# The Acceleration of China's Financial Reforms—Pursuing More Efficient Resource Allocation

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*China's economy has been prone to excess investment because the financial system, which centers around indirect finance by state-owned commercial banks (SOCBs), does not allocate resources as efficiently as needed for a market economy. Clear signs of the financial system's shortcomings, combined with China's WTO commitment to open up the financial sector to foreign participation, have driven financial reform at an accelerating pace in recent years and produced some results. However, more work lies ahead, particularly in improving the capability of SOCBs to make lending decisions and manage risk.*

## 1. Basic Structure of China's Financial System

The chief aim of the 11th five-year plan starting this fiscal year is to sustain the economy's growth by shifting the focus from investment and exports to consumption, streamlining the industrial structure, and improving the efficiency of resources.

However, entering 2006, the economy accelerated to 10.3% growth (yoy) in the first quarter and 11.3% in the second quarter, and dependence on investment and exports has increased. With some industries experiencing excess capacity, banks continuing to struggle with nonperforming loans, and mounting concerns of trade friction, macroeconomic controls were tightened from April.

The underlying cause of the excessive and inefficient investment is the lack of adequate market mechanisms to allocate financial resources efficiently in the budding market economy. After China began opening the economy in 1978, the real economy shifted dramatically as the foreign and other non-state sectors expanded their presence. Yet the financial system continues to be dominated by indirect finance from state-owned commercial banks (SOCBs), and remnants of the planned economy continue to channel investment funds into the state sector. In fact, deposits comprise 72.5% of household financial assets, and bank loans account for 70.1% of corporate financing (both are cumulative totals from 2002 to 2004). Backed by a de facto government guarantee on deposits and a massive branch network, SOCBs are an oligopoly that controls 52.5% of total assets of financial institutions (end of 2005).

Since SOCBs serve the state-owned sector exclusively, the non-state sector must rely on nationwide (shareholding commercial) banks and city banks. Though generally more profitable, they are dwarfed in size by the SOCBs. Moreover,

**Exhibit 1 Total Assets of Financial Institutions in China (2005)**

| | Trillion RMB | Share (%) |
|---|---|---|
| State-owned commercial banks (4) | 20.0 | 52.5 |
| Shareholding commercial banks (13) | 5.9 | 15.5 |
| City banks (117) | 2.1 | 5.4 |
| Foreign-funded banks | 0.6 | 1.9 |
| Urban credit cooperatives | 0.2 | 0.5 |
| Rural credit cooperatives | 3.2 | 8.4 |
| Other financial institutions | 6.2 | 15.8 |
| Total | 38.1 | 100.0 |

Notes: Other financial institutions include policy banks, corporate group finance companies, investment trusts, finance and lease companies, and postal savings.
Source: Peoples Bank of China

nationwide banks are heavily concentrated on the coast, while city banks operate in specified geographic areas. As a result, small businesses and rural customers tend to be underserved and must resort to nonstandard finance.

Meanwhile, foreign banks are restricted in terms of geographic area, customers, and access to RMB-denominated services. Their mainstay services are foreign-currency loans and deposits and trade settlement, giving them a meager 1.9% share of the financial system.

The top priority of China's financial reform is to transform the SOCBs at the core of the financial system. SOCBs must revise their loan portfolios, which are heavily biased toward state-owned enterprises (SOEs), and convert into responsible commercial banks that allocate resources efficiently. But banking reform in turn depends on the success of stock market reform, which aims to correct structural distortions stemming from state ownership and the stock market's original function of financing state enterprises, and to develop the market infrastructure.

Meanwhile, despite large current account surpluses and massive capital inflows, China's capital controls remain fixated on capital flight and short-term transactions, while the foreign exchange policy emphasizes currency stability. The reason that policymakers cannot shift gears—even in the face of mounting trade friction externally and excessive liquidity domestically—lies with the nation's fragile banking system.

The pace of financial reform has accelerated in recent years, prodded by clear signs of the system's limitations and by China's WTO commitment to open up the financial sector—including allowing foreign banks to handle RMB-denominated services—within five years of the December 2001 accession. Below we examine the progress in reforming SOCBs and introducing market mechanisms.

## 2. Banking Reform

### (1) History of Banking Reform

After adopting the market opening policy in 1978, China began the conversion to a market-based financial system by establishing financial institutions and markets. In the erstwhile planned economy, practically all banking functions were concentrated in the People's Bank of China (PBC), whose role was to disburse policy-based loans. Today's four SOCBs were established as specialized banks with distinct business segments, and slated to become independent of the PBC by 1984. The four SOCBs are the Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC), Bank of China (BOC), and China Construction Bank (CCB).

Financial reform has aimed to secure investment funds necessary for economic development, and to improve investment efficiency through effective resource allocation. On the first point, the specialized banks were successful from the start. But they were much less effective at resource allocation. The problem was that the non-separation of government fiscal and credit policies, coupled with slow reform of SOEs, obligated SOCBs to provide policy-based loans to financially unsound SOEs. As a result, SOCBs continued to allocate financial resources inefficiently.

From the mid 1990s, banking reform began emphasizing more efficient resource allocation in three phases. The first phase in the mid 1990s was in response to the chaotic overheated economy of 1992 and 1993. The legal infrastructure was developed with the Central Bank Law and Commercial Bank Law (1995), and three new policy banks (China Development Bank, Export-Import Bank of China, and Agricultural Development Bank of China) were established in 1994 to perform policy lending. This freed up SOCBs to focus on commercial banking, blurring the original segmentation that existed at startup. These reforms allowed banks to establish lending standards based on the borrower's business performance, and to implement risk management practices such as pricing based on credit risk.

In the late 1990s, forewarned of the dangers of premature capital account liberalization by the Asian financial crisis, China moved to strengthen financial institutions and enhance banking regulation and supervision. Public funds were injected to recapitalize SOCBs in 1998 (RMB 270 billion), while four state-owned asset management companies (AMCs) were established in 1999 to help divest SOCBs of their massive nonperforming assets (NPAs). NPAs totaling RMB 1.4 trillion—mostly from bank credit extended prior to the Commercial Bank Law of 1995—were transferred to the asset management companies. As for banking regulation, as the first step to ensure financial soundness, a five-stage debt classification method was introduced experimentally in 1998, and formally adopted in December 2001.

## (2) Third Stage— Reform of SOCBs

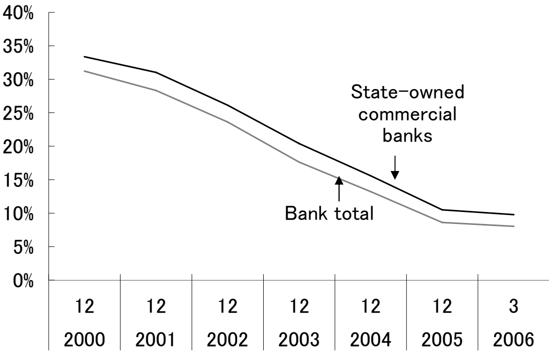
The third stage, which began in 2001, was prompted by China's WTO commitment to allow foreign banks into RMB-denominated services nationwide by December 2006. Financial regulation and supervision were brought up to international standards with the establishment of the China Banking Regulatory Commission (CBRC) in 2003, and stricter capital adequacy ratio regulations in 2004. In addition, efforts were accelerated to make local financial institutions, particularly SOCBs, more competitive.

### *1. Financial restructuring and conversion from state ownership*

In this period, SOCBs made significant progress in the disposal of non-performing assets. After making several sales to AMCs, their NPA ratio declined dramatically from 33.4% at yearend 2000, to 9.8% in March 2006.

The four AMCs also showed progress. By resorting mainly to debt-for-equity swaps, they reduced the disposal ratio to 68.6% by March 2006.[1]

**Exhibit 2 Nonperforming Asset Ratio of Banks**




Sources: For 2000-02, *Zaikei*, February 2004; for 2003 onward, CBRC.

The pace of reform has varied among the four banks. The leaders are China Construction Bank, who was chosen as a "model bank" at 2003 yearend, and Bank of China, with Industrial and Commercial Bank of China lagging behind. Following on 1998, public funds were re-injected into CCB in August 2004, BOC in September 2004, and ICBC in April 2005 via Central Huijin Investment Company (the investment arm of the central bank) out of the official reserve.

As a result, in 2005 NPA ratios plunged from double digits down to 4.62% for BOC, 3.84% for CCB, and 4.58% for ICBC. Meanwhile, capital adequacy ratios that had sunk below 8% rose to 10.42%, 13.57% and 9.12% respectively. Having improved their financial position, the three reformed banks are shedding their state ownership status and entering a new stage of converting to shareholding companies, accepting strategic investors, and listing on stock markets. Meanwhile, reform at the China Agricultural Bank continues to lag far behind.

[1] However, the asset recovery ratio remained low at 24.2% (of which the cash recovery ratio was 21.0%).

The conversion to shareholding companies occurred in August 2004 for BOC, September 2004 for CCB, and April 2005 for ICBC. In addition to recapitalizing, the three banks decided to accept strategic investors with the aim of acquiring business and risk management expertise and improving corporate governance. Strategic investors must satisfy certain criteria, and can take a maximum stake of 20% in any one company, with total foreign ownership in a company limited to 25%. After the ban was officially lifted on foreign investment in December 2003, foreign investment increased at SOCBs, nationwide banks, and city banks (Exhibit 3). At the smaller nationwide and city banks, strategic investors are participating at the limit with an eye on future business expansion. By comparison, foreign participation rates at SOCBs are lower—16.9% at BOC, 14.1% at CCB, and 10.0% at ICBC—and investors are multinational cross-industry consortia. In addition to participating in ownership, these

### Exhibit 3 Foreign Participation in Chinese Banks

| Chinese bank | Foreign shareholding bank | Nationality | Ownership stake (USD mil.) | (%) |
|---|---|---|---|---|
| ***State-owned commercial banks*** | | | | |
| Industrial and Comm. Bank of China | Goldman Sachs/Allianz/Amex | U.S./Germany | 3,780 | 10.0% |
| China Construction Bank | Bank of America (*3) | U.S. | 3,000 | 9.0% |
| | Temasek | Singapore | 1,400 | 5.1% |
| Bank of China | RBS/Merrill Lynch/Li Ka Shing Found. | U.K./U.S./Hongkong | 3,100 | 10.0% |
| | Temasek | Singapore | 1,500 | 5.0% |
| | UBS | Switzerland | 500 | 1.6% |
| | Asian Development Bank | International | 75 | 0.3% |
| ***Nationwide banks (*1)*** | | | | |
| Bank of Communications | HSBC (*4) | U.K. | 1,750 | 19.9% |
| Hua Xia Bank | Pangaea Capital Management | Singapore | 125 | 6.9% |
| | Deutsche Bank | Germany | 330 | 14.0% |
| Shanghai Pudong Development Bank | Citigroup (*5) | U.S. | n.a. | 4.6% |
| Minsheng Bank | Temasek | Singapore | 250 | 4.6% |
| Industrial Bank (Fuzhou) | Hang Seng Bank | Hongkong | 210 | 16.0% |
| | International Finance Corp. | International | n.a. | 7.0% |
| | GIC | Singapore | n.a. | 3.0% |
| Shenzhen Development Bank | Newbridge Capital | U.S. | 145 | 17.9% |
| ***City banks (*2)*** | | | | |
| Bank of Beijing | ING Groep NV | Netherlands | 220 | 19.9% |
| | International Finance Corp. | International | n.a. | 5.0% |
| Bank of Shanghai | HSBC | U.K. | 62 | 8.0% |
| Jinan City Commercial Bank | Commonwealth Bank of Australia (*7) | Australia | n.a. | 11.0% |
| Nanjing City Commercial Bank | BNP Paribas | France | 90 | 19.2% |
| Xi'an City Commercial Bank | Bank of Nova Scotia (*6) | Canada | n.a. | 12.4% |
| | IFC (*6) | International | n.a. | 7.0% |
| Hangshou City Commercial Bank | Commonwealth Bank of Australia | Australia | 80 | 19.9% |
| China Bohai Bank (new) | Standard Charterd Bank | U.K. | 123 | 19.9% |

Notes: Includes cases that are planned or under review by CBRC
(*1) There are 13 nationwide banks, which are shareholding commercial banks licensed to operate nationwide.
(*2) There are 117 city banks, which are licensed to operate in one city; reorganized from urban credit cooperatives.
(*3) Has option to increase participation to 19.9%.
(*4) Has option to double participation pending deregulation.
(*5) Has option to increase participation to 24.9%.
(*6) Bank of Nova Scotia and IFC are expected to increase participation to 12.4% and 12.5%, respectively.
(*7) Has option to increase participation to 20%.
Sources: *Business Week*, October 31, 2005, p.22; *The Banker*, May 2005, p. 18; Japan Center for International Finance, "Capital Participation of RBS in Chinese Banks and Entry of British Banks in China," October 4, 2005, p. 2; media reports.

foreign financial institutions are launching collaborative projects and joint ventures in their areas of expertise.

Regarding stock market listings, CCB became listed on the Hong Kong stock exchange in October 2005, and BOC in Hong Kong on June 1, 2006, and Shanghai on July 5. BOC's initial public offering set a domestic record at RMB 20 billion (approximately USD 2.5 billion). Meanwhile, ICBC's plan for listing was officially approved in July, and is slated to take place on the Hong Kong and Shanghai exchanges.

*2. Critical need for lending decision and risk management capabilities*

Hyper-investment and investment inefficiency in the rapidly expanding economy become problematic from 2003. Much of the investment is financed by loans from SOCBs. Amid monetary tightening and the shift in industrial structure, the CBRC remains vigilant about new NPAs surfacing.

SOCB loans have clearly led to excessive and inefficient investment for two reasons. First, SOCB lending decisions remain under the influence of central and local governments. Second, regulated interest rates limit their ability to set loan rates according to credit risk, thus impeding development of their lending decision and risk management capabilities.

As explained later, interest rate deregulation, which is occurring gradually, will increase leeway to set interest rates according to the borrower's creditworthiness. In the future, asset and liability management capabilities will become critical as competition intensifies—not only from the entry of foreign banks in RMB-denominated services, but the introduction of market-based interest rates, adoption of a wider currency band, and capital account liberalization.

Achieving greater shareholder diversity—which results from accepting strategic investors and listing on stock markets—not only enhances risk management capability and profit incentives, but promotes management transparency and corporate governance. This achievement and the conversion from state monopolies are in themselves a major step forward. But as long as ownership by strategic investors is restricted and government control remains the rule, genuine progress may be delayed.

Further enhancements to shareholder diversity and corporate governance will require domestic stock market reform. China's domestic stock market is stagnant due to serious structural problems and poor market infrastructure—which explains why SOCBs prefer the Hong Kong stock exchange. We discuss comprehensive reform of China's stock market in the next section.

## 3. Reform of Market Mechanisms

### (1) Stock Market Reform

*1. Structural problems*

Compared to the bank credit market, China's stock market capitalization is miniscule. It is small even compared to China's peers with large populations, ample resources, and high potential growth rates—Brazil, Russia and India (Exhibit 4).

**Exhibit 4 International Comparison of Credit & Capital Markets**

| | China | India | Brazil | Russia |
|---|---|---|---|---|
| | | | | (US$ billion) |
| Bank credit | 2,318.0 | 253.4 | 166.6 | 143.1 |
| Stock market cap. | 639.8 | 387.9 | 330.3 | 268.0 |
| Outst. domestic debt sec. | 483.3 | 239.2 | 371.6 | 29.4 |
| Government securities | 287.4 | 235.0 | 295.9 | 20.1 |
| Financial institutions | 183.7 | 1.4 | 71.7 | 0.0 |
| Corporate issuers | 12.2 | 2.8 | 4.0 | 9.3 |
| | | | | (% of GDP) |
| Bank credit | 140.5% | 36.9% | 25.2% | 23.7% |
| Stock market cap. | 38.8% | 56.4% | 50.0% | 44.3% |
| Outst. domestic debt sec. | 29.3% | 37.8% | 56.2% | 4.8% |
| Government securities | 17.4% | 34.2% | 44.7% | 3.3% |
| Financial institutions | 11.1% | 0.2% | 10.8% | 0.0% |
| Corporate issuers | 0.7% | 0.4% | 0.6% | 1.5% |

Source: IMF, *Global Financial Stability Report*, September 2005, p. 105.

The stock market is also plagued by qualitative problems: (1) under the principle of state ownership, over half of all shares are restricted shares and unavailable for trading, including state-owned shares of central and local and governments, legal person shares held by state-owned enterprises, and employee shares; (2) the stock market was originally established to finance SOEs, who dominate stock listings but are rife with management problems; (3) the market infrastructure lacks adequate accounting standards, disclosure rules, and investor protection measures; (4) securities firms have a fragile business foundation; (5) investors are mostly individuals with a short-term horizon, and rational institutional investors are absent; and (6) foreign investors are tightly regulated.

### *2. Reform gains momentum*

As the need for a viable stock market increased, reform efforts began to accelerate in connection with the 2001 WTO accession. The stock market's original role in the 1980s was to finance SOEs. More recently, its role is to facilitate SOE privatization and enhance their corporate governance. At the same time, from the perspective of shifting economic gears under the 11th five-year plan, the stock market will play a growing role in financing the non-state sector and in diversifying asset management.

Reform measures thus far include phased revision of the screening process for listing companies, improvement of the delisting process, and consolidation and reorganization of securities firms. To improve the structure of demand, phased actions are being taken to foster the investment fund market, deregulate investment by insurance companies and pension funds, and deregulate foreign investors.

In February 2004, the State Council issued a nine-point plan to reform, liberalize, and develop the capital market. The policy, which calls for comprehensive stock market reform, emphasizes the importance of capital markets, market principles, tradable shares, market expansion, and improvements in listed companies, financial intermediaries and oversight functions. Moreover, in January 2006, the revised securities law and company law came into effect, bolstering important market features such as corporate governance, disclosure, penalty provisions, and oversight.

The reform of non-tradable shares, which had been shelved after it triggered a stock market decline in 2001 and 2002, also began in earnest from April 2005. Steps were taken to avoid repeating past mistakes, including a scheme for owners of restricted shares to compensate owners of tradable shares for losses stemming from the increase in float, time limit on the sale of non-tradable shares, and freeze on IPO activity (from May 2005). As a result, the ratio of non-tradable shares plunged from 57.5% in May 2005 to 44.8% in May 2006.

As for foreign investors, volatility-causing short-term speculative trading was restricted, while investment restrictions were eased out of expectations that rational investors would enhance market stability and corporate governance. Although foreign investors had been restricted to B shares (foreign currency denominated), in December 2002 the QFII (qualified foreign institutional investor) system was introduced, opening the way for investment in A shares (RMB-denominated). In addition to over 30 financial institutions already designated as QFIIs, on January 30, 2006 other foreign investors satisfying new requirements were allowed to acquire A shares under specified conditions.[2]

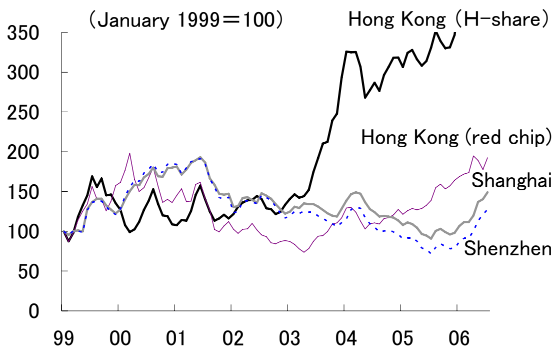
China has made some progress in its WTO commitment to liberalize the securities business. Although the maximum foreign stake in a joint venture is restricted to 33% for securities

[2] QFIIs must satisfy requirements such as industry experience, and may invest domestically in a specified quota of A shares. Foreign institutional investors that meet the new foreign investor qualification can own no more than 10% of a Chinese company listed on the Shanghai or Shenzhen stock exchange, and must hold the shares for at least three years.

companies and 49% for investment trust companies, foreign capital is actively entering the market and expected to help invigorate it.

As a result of reforms, stock prices—which remained sluggish for four and a half years after peaking in June 2001—bottomed out in June 2005 and began to recover (Exhibit 5). However, the lifting of the IPO ban in May 2006 has fueled concerns of an IPO rush not only by SOCBs but a large number of SOEs. Since this could destabilize the market, reforms will need to continue apace.

**Exhibit 5 Stock Price Indexes in China**




Notes: H shares (HKD-denominated) are Chinese company shares issued on the Hong Kong Stock Exchange Red chip shares (also HKD-denominated) are shares listed in Hong Kong in which Chinese central and local governments own at least 35%. Shanghai and Shenzhen indexes include both A shares (RMB-denominated shares held by Chinese) and B shares (foreign currency denominated shares owned by foreigners).
Sources: Stock exchanges

## (2) Introducing Market Interest Rates

Market interest rates are considered crucial for achieving efficient resource allocation and preparing the environment for monetary control through market mechanisms.

Beginning with the liberalization of call market interest rates in June 1996, China's introduction of market interest rates has proceeded from short-term to long-term rates, from lending to deposit rates, and from foreign currency to RMB. At present, market interest rates exist for the interbank call rate and bond repo rate, commercial paper rediscount rate, issuing rate of government bonds in the primary market, and government bond yields in the secondary market. Foreign currency denominated lending rates and large-lot deposit rates have also been liberalized.

Regarding RMB deposit and lending rates, the discretionary scope of financial institutions was expanded when the maximum lending rate was abolished in October 2004, while the minimum lending rate was kept at 0.9 times the official interest rate. They also have the discretion to set the deposit rate below the standard interest rate.

However, the standard interest rate, which determines the minimum lending rate and is equal to the maximum deposit rate, is fine-tuned according to loan period and industry. Lending rates are set low for the benefit of SOEs, while deposit rates are set low to increase the deposit-loan spread of SOCBs. Even after macroeconomic controls were tightened in 2004, lending rates have been raised twice for a total of only 0.54% on one-year loans (as of August 8, 2006).

## (3) Widening the Currency Band

*1. Cautious stance on capital account liberalization and currency band widening*

Since 1994, when controls were tightened on capital outflows and short-term transactions, the exchange rate had been effectively pegged at 8.27−8.28 RMB to the dollar. In July 2005, the first step was taken toward a floating exchange rate regime when China revalued the RMB 2.1% and adopted a managed float based on a currency basket.

China subsequently kept the foreign currency market separate from the overseas market, and maintained restrictions on capital transactions. However, to deal with the cumulative capital account surplus, restrictions on capital outflows were partially eased—the range of outward direct investment was expanded (May 2005), international organizations were allowed to issue RMB-denominated bonds (October 2005), and the ban was lifted on investment in foreign

### Exhibit 6 Capital Account and Foreign Exchange Liberalization Since 2005

| Year | Month | Description |
|---|---|---|
| **Capital controls** | | |
| 2005 | March | Foreign currency holding restrictions eased for companies. |
| | May | Outward foreign investment restrictions eased for Chinese companies. |
| | June | QFII (qualified foreign institutional investor) maximum investment raised from $4 bil. to $10 bil. |
| | Oct. | RMB-denominated bond issuance approved for ADB and IFC. |
| 2006 | Jan. | Investment in domestic stock market approved for foreign strategic investors. |
| | May | Reporting on foreign currency current accounts changed to ex post facto. |
| | | Procedures simplified for payment of trade in services, foreign currency purchase by individuals. |
| | | Ban lifted on foreign asset management by banks and foreign securities investment by fund management and insurance companies. |
| **Foreign exchange controls** | | |
| 2005 | May | Range of currencies expanded in foreign currency transaction centers. |
| | | Market maker system introduced for foreign currency transactions. |
| | July | Market-based managed floating exchange rate regime adopted. |
| | Aug. | Participation in the interbank RMB forward market expanded to foreign financial institutions. |
| | Sept. | Non-dollar currency band expanded from 1.5% to 3%. |
| | Nov. | Currency swaps begun by PBC. |
| 2006 | Jan. | OTC transactions and market maker system introduced in the interbank spot foreign exchange market. |
| | Feb. | Ban lifted on RMB interest rate swaps by financial institutions. |
| | April | Interbank currency swaps begun. |

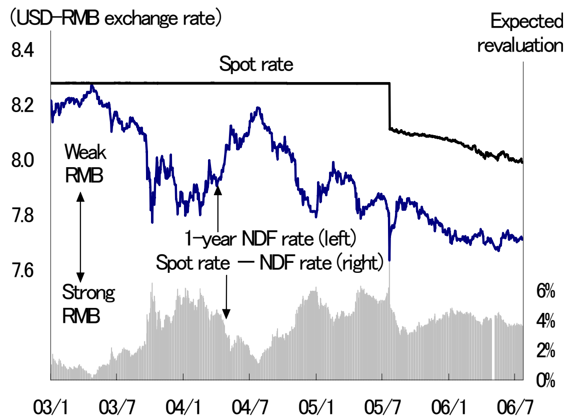
securities by institutional investors (Exhibit 6).

As a result, in 2005 the capital account surplus narrowed 40% from the previous year. However, because the current account surplus widened significantly, the combined surplus of USD 207.0 billion was unchanged from the previous year. The trade surplus, which is the main source of foreign currency, reached USD 61.3 billion in the first half of 2006, and is set to top the record USD 102.0 billion trade surplus of 2005. Actual foreign direct investment reached USD 28.43 billion in the first half of 2006, and is also poised to tie the record levels of 2004 and 2005.

Amid the large inflow of foreign currency, China has been selling RMB to stabilize the exchange rate, increasing the foreign reserve by USD 122.2 billion since December 2005, to USD 944.1 billion as of June 2006. Since the July 2005 revaluation, the daily trading band has been much smaller than the announced band of plus or minus 0.3%. As a result, the RMB has appreciated only 1.3% in the past year—less than half of market expectations.

The policy of exchange rate stability not only generates trade friction with the U.S., but injects new liquidity into the economy. Sterilization is being attempted through open market bond sales and issuance of PBC commercial paper. But its effectiveness is limited due to the sheer size of the foreign currency inflow. Money supply (M2) growth exceeds the 16% (yoy) target for 2006,

### Exhibit 7 USD-RMB Spot Rate and Non-Deliverable Forward Rate

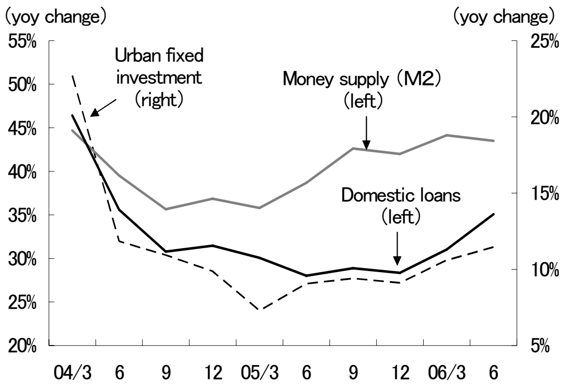



Source: Datastream

while loans for fixed investment are accelerating (Exhibit 8).

To rein in the economy while stabilizing the currency and avoiding interest rate hikes, macroeconomic controls were imposed in April. These controls emphasize direct measures such as restricting lending in industries with excess capacity.[3]

**Exhibit 8 Fixed Investment, Bank Credit, and M2 Money Growth**




Sources: National Statistics Agency, PBC

*2. Initiatives to expand risk hedging methods*

While the currency band has not been significantly altered under the new exchange rate regime, measures have been taken to strengthen the market's pricing mechanism and to enhance hedging methods against interest rate and exchange rate risks.

Prior to adoption of the managed float, only a few financial institutions in China could handle currency forwards, and their capacity was limited by the lack of hedging in the interbank market. In addition, interest rate arbitrage between RMB and foreign currencies—essential to the functioning of the currency forward market—was impeded by regulated interest rates and rules barring speculation.

In August 2005, the number of financial institutions handling currency forwards (contracts that specify the price, amount, and date of a currency transaction in the future) was expanded, and an interbank currency forward market was created. Foreign financial institutions were also allowed to handle currency forwards.

In January 2006, to strengthen the pricing mechanism, a market maker system was introduced in the Shanghai interbank market, and commercial banks were also allowed to conduct OTC transactions within the stipulated trading band.

In February 2006, financial institutions were allowed to deal in RMB-denominated interest rate swaps (contracts that exchange fixed and variable interest rates in the same currency).

In March 2006, the interbank call market began announcing official interest rates for overnight and one-week call loans. The aim here is to provide the market interest rates necessary to calculate the forward rate.

In addition, in April 2006, the ban was lifted on interbank RMB currency swaps (simultaneous spot and forward currency transactions of RMB and foreign currency; the swap rate is determined by the interest spread of the two currencies). The aim here is to invigorate currency forwards and rationalize the RMB interest rate mechanism. In the past, such currency swaps were conducted only between PBC and commercial banks for the purpose of adjusting monetary aggregates.

[3] The macroeconomic controls are diverse. Monetary tightening measures include a 0.27% increase in the standard lending rate, window guidance, ban on bank loan guarantees by local governments, and two increases in the deposit reserve ratio. Measures to curb excess capacity in industries such as aluminum, iron alloy, and cement include removing aging facilities, limiting new entry, and consolidating the industrial structure. In real estate, measures to restrict speculation in 2005 were followed by measures to correct the bias toward high-priced housing supply in May 2006, and stricter regulations on real estate investment by foreign capital in July 2006.

However, many of the risk hedging initiatives are still in the trial stage. Their development is constrained by systemic shortcomings such as the lack of market interest rates other than very short-term rates, capital controls, biased market expectations toward a stronger RMB, and accounting and tax issues.

## 4. Conclusion

After China began opening its economy in 1978, financial reform lagged conspicuously behind all other reform programs. Recently, however, domestic and external forces have combined to propel financial reforms such as the conversion of SOCBs from state ownership, elimination of restricted shares, easing of capital controls, and infrastructure preparations to widen the currency band. As China's economy continues to grow rapidly, disparities have widened between the real economy and financial system, while economic ties have strengthened with the global economy. As a result, the existing financial system and policy management regime have become unsustainable.

But despite acceleration, SOCB reform and the introduction of market mechanisms are both still in progress, with many urgent issues still to be addressed. Perhaps most important is the lack of measures to prevent new bad loans from cropping up at SOCBs, who wield a hefty weight in the domestic flow of funds. For SOCBs to become suitable financial intermediaries in a market economy, policies need to promote responsible management and to level the playing field with private banks. It is also critical to reduce the role of central and local governments in lending decisions, eliminate the de facto government guarantee enjoyed by SOCBs, and abolish the regulated interest rates that afford SOCBs a comfortable spread. To adapt to the new environment, SOCBs must learn how to make lending decisions, manage credit risk, accommodate interest rate risk, and generate income from sources other than the regulated interest spread.

In December 2006, foreign financial institutions will gain full access to RMB-denominated services, while capital controls will continue to be eased. They will start flexing their muscles and expanding their low market share. Given the limited time SOCBs have to improve their corporate governance mechanism, the pace of reform needs to increase further in the future.

But for a financial system long accustomed to regulated interest rates, capital controls, and pegged exchange rate, the introduction of market mechanisms will increasingly require policies to alleviate the financial system's destabilization. Reforms are expected to produce favorable results, such as diversifying the investment of household financial assets now concentrated in SOCBs, and expanding the financing alternatives of non-state enterprises and thus accelerating their growth. But at the same time, reforms may also drive ailing SOEs out of business, thereby weighing down SOCBs with more bad assets. Thus in addition to stricter supervision and regulation, measures such as deposit insurance are needed to enhance the safety net.

Going forward, China's ability to deal with these issues in an appropriate and timely fashion will be instrumental in determining the sustainability of the economy's growth.