Foreign Exchange Policy and Banking Reform in China

Until very recently, the two salient features of China's foreign exchange regime had been capital controls and the de facto peg to the U.S. dollar. On July 21, China's central bank—the People's Bank of China—changed the dollar peg to a basket peg based on a number of undisclosed foreign currencies. It also allowed a simultaneous 2 percent appreciation of the Chinese currency against the U.S. dollar, from 8.28 yuan to 8.11 yuan per dollar.

Meanwhile, despite gradual loosening, capital controls are still largely in effect. These features of the Chinese foreign exchange regime carry important implications for government efforts to resolve China's ongoing banking problems and to maintain the nation's financial stability.

Banks Play the Central Role in Financial Intermediation in China

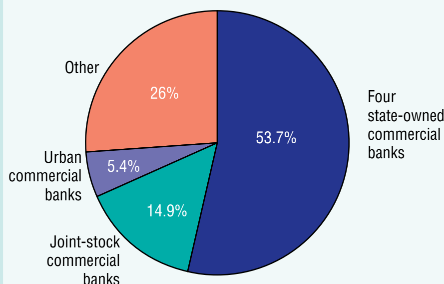
At the end of 2004, total bank deposits stood at 185.5 percent of GDP—with total bank loans at 138.1 percent. In comparison, the combined market capitalization of the Shanghai and Shenzhen stock exchanges was only 27.1 percent of GDP. China's banking sector is dominated by just four state-owned commercial banks (SCBs) that account for 54 percent of China's total bank assets and liabilities (*Chart 1*).

In terms of total assets, all four SCBs rank among the world's 40 largest. Quantity, however, does not mean quality. These banks have proved inefficient in allocating funds to China's economy. All four have low profitability. Moreover, the size of their bad-loan portfolios has been among the world's largest.

Chart 1

Chinese Banking Sector in Terms of Assets

(Percent, 2004 data)



SOURCE: China Banking Regulatory Commission.

Capital Controls Are Crucial to Banking Stability

Although appearances and reality can differ sometimes in Chinese banking, even the appearances look problematic. The latest official data show the average ratio of nonperforming loans to total loans for China's big four banks as 15 percent in first quarter 2005, down from 20 percent at the end of 2003 (*Table 1*).[1] While these ratios are well above those in most countries, private estimates have placed total Chinese impaired loans (including those already taken over by the government in trade for bonds) in the range of 50 percent of bank assets.

There are questions about the adequacy of the capitalization of the four big banks. The China Banking Regulatory Commission requires all banks to meet the minimum capital adequacy ratio of 8 percent, consistent with the Basel I international standard, by January 2007. At the end of 2003, the average capital adequacy ratio was only 4.6 percent for the four SCBs. This ratio was calculated with the knowledge that existing nonperforming loans were not provisioned for sufficiently.

Although they are technically bankrupt, none of China's state-owned banks has ever faced a bank run or closure. An often cited reason is that even though China has no official deposit insurance system, there is an implicit government guarantee on deposits. Aside from the applicability of this guarantee to any bank, the four SCBs are perhaps even less likely to be closed, owing to a dictum common in many countries. That is, some banks are viewed as "too big to fail."

Table 1

Recent Changes in Nonperforming Loan Condition in the Four SCBs

	Nonperforming loan ratio (percent)	Nonperforming loans (billion yuan)
2003:Q4	20.0	—
2004:Q1	19.2	1,889.8
2004:Q2	15.6	1,523.1
2004:Q3	15.7	1,559.6
2004:Q4	15.6	1,575.1
2005:Q1	15.0	1,567.1

SOURCE: China Banking Regulatory Commission.

There is, however, another less discussed reason why Chinese banks have not faced runs by depositors. The reason is capital controls. These controls largely prohibit Chinese citizens from investing overseas. With China's high domestic savings rate (as much as 40 percent by some estimates) and the relative scarceness of alternative financial vehicles such as stocks and bonds, opportunities for purchasing financial assets other than bank deposits are highly limited.

Financial Liberalization Puts Increasing Pressure on Capital Controls

In line with its World Trade Organization (WTO) commitment, China has gradually opened its domestic banking and financial sector to foreigners.[2] By October 2004, 62 foreign banks were operating in China. These institutions account for only 1.8 percent of total banking assets. However, with an aver-

age nonperforming loan ratio of only 1.3 percent, they are substantially more solvent than China's four SCBs.

Foreign banks differ markedly from Chinese banks in other ways as well. Government rules for Chinese banks largely restrict them to the most traditional functions of commercial banking. In contrast, many of the foreign institutions are so-called universal banks. These foreign institutions not only carry on the traditional functions conducted by China's state-owned banks, but also engage in investment banking, securities and insurance operations. The foreign institutions have global opportunities for funding. China's fragmented financial regulatory system, which includes completely separate organizations for banking, securities and insurance, is poorly equipped to deal with universal banks.

Moreover, despite China's WTO-linked openings to foreign financial institutions, the Chinese government still makes efforts to control capital flows. In 2004, the Chinese government announced a new rule under which foreign banks have to apply in advance for quotas for offshore borrowing.

What If China Removed Capital Controls Completely?

China has recently adopted measures to permit more flexible capital flows in response to increasing pressures on its currency. But there is much evidence that China continues to be concerned not only about capital inflows but also about capital outflows. Creating opportunities for Chinese citizens to invest abroad could lead to outflows of deposits from China's already troubled commercial banks.

A few days before China's central bank announced its new exchange rate regime, the government announced that Chinese multinationals would be permitted to acquire more foreign currency and lend the foreign currency to their subsidiaries. The new rules still limit the ability of Chinese to place their money abroad. However, if large outflows were to take place, Chinese banks that now rely on the government to preserve their captive deposit markets would have much more difficulty in stanching fund outflows that would erode the balance between assets and liabilities.

China's Policy Priority Lies in Bank Recapitalization and Privatization

On Dec. 31, 2003, the Chinese government conducted the third large-scale bank bailout in six years. The two previous bailouts had involved procedures that are standard across the world—the injection of domestic-currency-denominated capital and an exchange with the government of bad assets (impaired loans) for good assets (government securities).[3]

As part of the third bailout, however, the government injected $45 billion of foreign-currency-denominated reserve assets (dollar- and other currency-denominated bonds) to two SCBs—the Bank of China and China Construction Bank.[4] The two banks have since been restructured into joint-stock companies, and they are planning an initial public offering both domestically and overseas in an effort to diversify ownership and privatize, at least partially.

Even though Chinese banks' nonperforming loan ratios have fallen as a result of government intervention and the two newly restructured state-owned banks' financial footings have strengthened significantly, China's domestic banks have far to go before they are viable. Thus, the government's motivations to use capital controls to preserve a captive domestic deposit base remain strong.

Even though Chinese banks' nonperforming loan ratios have fallen as a result of government intervention and the two newly restructured state-owned banks' financial footings have strengthened significantly, China's domestic banks have far to go before they are viable.

China's Exchange Rate Question

The majority of recent disputes over China's foreign exchange rate have involved China's trade balance. Although China's overall current account surplus is small by Asian standards, its large surplus with the United States and other industrialized countries has ignited complaints that an undervalued Chinese currency bestows an unfair advantage on Chinese exporters. China's latest move to let its currency appreciate 2 percent against the U.S. dollar and the simultaneous change from a dollar peg to a basket peg are at least partly aimed at addressing the trade problem. Decisions about China's exchange rate regime are driven by factors other than the trade balance, in particular, the health of the banking system.

China's still-fragile banking conditions are likely to continue to motivate exchange rate intervention even under

the new basket peg system. So far, three of China's big four banks have received bailouts involving the exchange of bad loans for dollar- and other foreign-currency-denominated bonds.[5] The Chinese currency's appreciation means a reduction in the value of these foreign-currency-denominated assets relative to the banks' Chinese-currency-denominated liabilities and an accompanying move back in the direction of insolvency. The 2 percent appreciation on July 21 may not have a severe impact immediately in this regard. However, if it leads to further appreciation, there would be a more significant impact on the current bank reform plan.

Combined with the loosening of capital controls, this new basket peg adds an increasing urgency for China to resolve its banking problem.

Conclusion

The current debate on the Chinese currency involves two related but separate issues that have often been confused. One is capital controls, and the other is the exchange rate at which the Chinese currency is pegged, whether to the dollar or to a basket of foreign currencies.

The debate has largely focused on trade effects. Banking conditions and bank reform in China provide an alternative perspective in analyzing the country's foreign exchange policy. China's latest move from a de facto dollar peg to a basket peg, together with a simultaneous 2 percent appreciation of its currency against the U.S. dollar, represents a major step toward a more flexible foreign exchange policy.

Meanwhile, combined with the loosening of capital controls, this new basket peg adds an increasing urgency for China to resolve its banking problem. In fact, the quicker the banking problem is resolved, the sooner a more flexible foreign exchange policy can truly materialize in China.

—Dong Fu

Fu is an assistant economist in the Research Department of the Federal Reserve Bank of Dallas.

Notes

The author would like to thank Bill Gruben for helpful discussions and suggestions.

1. There are widespread disputes on the actual figure for nonperforming loans. Historically, Chinese banks used a four-tier loan classification system, which tended to underreport nonperforming loans. In 2002, they started to migrate to a five-tier classification system, which is more in line with the international standard.
2. Foreign banks can now engage in foreign currency transactions with all clients and with no geographical restriction. By July 2004, their share of foreign currency loans rose to 17.8 percent. So far, foreign banks have conducted business in Chinese currency with Chinese companies in 18 cities. At the end of 2006, foreign banks will be able to operate freely in China.
3. In 1998, the four SCBs received a capital injection of 270 billion yuan. In 1999–2000, four asset-management companies were set up and purchased 1.4 trillion yuan of nonperforming loans at book value from the four SCBs and one government policy bank.
4. However, for the time being, the banks are not allowed to sell the foreign reserve assets.
5. In April 2005, the Industrial and Commercial Bank of China—the largest of the four SCBs—received a $15 billion capital injection of foreign reserve assets.