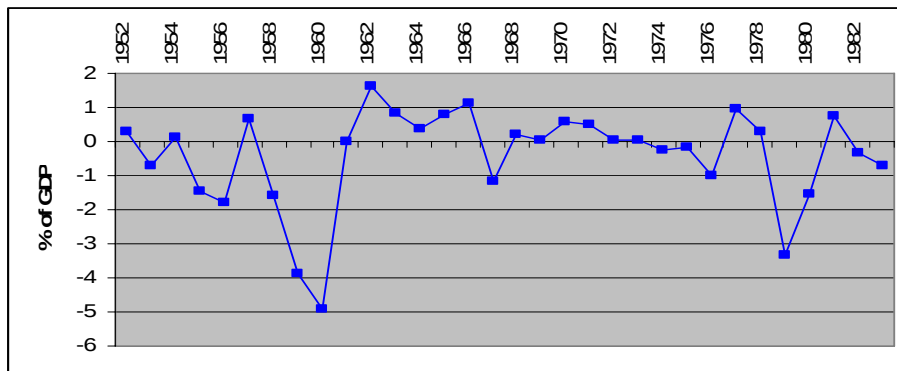
During the pre-reform era the main source of enterprise financing was fiscal appropriations. The SOEs' perennially employed fixed asset investment and working capital ('budgeted working capital') came from the state budget. Only temporary funds used for daily operations ('non-budgeted working capital') depended on short-term loans from the PBoC. From 1949-78, the PBoC was the only state bank in China, integrating the functions of the central bank such as financial supervision with those of policy banks and commercial banks such as loans. However, after initiating economic reforms, the State Council stipulated in June 1983 that SOEs should gradually switch to bank loans to supplement their insufficient working capital. As a result, fiscal appropriations as a source of financing were gradually replaced by bank loans. Before 1979, two-thirds of the fixed asset investment of SOEs was financed by fiscal appropriations from the government. By the mid-1980s, however, the proportion had decreased to one-quarter (Wu, 2005). This established a stronger relationship between the banks and SOEs (see Figure 3.4), which laid the groundwork for the following deteriorating Chinese financial stability.

Figure 2 – The Pre-AGT 1949-1983



In terms of government finance spanning from the years 1952-83, the government was running both budget surpluses and deficits (see Figure 2). The years marked by government deficit seem to correspond with certain tumultuous periods of the PRC, such as the Great Leap Forward (1958-60), and the most chaotic years of the Cultural Revolution (1966-68), which saw interruptions of economic activity. In addition, the year 1979 saw a huge budget deficit which was due to an expansion of enterprise autonomy, leading to increased salaries and bonuses, and accordingly more difficulties to balance state revenue and expenditure. This set the trend for the government budget deficits for the coming years as well.

Figure 2 – Government Surplus/Deficit 1952-1983 (% of GDP)



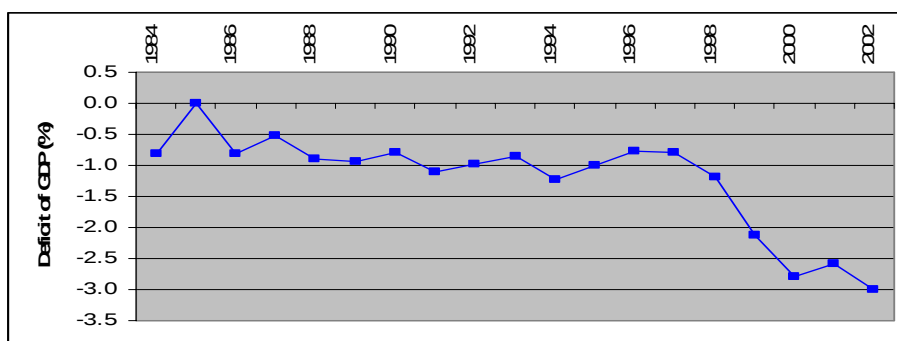
Source: China Statistical Yearbook, various years.

The first AGT implied total control and ownership by the state, with the notion that corporate governance was a non-issue. However, as China after 1978 opened the economy and ventured onto the path of economic reforms directed to transform the economy into a market economy, this eventually has an effect on the dynamics of the AGT which can be observed in the second AGT model.

4.1 The modified “Asian Governance Triangle” model

After 1983 there was a shift to banking lending as a main source of funding for the SOEs. Additionally, the government deficit remained about 1% of GDP for the period 1986-1996 (see Figure 4). After the Asian financial crisis, government deficits widened to 3% of GDP in 2002.

Figure 4 – Government Deficit* 1984-2002 (% of GDP)

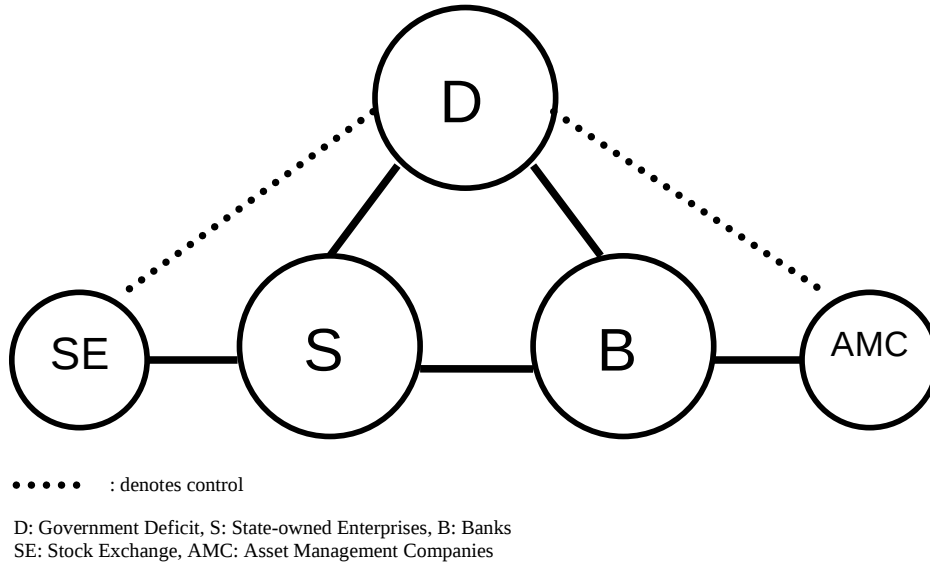


* Based on official figures and not included hidden liabilities, such as unfunded pension and NPLs.
Source: China Statistical Yearbook, various years.

Combined with the worsening fiscal situation, and the poor performance of both the banks and the SOEs, the stability of the triangle came under threat especially in the late 1990s. It seems that any financial worsening of the *S* and/or *D* entity was propagated to the banks, and thus the banks became the weakest link in the triangle. The increasing budget deficit meant that the banks had to step in and support the SOEs. This worsened the situation for the banks. However, the failure of the initial SOEs reforms to change the institutional framework of the SOEs, in which led to greater autonomy for the SOEs under the existing framework, was in fact counter-productive in establishing good corporate governances. The result was overspending,

and consequently the banks became the victims of both the government deficit and inadequate SOE reforms.

Figure 5 - The AGT 1984-2002



During the period 1984-2003, the government initiated further reforms to address the problems arising from the lack of corporate governance and pressing financial issues. This included the *zhuada fangxiao* policies, and also listing of certain SOEs on domestic stock exchanges (Shanghai and Shenzhen). The government retained a majority ownership, basically ensuring government control. This is the first step of bringing market economic practices in to the AGT. However, the dysfunctional domestic stock exchanges proved inefficient in improving corporate governance (Durnev et al, 2004). Only companies listed on overseas stock exchanges, such as PetroChina, saw improvements in corporate governance and transparency as they were subjected to the systems of well-functioning market economies.

In addition, the AMCs were established by the Chinese authorities in 1999 in an attempt to resolve the alarming high levels of NPLs. AMCs are formally legally independent agencies with a very broad mandate, namely collecting NPLs, restructuring them or converting them in to equity. The AMCs became an important tool to stabilize the AGT, i.e. relieving the banks of the NPL burden. Furthermore, the creation of the AMCs indicated the government's intention of using market practices in resolving the NPL problem, although under government control.

In the beginning of the 1990s the four specialized state banks (ABC, BoC, CCB, and ICBC) were transformed to wholly state-owned commercial banks (SOCBs). According to the Commercial Bank Law of the PRC of 1995, the SOCBs should stop doing any non-bank business, such as “trust and investment”. Furthermore, these wholly state-owned commercial banks should adjust their disposition of branches and take back the power of their branches to grant loans without authorization from the headquarters. In addition, all commercial banks should introduce modern management methods including asset-liability ratio management, internal risk control, conservative accounting, and the five-tier loan classification.

However, implementation of laws and regulations with the SOCBs has proven difficult. Some of the fundamental problems of the SOCBs are rooted in poorly defined relations of property rights and lack of proper governance structure. The SOCBs have been regarded as administrative organs by the government for a long time, which has complicated introduction of a system of board of directors and normal procedures for appointment and dismissal of presidents. In addition, even though the SOCBs are nominally state-owned banks, the owner is actually absent. Consequently, without pressure from the government, no one really cares about the financial and economic efficiency of state-owned banks.

The AGT model (see Figure 5) has been modified to take into account the emergence of stock exchange and role of AMC in the governance structure. However, the period still saw the continuation of a system pervaded by “the absence of the owner” and “unchecked insider control” despite policies promulgated to curb such phenomena. These problems became prevalent in China’s state-owned enterprises, with the consequences that most gains went to private individuals while losses were borne by the state. However, there were positive developments as well. The “PetroChina” model showed that the government could achieve better corporate governance through market forces, whilst the government still retained control, although not 100% ownership. As for the banks the government still pursued 100% ownership and control, which proved rather fruitless.

4.2 *The new “Asian Governance Triangle” – Beyond Dean’s model*

Since 2004, the fiscal situation in China has improved. The fiscal deficit of 2005 is estimated to be 0.8% of GDP and with favorable forecasts for the coming years. China's foreign exchange reserves also jumped 34% from 2004 to a new record of USD 818.9 billion in 2005. At the end of February 2006, China's reserves reached USD 854 billion; surpassing Japan to become the world's biggest holder of foreign exchange reserves (Business Week Online, 2006).

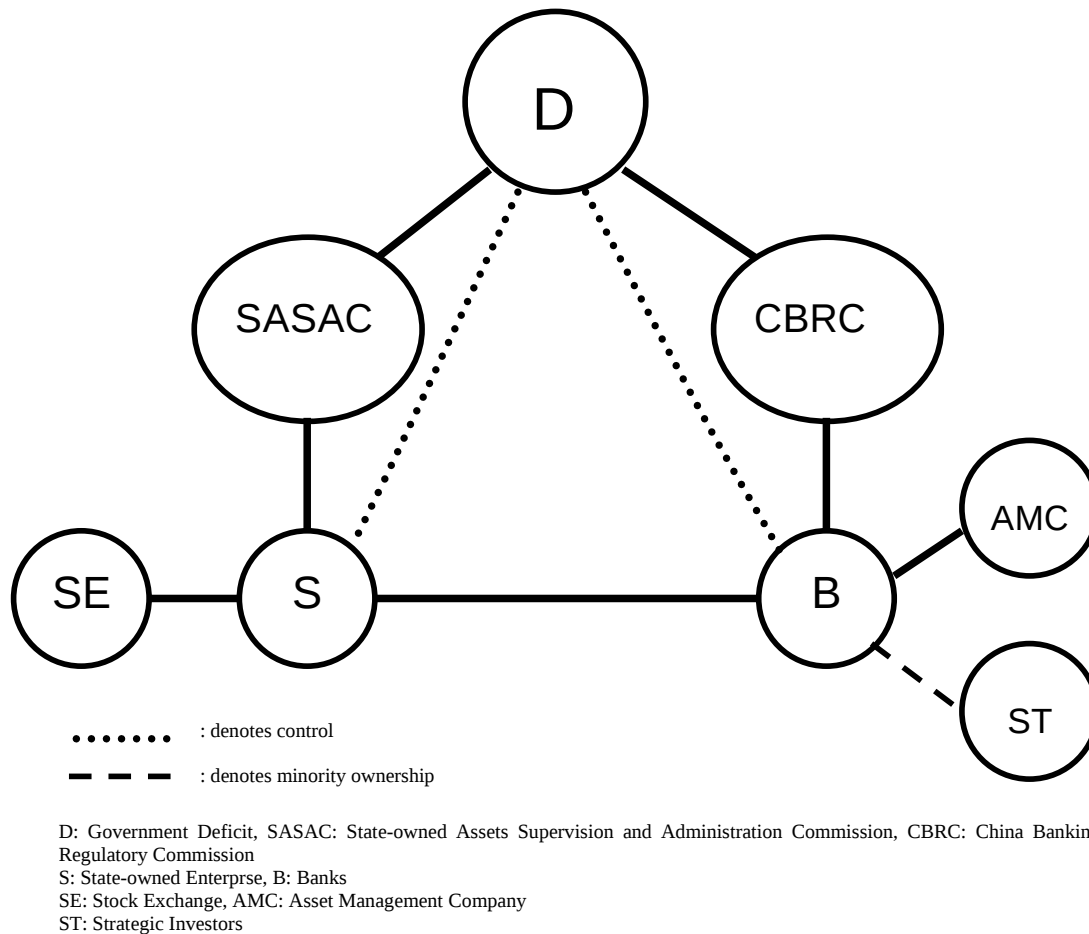
China's improved fiscal situation means that the government has been able to clean up the banks in terms of removing NPLs. Ma (2006) has estimated that China's estimated bank restructuring bill to date has reached RMB 4 trillion. This is roughly around 22% of the 2005 GDP. This has significantly strengthened the banking system, as evidenced by a declining NPL ratio which stood at an average of 10.4% (official figures) for the SOCBs in 4Q2005 (see Table 6). Thus, the strengthening of the banks is beneficiary to the stability of the whole AGT.

In a bid to improve corporate governance through supervision and regulation of the SOEs and the banks, the Chinese authorities in 2003 established the SASAC and CRBC respectively. SASAC's role includes both ownership and regulatory functions. However, its legal position still is unclear given the vague laws in China pertaining to governing control of state-assets. The CBRC took over from the PBoC as the banking regulator, and has contributed to better corporate governance through more transparency (disclosing NPLs ratio), sound banking policies (implementation of five-tier loan classification, capital adequacy policies) etc. These two entities constitute important elements of the government's strategy to reduce government interference, while at the same ensure control.

The economic reforms are of little use if it does not change the fundamental structures of the SOEs and the banks. The SOE reforms of the 1980s did little to improve the situation of SOEs in terms of removing government influence, and there were mixed results with the substantial restructuring of the SOEs in the 1990s. Some of the problems were solved, such as PetroChina, however the “remaining enterprise” was still there with unresolved problems. As for the banks, the Commercial Bank Law of 1995 stipulated that the SOCBs were to become modern, transparent enterprises,

however this did not materialize. The answer lies in corporate governance. NPLs clean ups and restructuring of the assets are all important, however if the operating system is not changed, the changes are of little permanent effect. The NPL ratio would just be increasing again if the same structure persisted.

Figure 6 – The New AGT 2003-2006



Corporate governance could not be improved with too heavy government intervention, nor too little intervention, as this would lead to unchecked insider control. The solution rests in letting the market to do its job. However, if the establishment of good corporate governance for the SOEs and banks translates into reduction of ownership and perceived loss of control for the government, then it is understandable from the government's point of view that this is undesirable. Yet, what is important to grasp, and what the Chinese government has done, is that reduction of ownership (e.g. from

100% to 70%) does not necessarily mean loss of control. The government will still have the majority of the shares and thus control, while a minority of the shares will be controlled by outsiders. Hence, the reduction of ownership is outweighed by improved corporate governance. However, the process of establishing corporate governance takes some time.

Research conducted on the SOCBs' behavior from 1997-2004 (Podpiera, 2006) suggests that their behavior has not substantially changed and become commercially oriented. The banks have slowed down credit expansion, but the pricing of credit risk remains undifferentiated. Furthermore, the SOCBs' lending appears to be driven mainly by the availability of funds (savings deposits) and does not take enterprise performance into account.

Financial crises have often taken place when internal fragility (weak banks) has led to a crisis on a country's external capital accounts. There is a belief in the market that the Chinese RMB is undervalued. It is difficult to say exactly by how much, however just the belief of undervaluation implies that there will be capital inflow and upward pressure on the RMB. According to Anderson (2005), the biggest problems seen in emerging markets today, and most emerging market crises seen in the last 15 years, have all been tied to fixed exchange rates. Countries have been holding desperately to a fixed-currency regime too long in the face of policies that have been going in different directions that have made that currency unsustainable. China is not there yet, but there is a very good chance that in a few years down the road China could be in a position that perhaps Argentina or the Asian crisis economies were in.

As of today, China's capital controls are shielding the AGT. A weakening of the capital controls until the banks have been cleaned up and adopted good corporate governance practices will indeed be a risky move. The Chinese authorities are aware of this, and as long the capital controls are in place it is unlikely there will be a run on the banks. If depositors flee the Chinese banks (or banking system) this would certainly constitute a great danger for the stability of the Chinese banking system and for the whole financial system. That makes the banking system possibly the weakest link in the financial system.

5. Conclusions

This paper has reviewed the “Asian Governance Triangle” proposed by Dean (2001), and investigated the historical and quantitative nature of the symbiotic relationships between the three entities of the triangle, namely the government budget deficit, industry (SOEs) and finance (banks). Furthermore, the SOE and banking reforms have been assessed in order to trace the developments in these two important entities of the AGT, as well as an overview of China’s fiscal situation. These assessments laid the basis for an evolutionary analysis of the AGT starting from the foundation of the PRC in 1949 and till present day. Moreover, this analysis identified three models of the AGT corresponding to three periods; 1949-1983, 1984-2002, and 2003-2006.

The analysis has revealed that the ‘loan for grant’ policy in 1983, leading to the SOEs’ subsequent heavy reliance on bank loans for funding, was an important factor to form a coherent ‘triangle’ which eventually led to instabilities of the whole of China’s financial system. Furthermore, failed SOE reforms to improve performance and efficiency, combined with a worsened fiscal deficit, moved China close to a financial disaster in the 1990s. The seriousness of the situation is highlighted through the AGT model which suggests that if one of the entities fails (government, SOE or banks) the financial system collapses.

The potential fatal characteristic of the AGT has been the notion that ‘everything is government-owned’, hence over-spending has been the norm among SOEs and consequently a very unhealthy NPL ratio has developed. In addition, the phenomena of “absence of the owner” and “unchecked insider control” have traditionally been prevalent in China’s state-owned industrial, commercial, and financial enterprises. The new AGT model proposed in this paper has illustrated that the government is trying to separate itself from the SOEs and the SOCBs through the establishment of SASAC and CBRC respectively. This further highlights that control is a more important factor than ownership, and that good corporate governance is a prerequisite for to the stability of the AGT. Ultimately, the success of the banking reforms and SOE reforms rests on the government’s ability to create strong incentives for SOEs and banks to base their operations on commercial principles.

China's resolve in dealing with the weaknesses of the AGT has so far shown results. The large centrally controlled SOEs have shown good profits and the banking system has been strengthened. The foreign exchange reserves also provide added security. However, it is still too early to judge the effectiveness of SASAC and CBRC in terms of improving corporate governance of the AGT. As of now, the AGT is shielded by capital controls. A banking crisis, with a spill-over to the whole AGT, seems like an unlikely scenario for now due to the capital control policy. This policy is a second-best policy given the problems of the SOEs and the SOCBs. It reduces efficiency and welfare by restricting domestic enterprises and households directly accessing to the international capital market. But it also prevents external speculative attacks that have triggered financial crises in some countries.

Over the years, a series of reforms of its SOEs and banking system has severed the symbiosis relationships through the introduction of banking and corporate governance in the system. Any disruption of the gradual approach towards the reforms by hastily adopting a flexible exchange rate and free capital flows would do more harm than benefit China in the long run.

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