

# **Banking Industry and Monetary Policy in China**

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By

Hongxi Wang

(2800222)

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Supervisor: Professor Marc Lavoie

ECO 7997

Ottawa, Ontario

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## **Abstract**

This paper reviews the evolution of China's banking industry, introduces the goals and instruments of China's monetary policy, as well as the reform on interest rates, and it conducts a study on China's current monetary policy.

We collect data on market shares, indicators of banking performances, and Non-Performing Loan ratios. Comparisons are made between Chinese domestic banking groups. We analyze the formation of Non-Performing Loans and give solutions to the problems with State-Owned Commercial Banks.

We introduce the history and current situation of Foreign Banks, highlight the Canadian financial Institutions in China, compare the performances between the Canadian "Big Six" and China's "Big Four", illustrate their strengths and weaknesses, and explore the causes of the poor performance of China's "Big Four."

# Banking Industry and Monetary Policy in China

## 1. Overview of China's banking industry

Prior to 1979, China's banking system played only a limited role in promoting economic growth; this reflects the limited role of banks in a highly centralized planning system whose primary functions were collecting revenue from State-Owned Enterprises (SOEs) and allocating investment through budgetary grants (Ma, 1997). In these circumstances, acting as cashiers, banks simply provided credit needed by SOEs for their production plans and provided/monitored cash used mainly to cover labor costs and purchases of agricultural products. During this period, the People's Bank of China (PBOC), as the sole bank, played dual roles of being the central bank and the financier of enterprises.

To establish a modern banking system, the government, in 1979, first removed the monopolistic position of the PBOC by establishing the Agricultural Bank of China (ABC), the Bank of China (BOC), and the China Construction Bank (CCB). The ABC was established to take over the PBOC's rural banking business and supervisory authority of a network of 60,000 Rural Credit Cooperatives (RCCs) that had been providing small-scale rural financing before 1995. The BOC was delegated to take over foreign currency transactions, while the CCB focused on the construction sector. The government established the Industrial and Commercial Bank of China (ICBC), the fourth specialized bank, and transferred the function of financing enterprises of industry and commerce from the PBOC to the ICBC in 1984. These financial institutions were called "specialized banks", also called State Owned Commercial Banks (SOCBs).

In 1983, the State Council promulgated *The Decision of the PBOC to Become Central Bank* and removed ordinary commercial banking businesses from the PBOC to commercial banks. However, it was not until 1986 that the PBOC was explicitly made responsible for monetary policy and the supervision of the financial system, including money and capital markets under relevant law and with legal provisions. In 1995, *the Law of the People's Republic of China on the People's Bank of China* was promulgated to define the functions and duties of the PBOC as a central bank. To further strengthen its authority as a central bank and reduce outside influence, the PBOC significantly reformed its branch networks in 1998 by closing some of its provincial branches and establishing new branches that would be able to conduct supervision across provinces.

In 1987, the Bank of Communications (BCOM), which was set up in 1908 in Shanghai and whose operations were merged to the PBOC in 1958, again became independent as a joint-stock commercial bank. In the 1980s, other commercial banks were established, including the state-owned China Investment Bank (established in 1981), and the CITIC

Industrial Bank (1987) owned by the China International Investment Trust Corporation (CITIC). The China Investment Bank was merged into the CITIC bank in 1999. In the 1990s, the government allowed the entry of more banks. The China Merchant Bank, the Hua Xia Bank and the Everbright Bank were set up in the first half of the 1990s. In 1995, the Minsheng Bank was established by Yonghao Liu and other wealthy business people as the first domestic private bank. Other established banks in this period include the Guangdong Development Bank, the Shanghai Development Bank, the Shenzhen Development Bank, the Fujian Industrial Bank, the Yantai Housing Saving Bank, and the Bengbu Housing Saving Bank. By the end of 2003, there were 11 joint-stock commercial banks (JSCBs).

In order to promote liquidity management by the PBOC at the banking system level, rather than at the level of individual banks, the government in 1994 decided to separate commercial lending and policy lending activities (IMF 1996). It, therefore, established three policy banks—the Export and Import Bank of China, the State Development Bank, and the Agricultural Development Bank of China—which would be responsible for providing policy financing in the areas of foreign trade, national infrastructure development and agricultural development respectively. In 1995, the *Law of the People's Republic of China on the People's Bank of China* and the *Law of the People's Republic of China on Commercial Banks* were introduced so that the afore-mentioned four specialized banks were transformed into wholly state-owned commercial banks (hereafter, these banks are called SOCBs). These laws gave rise to a de facto two-tier banking system that consists of (1) commercial banks that are subject to prudential regulations and are supervised by the PBOC, and (2) three policy lending banks, which are not subject to this law and whose operations are guided by their individual charters (IMF 1996).

From 2001, some of Urban Credit Cooperatives (UCCs) were merged and transformed into “City United Commercial Banks” (CUCBs). CUCBs are small and medium size banks financing mainly small and medium enterprises (SMEs) and individuals, whereas the SOCBs mainly finance state-owned large enterprises. At the end of 2002, there were 111 CUCBs, their deposits accounting for 5.3% of the total outstanding deposits, and their loans for 4.34% of the total outstanding loans. At the end of June 2003, there remained just 34,909 Rural Credit Cooperatives (RCCs), which still provide 80% of all rural finance; their deposits account for 20.7% of the total outstanding deposits and their loans account for 8.7% of the total outstanding loans.

Foreign Banks (FBs) were allowed to set up branch institutions in Shenzhen in 1981. Since then, their number has increased: By the end of 2001, there were 159 overseas branch banks and branch institutions. In addition, the number of Investment Trust Companies rose in the 1990s. However, after the collapse of the Guangdong International Investment Trust Company in 1998, the government launched a restructuring program for these companies, thus, their number declined from 240 in 1997 to 60 at the end of 2002. Table 1.1 summarizes

the banking system in China.

Table 1.1 China's banking system summary

**Central Bank:** the People's Bank of China (9 branches): Tianjin Branch, Nanjing Branch, Chengdu Branch, Shenyang Branch, Jinan Branch, Guangzhou Branch, Shanghai Branch, Wuhan Branch, Xian Branch;

**Policy Banks (PBs):** State Development Bank, Export and Import Bank of China, Agricultural Development Bank of China;

**Wholly State-Owned Commercial Banks (SOCBs):** Bank of China, Industrial and Commercial Bank of China, Agricultural Bank of China, China Construction Bank;

**Joint Stock Commercial Banks (JSCBs):** Bank of Communications, CITIC Industrial Bank, Everbright Bank of China, China Minsheng Banking Corporation, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Fujian Industrial Bank, Shanghai Pu Dong Development Bank, Yantai Housing Savings Bank;

**Other Financial Institutions:** City United Commercial Banks (111), Foreign Banks (159), Rural Credit Cooperatives (34909), Urban Credit Cooperatives (1049), as well as Securities Companies, Insurance Companies, and Trust and Invest Corporations (60).

Source: Website of China Banking Regulatory Commission <http://www.cbrc.gov.cn/>

The market shares by banking groups, in terms of asset, loans and deposits are illustrated in Table 1.2. SOCBs are the big brothers in China's banking sector, with more than half of the total market share, followed by Policy Banks, Joint Stock Commercial Banks, and City United Commercial Banks, the market share of Foreign Banks is less than 2% by the end of 1999.

Table 1.2 Sizes and Market Share by Banking Groups (as of 1999)

Banking Groups	Total Asset		Total Loans		Total Deposits	
	Value (RMB bn)	Share (%)	Value (RMB bn)	Share (%)	Value (RMB bn)	Share (%)
<b>SOCBs</b>	<b>10,634</b>	<b>72.6</b>	<b>6,581</b>	<b>71.6</b>	<b>8,026</b>	<b>82.2</b>
<i>ICBC</i>	<i>3539</i>	<i>24.3</i>	<i>2427</i>	<i>26.4</i>	<i>2981</i>	<i>30.5</i>
<i>BOC</i>	<i>2618</i>	<i>17.8</i>	<i>1364</i>	<i>14.8</i>	<i>1695</i>	<i>17.4</i>
<i>ABC</i>	<i>2276</i>	<i>15.5</i>	<i>1589</i>	<i>17.3</i>	<i>1591</i>	<i>16.3</i>
<i>CCB</i>	<i>2201</i>	<i>15</i>	<i>1201</i>	<i>13.1</i>	<i>1759</i>	<i>18.1</i>
<b>PBs</b>	<b>1585</b>	<b>10.8</b>	<b>1317</b>	<b>14.3</b>	<b>37</b>	<b>0.4</b>
<b>JSCBs</b>	<b>1582</b>	<b>10.7</b>	<b>802</b>	<b>8.7</b>	<b>1200</b>	<b>12.3</b>
<b>CUCBs</b>	<b>598</b>	<b>4.1</b>	<b>310</b>	<b>3.4</b>	<b>459</b>	<b>4.7</b>
<b>FBs</b>	<b>267</b>	<b>1.8</b>	<b>172</b>	<b>1.9</b>	<b>46</b>	<b>0.5</b>
<b>Total</b>	<b>14,666</b>	<b>100</b>	<b>9,182</b>	<b>100</b>	<b>9,768</b>	<b>100</b>

Source: Website of China Banking Regulatory Commission <http://www.cbrc.gov.cn/>

In the past 20 years, China's banking sector has been changing continuously, along with its transition from a planned economy to a market economy. At present, an organizational system for China's banking sector, which separates policy finance from commercial finance and meets the need of contemporary market economy, has been established. With the People's Bank of China (PBOC) as the central bank, implementing monetary policy independently, and with state-owned commercial banks as the mainstay, coexisting with various financial institutions, a unified, open, orderly and competitive banking market system has been primarily set up in China. However, with the speed up of the world economic integration process and the gradual opening of financial markets after China's entry into WTO, China's banking sector will have to face more powerful competition and challenges.

## **2. The Central Bank and the Conduct of Monetary Policy**

### **2.1 The Central Bank – PBOC**

**Origins of the PBOC:** As mentioned in the previous part, before 1979, China's banking system was exclusively dominated by a single bank. The PBOC played dual roles, both as a central bank and a commercial bank. In 1979, the central bank activities of PBOC were separated from commercial banking activities after the creation of specialized banks and other non-banking financial institutions. In 1983, a State Council Resolution converted the PBOC into a central bank, but there was no clearly defined duties relating to business operation as well as financial supervision and control until the passage of *the 1995 Law of the People's Republic of China on People's Bank of China*. Under the 1995 law, the PBOC was granted legislative authority, under the supervision of China's State Council, to formulate and implement monetary policy. The law authorized the PBOC to control the whole banking industry in China. Moreover, the 1995 law granted the PBOC specific instruments to implement monetary policy.

**Functions of the PBOC:** According to Article 4 of the 1995 PBOC Law, the PBOC can perform the following functions:

- (1) Formulate and implement monetary policies in accordance with the law;
- (2) Issue Renminbi (RMB) and control its circulation;
- (3) Examine, approve, supervise and administer banking institutions in accordance with regulations;
- (4) Supervise and control the financial market in accordance with regulations;
- (5) Promulgate ordinances and rules concerning financial administration and business;
- (6) Hold, administer and manage the state foreign exchange reserve and gold reserve;
- (7) Manage the state treasury;
- (8) Maintain the normal operation of the systems for making payments and settling accounts;

- (9) Be responsible for statistics, investigation, analysis and forecasting for the banking industry;
- (10) Engage in relevant international banking operations in its capacity as the central bank of the State;
- (11) Other functions assigned by the State Council.

***Independence of the PBOC:*** Traditionally, central banks have been granted formal independence, but governments have retained enough power to influence important decision. More recently, legislation has moved in the direction of granting full autonomy to the central bank in money matters, under the assumption that a strong and independent central bank would be in a better position to maintain price stability. Why? One line of theory suggests that politicians are likely to have short-term horizons, which conflicts with monetary policy. For example, when inflation is not out of control, output can be boosted in the short run by a monetary stimulus. The cost to control high inflation is recognized later – maybe after the next election (Clinton, 2003).

The independence of central banks can be gauged based on specific institutional arrangements. Those include the appointment, length of tenure, the duties of central bank governors and statutory regulations regarding the scope of the central bank's influence on monetary policy. In some countries, central banks are viewed as subordinate to the government, so the government determines the monetary policy. In developed countries, the Bank of England, and the Bank of Japan are examples of central banks that lack independence. In contrast, in the USA, the Board of Governors of the Federal Reserve System is an independent agency that has the discretion to determine monetary policy without being subject to the control of other government officials. Emerging markets tend to have central banks that lack autonomy.

China is an example of a country where the central bank lacks autonomy from the government. Under the provision of Article 9 of the 1995 PBOC Law, The PBOC has a board of directors including a governor, a deputy governor, vice ministers of the Ministry of Finance and various State Council commissions, a deputy director of the State Planning Committee, and the presidents of the specialized banks. The governor of the PBOC is also the chairman of the PBOC's Board of directors. The State Council nominates the governor as well as the deputy governors of the PBOC. According to the 1995 law, the State of Council has the power to shape the composition of the leadership of the PBOC. Although the PBOC can determine the subjects for discussion in its agenda, it is ultimately the State Council that decides all important questions.

Article 5 of the 1995 PBOC Law specifies that the PBOC "shall report its decision to the State Council for approval concerning the annual money supply, interest rates, foreign exchange rates, and other important matters specified by the State Council before they are implemented." Moreover, as specified in the Law, the State Council also monitors the operations of the monetary policy committee and supervises the budget of the PBOC.

An independent central banker, being immune to political pressure, is more likely to have a stable tenure in office; the lack of independence of the PBOC has prompted volatility in the top leadership positions of the PBOC.

## **2.2. The Conduct of Monetary Policy**

***The goal of monetary policy:*** Stipulated in Article 3 of the 1995 PBOC Law, the aim of monetary policies is to maintain the stability of the value of the currency and thereby promote economic growth.

***Tools of Monetary policy:*** According to Article 22 of the 1995 PBOC Law, the PBOC may use the following instruments to implement the monetary policies:

- (1) Reserve funds at a required ratio deposited in the PBOC by banking institutions under demand;
- (2) Base interest rates fixed by the central bank;
- (3) Rediscount for banking institutions which have opened accounts in the PBOC;
- (4) Provision of loans for commercial banks;
- (5) Deals in State bonds and other government bonds and foreign exchange on the open market; and
- (6) Other monetary policy instruments defined by the State Council.

### ***Study of China's monetary policy in 2004:***

According to *the Financial Post* (April 16, 2004), China's Gross Domestic Product (GDP) grew at 9.7 percent in the first quarter of 2004. This was higher than last year's full-year 9.1 percent increase. The investment in fixed assets was up 43 percent against a year earlier. Central bank's monetary policy in year 2004 is to rein in excessive money and credit growth, avoid excessive volatility of interest rates and accelerate interest rates liberalization. The target of the 2004 monetary policy is to keep the M2 and M1 growth rates at around 17%, new RMB lending around RMB 2.6 trillion Yuan (unit of China's currency), and the Consumer Price Index (CPI) around 3%. To reach those targets, various monetary policy instruments are being applied or will be applied in a flexible manner.

- (1) Sterilize excessive foreign exchange positions through open market operations while maintaining sufficient liquidity in the market

Over the past two years, China's foreign exchange reserves have grown fast, leading to substantial increase in base money injection as a result of foreign exchange purchases. In line with the overall money and credit plan, the PBOC has maintained stable growth of base money through open market operations. By the end of 2003, the central bank has made 63 issues of central bank bills, with a total issuance amount of RMB722.68 billion Yuan, and outstanding amount of RMB337.68 billion Yuan. In 2003, base money injection as a result of foreign exchange purchases added up to RMB 1145.9 billion Yuan, while open market

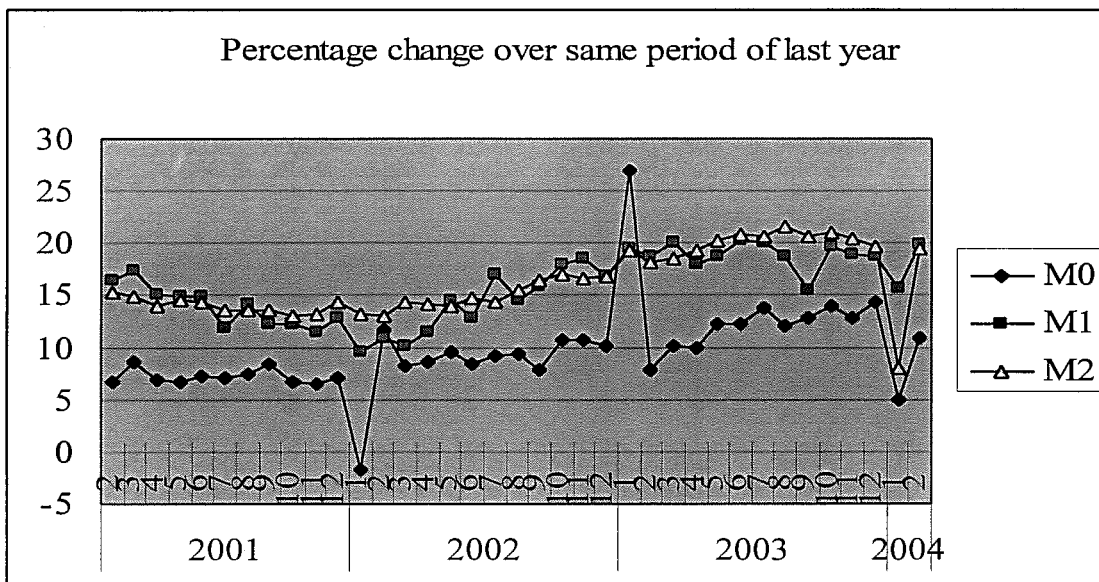
operations withdrew RMB 269.4 billion Yuan base money, resulting in a net base money injection of RMB 876.5 billion Yuan (data source: [www.chinamoney.com.cn](http://www.chinamoney.com.cn)).

At the same time, the PBOC has provided sufficient liquidity to financial institutions through flexible market operations. At the end of last August, the Initial Public Offering (IPO) of Huaxia Bank led to a relatively large liquidity shortage for the commercial banks. Under such circumstance, the PBOC, on August 26 and September 2nd, 2003, twice reduced the issuance scale of 3-month central bank bills and injected liquidity to commercial banks through 7-day reverse repo transactions; at the time of Changjiang Power IPO on November 11 last year, the PBOC again conducted 7-day reserve repo transactions. Under the guidance of open market operations, the 7-day repo rates, the typical inter-bank interest rate, have remained stable at around 2.15% despite the liquidity fluctuations resulting from IPOs, which indicates that open market operations have reached the expected target.

Given the sufficient liquidity of financial institutions and the falling trend of money market rates during the first quarter of 2004, the PBOC intensified sterilization operations. In this period, the cumulative amount of central bill issuance reached RMB 435.2 billion Yuan and the outstanding amount stood at RMB 615.45 billion Yuan; base money injections as a result of foreign exchange purchases amounted to RMB 291.6 billion Yuan, and open market operations withdrew RMB 281 billion Yuan, resulting in a net base money injection of RMB 10.6 billion Yuan and basically offsetting the foreign exchange position of base money.

Chart 2.1 illustrates the percentage change in money supply in terms of M0, M1 and M2 during the period of Feb. 2001 to Feb. 2004.

Chart 2.1 Percentage changes in money supply from Feb. 2001 to Feb. 2004



Data Source: PBOC website <http://www.pbc.gov.cn>

Note: M0=currency in circulation, M1=money, M2=money + quasi-money

- (2) Use reserve requirement policy in a flexible way to lower the cost of currency withdrawal and improve the operation of commercial banks.

In order to rein in the obviously excessive credit growth, the PBOC raised the required reserve ratio by 100 basis points (BPs) on September 21, 2003. Traditional Money and Banking theories regard a required reserve ratio hike as a relatively drastic measure, nevertheless the central bank interpreted it as a mild move. The major reason is that the central bank has to withdraw a large amount of excess liquidity because of the fast growth of foreign exchange reserves. To do so, if the central bank only issues central bank bills without any other measure, it has to raise the interest rates on central bank bills to a very high level given the strong economic expansion momentum and the commercial banks' wide interest rate differentials, which is larger than the returns on central bank bills. However, high interest rates would have significant implications on the economy. In contrast, the 100 BPs rise of required reserve ratio enables the central bank to reduce at a lower cost the commercial banks' excess reserve by around RMB150 billion Yuan, accounting for only 6% of their holdings of Treasury bills, financial bonds and central bank bills. Therefore, the required reserve ratio hike is actually a mild policy measure. Moreover, the policy was announced one month in advance, giving sufficient time for financial institutions to manage their liquidity. The PBOC also provided timely support to those financial institutions with short-term liquidity difficulties, so as to maintain the overall stable developments of financial operations and money market interest rates.

On March 25, 2004, with the approval of the State Council, the PBOC announced that the required reserve ratio for financial institutions with a capital adequacy ratio (CAR) below a specific level would rise 50 BPs to 7.5%, while the ratio for other financial institutions remained unchanged. State-owned commercial banks, urban and rural credit cooperatives were exempt from the differentiated required reserve ratio policy. On April 11, 2004, the PBOC announced again that the required reserve ratio for all financial institutions except urban and rural credit cooperatives would rise 50 BPs starting from April 25, 2004.

The differentiated required reserve ratio scheme is both a transitional policy in line with China's current financial system, and an innovation based on the original purpose of the required reserve ratio policy, i.e., to ensure the payment and settlement of commercial banks, and to prevent over-lending by financial institutions attracted to favorable loan terms which may undermine their liquidity and payment capacity. The required reserve ratio policy then gradually evolved into a monetary policy instrument, and the deposit insurance regime combined with supervision on capital adequacy ratio started to replace it as a policy tool to impose prompt corrective actions on financial institutions based on different risk profiles. Given the fact that China has not established a deposit insurance system, and since quite a number of financial institutions failed to reach the 8% capital adequacy ratio, the differentiated required reserve ratio scheme is conducive to curb excessive credit expansion of the financial institutions with a low capital adequacy ratio and poor asset quality, and to prevent the one-size-fits-all approach in macro financial adjustment and regulation.

### (3) Utilize other monetary policy instruments

At the same time, the PBOC will strengthen credit management by rigorously curbing loans to over-invested industries, keeping the proportion of medium and long term loans at a reasonable level. The PBOC will also endeavor to adjust loan structure, urge financial institutions to implement credit policy, promote financial ecological development, enhance re-lending and rediscount management, continue to improve financial services to rural economy, and further promote inter-bank market development.

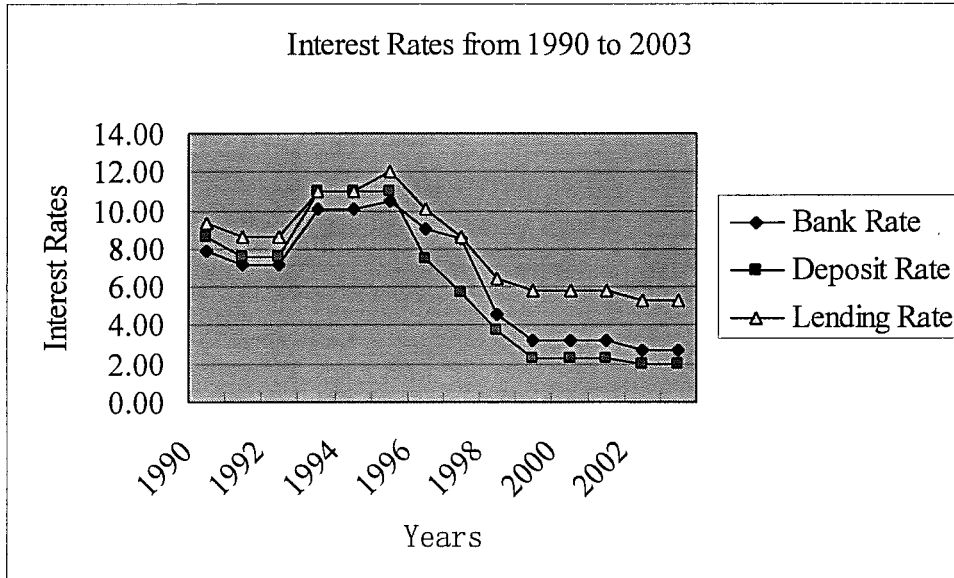
### (4) Interest rates remain unchanged, though many predicts the PBOC will raise the interest rate to slow down the economy

It is well known that, in 1997 and 1998, to stimulate economic growth by expanding domestic demand, the PBOC cut interest rates on savings and loans several times (Chart 2.2) to promote spending, but with little success. This strategy was intended to rescue state-owned enterprises struggling to pay mounting interest payments as well as to narrow the difference between China's interest rates and international interest rates, thus sharpening the competitiveness of domestic export-oriented enterprises in the international market.

In late 1999, the PBOC decided to abandon the ineffective "softer" tools of interest rate cuts

and the wider floating range on lending rates in favor of increasing the money supply by reducing the percentage of money the financial institutions were required to deposit in the central bank. This increased the available fund resources of commercial banks.

Chart 2.2 Evolution in interest rates from 1990 to 2003



Data Source: *International Financial Statistics (IFS)*

### 2.3 The Reform on Interest Rates – Interest Rate Liberalization

A well-functioning financial market channels savings efficiently to the most productive opportunities. When the government explicitly directs funds to certain investments which would either not be able to attract funds on their own or would attract them only at a higher rate of interest, it tampers with the workings of the marketplace. The usual way for a government to support particular activities is by controlling interest rates.

In China, the controls on interest rates, together with government restrictions on bank lending, have resulted in a segmented financial market. Substantial differences exist between the interest rates charged by official lenders and informal lenders and between the ability of state borrowers and private borrowers to access loans. The maintenance of interest rates at artificially low levels to support the activities of state-owned enterprises has made it difficult for domestic savers and investors to see the true price of capital. Demand and supply behavior has been distorted as a result, leading to a misallocation of investment funds and discrimination against the private sector. As the private sector's role in the economy has become more significant, these distortions have become an increasing problem.

The liberalization of interest rates will gradually lead to the convergence of official and

market rates, similar to the way commodity prices and foreign exchange rates changed after liberalization. Interest rates should reflect the true scarcity of capital, and commercial banks will be able to set lending rates on the basis of costs. Banks will be more likely to focus on creditworthiness rather than ownership type in making lending decisions, increasing the funds available to private entrepreneurs. By raising the efficiency of investment and transferring more resources into the private sector, financial reform can play a valuable role in boosting growth and the structural transformation of the economy.

In recent years, China's market-based interest rate reform has advanced steadily, with significant progress achieved in the deregulation of money market interest rate.

First, the market has been playing an increasingly important role in determining the types of interest rates in the money market, which now include an inter-bank lending rate, a bond repurchase rate, a bill market discount rate, an interest rate in the primary and secondary markets of government bond and policy financial bond.

Second, management of interest rates on loans and deposits has been streamlined. The previous practice of regulating most types of interest rate has been changed and commercial banks have been given greater flexibility in managing the interest rate.

Third, the floating band of interest rates on loans to small and medium sized enterprises has been widened three times, leading to improved risk management capability of the banks and enabling these enterprises to have easier access to bank credit.

Fourth, the management of interest rates on foreign currency has been relaxed. At present, there are only a few types of foreign currency interest rates that are still subject to the central bank management.

Fifth, for large amount of time deposit, for example, deposit made by domestic insurance company, the interest rate can be determined by the negotiation between the commercial bank and the insurance company.

Now, to further advance interest rate liberalization, the following measures are under discussion:

First, further widen the floating band of lending rates. At present, different lending rate bands around the central bank's benchmark rate are applied to loans extended by different types of financial institutions and provided to enterprises of different size. The rural credit cooperatives in selected areas may set their lending rate within 90-200 percent of the central bank's benchmark rate. Other rural credit cooperatives may set their lending rate within 90-150 percent of the benchmark rate. For the commercial banks, the interest rate they

charge on loans to the small and medium-sized enterprises shall be within 90-130 percent of the benchmark rate; that to the large enterprises shall be within 90-110 percent of the benchmark rate; and that to a few key enterprises may not exceed the benchmark rate. In the next-stage reform, the floating band on lending rate will be further widened. In particular, the range above the benchmark rate will be further expanded to give the banks greater flexibility in managing their lending rate.

Second, the interest rate on deposits shall be allowed to move downward against the benchmark rate. In China, the 8% capital adequacy requirement set by the Basle Committee on Banking Supervision in its 1998 Capital Accord has not been strictly enforced in the regulation of financial institutions, and the Prompt Corrective Actions have not been adequately established. Some financial institutions with poor performance and inadequate capital and liquidity tend to attract deposits by offering high interest rates. The riskier a financial institution is, the more likely it is to offer high interest rates, resulting in deteriorating financial positions of these institutions.

In China, almost no financial institutions offer below-benchmark interest rate on deposits, while in other countries; many banks set their deposit rate below the central bank's benchmark rate. One of the main reasons is that financial regulation in China has not strictly enforced the requirements of the Basle Committee's Capital Accord, and the excessive expansion of the balance sheet of the deposit-taking institutions has not been effectively contained. The China Banking Regulatory Commission (CBRC) is going to introduce stricter capital adequacy requirements. After such requirements are imposed, the banks that have inadequate capital and have difficulties in strengthening their capital base will have to reduce the growth of their risk assets. Without effectively lowering the risk weight of the assets, they will have to tighten their balance sheets. So they may offer lower interest rate on deposits.

### **3. China's Commercial Banking Industry**

#### **3.1 State-owned Commercial Banks (SOCBs)**

Another name for State-Owned commercial Banks is the "Big Four" including BOC, ICBC, CCB, and ABC. In the banking sector, the four SOCBs remain dominant with market shares in terms of loans, deposits, and assets that are illustrated in Table 3.1. Before 2001, their market share, in terms of total assets, remained more than 80%, and more than 60% in terms of loans. But in 2002, there was a significant decline in the three indicators, total assets decreased to 62% from 82%, deposits dropped from 68% to 60%, loans fell to 57% from 63%. One reason for the decline is the impact of China's entry to WTO, introducing competition from foreign banks; another reason is the disposal of Non-Performing Loans (NPLs), the stricter regulation and supervision on the Capital Adequacy Ratio (CAR) and

corporate governance.

Table 3.1 Market Shares of the four SOCBs

Items	2000	2001	2002
Deposits (%)	70.7	67.8	59.6
Loans (%)	64.8	62.8	56.6
Total assets	84.0	82.6	62.0

Source: *Almanac of China's Finance and Banking, 2000, 2001, 2002.*

**3.1.1 Legislation framework:** *The Law of the People's Republic of China on Commercial Banks* (1995) provided the framework for the structure and operation of state-owned commercial banks. As detailed in Article 3 of the 1995 Law, in addition to demand deposit accounts, state commercial banks offer many other forms of deposit accounts, including time and saving accounts. With respect of loans, commercial banks can usually accommodate all types of borrowing and are empowered to make not only commercial loans but also consumer and mortgage loans. Articles 38 of the 1995 Law provides that "A commercial bank should decide the interest rates of loans in accordance with the upper and lower limits of loan interest set by the PBOC."

In terms of autonomy, Article 35 says: "In issuing loans, a commercial bank should closely check the use of the loan by the borrower, the repayment ability of the borrowers and the mode of repayment of the loans. No unit or individual is allowed to force the commercial banks to issue loans or provide guarantees." It seems that commercial banks enjoy high independence in doing business, but, in reality, significant influence on lending decision making comes from government and its agencies. Moreover, a conflicting regulation in article 41 makes the autonomy of commercial banks a problem, article 41 says: "Solely State owned commercial banks should issue loans to special projects which have been approved by the State Council. The State Council will adopt corresponding measures to make up for the losses of the banks because of issuing the loans. To adopt what measures is up to the decision of the State Council."

**3.1.2 Stipulated ratios between assets and liabilities:** (1) The Capital Adequacy Rates (CAR) must not be less than 8%; (2) The ratio between loans and deposits must not exceed 75%; (3) The ratio between circulating assets and circulating liabilities must not be lower than 25%; (4) The ratio between the balance of loan of one borrower and the capital of the commercial bank must not exceed 10%; and (5) more than a 10% share in a commercial bank by one organization or individual needs approval.

*The minimum registered capital* (The registered capital should be the actual paid-in -capital), according to Article 13 of 1995 Law, is RMB 1 billion Yuan for setting up a commercial bank, and is RMB 100 million Yuan for setting up an urban cooperative commercial bank.

### 3.1.3 Problems with SOCBs:

Though the SOCBs remain the dominant forces in the industry with strength in extensive country wide branches and distribution network, compared to Joint-Stock Commercial Banks and Foreign Banks, the SOCBs show weakness and problems in profitability, capital adequacy, risk management, and NPLs.

#### (1) Low levels of Capital Adequacy Ratio (CAR)

CARs are a measure of the amount of a bank's capital expressed as a percentage of its risk weighted credit exposures. Minimum CAR has been developed to ensure banks can absorb a reasonable level of losses before becoming insolvent, and to protect depositors and promote the stability and efficiency of the financial system.

The recommended approach for calculating CARs and recommended minimum CARs for international banks, known as the "Basle Capital Accord", issued in 1998 by The "Basle Committee", has been adopted by the OECD countries and many developing countries. The PBOC applies the principles of the Basle Capital Accord in China, but it is not strictly followed in practice.

The amount of SOCBs' capital has been small. Given that they could not find ways to increase capital, the Ministry of Finance issued RMB 270 billion of 30-year special government bonds in August 1998. As a result of this capital injection, SOCBs capital adequacy ratios reached 8%. But since then, the capital adequacy ratios of the SOCBs have dropped (see Table 3.2). At the end of 2002, except that the capital adequacy ratio of BOC was higher than 8%, the ratios of the other three SOCBs were lower than the international standard. This is true especially for the ABC whose capital adequacy ratio amounted to only 1.44%.

Table 3.2 the Capital Adequacy Ratio of the SOCBs

	1997	1999	2002
ICBC	2.55	5.7	5.54
BOC	4.7	3.0	8.15
CCB	2.73	2.5	6.91
ABC	2.14	5.1	1.44

Source: Annual Reports of the Industrial and Commercial Bank of China

The decline in the capital adequacy ratio results from two factors. One is that the speed of loan increases is higher than that of capital increases in SOCBs. In 2003, the loans of four banks increased rapidly, 26.5% in the BOC, 19.25% in the CCB, 13% in the ICBC. The ABC increased loans by RMB 363.1 billion. The other factor is related to a decline in profits

from lending activities. Based on the data provided by the *Almanac of China's Finance and Banking*, the average profits on assets of the "Big Four" is close but less than 0.2%.

## (2) Low profit rates

As shown in Table 3.3, the profits on the assets of the SOCBs have been lower than those of policy banks as well as those of joint-stock commercial banks. Profits of all these Chinese banks are much lower than those of foreign banks. The four SOCBs' profits remain low for several reasons: First, their incomes depend mostly on operating income. Second, their operating incomes depend mostly on interest incomes. Third, the amount of provision for loan losses increased. The huge accumulated NPLs have become a big constraint to the SOCBs' performance; around 70% of the operating profit goes to write off NPLs.

Table 3.3 Profits on Asset of China's Banking Sector

	SOCB	PBs	JSCBs	FBs
1998	0.1%	0.11%	0.97%	--
1999	0.17%	0.15%	0.64%	2.69%
2000	0.25%	0.51%	0.49%	1.92%
2001	0.2%	0.49%	0.49%	2.26%

Source: *Almanac of China's Finance and Banking 1999-2002*

## (3) Poor risk management

The concept and philosophy of risk management is quite different under a planned economy and a market economy, due to the fact that the SOCBs are created and operated under the planned economy, and their major customers are other SOEs, the SOCBs and SOEs, that belong to the same owner – the government. From the point of view of government, lending and borrowing is like to withdraw the money from one pocket and put it in the other, so that the SOCBs have no incentives to follow credit criteria in decision making on lending, and no incentives to monitoring and manage risk after the issuance of loans. Although, most of the SOCBs have decades of operating history, most of the management have an incorrect concept on risk management. Table 3.4 illustrates some of the differences:

Table 3.4 Differences in risk management under market economy and planned economy

Under market economy	Under planned economy
Risk is an endogenous variable	Risk is an exogenous variable
Prices are volatile	Prices are fixed
Capital is clearly defined in both an economic sense and a legal sense	Capital is not defined
Capital is the bottom line for risk responsibility (loss), bankruptcy rule must be enforceable.	Enterprises are owned and supported by government, bankruptcy is not defined.
Taking risk is encouraged given risk-return trade-off	Taking risk is discouraged
Managing risk is not equal to preventing or avoiding risk	Managing risk is equal to preventing or avoiding risk
Risk management is an ex ante process	Risk management is an ex post process

Source: presentation of Dr. Zhongyang Chen (Renmin University of China)

#### (4) Non-Performing Loans (NPLs)

China's state-owned banks act as the prime lender to other State-Owned Enterprises (SOEs). Though SOEs produce only one third of the country's industrial output, it accounts for nearly 90 percent of the loans granted by the SOCBs. In issuing loans, policy imperatives, rather than commercial considerations, are a determining factor in lending decisions; this phenomenon is more common at lower-level financial institutions. For instance, one study of China's UCCs reports that 90 percent of the loans are made in response to pressure from various government agencies.

Though Non-Performing Loans (NPLs) in "the Big Four" have been a serious problem since the middle of the 1990's, in January 1998, the Governor of the PBOC, for the first time, disclosed data regarding NPLs at a press conference. According to the report, the NPL ratio reached 25-26% at the end of 1997, of which past-due loans constituted 15%, past-due beyond 2 years 8%, and bad loans 2%. The 1997-2003 data of NPLs, reported by the Governor of the PBOC, are shown in Table 3.5. It should be noted that all the data are classified based on the four-category classification, except those for 2002 and 2003.

The data released on NPLs are likely to be underestimated for several reasons. First, the 1998's figure of 10% appears puzzling given that the NPL ratio of SOCBs reached more than 25% in other years. Because there were no special measures executed in 1998, some have pointed out that 10% was meant to refer to the ratio of bad loans, as it is likely that the NPL ratio reached 25% in 1998 as well. Second, the NPL data of 1999 is also somewhat doubtful. After the SOCBs transferred RMB 1.4 trillion of NPLs to the four Asset Management Companies (AMCs), the PBOC unambiguously stated that this enabled the

NPL ratio of the SOCBs to be reduced to 10%. However, this adjustment appears not to be reflected in the official data.

Table 3.5 Publicly Announced NPL Ratios of SOCBs

	1997 <sup>①</sup>	1998 <sup>②</sup>	1999 <sup>③</sup>	2000 <sup>④</sup>	2001 <sup>⑤</sup>	2002 <sup>⑥</sup>	2003 <sup>⑦</sup>
Ratio of NPLs	25	10	25	25	25.3	25.3	22.2
Total Loans(100 million) <sup>⑧</sup>	--	62476.8	65819.6	65207.8	70577.8	80361.2	--
Amount of NPLs (100 million) <sup>⑨</sup>	12864.5	6247.7	16454.9	16301.9	17644.4	20331.4	20000
NPLs /GDP (%)	17.2	7.9	20	18.2	18.4	19.8	17.1

*Data source:*

- ① Speech of the PBOC 's Governor in January 1998 (International Financial Newspaper, January 19,1998).
- ② Speech of the PBOC 's Governor in 1999,the ratio of past-due loans beyond one year was 7.2%, bad loans 2.9%.
- ③ The Governor of PBOC answered questions at a press conference of the Information Office of the State Council, January 20, 2000.The ratio of past-due loans beyond one year was 5.3-6.3%, bad loans 2.7%.
- ④ Speech of the PBOC 's Governor in January 2001,after removing RMB 1.4 trillion NPLs to the 4 AMCs, the ratio of NPLs was 25%.
- ⑤ Speech of the PBOC 's Governor, Dai Xianglong,at the Senior Forum of Development of China, March 2002.
- ⑥ Speech of the China Banking Regulatory Commission 's Governor (CBRC), Liu Mingkang, at a press conference, May 2003.
- ⑦ At the end of September 2003, NPLs data from the Daily Time of Economy on China, 13 November, 2003.
- ⑧ According to the Almanac of China 's Finance and Banking, adding data of the 4 SOCBs.
- ⑨ According to the NPLs ratio and loans sum announced by the Chinese government.

Based on NPL data released by the government, there were wide ranges of different estimates with respect to NPL ratios. Some estimated that the NPL ratios of SOCBs reached 39% in 1999 and 29.2% in 2000 (Shi Huaqiang, 2003). Foreign research institutions and credit rating agencies also carried out several estimates, For example, Moody's Investors Service estimated that the NPL ratio of SOCBs was in the range of 35%-70% in 1996, while Morgan Stanley Dean Witter estimated that the ratio was 36% in 1998 (Li Hongjiang 2002).

Regardless of which data or estimates are correct, the fact is that the sheer amount of China's banking sector NPLs is immense, and the problems it presents are serious. For example, at the end of July 2001, in ChaoYang City, the balance of loans issued by all financial institution was RMB 6.76 billion, of which NPLs were RMB 4.9 billion. This means that the NPL ratio was 72.4% (Wu Liang 2002). Given that the accounting and auditing systems were opaque before 2002, collecting reliable data is an extremely difficult task. Furthermore, as pointed out earlier, the four-category classification basis allows some banks to underreport the true amount of NPLs by making new loans to pay back old loans, so that the banks are able to manipulate their NPLs on the balance sheets. Outsiders didn't easily trace this

practice.

The PBOC once required that the SOCBs should disclose NPL data based on the five-category classification from 2002 onward. From 2000 on, except for the ABC, the SOCBs have begun to disclose NPL data under the five-category classification in the respective Annual Reports. So far, the ABC has not followed this requirement. On December 26, 2003, the ABC issued the Annual Report of 2002. In this report, it showed that the NPL ratio was 30.07% in 2002, which was lower than last year in the order of 4.99% based on the four-category classification. The NPL ratios reported in Table 3.5.1 are based on the Annual Reports of the three SOCBs, as well as other information sources.

Table 3.5.1 Trends of SOCBs' NPLs (Based on the Five-Category Classification)

	2000	2001	2002	Sep. 2003
ICBC	34.43	29.78	25.69	21.00
BOC	27.2	27.51	22.49	17.00
CCB	20.27	19.21	15.17	11.00
ABC①	--	35.06	30.07	--

Source: Annual Reports of ICBC, BOC, CCB; Daily Time of Economy.

Note①: Financial Times, July 11, 2003 (the Agricultural Bank of China issued its Annual Report 2002, which reported that the NPL ratio was 30.07%, lower than last year in the order of 4.99% based on the four-category classification. If the figure had been based on the five-category classification, the ratio would be expected to be higher than 38 %.)

Table 3.6 shows that: the NPLs ratios under five-category classification are higher than those under four-category classification; the NPLs ratio declined for all SOCBs. At the end of 2002, the CCB indicated the lowest NPL ratio of 15.17% among the four, while the ratios of other banks remained high. According to the report of *Daily Time of Economy*, by September of 2003, the CCB have decreased the ratio to 11%, this ratio will reach 10%, which is the lowest NPLs ratio of public listing in domestic market.

The China Banking Regulatory Commission (CBRC) stipulates that all SOCBs and joint-stock commercial banks should adopt the five-category classification system from 2004. According to figures provided by the CBRC, the amount of NPLs totaled RMB 2.54 trillion at end of June 2003. The amount includes NPLs of major financial institutions (such as the four SOCBs, three policy banks and eleven joint-stock commercial banks), who's aggregate loans accounted for 82% of the total loans. The amount of NPLs of SOCBs reached about RMB 2 trillion. At the end of September 2003, NPL ratios of various financial institutions under the four-category classification were 21.4% for the four SOCBs, 18.1% for policy banks, and 8.4% for joint-stock commercial banks. The decline in the NPL ratio in 2003 may be attributable to an increase in new loans. At the end of December, 2003, the loans of RMB and foreign exchange in all financial institutions were RMB 17 trillion, which

were higher than 2002 by 21.4%. The balance of RMB loans was 15.9 trillion, which were higher than 2002 by 21.1%. These loans increased in the areas of agriculture, infrastructure, and individual consumption (China Monetary Policy Report, 2003). An increase in loans had a diluted effect on reducing the NPL ratio. Moreover, the NPLs problems of CUCBs and RCCs appear more serious than those of SOCBs and other banks. Based on the four-category classification, the NPL ratios of CUCBs are estimated to have reached more than 30% - much greater than the national average (Economic Daily, December 3, 2002). The ratios of RCCs are likely to be even greater than those of the CUCBs, although relevant data is not available.

***Solutions to NPLs:*** In early 2004, the government launched a program of comprehensive banking sector reform. The program includes the disposal of the NPLs of SOCBs through various measures: recapitalization, reform of the capital market, improvement of corporate governance, and preparing SOCBs for public listing.

***(1) Capital injection:*** The government injected foreign exchange of \$45 billion (RMB 372 billion) into two of the SOCBs (BOC and CCB) at the end of 2003. As a result of the cash injection, the two bank's capital adequacy ratios exceeded the international standard. Given that China has ample foreign reserves, utilizing foreign exchange reserves to inject capital to banks is both a measure to resolve the problems of capital inadequacy and could be regarded as a reasonable way of utilizing foreign exchange reserves. This injection is different from the first injection: the first was free cash injection from the Ministry of Finance while the later was in the form of long-term investment by China HUIJIN Invest Corp, which was established by the State Council. HUIJIN as the shareholder has the jurisdiction to help and assist the BOC and CCB to become public listed banks.

It is widely viewed that the injection into the two SOCBs is just a first step in China's banking restructuring strategy; the remaining two SOCBs (ABC and ICBC) are expected to follow along the same path in the near future.

***(2) NPLs taken over by AMCs:*** To acquire NPLs from SOCBs, in 1999 the government established four Asset Management Company (AMCs), capitalized at RMB 10 billion each: Cinda associated with the CCB, Great Wall with the ABC, Oriental with the BOC, and Huarong with the ICBC. Information summarizing these AMCs is reported in Table 3.6. As wholly state-owned financial institutions, the AMCs are under the supervision of the PBOC, with guidance from the State Securities Supervisory Committee of China and the Ministry of Finance. The general mandate of the AMCs is to collect debt, restructure or assign NPLs; convert NPLs into equity; issue financial bonds and borrow from financial institutions; and, recommend companies for listing.

Table 3.6 Details of AMC's (Hundred Million RMB)

ACMs	Cinda	Huarong	Greatwall	Orient	Total
Time of establishment	1999.4	1999.10	1999.10	1999.10	--
Related SOCBs	CCB	ICBC	ABC	BOC	--
Total Asset (1999)	22,011	35,399	22,759	9,103	89,277
NPLs removed	3,730	4,077	3,458	2,674	13,939
Capital	100	100	100	100	400
Central Bank Lending	0	947	3450	1074	5479
Financial Bonds	3730	3130	0	1600	8460

Source: Websites of Asset Management Companies (AMCs)

Note: RMB 80 billion of the NPLs received by Cinda were removed from the State Development Bank

The AMC's took over SOCBs' NPLs, which had been contracted before 1996. The past-due and idle loans classified under the four-category loan classification were purchased at their book value. This indicates that the government took over the NPLs produced in the era of planning economy. The total NPLs received by the four AMC's were RMB 1.4 trillion, which accounted for 15.6% of the total assets of the four SOCBs. The four AMC's financed this transfer by issuing bonds of RMB 85 billion and borrowing RMB 55 billion from the PBOC. This operation, however, did not increase reserves, since the SOCBs' total borrowings of RMB55 billion from the PBOC were deducted from their liability (and the total amount of RMB850 billion in bonds issued by AMC's appeared on the asset side of the SOCBs in exchange for a reduction of transferred NPLs of RMB 1.4 trillion.) The interest rate for the PBOC lending was 2.25%.The purchase of RMB 1.4 trillion NPLs was completed by the end of 2000.

In fact, the quality of the transferred NPLs was extremely poor. More than 70% of the debt assets are credit loans, which are large loans, made by the state-owned enterprises for investing in equipment and production capacity. It has been pointed out that 40% of SOCBs' assets are NPLs and should be written off (*Economic Daily*, Nov.14, 2001).

As for measures to cope with the RMB 1.4 trillion worth of NPLs transferred, the AMC's have used two approaches: One is to conduct a debt-equity swap, this approach is applicable to largely state-owned enterprises, that are relatively better performing and thus can be regarded as candidates for becoming public companies. the procedures of debt-equity swap program between AMC's and enterprises are:

- (1) The State Economic and Trade Commission (SETC) investigate state-owned enterprises and makes recommendations to the relevant AMC;
- (2) Based on the enterprises book value, the AMC purchases the principal and interest (owed by the enterprise) from the relevant SOCBs;

(3) The AMCs are in charge of arranging debt-equity swaps and signing contracts with enterprises after their own investigation;

(4) The AMCs as shareholders are supposed to encourage the enterprises to improve their management in order to realize a public listing, and thereby recover the costs of their acquisition by selling stocks on the stock market, or by facilitating the enterprises to buy back their stocks (repurchasing arrangement).

The other approach is to directly deal with transferred NPLs to firms that are unlikely to survive. It includes bidding, auctions, restructuring of debt, liquidation and bankruptcy, contracting agreements, and Asset Backed Securities (ABS). The most widely used methods have been bidding and auction. The AMCs held various auction fairs and exhibitions of the assets they acquired for sale (including land, buildings and tangible assets such as vehicles). They also used package selling for disposing debts by category. The assets were packaged on the basis of the characteristic of the areas or industries. Generally used practices are: (1) packaging debts and establishing an AMC with foreign investors; (2) directly sell the package to domestic or foreign investors, and entrust the asset package to foreign investors; (3) setting up a securitization fund for each package. In November 2001, Huarong established a first joint venture company with Morgan Stanley and Rongsheng with Goldman Sachs.

As of June 2003, the data on the amount of NPLs recovered by the AMCs is shown in Table 3.7. The AMCs have made some progress in cash recovery: not only in terms of the cash recovery but also the recovery rate.

Table 3.7 Balance of AMCs' Recovering NPLs (June 2003)

ACMs	Cinda	Huarong	Greatwall	Orient	Total
Purchased Asset Sum	3,730	4,077	3,458	2,674	13,939
Settled Asset Sum	941.28	536.8	1204.69	935.67	3014.42
Recovery of Cash Sum	296.25	136.33	129.75	229.96	792.29
Rate of Recovery of Cash	31.47	25.4	10.77	24.58	21.9

Source: Newspapers

### 3.1.4 Solutions to SOCBs

Facing the above listed problems, the government and the SOCBs have taken a series of measures such as NPLs disposal, promoting modern corporate governance, and introducing competition in the banking sector. The success of SOCBs is relying on the reform in corporate governance and the diversification in ownership. For corporate governance, the CBRC has drafted ten guidelines, the ten guidelines requiring better corporate governance are:

1. Having a clear corporate governance structure comprising the general shareholders meeting, a board of directors, a board of supervisors and an executive management, with all the necessary checks and balances;
2. Selecting domestic and foreign strategic investors to form synergy;
3. Setting out clear-cut strategies;
4. Establishing sound decision-making process, internal controls and risk management system;
5. Adopting reduced layers of hierarchy and streamlined business structure;
6. Introducing accountability and motivation;
7. Having in place the prudent accounting practices and transparency;
8. Building up an up-to-date management information system;
9. Underpinning staff training plus talents recruiting;
10. Giving a full play to the professional consulting services.

The diversification in ownership is fundamental to the success of the reform on the “Big Four”, though it is controversial regarding the (Initial Public Opening) IPO of the SOCBs. The authority has taken IPO as an alternative to restructuring in banking system, and the following seven benchmarks are recommended by the CBRC to measure the banks’ progress on the way to restructuring and IPO:

1. Net ROA (Return on Assets) ratio will reach 0.6 per cent by 2005, and will be further increased to the level of the best international banks by 2007;
2. Net ROE (Return on Equity) ratio will reach 11 per cent or above by 2005, and be further increased to 13 percent or above by 2007;
3. Cost/ income ratio will be controlled within the range of 35 to 45 per cent starting from 2005;
4. Non-performing asset ratios will be controlled within the range of 3 to 5 per cent;
5. The largest exposure to a single borrower will be no more than 10 per cent of the total capital;
6. Capital adequacy ratio (CAR) will be above 8% all the time;
7. The NPLs provision coverage ratio will reach 60-80 percent by 2005 and banks will try to reach 100 percent by 2007.

### ***3.1.5 Comparison with the Canadian “BIG Six”***

Canada’s banking industry is similar to China’s Banking industry in that both of them are comparatively concentrated. China has the “Big Fours” with more than 60% of the market share, while Canada has the “Big Six”, holding more than 90% of the assets in the industry. As of June 2000, in the Canadian banking sector, there were 11 domestic banks and 38 foreign banks, with about 8400 branches and more than 222,000 employees.

Table 3.8 is the summary of bank ranking of China's "Big Four" and Canada's "Big Six", in terms of assets. All the six largest Canadian banks are behind China's "Big Four". But, in terms of the pre-tax Return on Asset (ROA), the Royal Bank of Canada is the highest (1.15%), followed by Scotia Bank (0.91%), the Bank of Montreal (0.77%), and the National Bank of Canada (0.67%). the ROAs of the "Big Four" in China range from 0.10% to 0.38%, and are far below that of the "Big Six" in Canada.

Table 3.8 Bank ranking in terms of Assets

Asset Rank 2002	Bank	Country (Year End)	Assets (\$millions CDN)	Pre-Tax Profit (\$millions CDN)	Pre-Tax Return on Assets (%)
18	Industrial and Commercial Bank of China	China (12/02)	910,422	1,316	0.14
23	Bank of China	China (12/02)	684,975	2,628	0.38
29	China Construction Bank	China (12/02)	587,637	827	0.14
32	Agricultural Bank of China	China (12/02)	567,314	555	0.10
51	Royal Bank of Canada	Canada (10/02)	372,995	4,282	1.15
60	Scotiabank	Canada (10/02)	291,174	2,642	0.91
64	Toronto-Dominion Bank	Canada (10/02)	273,318	-453	(0.17)
65	Canadian Imperial Bank of Commerce	Canada (10/02)	269,399	416	0.15
66	Bank of Montreal	Canada (10/02)	248,690	1,925	0.77
149	National Bank of Canada	Canada (10/02)	75,438	503	0.67

Source: CANADIAN BANKERS ASSOCIATION, [www.cba.ca](http://www.cba.ca)

The fundamental difference between the "Big Six" and the "Big Four" lies in ownership. Canadian banks are widely held with no individual shareholder holding more than 10%, and all of them are publicly listed banks. By contrast, all the "Big Four" are 100% state-owned banks. To increase the strength in competitiveness, the Chinese government is taking steps to reconstruct the banks, including permitting foreign investment and IPO, among the four banks. BOC and CCB have planned their overseas IPO, which could be as early as next year.

Comparing the balance sheet of the "Big Six" (Table 3.9) and the Financial Highlights of Bank Of China (one of China's "Big Four", Table 3.10) leads to another difference: an item called "Non-performing Asset" appears on the asset side of BOC's balance sheet, while the Canada's "Big Six" do not include this item. More importantly, the amount of the non-performing asset is significantly big, as high as 22.49% of the total assets.

Table 3.9 Balance sheet items of the “Big Six”

For the fiscal year ended Oct. 31	Total Assets (\$ millions)	Total Loans (\$ millions)	Total Deposits (\$ millions)	Total Shareholders' Equity (\$ millions)	Common Shareholders' Equity (\$ millions)	Assets to Shareholders' Equity	Average Loans as a Percent of Average Assets
	Annual Average	Annual Average	Annual Average	Annual Average	Annual Average	Annual Average	
1999	1,282,869	756,691	850,668	57,837	48,903	22.18	58.98
2000	1,349,149	779,824	922,634	63,198	54,116	21.35	57.80
2001	1,474,126	832,872	988,406	69,614	60,258	21.18	56.50
2002	1,575,492	878,271	1,049,774	74,469	64,985	21.16	55.75
2003	1,610,230	877,038	1,054,956	75,318	66,465	21.38	54.47

Source: CANADIAN BANKERS ASSOCIATION, [www.cba.ca](http://www.cba.ca)

Notes: “BIG Six” include BMO Financial Group, CIBC, National Bank of Canada, RBC Financial Group, Scotiabank, TD Bank Financial Group.

Table 3.10 Financial Highlights as of 2002 (Bank of China)

	Profit and loss (RMB million)		Balance sheet (RMB million)			Ratios (%)		
	2002	2001		2002	2001		2002	2001
Net interest income	54,091	50,930	Customer loans and bills discounted	1,817,545	1,631,769	Non-performing assets	22.49	27.51
Other operating income	22,244	14,709	Non-performing assets	408,531	436,020	Provisions coverage	21.09	16.8
Operating profit before provisions	52,271	41,590	Total assets	3,593,908	3,361,619	Cost income ratio	37.89	37.95
Provisions for bad and doubtful debts	26,711	23,194	Total risk weighted assets	2,309,861	2,201,020	Return on equity before provisions	23.86	19.77
Pre-tax profit	13,791	10,914	Customer deposits	2,755,271	2,477,143	Return on equity	4.31	3.76
Net profit	9,445	7,908	Owner's equity	219,660	218,420	Capital adequacy ratio	8.15	8.3

Source: Website of the Bank of China

Note: Bank of China is one of the "Big Four" in China

The last difference lies in the income statement, comparing Table 3.11 and Table 3.12 with Table 3.10, the average Return on Equity to the "Big Six" is about 20% (ROE = Asset to Shareholder's Equity Ratio \* ROA). BOC's ROE is much lower, only 4.31%. Since we do not have the aggregate financial data to the "Big Four" in China, we can't make the comparison on the aggregate level, but, generally speaking, the "Big Four" financial performances are not as good as the "Big Six". There are several reasons for the poor financial performance. One reason is that BOC's Asset to Shareholder's Equity Ratio is lower (about 16), compared to that of the "Big Six" (around 21); another reason is the limited source of income. The BOC, due to the under-developed financial market in China, holds a very limited asset portfolio; "other income" is less than 30% of the total income. But for the "Big Six", the proportion of "other income" in total income is greater than 50%. The last reason for the low ROE of BOC, and also the hard nut to crack in China's banking sector is the NPLs. To disposal the huge amount of Non-Performing Loans, banks in China are required to increase the NPLs provision coverage ratio to 60-80% by 2005, so the NPLs have been a constraint on the performance of the "Big Four".

Table 3.11 Income statement of the "Big Six" (\$ millions)

For the fiscal year ended Oct. 31	Total Interest Income	Total Interest Expense	Net Interest Income	Provision For Credit Losses (LLP)	Net Interest Income after LLP	Other Income	Net Interest and Other Income	Total Non-Interest Expenses	Provision For Income Taxes	Net Income (Loss) For The Period
1999	69,620	46,878	22,742	2,925	19,817	25,097	44,915	31,370	4,276	9,117
2000	78,601	54,740	23,861	3,699	20,163	30,754	50,917	35,692	5,306	9,651
2001	79,915	52,421	27,494	5,749	21,745	31,311	53,056	40,023	2,931	9,683
2002	64,041	33,125	30,916	8,829	22,087	28,583	50,670	41,345	1,855	6,982
2003	61,173	30,872	30,301	3,575	26,726	31,381	58,107	42,674	3,770	11,070

Source: CANADIAN BANKERS ASSOCIATION, [www.cba.ca](http://www.cba.ca)

Table 3.12 Income statement as a percentage of total assets:

For the fiscal year ended Oct. 31	Dividend Payout Ratio	Net Interest Income	Loan Loss Provision	Other Income	Net and Other Income	Non-Inte rest Expenses	Net Income Before Taxes
1999	0.30	1.83	0.23	1.96	3.56	2.45	1.11
2000	0.32	1.82	0.27	2.28	3.83	2.65	1.18
2001	0.38	1.92	0.39	2.12	3.66	2.72	0.94
2002	0.59	2.01	0.56	1.81	3.27	2.62	0.64
2003	0.40	1.88	0.22	1.95	3.61	2.65	0.96

Source: CANADIAN BANKERS ASSOCIATION, [www.cba.ca](http://www.cba.ca)

### 3.2 The Joint Stock Commercial Banks (JSCBs)

There were 11 Joint Stock Commercial Banks (JSCBs) by the end of 2003; those Joint Stock Commercial Banks include the BOCOM, CITIC Industrial Bank, Xiamen Industrial Bank, the China Merchants Bank (CMB), China Everbright Bank, Hua Xia Bank, Guangdong Development Bank, Shanghai Pudong Development Bank, China Minsheng Banking Corporation. Among the JSCBs, only BOCOM can rival the “Big Four” in terms of amount of assets. BOCOM and the CITIC Industrial Bank are the first two comprehensive commercial banks in China. One of the advantages that these banks enjoy is that they are not subject to the restrictive policy-lending requirements of the State Council.

Xiamen International Bank is China’s first foreign joint venture in financial services.

China Minsheng Banking Corporation is the first listed private bank, although it is a minor bank with only eight branches employing 2,000 employees. By focusing on private sector enterprises, the bank has shown a spectacular rate of growth, a 45% increase in profit in 2003, with an unusually low level of non-performing loans. Given the success of the China Minsheng Banking Corporation, the State of Council is considering the establishment of ten private commercial banks across different provinces of China.

Five of the JSCBs - Shenzhen Development Bank, Shanghai Pu Dong Development Bank, China Minsheng Bank, China Merchant Bank, and Hua Xia Bank, have been listed on China's A-share market since 1991, 1999, 2000, 2002, 2003 respectively. Mingshen Bank is the only private bank in China, with all the shareholders including the holders of non-traded shares being private investors.

Shown in Table 3.4, the average Return on Asset (ROA) of the JSCBs (0.49% in 2001) is much higher than that of the SOCBs (0.2% in 2001). Moreover, except for the Everbright

Bank of China, the NPL ratios (Table 3.13) for the SJCBs are all lower than that of State-owned banks (25% in 1999). China Minsheng Bank, with zero governmental share, has the lowest NPLs ratio, while Everbright Bank of China, with governmental share of 31%, has the highest NPLs ratio. The better performances of the SJCBs are partly due to the fact that the JSCBs do not necessarily meet the restrictive policy-lending requirements of the State Council.

Looking at the data listed in Table 3.13, we find that, except for CITIC industrial Bank, there is a positive correlation between governmental ownership and NPLs ratios, This finding strongly supports China's policy on diversifying the ownership of the SOCBs.

Table 3.13 Ownership, NPLs ratio, and ROEs of JSCBs in China (as of 1999)

	Largest share holder	Ownership of government	NPL ratio	Profitability (ROE %)
Bank of Communications	Shanghai Government	20	20.0	6.9
Everbright Bank of China	The State Council	31	39.0	7.4
CITIC Industrial Bank	The State Council	100	13.2	16
Guangdong Development Bank	Guangdong Government	12	-	4.2
Fujian Industrial Bank	Fujian Government	20	14.2	8.7
China Minsheng Bank	Private	0	8.7	17.4
China Merchants Bank	The State Council	22.8	13.3	8.2
Shenzhen Development Bank	Shenzhen Government	14.5	24.6	17.8
Shanghai Pu Dong Development Bank	Shanghai Government	23	9.1	16.8
Huaxia Bank		20	-	8.1

Source: The websites of those banks

Notes: CITIC Industrial Bank is owned by China International Trust and Investment Company (CITIC), CITIC is 100% owned by the State Council.

### 3.3 The Foreign Banks in China

By the end of 2000, there were a total of 74 foreign banks, from 18 countries, with 161 branches in 23 cities across the country. The total assets of foreign banks increased from

US\$5.53 billion in 1992 to US\$34.4 billion in 2000, representing an annual increase of 25.7% over the period. Although their total assets were less than 2% of those in China's banking sector in 2000, foreign banks assumed a more active role in foreign currency business: foreign currency loans extended by foreign banks accounted for 23% of the total of the Chinese banking sector.

### ***3.3.1 History***

Foreign banks were first allowed to open representative offices in the late 1970s. Since then, the opening-up of China's banking industry experienced the following four stages:

***Stage 1: 1980s to early 1990s.*** Foreign banks were allowed to open operational branches in Special Economic Zones (SEZs). Early instances included Hong Kong banks operating in nearby Shenzhen. In 1990, arrangements were put in place for them to operate in Shanghai. Later the arrangements were extended to seven other coastal cities.

***Stage 2: Mid 1990s.*** Improved regulations on opening up to and supervising foreign banks were formally promulgated, allowing foreign banks to operate in 23 cities.

***Stage 3: Since 1996.*** Foreign banks have been allowed to open branches all across China. A pilot program was initiated in the Pudong area of Shanghai for foreign banks to undertake local currency business. Foreign banks in Shenzhen and Shanghai have been allowed to undertake a wider range of activities.

***Stage 4: since 2002, after China's entry to WTO:*** In accordance with related WTO accords, China will gradually lift restrictions on foreign-funded banks: In two years after WTO accession, China will allow foreign banks to handle Renminbi service for Chinese enterprises; in five years after WTO entry, it will lift all regional restrictions; China will permit foreign banks to provide services for all Chinese clients, it will also permit them to set up business outlets in the same region, requirements of examination and approval are the same with Chinese-funded banks.

In five years after WTO entry, China will abolish all existing non-cautious measures regarding restrictions imposed on foreign banks in their ownership, forms of operation and establishment, including their branch offices and the issuance of licenses. Foreign-funded non-banking institutions are allowed to be established to provide automobile consumption credit business, which enjoy equal treatment with the same type of Chinese-funded financial institutions; foreign-funded banks can, within five years after WTO entry, provide automobile credit service for individual Chinese residents. Foreign-funded financial leasing companies are allowed to provide financial leasing service within the same period of time as that of Chinese firms.

### ***3.3.2 Current situation***

According to *China Business Weekly* (April 5-11, 2004), by the end of 2003, foreign banks had established 191 operational institutions with total assets of USD 46.6 billion. Though they account for only 1.4% of the overall bank assets in China, their performance in terms of profitability is much better than that of domestic Chinese banks (Table 3.4).

Meanwhile, 84 of them have acquired licenses for Renminbi business. Starting from last December, foreign banks were allowed to provide RMB services for Chinese enterprises in certain regions, including Shanghai, Shenzhen, Tianjin, Dalian, Guangzhou, Zhuhai, Qingdao, Nanjing, Wuhan, Jinan, Fuzhou, Chengdu, and Chongqing.

To get involved in the RMB business without the restrictions and leverage on the existing retail network of the domestic banks, several foreign banks (e.g. Citibank, HSBC) have taken minor stakes in joint-stock & city commercial banks, and more acquisition deals are expected to take place in the near future. To accelerate the reform in the banking industry, and to open the ways for the introduction of international standards and financial expertise, the PBOC may possibly raise ownership ceiling to 24%, which could give overseas lenders a controlling stake of China domestic banks.

For the auto financing services, The CBRC has received and is reviewing applications from GMAC- SAIC Automotive Finance Company, Ltd., Volkswagen Financial Services (China) Co., Ltd., and Toyota Automotive Financial (China) Co., Ltd.

### ***3.3.3 Canadian financial institutions in China***

#### **(1). Manulife in China**

In the financial industry in China, insurance has maintained the leading position in opening-up. By the end of 2003, 37 foreign insurance companies from 13 countries and regions launched 62 insurance branches in China. They received insurance premiums of 4.65 billion Yuan (USD 561.5 million) during 2003, a 44.5% increase compared to 2002. Foreign insurance companies have acquired a considerable market share in some major cities such as 51% in Guangzhou.

Manulife, a leading Canada-based financial services provider, was first permitted to expand its business in China through its joint venture life insurance company: Manulife-Sinochem Life Insurance Co. Ltd.. Manulife-Sinochem, a joint venture company between Manulife (International) Limited (51%) and China Foreign Economic and Trade Trust & Investment Company (a member of the Sinochem group, 49%) was established in 1996, with its headquarter in Shanghai and branch operations located in Beijing and Guangzhou.

*Competitive strength:* As the first joint venture life insurance company in China, Manulife-Sinochem inherits the tradition of Manulife Financial, taking advantage of its insurance expertise, while depending on Sinochem's understanding of the Chinese market to make considerable developments in agency training, product design, market exploration and service effectiveness.

*Business scope:* Manulife-Sinochem provides a wide range of insurance products, quoted in RMB currency, to meet the needs of customers. The scope of its business includes life insurance for both local people and foreigners. Since opening, Manulife-Sinochem has developed more than 40 types of products, including: investment-linked rider, profit-sharing life insurance policy ("Financial Expert," "Smart Baby," "Sunshine baby," "Endow Lucky Star Plan," "Par Pure Whole life," "Par whole life with cash coupon," "Lady plan with retirement supply/with baby birth," and "Lady plan with earlier wealth acceleration/with baby birth."), family medical insurance ("one policy, whole family"), and etc.

*Brand awareness:* Manulife-Sinochem's brand awareness in Shanghai continues to improve through newspaper, billboard, bus ads, and television commercials. In order to stay on top of consumer's habits and attitudes, Manulife-Sinochem has also carried out large-scale market research to identify what products should be developed and what image the Company should project.

*Outstanding professional development of employees:* as part of the company's core values, Manulife place heavy emphasis on the professional development of its field forces and employees. Due to its consistent efforts on staff training, Manulife is honored to be recognized by the LOMA organization, as one of the premier insurance education institutes in the world.

*Achievements:* 2002 was Manulife-Sinochem's sixth year of successful business operations in China. It has been growing to a company with 3,000 professionally trained agents and 250 employees serving more than 140,000 customers. In 2001, total premiums and deposits were RMB 275 million. For the first three quarters of 2002, total premiums and deposits increased 48 per cent over the same period last year. At the same time, the management of the company earned rich experience and knowledge in understanding and developing China's insurance market. That knowledge, said Raymond Chan, General Manager of Manulife-Sinochem, "will be invaluable in the future, as we move ahead with our expansion plans into Guangzhou and beyond." (Source: Website of Manulife-Sinochem)

## **(2). Sun Life in China**

Sun Life's first presence in China was in 1999 with the establishment of a Joint Venture company, Sunlife-Everbright. In October 2003, it was granted approval by the China Insurance Regulatory Commission (CIRC) to begin preparing operations for selling life

insurance in Beijing. Previously, Sun Life-Everbright has been operating in Tianjin for more than a year and has 2,500 agents in 16 sales offices.

### **(3). Canadian banks in China**

Canadian banks have a well-developed presence in the global financial services marketplace; around 37% of the assets of the “Big Six” are employed in international operations. Among the 191 foreign banking institutions in China, four of them come from Canada, they are: Scotia Bank, CIBC, Royal Bank and Bank of Montreal.

It is worthy to mention that Scotia Bank is the first Canadian bank to receive license for local currency business in China. In Oct. 2002, the Chinese government granted Scotia Bank's Guangzhou branch the Canadian banking system's first local currency banking license in China. The license allows Scotia Bank to conduct business using Renminbi (RMB), with foreign companies and a select group of local companies in the nine industrialized cities open to foreign banks for this type of business.

Obviously, this license gives Scotia Bank an excellent opportunity to expand its financial services in the Chinese domestic banking market. Previously, Scotia Bank could only accept deposits and grant loans in foreign currencies in China. Bank services available in China include: deposits, foreign currency exchanges, cash advances, loans, letters of credit, letters of guarantee, collections, balance reporting and wire/SWIFT transfers.

Scotia Bank has been operating in China since 1982, with two branches (Guangzhou, Chongqing) and a representative office in Beijing. In September of 2002, Scotia Bank and the International Finance Corporation signed a Memorandum of Understanding with Xi'an City Commercial Bank for a minority stake in XACB. This investment is expected to be completed in 2004 ([www.beijing.gc.ca](http://www.beijing.gc.ca)).

## **4. Conclusion**

With the transformation from planned economic mechanisms to market economic mechanisms, great changes and a series of critical reforms have taken place in China's banking industry. But the reforms in the banking industry are behind those in other sectors, for example, in the manufacturing industry. Twenty years ago, the large-scale state-owned manufacturers represented nearly 100% of total output, now, more than half of the output comes from SMEs which are mainly managed by private individuals. By contrast, in the banking industry, the “Big Four” still dominate the banking sector with more than 50% of the total market share. As the analysis in this paper shows, the “Big Four” have weaknesses or problems of profitability, capital ratios, and non-performing loans, but, at the same time, it has strength in national wide distribution networks and high brand name awareness. The

main problem faced by the “Big Four” is that of ownership. The high correlation between governmental ownership and NPL ratios suggests that the diversification of ownership is crucial to the success of the reform on the “Big Four”. With the disposal of NPLs, the restructuring of ownership, the autonomy on business operation, and the improvement of the macro-economic environment, the “Big Four” is predicted to continue to remain the leader in China’s banking industry.

Comparing with the “Big Four”, the JSCBs are competitive. With higher profitability and lower NPL ratios, they enjoy more freedom in business decision and improved corporate governance. But when compared with their direct competitors - FBs, they are weak both in profitability and in corporate management. To compete with FBs, the JSCBs need to expand income sources by developing new products and offering more value added services, and to establish better incentive systems to attract and retain talents.

China’s entry to WTO gave foreign banks the opportunities to expand their business in China. Among the banking groups comprising China’s banking industry, FBs show great competitive advantages in innovation and management. Starting in 2007, five years after China’s entry to WTO, FBs will be given equal treatment relative to Chinese domestic banks. This will result in fierce competition between Chinese domestic banks and FBs. As a result, Chinese domestic banks are supposed to speed up reform and learn from FBs during the coming years, so as to lead to a win-win situation.

Like the big gap in economic development level between China and Canada (China’s GDP per capita just reached 1000US\$ last year), Canadian banks outperform Chinese banks in all performance indicators, and the gap between the two countries in the banking industry is expected to be narrowed gradually given a consistent growth in China’s economy.

Though the central bank – the PBOC – lacks independence, it has discarded most of the non-market measures that were previously used under the planned economy. Monetary policy instruments, such as open market operations and reserve requirement policies, are employed in a very flexible way to conduct monetary policy. Reforms on the liberalization of interest rates are in progress. The establishment of deposit insurance is in a feasibility study phase. The PBOC, as well as the CBRC are preparing to take further steps to foster a safe and efficient financial environment.

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