Spring 5-1-2005

China’s Financial Institutions: Analysis of the Dynamic Changes and Associated Inefficiencies Under a Hybrid Capitalistic Approach

Juan J. Zhou

China's Financial Institutions: Analysis of the Dynamic Changes and Associated Inefficiencies Under a Hybrid Capitalistic Approach

Juan J. Zhou

Syracuse University

INEFFICIENCIES OF CHINA'S FINANCIAL SYSTEM

Abstract

China has risen to the forefront of international scrutiny because of its unique political and economic structure and evolution. The growth and development of China as a world economic power has resulted from the political-economic reform efforts of Communist leaders within China. Under Mao Ze Dong, during the pre-socialistic modernization period, China began its reform of rehabilitation from war time and social-economic restructuring by instituting socialistic ideology. During the Dengist period under Deng Xiao Ping, there was a transition from an agricultural to an industrial economy. After Deng, socialist modernization reform has continued under China's hybrid capitalistic economic model, with particularly significant effects on the rapidly structured financial market. Entrenched with the within China's hybrid capitalistic economic model are the politically and socially inextricable characteristics of which are based on generations of behavior. Reform inefficiencies have resulted from state enterprises that lacked control, financial structure, and balance between state and private behavior. The evolving capital market within China faced serious problems due to inefficiencies within state sector enterprises' financial system. Moreover, the banking system within China is inefficient and poorly organized. Problematic issues such as financial institutions' weak intermediary role, disorganization of financial assets, and unstable lending policy has been masked by the public's trust in the state and political-social behavior of Chinese enterprises. However, in order to transition China's banking system to modern practice, bank intermediation,

capital asset balance, and foreign investment decontrol must be established. Creating a modern financial system in China will rely on reforming behavior as much, if not more than the reformation of policy.

China's Financial Institutions: Analysis of the Dynamic Changes and Associated Inefficiencies Under a Hybrid Capitalistic Approach

Introduction

The dynamic transformation and growth of China's economy have triggered perplexing economic issues. At the center of the economy control dilemmas is the matter of how to integrate changing social communist government philosophies with a dynamic capitalistic environment so as to promote the efficiency of China's economic system.

China has shown explosive economic growth, even after taking account of likely overstatements by Chinese national measurements. After economic stagnation under Mao's Great Leap Forward of the late-1950s and Cultural Revolution from the mid-'60s to the mid-'70s, China's growth rate for gross domestic product per capita averaged 5 percent per year in the 1980s and 8 percent in the 1990s (Barro, 2002). This performance brought China from a per capita GDP of $700 in 1960 to the middle-income level of $4,300 in 2001 (Barro, 2002). As China's economic presence has grown, concerns about the effect of the Chinese government's political-economic actions on China's economic system and its impacts in a globally expeditious world market have risen to the forefront of China's economic development.

Unlike many of its predecessors in economic reform, China has been a relatively reluctant reformist country, choosing to proceed cautiously and standing firm in face of foreign pressures to do otherwise. China's relative insulation from world capital markets helped the country avoid economic depression during the Asian financial crisis in 1997, when Asian economic activity contracted, unemployment soared, bankruptcies were rampant, and poverty increased (United Nations, 1999). From 1995 to 2001 China was able to establish a 7 percent per capita growth, while many of its neighbors suffered from the Asian financial crisis (Barro, 2002). However, to promote longer-term growth, China will logically need to increase integration with global financial markets.

Assessing China’s economic transitions reveal a badly fragmented economy laden with many state sector inefficiencies. Two decades of uninterrupted market transformation and renewed determination to move ahead in market reform have made China’s economic potential more evident. Further reform on part of the government, industry, and financial system within China is needed in other to realize the full benefits of trade and investment liberalization. In particular, this paper is an analysis of the inefficiencies of the financial institutions and its practices since the establishment of the People’s Republic of China in 1949 that has prevented it from realizing further market potential.

Characteristics of Chinese Capitalism

Chinese capitalism has been a revolution from traditionalistic capitalism, embedding itself within particular political and socio-economic contexts that can not be easily isolated. Unlike American, German, or

Japanese genres of capitalism, China's has been a gradualist approach instead of a direct push for capitalism, yet yielding unexpectedly swift results within three decades.

Chinese hybrid capitalism has several key defining attributes. One, Chinese capitalism is a particular social system of economic action and business activities that manifests itself through complex webs of family networks and personal relations. "Guanxi," a term directly translated into the word 'relationship,' has been used by many academia and professionals to describe the prevalent social factor in Chinese business.

> Chinese capitalism is organized and coordinated via neither market relations nor hierarchies of 'rational' firms, but rather encompasses both markets and hierarchies to configure capitalist institutions through an informal system of social relationships and family obligations (Hamilton, 2000, p. 56).

Second, Chinese capitalism is not bound within specific territorial boundaries of nation-states. Dominance of ethnic Chinese in many Asian territories such as Taiwan, Singapore, and Malaysia attest to the convoluted spread of Chinese capitalism around the world. Through centuries of distinctive cultural practices and social organization, Chinese capitalism relies heavily on distinctive economic behavior and social action among ethnic Chinese. China, in essence is the base of Chinese cultural coherence and legitimacy.

Third, Chinese capitalism lacks dependence on state structures and policies, but relies on the key role of social actors rather than institutional structures in coordination with economic organization. Much of this is a result of centuries of corruptive practices within governmental and organized institutions. Corruptive practices therein have reinforced the relational and personal networks in Chinese capitalism.

Acceptance into the WTO and acknowledgement of China’s economic potentials has placed China under scrutiny, particularly the culture of conducting business in China that differs quite strikingly from western counterparts. Many critics have emphasized the importance of establishing institutional reform and regulatory statutes to stimulate behavioral change. However, cultural change will need more than regulatory proceedings to progress to the stage that some critics desire.

Hybrid Capitalism Development Under Chinese Politics

Chinese central government has employed a phased plan of progressively increasing market forces and eliminating areas of central planning. Under the plan, separate channels for development outside the state sector, operating under different rules and conditions, have flourished. Hybrid capitalism has two significances; one refers to the co-existence of state-owned and private enterprises, the other refers to the mode by which Chinese capitalism has transpired under cultural and ethnic influences. Both conceptions are interrelated by the co-existence of complex social interactions and institutional relationships among economic players. China's capitalistic development can be generally described as a phased process concurrent with the different political leadership of the central government.

Socialist Modernization

Japanese invasion, civil war, and the consequences of these actions had decimated the Chinese economy at the foundation of the People's Republic of China in 1949. China's economic growth during war time had declined sharply from previous peak levels of 9.4 percent to virtually zero growth (Lee, 1978). Under the Communist leader Mao Ze Dong, rehabilitation and reconstruction through collectivization of agriculture, state control of industries, government organization of people's communes, and industrial mobilization of economic activity were pushed rigorously (Lippit, 1987). Between the period of 1952 to 1978 and through an unintentional trial-and-error process, Mao established a large state sector regime. In an effort to collectivize agriculture and speed land reform, Mao established rural collectives and peoples communes. These collective units were also part of Maoist efforts to decentralize state administration and weaken bureaucratic power (Lippit, 1987). As a result, many private, household, sectors were brought under state control but controlled through local governing bodies.

Mao's vision for the new China incorporated traditional socialist values such as equality, solidarity, and social welfare. Mao was, however, extremely critical of the personal material gain that drove capitalism, and therefore resilient in disregarding foreign capitalistic ideology and foreign involvement. Propaganda highlighting values of "serving the people" and "fight self" encourage those in authority to refrain from using their positions for personal benefit, and those out of it to stand up for social consciousness (Lippit, 2000). These propaganda programs translated into some deformity of occupational concentration and purpose. Intellectual workers ranging from teachers to bureaucrats were pressured to take long durations of retreats to rural areas and complete physical labor, having to divide their time of academic study and/or teaching with that of field work (Cheng, 2003). Social pressures, moral appeals, and collective emphasis, particularly with the intertwinement of state and household industries during this period further entrenched the overlap of social relationships and political networks under economic environments (Riskin, 1987).

Capitalistic Development & Reform

Under Deng Xiao Ping, also known as the Dengist Period, the structural and ideology revolution began. To fully lead China into social modernization meant a possible break from the very ideology and leadership of Mao. Hailed as the founder of People's Republic of China and author of its central body of doctrine, Mao was not only a prestigious leader, to many he was the very icon of modern China (Z. Zhou, personal interview, March 15, 2005). The entrenchment of politics into civilian ideology and living customs made reform and development difficult for "Dengists," followers of Deng, to reform. Dismantlement of Maoist leadership and ideology needed to start with rooting out Maoist politics, policies, and institutions, then had to face the more challenging task of replacing old ideology with a new (Henderson, 1999). In order to stabilize Chinese politics, Deng and his followers dismissed harsh retaliation methods used previously by Maoists; rather Deng chose swift, decisive, and strategic change of leadership and reform within the communist party (Baum, 1994). Deng managed the dilemma of Maoist de-entrenchment with great sensitivity. In 1981, he finally issued a major document criticizing Mao's political ideas in relation to the Cultural Revolution, one of the programs during Mao's leadership that had met with overwhelming social failures (Blecher, 2000). It was a refreshing change from the Manichaean approach to problems that had stifled serious debate of Deng's predecessors.

Chinese economy relied heavily on its land resources and was largely concentrated in agriculture and natural industries consisting of steel, coal, electric power, and cement (World Bank, 1995). During the Deng period, rural reform span spontaneously toward contractual relationships; a form of bartering that traded land or items in return for a payment in cash or kind (Blecher, 2000). The agricultural "household responsibility system," which were originally collectivistic programs holding households and respective communes responsible for certain agricultural goals, grew increasingly comprehensive and individualistic (Baum, 2000). Swift pace of rural institutional reform and some removal of entry barriers also spurred the increase of a new class of entrepreneurs in non-agricultural venues that helped develop China's prospective market-based economy (OECD, 2002). Under Deng, enterprises were given more autonomy; enterprises were permitted to make own decisions regarding above-quota output, and to negotiate selling prices (Blecher, 2000). Rapid institutional and economic changes, however, did not warrant a complete transformation of the basic political ideology and institutional features of the Chinese political system and leaders.

Reform's mixed results during the latter periods under Deng stirred debate internally within the party and within the intellectual community. During the late 1980s, there were an increase number of small private merchants competing against state enterprises, depletion of foreign exchange reserves, rise of corruption, and inflation; but also showcased record foreign trade volumes, growing influx of foreign investments, and declining poverty (Barale, 1989). Infamously known as "6-4" amongst the Chinese community, the Tiananmen Square incident on June 4, 1989 and similar student reform movements was the concurrent result from the period's high economic growth rate, crystallization of the political and economic systems' boundaries, and emergence of reformist optimistic and proactive opinion (Barale, 1989). Fearful that inflation, crime, and intensifying tensions would destabilize and destroy the economy, party leaders decided to take forceful measures to maintain social and political stability. Chinese leaders were not ready to relinquish institutional ideology and political structure. These decisions garnered much criticism, particularly under the media politics of the 1989 student movement, portraying the government as a corruptive, unreasonable, and authoritarian force suppressive of the masses. During the progress of student protests, organization of unofficial trade unions formed within diverse industries; and more increasingly under direct partnership with intellectuals (Henderson, 1999). Socio-economic change had advanced more rapidly than political and institutional change. Dengists emerged from the late 80s political-economic crises by enforcing stricter economic policy; slowing down growth to tame inflation, and circumscription of the market (Blecher, 2000). Tightened credit and fiscal policies served to curtail industrial investment, while rural industries were closed or restricted by credit, tax, and regulatory polices (Lardy, 1998). Heightened opinions, economic uncertainty, and fear of losing control of civil society led the Dengist government to follow strict restrictions on civil liberties in addition to their monopolistic rule of economic transformation.

Structural Development of China's Hybrid System

The reform years under Deng had created a combination of market forces, state and collective ownership, entrepreneurialism, as well as heightened tensions. Previously, China lacked the legal, institutional, and governance structures needed to support an economic system based predominantly on private ownership. However, with government's reform efforts and growth of individualistic behavior, and increasingly structures to accommodate such behavior, growth of private and market entities have increased dramatically.

Privatization

Privatization of state-managed enterprises is a strategy to restructure China's economy and give empowerment to local governments in relinquishing unprofitable and/or small state and collective enterprises. Privatization has been crucial in restructuring. Chinese central authorities chose a method of selling state shares, particularly to employees of state-owned enterprises, rather than free distribution of shares (OECD, 2002). The strategy was carefully implemented through staged applications, with the first large scale piloting in Zhucheng in 1994, a small city in Shangdong province that generated comprehensive media coverage (Henderson, 1999). In 1997, the Chinese government extended this practice to all the cities in China (OECD, 2002). Between 1993 and 1998, Guanxi province reformed 15 percent of the total number of state-managed enterprises in Guanxi, an example of the effectiveness of the program in smaller regions (Chinese Financial Annual, 1998).

State-managed and owned enterprises were transformed in various forms, including changing into joint stock companies that the state remained the largest shareholder, or sold to employees in a framework of the co-operated shareholding system (OECD, 2002). Less frequently, wholly capital privatization occurred, usually with financially unstable companies, which were auctioned off at centers for the sale and exchange of state assets (OECD, 2002). Most of the state-managed companies that remained were in certain high technology or raw resources industries that were considered strategic at the national level (Lardy, 1998).

Fragmentation

Fragmentation of wholly and partially state-owned enterprises is very prevalent in China. The practice of locally autonomous enterprises, in addition to large state production units initiated under the Maoist period, has continued to exist. Thus, not only does each ministry under the Chinese central government have its own enterprises, but each province, and sometimes each municipality have its own production systems (OECD, 2002). Large percentage of these state-owned and joint-state enterprises is kept under regional control and under diverse governing bodies; thereby making up a highly fragmented industry structure.

Chinese private enterprises are fragmented by competition and competitors more so than by goods and services produced, due to Chinese businesses' proliferation practices and government's pressure to acquire diverse loss-making state companies by capable private businesses (Lardy, 1998). Private enterprises remain highly localized, though several have established nationally and internationally through strong management and ability to negotiate with the state and respective governing bodies ("The struggle of the champions," 2005).

Industry Inefficiencies

The 1990s provided reform opportunities with its continued expansion and economic growth, as well as shifting emphasis to private enterprises. However, massive economic problems of declining arable land, unemployment, growing gap between rich and poor, and inflation related directly to the shifting of state-owned enterprises to non-state firms (Benewick & Wingrove, 1995). In general, Chinese industry is laden by two problems: low pace of consolidation in the different sectors and the slow exit from the market of inefficient producers. Increased burdens of responsibilities and lack of appropriate resources were the primarily causes of the failure of many state-owned enterprises (Lardy, 1994).

State-owned enterprises were obligated to provide broad range of social services, which should have been financed from the government budget instead of from individual enterprises, and employ certain number of workers to meet government's political agenda of maintaining low levels of unemployment. Between 1978 and 1994, employment in state-owned firms increased by 40 million (Lardy, 1998). Forced to stabilize employment rate, and absorb a disproportionately large share of investment resources, which were largely misallocated, many state-owned firms were driven into bankruptcy. For these reasons and continued government pressure, financial performance declined and many state firms, inclusive of state-owned financial institutions, and were unable to service debt borrowed.

Being highly fragmented, China's industry sector lacked an appropriate level of consolidation and standardization. As a means of solving this problem as well as the issue of loss-incurring enterprises, the central government increasing privatized state-owned firms and eased bankruptcy laws to eliminate unproductive enterprises.

Financial System's Influence on China's Hybrid Capitalism

A large contributing factor to China's hybrid capitalism has been the financial system, which has both sustaining and constricting influences on the liberalization of China's economy. The banking system in China has been prevailing as the central government's institutional tool in sustaining reform strategies implemented for China's economic development. Assessing China's economic transitions reveal decades of state-owned banks having channeled civilian savings into unreformed, money losing enterprises, resulting in a dramatic rise of debt in state-related organizations. The predominate reason why strengthening China's financial institutions' weak and frequently inability to exercise appropriate control and prudential supervision of lower branches has been difficult is because of the tight and conflicting central government oversight on these financial institutions.

China's Banking System

Role of financial institutions.

Financial institutions, as an intermediary between depositors and borrowers, serve multiple roles. First, banks provide efficient mechanisms for pooling of funds from small depositors, obviating the need for firms to raise funds directly from large number of lenders. Second, financial institutions function in a way to alleviate time span inconsistencies between lenders and borrowers. Banks can meet short-term withdrawals from other depositors due to the large number of clients they serve. Third, lending to broad range of projects diversifies risk better than if individual depositors were to invest themselves. Fourth, financial institutions accumulate valuable skills and experience in evaluating investment projects in differentiated markets. Finally, financial institutions provide discipline and enforcement mechanisms by ensuring that quality borrowers are provided with lower cost of funds, and low quality borrowers are monitored and enforced to amortize their loans (Brealey, Myers, & Marcus, 2004)). In a fully conceptualized capital market, both financial institutions and capital market can perform intermediary and disciplinary functions. However, China's financial intermediaries had not yet evolved to such stages.

Pre-reform banking system and early reform.

Pre-reform China had no capital markets and banks did not serve as intermediaries for two reasons. One, the source of bank deposits in developing market economies, household savings, was extremely small. The Chinese national savings were mobilized almost entirely within the government sector, which were derived from profits of state-owned enterprises (Lardy, 1994). Second, investment was financed predominantly from interest-free budgetary grants, and to a lesser degree from the retained profits of enterprises (Lardy, 1998). The budget, county and lower-level governments were all sources of working capital of state-owned enterprises, and therefore circumscribed the intermediary and disciplinary role of banks (Jefferson & Singh, 1999). At the time of financial sector reform, China had only a simple institutional structure consisting of a few banks and a network of rural credit cooperatives, a form of informal financial institution tied together by townships (United Nations, 1999). The People's Bank of China, PBoC, simultaneously served as China's central bank, regulating money supply, fixing interest rates, managing the state's holdings of foreign exchange, and supervising and controlling all other financial institutions (People's Bank of China, 2005). In essence, China had a mono-bank system, which operated as the central governmental and sole commercial bank. Unlike many developed financial systems, China's central bank, PBoC, is not an independent body; rather it is a ministry under the State Council of China (Standard Chartered, 2001). By construction, it shares policy making power with other ministries under the central government, if not directly subjected to mandates of the State Council (OECD, 2002).

Banking reform: late 1970s to 1990s.

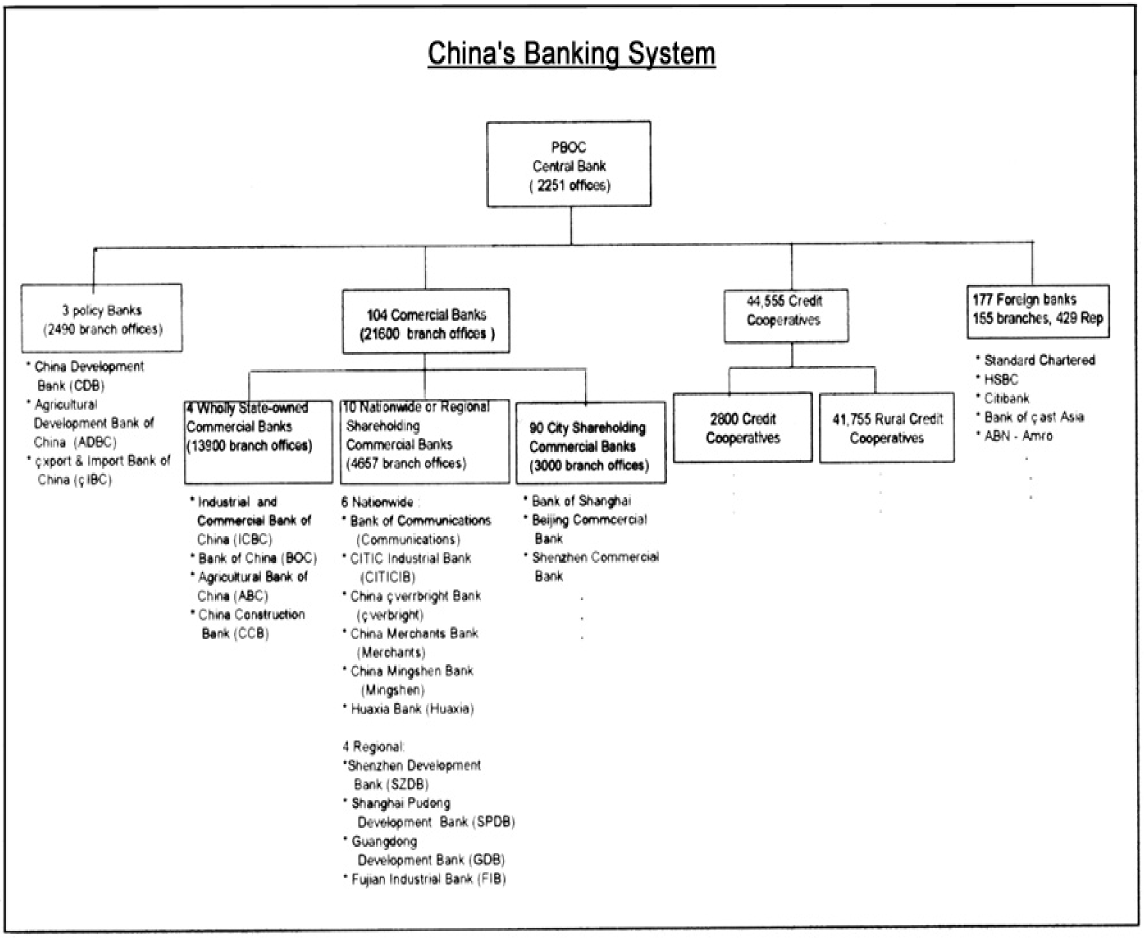
China's financial system grew more complex as reform underwent, with new array of banks and non-bank financial institutions. Initially, new non-bank financial institutions competed very limitedly because of small capital and centrally set interest rates. Having no mandatory burden of financing state-owned enterprises, the new institutions had stronger financial position and more efficient intermediation between depositors and borrowers. Consequently, these institutions grew. During the late 70s through the 80s, the Chinese government elevated subordinate banks under the People's Bank of China, and distinguished the banks from one another (Lardy, 1994). At the same time, banks were authorized broader business scope, including the sale of bonds on international markets (Huang, 1999). Explanations for such institutional changes revert to China's increasing participation in international economy, particularly its entry into the World Bank and the International Monetary Fund in 1980 (OECD, 2002). In December 1981, China Investment Bank, CIB, was created to serve as the institution to control disbursement of project funds provided to China by the World Bank, and later on for the Asian Development Bank in 1986 (OECD, 2002). Disbursement power of the CIB included foreign currency loans to finance rising imports of technology and capital goods; and domestic currency loans to finance local counterpart component of foreign-funded projects.

Beginning in mid-1980s, the People's Bank of China became responsible for issuing currency, managing credit, setting interest rates, and supervising China's foreign exchange business; signifying its growing role

(Lardy, 1998). Comprehensive business scope of the four major specialized banks gave other rising financial institutions little opportunity; thus the four specialized banks faced few competition. To increase competition, the State Administration of Exchange Control gradually approved increasing numbers of branches of specialized banks to enter foreign exchange business (Huang, 1996). At the end of 1994, the central bank allowed for fourteen new banks to establish limited branches, sub-branches, and organizational structures below the sub-branch level (Lardy, 1998). Despite these allowances, the four major banks have continued to dominate in the provision of financial services due to the limited geographic mobility of the Chinese public and the limited geographic location of the new banks.

China's modern banking system is divided into three segments: four major state-owned commercial banks, twelve joint stock banks, and city commercial banks [see Table 1.1]. In 1994, "policy banks" were created to take over non-commercial lending previously carried out by the commercial banks ("China and the WTO: perspective on a changing environment," 2005). Policy banks function similar to development banks but have diversified into more traditional commercial banking activities, specifically in public sector loan services. Additionally, China has a postal savings bank, which takes deposits but does not make commercial loans, along with a large network of urban and rural credit co-operatives (OECD, 2002). Credit co-operatives networked across the country provides services similar to commercial banks, though many are not consider formal commercial banks under the current regulatory framework.

Table 1.1



Source: Standard Chartered, April 2001
http://www.tdctrade.com/econforum/sc/sc010402.htm

Renminbi & the Currency System

Renminbi development.

Renminbi's issuance dates prior to the establishment of People' Republic of China in 1949. To unify and establish consistency of the currency usage throughout China, the Government Administration Council of Central

People's Government called in currency issuances by the Northeast Bank and People's Bank of Inner Mongolia, as well as unified the Xin Jiang bank note (Yeung, 2004). China's existing exchange rate is a floating rate system that is dictated by bank's purchases and sale system (OECD, 2002). The Renminbi was informally pegged against the dollar in 1994. It pegged the Renminbi to the US dollar at around 8.3 Renminbi for every US dollar, allowing the rate to float between designated ranges. The Chinese government firmly maintained its exchange rate after the breakout of the Asian Financial Crisis in 1997, which made southeastern Asian nations devalue their currencies one-by-one (China Internet Information Center, 2003).

Currency system reform.

Reform of the late 1970s included the reform of the Renminbi currency through the issuance of foreign exchange certificate, FEC, to represent a partially convertible currency for foreign use (Brahm, 1996, p. 120). This dual track currency system designated Renminbi-use to domestic parties, while foreigners were forced to use foreign exchange certificates. The usage was more specifically toward rationing consumer commodities, particularly imports; consequently it provided avoidance of unnecessary drain and leakage of China's minimal foreign exchange reserves (Henderson, 1999). During the 1980s, China's growth economically indicated increased needs for raw materials and technology imports. With the expansion of the domestic consumer market, the FEC became an institutionalized section of the regulatory mechanism, until it was abolished in 1993 (Zhang, 1999).

Prior to the Asian Crisis, reform of the currency system involved the Renminbi being staged at artificially high levels by the government. At the onset of the Asian Crisis, financial trading system was liberalized to incorporate two exchange rates, the official rate and the "internal settlement rate" that was executed between the People's Bank of China and China's foreign trading companies (Henderson, 1999, p. 86). Criticisms of China's two exchange rates were largely based on the allegation that the official Renminbi rate was overvalued against the dollar as a protective measure to let domestic trading companies obtain competitive leverage over foreign trading partners. The dramatic increase of consumerism in the 1980s, generated a trade balance in favor of imports, drained foreign exchange reserves. Following the import increases, the government devalued the Renminbi in attempts to higher export and increases the cost of imports (Lardy, 1998). Regulations to sustain balance coincided with a drop of internal settlement rate of the black market for foreign exchange, a large influencer in the early financial reform periods. During the mid-1980s, State Administration of Exchange Control, SAEC, was delegated the task of setting up limited number of foreign exchange adjustment centers, also known as "swap centers," where foreign trade investors could trade foreign exchange and Renminbi at rates between designated parameters (Wang, n.d.). To stabilize the exchange rate, the swap center rates began to shift closer to black market rates, further devaluing the Renminbi. State investment was additionally promoted for export industries in a measure to increase exports. In 1994, China Foreign Exchange Trading System based in Shanghai, gradually replaced swap centers (Henderson, 1999).

China's reformist economy had let it survive the Asian financial crises of the later 1990s, and generate much international attention and diplomatic importance in its ability to stabilize its financial market. Despite the Asian crisis in 1997 that showed the devaluation of Asian currency, China and the Chinese government were able to maintain level constancy of the Renminbi. China was able to avoid large financial distress faced by Asian counterparts partly because of insulation of account surpluses, capital account controls, and large foreign exchange reserves (Huang, 2002). Maintaining the value of the Renminbi was politically and economically employed as a tool to increase China's image of international responsibility and economic stability. China's relatively stable currency value in comparison to flailing Asian economies allowed China to gain valuable export market share over its Asian counterparts. To fully leverage this opportunity, the Chinese government additionally released orders to state banks to financial support state-owned enterprises and to focus on exports. In 1998, China cut interest rates three times to reduce domestic costs for exporter operations, another strategy to increase domestic export (Hamilton, 2000).

Since 1995, the Chinese government has held and continues to hold the Renminbi at approximately $8.28 against the dollar, and shows no inclination to adjust the pegging policy in the near future (Central Intelligence Agency, 2005). Strategically, China has established competencies in pegging the Renminbi against the U.S. dollar, and is unlikely to risk destabilizing the current economic role of the Renminbi, though consistent pressures from foreign countries, particularly the U.S., has been put on the central government (Blustein, 2005).

Financial Institutions' Challenges

Domestic bank's competitiveness faces several problems; amongst them are the low profitability, poor asset quality from high non-performing loans together with inadequate capital, and impaired ability to control loan quality (OECD, 2002). These problems are partly due to accumulated burdens arising from past inefficiencies, and ongoing weaknesses in governance and operating capabilities. The lack of freedom and complex hierarchical procedural issues that coincides with close government coordination is also a hindrance. These issues also undermine the effectiveness with which banks are able to allocate credit and to exercise financial discipline over enterprises, posing potential risks to financial stability.

Financial Institutions as a Reform Tool

Only 0.6 percent of the total number of enterprises created between 1988 and 1996 has been put into bankruptcy despite continuously poor financial results, which signified the government's allowance for low mortality rate of these companies (OECD, 2002). In addition, there exists a strong anti-creditor prejudice, especially against banks, despite provision in the bankruptcy law that give creditors a priority on the remaining assets (Lardy, 1998). Usually, remaining assets are only enough to cover employee rehabilitation expenses, which in turn infers that the rate of recovery on initial loans by domestic banks is extremely low.

Three interrelated problems emerged out of the early banking reform systems to constrict development of financial institutions within China because of its use by the government as a complementary tool for industry reform. First, firms increasingly borrowed to finance purchase of new equipment, productive assets, production inputs, wage costs, and social services for their employees, at times even to meet pension and tax obligations (Yeung, 2004). Indebtedness far exceeded the assets of state-owned firms. State-owned enterprises built up large unfunded pension liabilities, unpaid tax liabilities, and inter-enterprise debts, which are triangular debts partly within the state-owned enterprise sector (Lardy, 1998). The government assumed the burden of subsidizing growing losses through fiscal subsidies and "policy loans," which were loans taken from the state-owned banking system (Lardy, 1998). Financial institutions were in essence a form of budgetary fund for state-related operations and enterprises. The early 1990s absorbed 10 percent or more of gross domestic product each year for these direct and indirect subsidies (World Bank, 1995). The strategy of preventing the emergence of economic failures was accomplished largely by deferring industrial restructuring, a process financed by the buildup of huge financial liability on the part of state-owned firms (Jefferson & Singh, 1999). Consequently, state-owned firms are predisposed to become insolvent. Second, state-owned banks and financial institutions extended loans without consideration of financial deepening. In a market economy, an increase of the size of the financial sector, as measure by assets, which in China's case are largely loans, relative to real output can indicate financial deepening (Brealey, & et. al., 2004). Given the large percentage of nonperforming loans, and China's ratio of money to gross domestic product was over 100 percent in 1996, a crisis will occur should money in savings accounts decrease and banks lose their liquidity (State Statistical Bureau, 1997). Third, decreasing government revenues between 1978, at 31.2 percent, and 1995, at 10.7 percent, signified that the state was increasingly unable to finance normal governmental expenditures from state budget (State Statistical Bureau, 1996). Financial institutions limited reserves would go to fund state expenditures when a need arise.

After 1993, the Chinese government realized the high amount non-performing loans, NPLs, to which the People's Bank of China reacted by significantly reducing both its subsidies to state-owned enterprises and its loans to commercial banks (Lardy, 1998). According to the OECD (2002), subsidies to the state-owned enterprises were reduced from 7.5 percent of GDP in 1992 to 2.3 percent in 1994, and to less than 1 percent after 1995.

From 1994 to 1998, loans from the People's Bank of China to state commercial banks grew at an average annual rate of 6 percent as opposed to 20 percent before 1994 (Chinese Financial Annual, 1998). The government's subsequent decision to turn the big four state banks into commercial banks and cleanse balance sheets made the banks more conservative, due the fact that bad loans were now less likely to be financed by new loans from the People's Bank of China (OECD, 2002).

These initial steps were followed by a series of reforms to the evolving banking system. The Chinese government required the four state commercial banks to increase their profits and "clean up balance sheets" by restricting bad debt (De Brower, & Pupphavesa, 1998). With new contexts and restrictions, the four state banks were increasingly unwilling to lend money to companies that were heavily in debt. During the course of 1997, over two thousand large and medium sized Shanghai state companies were audited and ranked according to their financial situation; to which they were then issued "loan certificates" summarizing their credit track record, allowing for proof of documentation when making new credit requests to banks (De Brower, & Pupphavesa, 1998). These initial reforms helped to stabilize the previously heavily indebted and high non-performing loaning during the Asian crisis.

Public sector impacts.

Public sector is essential during the macroeconomic fluctuations of the economy, particularly when a deficit, or low borrowing level, occurs.

Problems of the budget deficit can be alleviated by the sale of treasury bonds, but the broader problem of public sector deficit being at unsustainable level over gross domestic output have multiple implications (Stoll, 1998). China's high public sector deficit reduces the flow of savings available to finance non-state investment, leading them to rely on informal credit markets, reinvestment of profits, and closely allied state-owned firms for financing (Jefferson & Singh, 1999). State-owned enterprises, however, refrain from extending excessive indirect credit in case they create new competition in their core businesses; contributing to the problem of insufficient resources for the public sector. The need to sustain loss-making state-owned enterprises influences bank lending by limiting the ability to vary interest rates to reflect risk, which implies that cost of credit varies widely among borrowers of comparable credit worthiness.

Due to the non-recoverable borrowing by state firms, the public sector deficit accumulated over time, reducing the net worth of government assets below the optimum level of efficient economies. Under such premises, as the government debt rises above share of output, investors will lose confidence in the ability of the government to finance its expenditures on a non-inflationary basis and will demand higher interest to compensate for the anticipated increase in inflation. The unpredictability and lack of guarantee in a commercial environment had prevented Chinese banks to operate fully on commercial terms until borrowing behavior fundamentally changes.

Banking profitability.

Chinese banks' profitability has declined steadily; in 1999, reported profits before tax of the four largest state-owned central banks ranged between slightly negative as a ratio of total assets to 0.33 percent (OECD, 2002). The Bank of China lost monopolistic offering of deposits and loans denominated in foreign currencies and settlement of foreign trade transactions, and other types of foreign exchange business; falling to two-fifths of the banks' share of the market in foreign trade settlement (Lardy, 1998).

Reported profits are also a poor measurement tool because of habitual practices in overstating profits. This includes sub-par practices in accounting for the accrual of interest on loans, which are below international standards. Profit figures are also overstated by relatively low charges for loan provisions, meaning that banks are allowed to set aside only 1 percent of total loans as provisions. Under international standards, 1 percent is low, and particularly unrealistic given the indebted financial condition of China's banks. Another overstating profits practice is that Chinese banks are allowed to take very limited write-offs on bad loans ("China and the WTO: perspective on a changing environment," 2005).

Low level of profits is also attributed to inefficiencies that lead to excessively high costs in bank operations. Extensive branching of small and poorly located offices, with occasional overstaffing makes it economically costly (Yeung, 2004). Bank costs are further inflated by the relatively high turnover tax rate imposed on bank loans; prior to 2001 it was at 8 percent, to which lowered to 7 percent in 2001 (OECD, 2002). A last major influential factor to low profitability is the use of low or outdated technology, which further contributes to relatively low productivity in bank operations at the branches.

Credit policy reform.

After initial steps at reform, and the Asian crisis, the Chinese government put much emphasis in stabilizing the already fine balance between credit and savings. Bank loans to state-owned and public sector were given out sparingly in order to reduce the social costs of transition; waiting for companies to be privatized, merged, or put into bankruptcy. Bank lending, which was growing at an annual pace of more than 20 percent in the summer of 2004, has diminished to 10 percent in March of 2005 ("Finance and economics," 2005).

Non-performing loans of banks have inflated national public loans; another inefficiency of the financial system that has not been solved. In the late 1990s, OECD estimated approximately 50 percent or more of the total loans of state-owned central banks are national public loans (2002). China's banks have low levels of capital to cushion against national public loans, low profitability, and high national public loans; consummating into a decreased ability of Chinese banks to compete against increasing foreign competition. Financial weaknesses of the banks directly limit the capacity of institutions to invest in improvements in their capabilities, to raise funds in domestic or foreign financial markets, and to form alliances with foreign banks. These conditions tend to also weaken internal incentives to asses and monitor credit risks.

Since the inception of new banking law in 1996, authorities have taken several initiatives to improve bank-lending standards (Chan & Rotenberg, 1999). Direct quotas on bank lending were abolished and replaced with required ratios of assets to liabilities and asset liability system to regulate aggregate credit. Banks were required to establish a strict separation between loan origination and loan approval, something previously foreign in practice and the source of many fraudulent practices. The government has strengthened the accountability by making higher-level bank offices responsible for lower branch's compliance with lending standards, and by making lending officers and their senior management accountable for new bad loans (Yeung, 2004). These measures reinforced earlier policy banks creation to take responsibility over government directed or other preferential lending, previously carried out by the commercial banks. Such reforms have substantially reduced obvious government direction of credit, and have significantly improved lending standards and credit quality. Though, non-commercial consideration continue to influence lending decisions to a lesser degree and through more indirect channels, state-owned central banks were allocated minimum quotas for matching lending to infrastructure projects financed by the government's special bond issues in 1998 (Yeung, 2004). Continued operation of numerous loss-producing state-owned enterprises unable to service loans suggests that banks continue to provide working capital to firms that would not meet basic standards of creditworthiness. Government allowance for such enterprises should decrease in order to improve market efficiency of the financial system.

Asset management & equity.

In 1998, the central government launched a program of recapitalization of the four biggest state commercial banks, which has helped the biggest state-owned enterprises to reduce their debt. The program allowed banks to write-off from the balance sheet certain non-performing loans made to state-owned enterprises. Corresponding loans to the state-owned enterprises were taken over by four liquidating companies created for the purpose; China Cinda, China Huarong, China Great Wall Asset, and China Oriental (OECD, 2002). The liquidating, or asset management, companies take over assets and are responsible for selling the assets. The difference between the initial value of the asset and the amount recovered is that the recovery or asset sale is financed, if properly implemented, by state bonds (Brealey, & et. al., 2004).

Since 2002, the program has contributed to a substantial reduction of the debt of the largest state-owned enterprises, and has boosted the profitability of the public sector ("SASAC sets deadline for debt-to-equity swap", 2005). It represents initiative steps towards resolving the structural problem that links state-owned enterprises investment performance and the evolution of state commercial bank lending practices. Asset management companies have not concentrated on new loans but have concentrated on old loans that are difficult to recover, giving state commercial banks leeway in efforts on reforming credit lending practices on the new loans made since the mid-1990s, as well as cleansing portfolios of non-performing investments. The Chinese government has made clear indications of letting asset management companies actively play a supervisory role and focus on debt resolution and restructuring of state-owned enterprises. Asset management companies are entitled to trade assets among themselves to become larger creditors and concentrate their effort on more limited number of enterprises (OECD, 2002).

Asset management companies, however face several challenges. Most asset management companies entering boards of major state-owned enterprises are unable to maximize their influence and control the actions of the managers, and/or to censure them for several reasons. Firstly, there is an asymmetry of information provided to the different parties. The lack of transparency in the accounting system and poor functioning of board of directors allows state-owned managers to continue to control access to strategic information on firms. Secondly, there is a large number of companies under the program, resulting in the handling to billions of Renminbi assets, and tens of thousands of debtor companies. Overload of duties and responsibilities disperses concentration of the asset management companies. A third corresponding deterrent is that asset management companies lack sufficient supply of human resources and skills to play a strategic role in state-owned enterprises governance; including financial management and technology skills. Lastly, according to statutes that created asset management companies, they lack effective shareholder power, and are subject to negotiation with the central and local bureaucracies in charge of large state-owned enterprises, and thereby undercutting their power to force restructuring of the state-owned enterprises. China Huarong and China Cinda, some of the more notable asset management companies have difficulty dealing with strong conglomerates such as Monkey King Group and Zhengzhou Baiwen in restructuring plans. Both state-owned enterprises tried to escape control of asset management companies by either petitioning for bankruptcy to resist restructuring plans or committing actions to resist bankruptcy procedures and shutdown (World Bank, 2000).

Improving competitiveness & foreign bank involvement.

As evidenced by the relatively low rates of capacity utilization in many branches of Chinese industry in the mid-1990s, lack of competition from non-state sector to encourage production contributes to the lagging economic performance of many state-owned firms (Lardy, 1998). Previously, foreign banks assets were insignificantly small compared with assets of domestic financial institutions. In conjunction with protecting domestic firms, role of foreign financial institutions in China is limited because of the constraint on services permitted and geographic areas these foreign banks are licensed to operate.

The Chinese government in the 1990s acted on initiatives of reforming the domestic currency business, marking a step toward giving foreign banks the awaited right to take Renminbi deposits and make Renminbi-denominated loans (Lardy, 1998). To assure domestic risk is minimized, the Chinese government set strict restrictions on foreign banks. Firstly, foreign banks may carry out business dealings only with Chinese firms that are joint-venturing or have foreign-related business operations (Benewick, & et. al., 1995). This proved to be problematic for foreign banks due to the small number of foreign-related Chinese firms at the time. In addition, this limitation made it difficult to establish ties with those firms that were not already expanding ties to foreign business. Secondly, foreign banks are limited in providing full services of the domestic currency business. A stake in the profitable credit card business was not available for foreign banks. Thirdly, foreign banks must relinquish right to preferential tax rate, to which was a capital and opportunity loss for foreign banks (Brahm, 1996). Finally, to prevent unnecessary integration and protection of domestic money market, the Chinese government limited the number of joint and foreign banks authorized to conduct Renminbi businesses (Lardy, 1998).

Prior to large financial reform of the 1990s, foreign banks faced strict policy, geographical, and customer limitations, which were designed to protect state commercial banks from foreign competition. In 1999, foreign banks accounted for only approximately 2 percent of the total bank assets in China (OECD, 2002). Following China’s WTO commitments, several key restrictions on foreign bank operations will be phased out within a five year plan. In late 2004, China Banking Regulatory Commission, CBRC, announced steps to improve foreign banks’ access in China’s domestic market, primarily by offering Renminbi-denominated banking services in Beijing, Kunming, Xiamen, Ningbo, Shenyang, Shantou, and Xian (Economist Intelligence Unit, 2004).

Also according to China’s WTO agreements, the country must allow foreign banks to issue Renminbi-denominated credit cards by 2007, to which the Chinese government seems active in abiding (Economist Intelligence Unit, 2002a). After accession into the WTO, China has allowed foreign banks to issue credit cards domestically, giving the right for foreign banks to do full-service banking for Chinese companies (Areddy, 2004). Foreign banks are able to offer foreign currency-denominated credit cards to Chinese civilians with foreign currency-denominated salaries. And already foreign banks are taking advantage of the opportunity to expand presence in China. In September, Canada's Bank of Nova Scotia secured regulatory approval to increase its stake in Xian City Commercial Bank to 12.5 percent (“China finance,” 2005). In November, Commonwealth Bank of Australia announced it had reached an agreement to buy 11 percent of Jinan City Commercial Bank, China's eighth-largest city commercial bank, and with the option to increase to 20 percent ownership (“China finance,” 2005). Foreign banks have competitive advantages in many areas: good asset quality, superior skills and technology, international expertise, overseas networks and access to diverse global markets, flexible management structures, and good risk control and assessment. However, foreign banks lack a substantial comparative advantage with China; the ability to establish networks with domestic enterprises and customers. CBRC stated that by the end of 2006, all geographical restrictions on local currency banking will be removed (Economist Intelligence Unit, 2004).

Creating a Modern Financial System Up to International Standards

China's banking system has undergone significant changes in the last two decades. In the course of its transformation from a mono-bank system typical of centrally-planned economies, to an increasingly diversified, multi-layered system comprising of central bank and growing number of domestic and foreign commercial banks, China's banking system is now among the world's largest, particularly in relation to gross domestic product, GDP (OECD, 2002). Parts of the banking system are comparable in the sophistication and market orientation to those found in other emerging economies and the banking system is rapidly modernizing further, while some parts are still heavily influenced by past centralized system.

Lending Policy

After decades of extending loans largely at the will of political agendas, Chinese banks have not accumulated sufficient experience in commercial banking. Credit policy standards continue to be lax, and personnel lack appropriate credit training (Lardy, 1998). Civilian borrowing has increased dramatically in the past decade, surpassing in growth rate of enterprise borrowing ("Borrowing accelerates," 2003). The Chinese central bank has tried to address such issues by limiting simultaneous borrowing, and greater financial disclosure of borrowers. However, the central bank is limited in regulatory and supervisory abilities and thus can not offer strong leadership position to transition China's current state to a commercial banking system.

China has only just initiated the institutional transformation that is required to allocate capital more efficiently. The creations of new commercially-oriented banks are better equipped to meet the needs of a modern economy. However, the state has under-capitalized these new financial institutions by insulating state banks against competition, and consequently diminishing new commercial banks' catalytic role in reforming China's financial structure. The pervasive problem of new commercial banks is the lack of controls on lending policies. During the reform era, banks loaned randomly to enterprises; in the past decade, financial institutions have moved to lending indiscriminately to individual consumers. Lending to state sectors enterprises has decreased in proportion over the years, largely due to the decreased number, and has freed up banks to transfer capital investments in more private enterprises (Economist Intelligence Unit, 2002b).

The reforms of the late 1990s contributed to an increased pace of restructuring, constituting an important break in the conservative philosophies of the 1980s. Inefficiently and misallocated funding of state-managed enterprises, high market demand, and consumer optimism contributed to the difficulty of choosing profitable companies. However, it was an improvement from the 1980s, where policy of granting loans to loss-making companies for purchases of production equipment or other costly investment projects was in effect (Lardy, 1998).

Debt un-payment consequences have been few and hard to enforce, and continue to be a hazard in the stability of asset to liability ratio of financial institutions within China. A more defined separation of commercial from policy lending needs to be in place to increase independence of financial institutions in regards to political interference in lending decisions.

Culture of credit loaning of banks and loan officers is still socially networked. Despite absence of explicit government-directed credit, close relationships among banks, major industrial customers, and government exist. To solve the difficulty of containing imprudent lending relies on changing commercial behavior and not only institutional and structural reform.

Intermediation

As mentioned previously, China's banking system lacks efficient intermediation. Efficient financial systems contribute positively to economic growth and stabilization, especially through the allocation of funds to highest returning projects, increasing marginal productivity of capital, and maximizing usage of capital resources by continuous utilization in investments. In China, these banks are vital for two reasons. First, the Chinese population for many social reasons holds confidence in the banking system and supplies banks with enough equity to finance debt and liability, as well as provide much of the investment capital needed. Much attributed to this reason, China has not suffered widespread bank failures or seizure of savings from the state through inflation tax (Boyd, Chang, & Smith, 2004). Second, the variety of financial assets has grown slowly, remaining concentrated in cash savings (*Almanac of China's Finance and Banking*, 1997). Banks, thus, have opportunities to create capital assets and credit cooperatives.

With the increase of foreign involvement, Chinese banks' role as intermediaries between domestic enterprises and foreign investors are progressively important. Domestic banks can leverage their social networks and familiarity with the business environment as competitive advantages. In addition, more diverse intermediation will give China's banking system opportunities to gather skills and experience.

Measurement and Transparency

Overall, most commentators agree that the quality of the Chinese accounting and auditing framework is quite good compared to other emerging or transitioning countries. However, transparency and disclosure practices are not up to international standards. Financial management and reporting are plagued with fraud and pervasive irregularities. Particularly strong examples of the scale of this problem are the recent cases of financial mismanagement of trust and investment companies. In 2002, an estimated of nearly half of the 1,500 listed Chinese companies engages in some form of accounting irregularities (Leggit, 2002).

Measurement of the public sector deficit served to indicate a broad assessment of resources requirement of the state in its entirety of agencies and enterprises. The indicators include borrowing to finance government's budget deficit; specific instances are the sale of government bonds and borrowing by the treasury from central bank, state-owned enterprises issues of bonds and stocks to the public, and borrowing from the banking system (Lardy, 1998). Bank information disclosure is an essential part of financial transparency and reform. Chinese banks are progressing gradually from "selective" information disclosure to substantive transparency (OECD, 2002). A mandatory disclosure mechanism is being constructed with various measures to improve the financial strength of major banks in China.

Compared to other transition and emerging economies, China's accounting and auditing are relatively proficient, but transparency and disclosure practices are still behind international standards. Accounting standards in China are set by the Ministry of Finance. It's Advisory Committee, including representatives of the accounting profession, academics, and State Audit Committee has the authorization to review draft legislation, though they have no role in preparing draft policies (United Nations, 1999). This contrasts with most advanced market economies around the world where much of the accounting policies are directly attributed to the active accountancy industry. Partly due to this approach, the accounting industry and profession, as well as the consequent implementation of the standards are weak. Ministry of Finance has made clear indications of bringing the accounting standards up to international level, and in 1999 adopted new accounting standards following western examples (Chen & Yuan, 2004). Unlike previous accounting standards, the set of standards adopted in 1999 is an accounting disclosure and policy system set effectively by enterprises instead of the government.

In contrast to accounting standards set by the government, audit standards are set by a professional organization, the Chinese Institute of Certified Public Accountants, CICPA (Chen & Yuan, 2004). The CICPA requires more independence from the state; currently it is headed by the deputy Finance minister, and has been weak in creating the requisite guidance and adopting training programs that would help lift the implementation standards (Chan & Rotenberg, 1999). The big four accounting firms of the U.S. have audited China's banking sector as well as a few firms that have been involved in international capital markets, but these foreign banks have not been allowed a competitive presence in the domestic corporate sector (Chen & Yuan, 2004).

Non-financial disclosure, including ownership, control, and governance-related disclosure are also lacking, somewhat correlated with the advanced black market and illegitimacy of many businesses in China and Asia

(De Brower & Pupphavesa, 1998). Transparency and disclosure reform still remains in its early stages and the concept of continuous disclosure of items that materially affect the business is foreign to many.

In 2002, the Chinese government disclosed new requirements for improving accountancy transparency, in an effort to bring regulation of the banking sector up to international standards. New regulation requires annual releases of financial reports, including financial statements, balance sheets and equity positions, including banks to have financial records audited annually by an accredited firm. Regulatory provisions for online-banking were also established. People's Bank of China, PBoC, required all banks offering online services for the first time to file applications with PBoC prior, and must report quarterly its business details (Economist Intelligence Unit, 2002a).

> Although recent disclosure of negative information has not had significant influence on public confidence, foreign investment and bank management, the necessity of enhanced disclosure and its increasing importance in the long run is substantive (Chen, 2003).

Strategies to Improve Domestic Banking

Central government, supervisory officials, and banks, have made strong efforts to correct weaknesses of domestic banks. Over the last several years, state-owned central banks have closed smaller outlying branches and transferring their business to larger city branches and headquarters; between

1997 and 2000, nearly 21,000 offices were closed (OECD, 2002). Large efforts on cutting surplus staff and maximizing productivity have been implemented, mostly by investing extensively in equipment and other facilities to modernize and improve efficiency of bank operations (World Bank, 2000). In addition to cost cutting, China banks' business strategies have focused on two objectives; improving credit quality, and diversifying and strengthening products in areas of greatest comparative advantage (Yeung, 2004). Strong encouragement from supervisory authorities gave banks empowerment; banks have tightened internal controls on lending, upgraded internal accounting and information technology systems. These changes are critical because of rapid shift of China's enterprises in response to trade and investment liberalization. Effective and forward-looking credit assessment capabilities for China's banks must be improved.

China's domestic commercial banks possess important competitive advantages in raising deposits, servicing customers, and having close relations and knowledge of their clientele. Close ties with the government, primarily in their role in financing state-owned enterprises and government infrastructure projects present advantages of increased capability as a result of extensive opening of the economy to international markets and protection from entry of foreign-invested enterprises. Cash management, foreign exchange, and other services for commercial customers should develop further so as to improve profitability and enhance banks' ability to retain most profitable enterprise clients. One of the largest areas for growth is the exponential expansion for housing and home ownership, automobile purchases, and other consumer durables. Issues with profitability may be appeased by tapping into this area of growth.

To strengthen competitiveness, domestic banks should exploit their key advantages of the close relationships and knowledge about domestic enterprises and households. Special efforts should be made to form alliances among domestic banks or with foreign banks to exploit their complementary advantages, which Chinese banks seem to be already taking the initiative, as can be seen from recent partnering. Bringing in a foreign partner who can introduce better risk management and other systems and practices which it would otherwise take years to develop and master can produce almost instant benefits (Economist Intelligence Unit, 2005). In order to stimulate the transformation of domestic banking system, China should continue to utilize the role of foreign financial institutions, and eliminate their limitations in domestic financial system.

Conclusions

A central part of China's success has been its gradualist stance toward economic and political reform. In contrast with Russia's unsuccessful shock therapy, China managed to liberalize slowly without losing control of the legal system and the political process. The often-condemned suppression of the Tiananmen Square student uprising in 1989 was a crucial part of this approach. Had the government yielded to the student protests, the likely result would have been political chaos and poorer economic performance (Barro, 2003).

China's financial system has made important progress in recent years. The stock market has expanded impressively since its inception in the early 1990s, reaching a market capitalization of more the 50 per cent of GDP by 2001 (OECD, 2002). In 2004, China's stock market has developed into Asia's third biggest with more than 1,300 companies 4 trillion Renminbi of market capitalization and more than 70 million stock traders ("Sustainable growth needed for China's stock market," 2004). The financial supervisory and regulatory structure have also been thoroughly reorganized and rationalized along lines consistent with international best practices.

Despite progress, the financial system still has inadequacies in carrying out several basic functions in the economy. Savings mobilization has been relatively effective, but credit lacks proper allocation practices. State-owned enterprises still receive bulk of the funds allocated by the formal financial system, while non-state enterprises receive much lower share than is warranted by their importance in the overall economy. The need to sustain loss-making state-owned enterprises continues to influence bank lending; largely by the limited ability to vary interest rates to reflect risk, implying that cost of credit varies widely among borrowers of comparable credit worthiness.

Habit of government-mandated lending and weak contract enforcement and bankruptcy regimes has created a distorted credit culture, which banks have limited incentives and ability to maintain strict lending standards and enforce loan contracts. The weakness of discipline has been aggravated by excess and inefficient investment behavior of many enterprises, which has been inherited by the modern Chinese economy.

The government continues to struggle in sustaining adequate job growth for millions of workers laid off from state-owned enterprises, migrants, and new entrants to the work force; reducing corruption and other economic crimes; and keeping afloat the large state-owned enterprises, many of which had been shielded from competition by subsidies and had been losing the ability to pay full wages and pensions (Central Intelligence Agency, 2005).

Critical concerns that China's financial infrastructure will not support rapid growth and consumption of the 21st century have put considerable attention in decreasing the economic growth. Government's careful application of fiscal policy to restrain temporary exponential growth has been successful. Fixed asset investments have decelerated to 26 percent growth, as compared to 50 percent the previous year (Chipman, 2005). Accompanying these early signs of success have also generated a renewed sense of confidence in the Chinese government and its commitment to dealing with important economic issues and to building multi-lateral, open-business relationships in the worldwide community (Chipman, 2005). However, temporary successes may not be enough to impede the pursuant problems with rising unemployment, deflation from overinvestment in manufacturing capacity, a banking system struggling with non-performing loans, and a growing deficit caused by government efforts to keep real GDP at the range of seven to eight percent (Economist Intelligence Unit, 2002b).

These weaknesses in the financial system are partly a reflection of the fact that China is still a developing country. It also reflects the fact that evolution of the financial system has lagged behind real economic progress. China's transition to a market economy needs the creation of a modern banking system, one that will meet accepted international accounting standards. The implementation of a hybrid modern commercial banking system in China reflects the understanding by Chinese leaders of the underlying structural problems in the banking system. After China's accession into the WTO, the central government remains committed to meeting obligations with the biggest obstacles being enforcement mechanisms at the local level ("China and the WTO: perspective on a changing environment," 2005). Accession to the World Trade Organization helps stabilize, if not strengthen, China's ability to maintain growth rates but puts additional pressure on the hybrid system of political controls and growing market influences.

Being the country that supplies the largest labor force and consuming population, and having an economy increasingly exposed to market forces, China has large effects on the current world market. The complexity of certain factors of China's economic system require an identification of political, social, and economic structures and practices, as well as the inefficiencies that may produce problematic imbalances in China's economy.

Capital resources and structures, being the groundwork for economic development, has been particularly important in that inefficiencies regarding how capital is processed and allocated are now more obvious. In association, the hybrid system of a large government enterprise sector transitioning into a market economy, in which China has successfully built its reputation, has shown the importance of managing state enterprises. China's hybrid capitalistic progress has given credibility to a different form of capitalistic development. China now needs to establish the basic institutional and regulatory reforms to meet international requirements.

Though findings have largely revealed cyclic problems in which certain areas interact in mutually reinforcing ways to impede progress, particularly involving weaknesses of the state-owned enterprises and banking system, there is also a less prominent issue of business mentality in China. There exists a strong underlying cultural ideology that makes true separation of policy and commercial still remote. Though there are institutional and structural reform that may speed China's transformation, detaching fundamental social-political-economic aspect of Chinese business behavior require decades if not a half a century of shifting from social norms and communication networks of traditional Chinese business culture to that of market capitalism. It is precisely this reliance on personal networking and close interrelation between distinct areas that makes China a unique specimen in capitalistic reform. It is important to identify and understand the structural and institutional inefficiencies of China's growing economy, but in order to reduce China’s long-term growth uncertainties, additional concentration needs to be put on the socio-economic factors. Before expanding on the advanced institutional and regulatory reforms to the likes of western economies, China’s next step is to implement socially reformative initiatives to change the behavior of its consuming public, highly personalized-business-dealing commercial class, and commercially-affiliated politicians. Those that propose direct transition in reforming China’s economic and capital development to that equivalent of western examples will need to acknowledge the existence and influences of these underlying cultural factors on China’s economic progress as well as its more obvious structural inefficiencies. China’s current approach should be to reform structures and institutions to meet international standards and reduce major internal inefficiencies, predominately in its policies toward state-owned enterprises and the banking system. However, China, being uniquely differentiated by its culture, history, and people, may develop its own capitalistic regime without following the exact steps of other established economies.

References

Almanac of China's Finance and Banking 1997. (1997). Beijing: China Financial Publishing House.

Areddy, J.T. (2004, June 8). Industrial China goes into banking [Electronic version]. *Wall Street Journal*, A12. Retrieved April 18, 2004, from Proquest database Web site: http://proquest.umi.com/pqdweb?index=0&did=648425061&SrchMode=1&sid=5&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1114448602&clientId=3739

Barale, L.A. (1989, October 15). China before Tiananmen: the economic background to a political disaster [Electronic version]. *Wall Street Journal*, A26. Retrieved May 21, 2005, from Proquest database Web site: http://proquest.umi.com.libezproxy2.syr.edu/pqdweb?index=6&did=350078&SrchMode=1&sid=2&Fmt=6&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1117125630&clientId=3739

Barrow, R.J. (2002, September 30). China's slow yet steady march to reform [Electronic version]. *Business Week*, 3801, 28. Retrieved May 21, 2005 from Proquest database Web site: http://proquest.umi.com.libezproxy2.syr.edu/pqdweb?index=2&did=199513631&SrchMode=1&sid=2&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1117125630&clientId=3739

Baum, R. (1994). *Burying Mao: Chinese Politics in the Age of Deng Xiaoping*, p. 36-57. New Jersey: Princeton Unversity Press.

Benewick, R., & Wingrove, P. (1995). *China in the 1990s*. Vancouver: University of British Columbia Press.

Blecher, M. (2000). The Dengist Period: The triumphs and Crises of Structural Reform, 1979 to the Present. In C. Hudson (Ed.), *The China Handbook: Prospects onto the 21st Century* (pp. 19-37). New York: AMACOM.

Blustein, P. (2005, May 11). Putting pressure on China's peg Washington Post Online Web site: http://www.washingtonpost.com/wp-yn/content/article/2005/05/10/AR2005051001460.html

Borrowing accelerates [Electronic version]. (2003, May). *The Banker*, 12. Retrieved March 28, 2005, from Proquest database Web site: http://proquest.umi.com.libezproxy2.syr.edu/pqdweb?index=0&did=339214711&SrchMode=1&sid=20&Fmt=2&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1117144180&clientId=3739

Boyd, J.H., Chang, C., & Smith, B.D. (November 2004). Deposit insurance and bank regulation in a monetary economy: a general equilibrium exposition [Electronic version]. Retrieved March 28, 2005, from Proquest database Web site: http://proquest.umi.com.libezproxy2.syr.edu/pqdweb?index=0&did=674939411&SrchMode=1&sid=15&Fmt=2&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1117143258&clientId=3739

Brahm, L.J. (1996). *China as No. 1: The New Superpower Takes Center State*. New York: Butterworth-Heinemann Asia.

Brealey, R.A., Myers, S.C., & Marcus, A.J. (2004). *Fundamentals of Corporate Finance, 4th Edition* (pp. 394-414). New York: McGraw Hill/Irwin.

Central Intelligence Agency (CIA). (2005). The World Fact Book: China [Electronic version]. Retrieved April 17, 2005, from CIA online Web site: http://www.odci.gov/cia/publications/factbook/geos

Chan, L.M.W., & Rotenberg, W. (1999). Accounting, accounting education, and economic reform in the people's republic of China [Electronic version]. *International Studies of Management & Organization, 29*(3), 37-54. Retrieved April 20, 2005, from Proquest database Web site: http://proquest.umi.com/pqdweb?index=8&did=52745560&SrchMode=1&sid=1&Fmt=4&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1115704157&clientId=3739

Chen, J. (2003, May). Bank information disclosure in China: Evolution and enhancement [Electronic version]. *The Banking Law Journal, 120*(5), 417. Retrieved March 26, 2005, from Proquest database Web site: http://proquest.umi.com/pqdweb?index=8&did=345836611&SrchMode=1&sid=1&Fmt=2&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1113663903&clientId=3739

Chen, K.C.W., & Yuan, H.Q. (2004, July). Earnings management and capital resource allocation: evidence from China's accounting based regulation of rights issues [Electronic version]. *The Accounting Review, 79*(3), 645-665. Retrieved April 17, 2005, from Proquest database Web site: http://proquest.umi.com/pqdweb?index=0&did=672946001&SrchMode=1&sid=1&Fmt=6&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1115704156&clientId=3739

Cheng, S. (2003, April 24). Screening the revolution [Electronic version]. *Far Eastern Economic Review, 166*(16), 52-54. Retrieved May 18, 2005, from Proquest database Web site: http://proquest.umi.com.libezproxy2.syr.edu/pqdweb?index=7&did=3286791

91&SrchMode=1&sid=5&Fmt=4&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1117122952&clientId=3739

China and the WTO: perspective on a changing environment [Electronic version]. (2005, February). *China Law & Policy*. Retrieved April 16, 2005, from Proquest database Web site: http://proquest.umi.com/pqdweb?index=8&did=805805921&SrchMode=1&sid=1&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1115706283&clientId=3739

China finance: Tie-ups with foreign banks are just getting started [Electronic version]. (2005, January 26). *EIU ViewsWire*. Retrieved April 2, 2005, from Proquest database Web site: http://proquest.umi.com/pqdweb?index=2&did=788720361&SrchMode=1&sid=2&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1113664625&clientId=3739

Chinese Financial Annual. (1998). Peking: ZhongGuo JinRong NianJian BianJi Bu.

China Internet Information Center. (2003, December 31). Renminbi to be pegged to a basket of currencies. Retrieved on May 7, 2005, from china.org.cn Web site: http://www.china.org.cn/english/2003/Dec/83712.htm

Chipman, S. (2005, February). Too much, too fast: will China have a soft landing or no landing at all? [Electronic version]. *Mergers and Acquisitions, 40*(2), 6-7. Retrieved April 18, 2004 from Proquest database Web site: http://proquest.umi.com/pqdweb?index=9&did=795407011&SrchMode=1&sid=1&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1114445120&clientId=3739

De Brower, G. & Pupphavesa, W. (Eds.). (1998). *Asia Pacific Financial Deregulation*. New York: Routledge.

Economist Intelligence Unit. (2002a, August). Finance watch: China [Electronic version]. *Business Asia, 34*(16), 7. Retrieved April 18, 2004 from Proquest database Web site: http://proquest.umi.com/pqdweb?index=4&did=152312001&SrchMode=1&sid=5&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1114448602&clientId=3739

Economist Intelligence Unit. (2002b, December). Finance watch: China [Electronic version]. *Business Asia, 34*(24), 12. Retrieved April 18, 2004 from Proquest database Web site: http://proquest.umi.com/pqdweb?index=2&did=256227121&SrchMode=1&si

d=5&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1114448602&clientId=3739

Economist Intelligence Unit. (2004, October). China finance: Foreign banks to receive more market access [Electronic version]. *EIU Viewswire*. Retrieved April 18, 2004, from Proquest database Web site: http://proquest.umi.com/pqdweb?index=7&did=735863181&SrchMode=1&sid=1&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1114457739&clientId=3739

Economist Intelligence Unit. (2005, January). China finance: tie-ups with foreign banks are just getting started [Electronic version]. *EIU Viewswire*. Retrieved April 18, 2004, from Proquest database Web site: http://proquest.umi.com/pqdweb?index=3&did=788720361&SrchMode=1&sid=1&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1114457739&clientId=3739

Finance and economics: dim sums; China's economy [Electronic version]. (2005, August 21). *The Economist, 372*(8389), 68. Retrieved on March 26, 2005, from Proquest database Web site: http://proquest.umi.com/pqdweb?index=1&did=681229531&SrchMode=1&sid=1&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1113663903&clientId=3739

Hamilton, G.G. (2000). Reciprocity and control. In H.W.C. Yeung & Kris Olds (Eds.), *Globalization of Chinese Firms* (pp. 55-74). New York: Macmillan.

Henderson, C. (1999). *China on the Brink: The Myths and Realities of the World's Largest Market.* New York: McGraw-Hill.

Huang, Y.S. (1999). *Inflation and Investment Controls in China: The Political Economy of Central-Local Relations During the Reform Era.* New York: Cambridge University Press.

Huang, Y.P. (2002, November). China's last steps across the river: enterprise and banking reforms [Electronic version]. *The Journal of Asian Studies, 61*(4), 1346-1349. Retrieved on May 21, 2005, from Proquest database Web site: http://proquest.umi.com.libezproxy2.syr.edu/pqdweb?index=6&did=281483051&SrchMode=1&sid=5&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1117134154&clientId=3739

Jefferson, G.H., & Singh, I. (1999). *Enterprise Reform in China: Ownership, Transition, and Performance*. New York: Oxford University Press, Inc.

Lardy, N.R. (1994). *China in the World Economy*. Washington, D.C.: Institute for International Economics.

Lardy, N.R. (1998). *China's Unfinished Economic Revolution*. Washington, D.C.: Brookings Institution Press.

Lee, H.Y. (1978). *The Politics of the Chinese Cultural Revolution: A Case Study*. New York: University of California Press.

Leggit, K. (2002, August 7). Charges are filed in landmark Chinese fraud case – three former executives of a listed store operator accused of hiding losses [Electronic version]. *Wall Street Journal*, A12. Retrieved April 18, 2004, from Proquest database Web site: http://proquest.umi.com/pqdweb?index=0&did=146789541&SrchMode=1&sid=1&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1115607381&clientId=3739

Lippit, V.D. (1987). *The Maoist Period 1949-78: Mobilizational Collectivism, Primitive Accumulation, and Industrialization* (pp. 106-107). New York: AMACOM.

Lippit, V.D. (2000). The Maoist Period 1949-78: Mobilizational Collectivism, Primitive Accumulation, and Industrialization. In C. Hudson (Ed.), *The China Handbook: Prospects onto the 21st Century* (pp. 3-18). New York: AMACOM.

OECD, Organization for Economic Co-Operation and Development. (2002). *China in the World Economy: The Domestic Policy Challenges.* Paris: OECD.

People's Bank of China. (2005). Retrieved May 15, 2005, from People's Bank of China Online Web site: http://www.pbc.gov.cn

Riskin, C. (1987). *China's Political Economy: The Quest for Development Since 1949.* New York: Oxford University Press.

SASAC sets deadline for debt-to-equity swap [Electronic version]. (2005, January, 20). *SinoCast China Business Daily News, (16)*, 23. Retrieved March 26, 2005, from Proquest database: http://proquest.umi.com/

State Statistical Bureau. (1996). Statistical Communique on Socio-Economic Development in 1996 [Electronic version]. *Beijing Review, (16)*, 23. Retrieved March 26, 2005, from LexisNexis database Web site: http://web.lexis-nexis.com/

State Statistical Bureau. (1997 March). Statistical Communique on Socio-Economic Development in 1996 [Electronic version]. *China Statistical*

Yearbook 1996 (pp. 223). Retrieved March 26, 2005, from LexisNexis database Web site: http://web.lexis-nexis.com/

Standard Chartered. (2001, April). China's banking system in transition [Electronic version]. *Hong Kong Trade Development Council* Online, Economic Forum, Business Intelligence. Retrieved March 26, 2005, from Web site: http://www.tdctrade.com/econforum/sc/sc010402.htm

Stoll, H.R. (1998). Regulation of financial markets: a focused approach. *Multinational Finance Journal, 2*(2), 87-99. Retrieved March 26, 2005, from Proquest database Web site: http://proquest.umi.com.libezproxy2.syr.edu/pqdweb?index=2&did=5549742 3&SrchMode=1&sid=2&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1117138569&clientId=3739

Sustainable growth needed for China's stock market [Electronic version]. (2004, October 7). Retrieved May 20, 2005, from People's Daily Online Web site: http://english.people.com.cn/200410/07/eng20041007_159212.html

The struggle of the champions – China's champions; China's big companies [Electronic version]. (2005, January 8). *The Economist, 374*(8408), 58. Retrieved May 20, 2005, from Proquest database Web site: http://proquest.umi.com.libezproxy2.syr.edu/pqdweb?index=6&did=7768895 21&SrchMode=1&sid=1&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1117130592&clientId=3739

United Nations. (1999). *World Economic and Social Survey 1999: Trends and Policies in the World Economy.* New York: United Nations Reproduction Section.

Wang, Y.F. (n.d.). Retrieved March 26, 2005, from http://c-faculty.chuo-u.ac.jp/~toyohal/JSME/pdf03s/03s220-wang.pdf

World Bank. (1995). *Meeting the Challenge of Chinese Enterprise Reform*. Washington: World Bank.

World Bank. (2000). *Aftereffects of the Asian Crisis*, p. 31. Washington: World Bank.

Yeung, H.W.C. (2004). *Chinese Capitalism in a Global Era: Towards hybrid capitalism*. London: Routledge.

Zhang, W.Y. (1999). Development in Chinese corporate finance and its implication for ownership reform. In G. De Brouwer, G., & W, Pupphavesa, (Eds.), *Asia Pacific Financial Deregulation*. London: Routledge.