

Financial Reform in China

Richard Pomfret*

The paper analyzes the place of financial reform in China's economic reforms since 1978. While international transactions were gradually freed in response to the needs of the open door policy, domestic financial markets remained repressed through the 1980s. The reform process has created pressures for financial reform, which is difficult to undertake piecemeal because financial markets are interconnected. Attempts at gradual reform had little impact in the financial sector, and in 1990 and 1991 more far-reaching reforms were initiated. Developments during the early 1990s in bond and equity markets and in banking reform are described and evaluated. (JEL P34, O53)

I. Introduction

The People's Republic of China in the 1970s was an extreme case of a financially repressed economy.¹ Physical planning was the order of the day. The government played the role of transforming savings into investment; the level of international trade was determined by estimating import requirements and then allocating available supplies to exports in order to meet these requirements. Thus, neither interest

*Professor, Department of Economics, University of Adelaide, Adelaide SA 5001 Australia. Initial research was conducted in the second half of 1991 when I was a visiting professor at Fudan University financed by the Ford Foundation. A briefer visit to Beijing and Shanghai in October 1992 financed by the UNDP allowed me to conduct interviews and update material. Earlier versions of this paper were presented at the Australian Economists' Conference in Melbourne (July 1992), the International Economics Association Congress in Moscow (August 1992) and staff seminars at Macquarie and Adelaide universities; I am grateful for comments by participants.

¹Financial repression was first defined by McKinnon (1973) and Shaw (1973). The subsequent literature and empirical evidence is thoroughly reviewed in Fry (1988) and summarized in Pomfret (1992, Chapter 11). For alternative accounts of recent financial developments in China see Overholt (1991) and Tam (1991). [Seoul Journal of Economics 1992, Vol. 5, No. 4]

rates nor the exchange rate played a significant role in resource allocation.

With the initiation of economic reforms in the late 1970s, the backward financial development frequently became a stumbling block. The lack of currency convertibility inhibited direct foreign investment and the overvalued yuan discouraged exports. Attempts to overcome these drawbacks by a two-currency system and later by multiple exchange rates were partial solutions which introduced new inefficiencies. The absence of a domestic financial market limited the government's access to domestic resources and its ability to conduct macroeconomic policy. Worst of all, the absence of a market-determined interest rate structure meant that capital continued to be inefficiently allocated.

Financial reform has moved slowly since 1978-79, although frequently unintended consequences of the cautious reforms have accelerated the pace of change. During the 1980s the most important reforms were in the area of international transactions, often in response to the needs of foreign investors. Domestic financial market reform progressed much more slowly, even though the government first issued bonds in 1981. In the 1988-90 austerity program, the authorities resorted to administrative measures to slow inflation rather than relying on macroeconomic policy. Nevertheless, in the early 1990s the domestic financial market began to develop more rapidly; important symbolic gestures were the opening of stock markets in Shanghai and Shenzhen, and the official approval for the first new foreign bank branches in Shanghai since 1949.

This paper analyzes the financial reforms, with particular emphasis on the recent changes. Thus, the foreign exchange market is dealt with rather briefly in the second section. Section III analyzes the macroeconomic pressures for ending financial repression. Section IV turns to microeconomic concerns, focusing on financial intermediaries and especially the role of banks. Section V describes the recent experience with stock exchanges. The final section offers some conclusions about how far financial reform has come in China and about the prospects for further financial development in the 1990s.

II. Exchange Rate Policy²

Before 1978 the exchange rate of the inconvertible yuan had little

²The first part of this section is based upon Pomfret (1991, pp. 29-33) and Lardy (1992, Chapters 2-3).

economic significance, since import needs were determined by the planners and exports were in response to government command; trade was balanced, and domestic prices were unimportant in determining which goods were imported and exported. The opening up of China to tourists and to foreign investors created a need for some degree of convertibility, and in 1980 the government introduced Foreign Exchange Certificates (FECs) which were issued to people who might have legitimate grounds for converting unused yuan into foreign currencies (e.g. tourists). The FECs were ostensibly equal in value to the domestic renminbi yuan (RMB), but they immediately traded at a premium on the black market. The black market premium indicates that the yuan has been continually overvalued.

The exchange rate had been fixed at 2.46 yuan/US dollar from 1955 to 1971, after which the yuan appreciated against the dollar during the 1970s and depreciated in the early 1980s. By the end of 1983 the exchange rate was 2 yuan/\$1. One consequence of the yuan's overvaluation was that most exports were at a loss in domestic currency terms. In January 1981 the government introduced an internal settlement rate (at 2.8 yuan/\$1) to provide greater incentives to exporters and to reduce financial losses on export sales. This dual exchange rate system penalized tourists and remittance senders, who received the less favorable official rate, and the latter group reacted by sharply reducing remittances sent to China through official channels (Lardy 1992, p. 68). Use of the internal settlement rate was discontinued after 1984. In 1984 the first major import liberalization was introduced, together with reforms to decentralize foreign trade decisions. Within the context of an overvalued exchange rate and inadequate central control over credit creation, the 1984 reforms set in motion an import-buying spree. The current account surpluses of 1980-84 were transformed into a \$12 billion deficit in 1985, which had to be financed by running down reserves and by foreign borrowing. Opponents of reform blamed the import liberalization and decentralization for the loss of reserves and accumulation of foreign debts, but the negative consequences of the reforms were due to an exchange rate which made imports attractive and an absence of control over credit creation, so that the imports could readily be financed at a local level.

Between 1984 and July 1986 the yuan was devalued in several steps to a rate of 3.7/\$1. Despite the 83% devaluation against the dollar (and even bigger devaluation against other major currencies), the yuan remained overvalued. The black market premium for FECs rose to over

50% in 1987 and over 100% in September 1988. Since many domestic prices remained controlled, inflation in China was in part repressed, but the black market exchange rate implies that the yuan had become significantly overvalued by late 1988. As demand for imports increased, the authorities tightened up the quantitative restrictions on imports, which was of course contrary to the reforms' aim of increasing reliance on the price mechanism. An overvalued yuan also made exporting less attractive.

The Chinese authorities were unwilling to take the obvious step of devaluing the yuan to an equilibrium level and then maintaining a steady real exchange rate, because they feared that devaluation would set in motion a vicious circle of devaluation-inflation-devaluation. Thus, they first set out in September 1988 to deal with the root cause of inflation by initiating an austerity program.

Meanwhile, in the mid-1980s an ad hoc multiple exchange rate system emerged. For foreign investors the convertibility problem was the major obstacle to investing in China, and many investors negotiated the rate at which they could exchange RMB into foreign currency for imported inputs or to repatriate profits. Since this rate was often unattractive they also resorted to charging domestic customers in FEC, or buying Chinese goods with their RMB profits and then exporting them. These are all second-best solutions to the problem, which are likely to involve substantial resource misallocation. Also, efforts were increasingly being diverted from productive activities to searching for the best way to make foreign exchange transactions.

A partial attempt to reunify the exchange rates was made by establishing Foreign Exchange Transaction Centres (more commonly referred to as swap centres). The swap centres were first set up in 1986 to allow certain companies short of foreign exchange to trade with foreign exchange companies at negotiated rates.³ Initially the swap centres were intended primarily for joint ventures, but access was gradually widened to include foreign trade corporations, other Chinese com-

³The crucial legislation was Article 14 of the Provisions for the Encouragement of Foreign Investment promulgated on 11 October 1986, which allowed foreign-invested ventures to swap foreign for RMB. One of the first reported swaps involved the Beijing Great Wall Hotel selling \$2.5 million to Beijing Jeep (Zhang 1987, p. 113). Organized swap centres quickly sprang up in many cities, and they numbered about one hundred by the end of 1991. Some had physically existed as foreign exchange centres before 1986 (e.g. the Shanghai FETC was set up in 1981), but only permitted enterprises to trade foreign exchange retention rights at a regulated rate (Xu 1991).

panies, and by December 1991 all PRC citizens with legitimate foreign exchange or need for foreign exchange. The swap centres are still unlikely to eliminate the black market because some Chinese residents may be unable or unwilling to explain their foreign exchange holdings or needs, and individual foreigners are still obliged to purchase their FEC at the official rate. Also the swap centres' 0.15% fixed commission may deter some transactors. Nevertheless, the swap centres represent a reasonably efficient foreign market and the exchange rate, which is similar (but not identical) in all the major centres, is now a good guide to the equilibrium value of the yuan.

Since December 1989 there have also been a series of devaluations bringing the official exchange rate closer to the swap centre rate. Especially in autumn 1990 there was an active debate over whether the time was ripe for unifying the two rates, abolishing the FECs, and moving towards full convertibility. The authorities opted for caution and devalued by 10% instead of the 20-25% required by the advocates of convertibility. Mini-devaluations in 1991 brought the exchange rate over 5.3/\$1, or about ten percent below the November swap centre rate of 5.86. This turned out to be a missed opportunity as fears of renewed inflation pushed the swap centre rate up to a 7.6 high in July 1992 and even when the rate fell to 7 in November it was still at a 25% premium over the official rate.

By the 1990s the worst inefficiencies arising from the inconvertibility and overvaluation of the yuan have been removed. In practice the yuan is convertible for most purposes at the unified rate of the swap centres. There are still restrictions on Chinese enterprises, who have to turn over some of their foreign exchange earnings to the Bank of China at the official rate. On 1st. December 1991 individual Chinese citizens were allowed to exchange RMB for foreign currency at the swap centre rate, as long as they had a legitimate reason for the foreign exchange or had obtained foreign exchange legally. The gap between the market-determined swap centre rate and the official rate now serves only as a tax on some export earnings by Chinese enterprises and on individual foreigners.

In Guangdong Hong Kong dollars appear to exchange fairly freely at a commonly accepted exchange rate. Elsewhere the yuan is the means of exchange, but the foreign exchange market is well-developed. One feature of this development is the gradual emergence of Shanghai as the dominant swap centre where the largest transactions are made. The presence of six foreign banks among the eighteen brokers on the

Shanghai swap centre provides a link to international swaps; almost all transactions in Shanghai are RMB for US dollars but the foreign banks can then arrange swaps among foreign currencies at competitive rates. The Shanghai centre also began experimenting with a forward market in June 1992, although trading was light during the remainder of 1992.⁴

III. Financial Repression and Macroeconomic Policy

Reform of the domestic financial system progressed much more slowly during the 1980s. The pre-reform financial system was practically a non-system given that the key allocative decisions were made by physical planning. The money supply was endogenous as the single bank printed money to meet the government's agricultural purchase requirements, the urban wage bill and so forth. Because the first of these demands is inherently volatile money growth was not steady, but the authorities managed to maintain price stability without queues by manipulating the list prices of consumer goods.⁵

With economic reform the government has been gradually losing physical control over the economic surplus. As early as 1981 the government started to issue bonds in order to cover part of the widening budget deficits. At the same time, money supply remained endogenous and its growth accelerated. The authorities were finding it increasingly difficult to prevent the greater liquidity from leading to inflation. During the first half of the 1980s this dilemma was masked by the rapid growth of money demand as incomes rose and the economy became increasingly monetized, but by 1988 inflation was rising rapidly and the central bank had no good instrument for dealing with the problem. The 1988-91 austerity program provided the stimulus for reform of the financial system during the 1990s, because it highlighted the interconnections between macroeconomic policy, the bond market and other financial markets.

From 1980 to 1989 government bond issues totalled around 100 billion yuan, with another 40 billion issued in 1990 and 1991.⁶ Before

⁴Over the first five months, trading amounted to \$100 million.

⁵For example, prices were increased 1961-62, reduced 1963-67 and kept largely unchanged 1968-78, with the changes being concentrated in commodities like tea, alcohol and cigarettes whose demand is inelastic (Peebles 1991).

⁶Sources vary on the totals, but the order of magnitude and increased growth since 1989 are agreed upon. Yang Zhaonan, Ministry of Finance, in an interview

1991 bond distribution was by compulsion; employees were forced to accept government bonds as part of their income. In 1991 a limited experiment of distributing 2.5 billion yuan worth of bonds through domestic financial institutions was tried, and this is likely to be the dominant distribution method in future.⁷

The growth of outstanding bonds was not fast, but it was sufficient to generate demand for a secondary market. This began with the exchange of treasury notes held by enterprises. Official and semi-official curb markets emerged in several large cities during the 1980s. Also, in the mid-1980's enterprises started to sell bonds to finance expansion.⁸ The issue of enterprise bonds accelerated after 1988, when the austerity program limited access to government funds. The number of government bond issues also increased after 1988 as the government sought to finance its budget deficit and to soak up excess liquidity in the economy.

The development of the secondary bond market is difficult to track precisely. Fairly organized markets appear to have existed at least since 1985 in Guangdong and 1986 in Shanghai. In April 1988 secondary markets were authorized and regulated by the PBOC in sixty-one cities.⁹ In March 1991 markets were permitted in all cities, and by the end of 1991 there were about a thousand secondary bond markets in 300 cities, employing more than a hundred thousand people.¹⁰

on 28 October 1992, gave a figure of 136 billion yuan for the outstanding government securities at the end of 1991; the majority (80 billion yuan) are treasury notes issued by the People's Bank of China on behalf of the Ministry of Finance. Zhang Jialun of the State Debt Management Department reported (in *China Daily*, 26 November 1991, p. 1) a slightly lower total (120 billion). Other sources give higher numbers, e.g. Xu (1991, p. 362) states that 101.5 billion yuan were issued by the end of 1989 and the *Far Eastern Economic Review*, 16 April 1992, p. 66, give figures of 14, 20 and 28 billion for 1989, 1990 and 1991.

⁷The sixty institutions participating in the 1991 underwriting experiment were rather reluctant, but the terms proved so attractive that announcement of a 3.6 billion yuan issue in Spring 1991 was oversubscribed 66% by would-be underwriters. Later announcements in 1992 received a less enthusiastic response because attention was diverted to the prospect of high returns on listed shares. (See section V)

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⁹The PBOC authorized 34 securities companies and 400 trust and investment companies nationwide to deal in PBOC-approved securities.

¹⁰*China Daily*, 26 November 1991, p. 1.

These statistics may be misleading, however, because they seem to represent places with authorized dealers, rather than unified bond markets as they exist in developed market economies. In 1988 prices differed from city to city, but the differential became smaller over the next two years. In December 1990 coordination was improved through the establishment of the Securities Trading Automated Quotations System (STAQ), based in Beijing and connecting over forty bond-dealers, and of the Shanghai Stock Exchange (SSE), which operated their own clearing systems as well as centralizing price quotations.¹¹

The evolution of the Chinese bond market has been tortuous, and as in many cases of countries emerging from financial repression, driven by government budget needs. As enterprise reforms spread to the urban sector the government's tax base dwindled further.¹² Reform allowed enterprises to retain part of their profits, which had previously accrued to the state. Thus, tax reform obviously had to accompany enterprise reform, but it has moved even more slowly. In 1983 an income tax (at a rate of 55%) was levied for the first time on state enterprises, but it was largely symbolic as enterprises had to hand over to the state their after-tax profits. In 1984-85 the government stopped collecting the after-tax profits, but imposed an adjustment tax on successful enterprises. An attempt at tax reform in 1987 was shelved, according to Xu Shanda, head of the tax reform department at the State Taxation Bureau, because of "ambivalence in the leadership".¹³ The current non-system involves enterprises in negotiating individual tax contributions with the government, which obviously has perverse incentive effects as an enterprise making additional profits has to bar-

¹¹In the same "Golden December" the Shenzhen Stock Exchange (SZSE) opened unofficially, but unlike the SSE bonds are not traded on the SZSE. In November 1991 31 bonds, valued at over 7 billion yuan, were trading on the SSE. Seven of these, accounting for two thirds of the total value, were Finance Ministry bonds. Ten were bonds issued by financial institutions (six by the Industrial and Commercial Bank, two by the Bank of China, and one each by the Construction Bank and the Communications Bank). The fourteen remaining bonds were issued by large enterprises, mostly but not all from Shanghai (four issues by a chemical company accounted for over half of the total value of enterprise bonds). One bond issued by a joint venture, Shanghai Volkswagen, traded on the SSE when the exchange first opened, but that bond matured during 1991.

¹²The impact of reforms on the government budget is analyzed in Blejer et al. (1991, pp. 19-30). McKinnon (1991, p. 111) reports that government revenue fell from 34% of GNP in 1978 to 19% in 1989.

¹³Quoted in *China Daily, Business Week*, 10 November 1991, p. 1.

gain with the government over how much of the profits it retains.¹⁴ It now seems certain that a uniform corporate income tax will be in place by the mid-1990s and that the value-added tax will be the other major revenue source. Meanwhile, government expenditures remain far ahead of revenues, requiring deficit financing either by bond issues or by increasing the money supply. For a government aware of the political consequences of hyperinflation, that choice is no choice.

For the macroeconomic policymakers at the People's Bank of China, the growth of a bond market provided the first opportunity to use more sophisticated monetary policies. During the 1988-90 austerity program open market operations appear to have been used to a limited extent. At their height the nominal interest rates on government bonds rose above 25% (and real rates reached 5-6%), and new bond issues certainly reduced the economy's excess liquidity. On the whole, however, the bond market was not large enough and open market operations were considered insufficient to defeat inflation. Thus at several points price reforms were postponed for fear of adding to inflation. There was, of course, ongoing opposition to price reform from conservative quarters, but the point is that even reformers felt a need to be cautious about risking the inflationary consequences of removing price controls. Thus, if price reform was to proceed and open market operations to be used for macroeconomic stabilization, the bond market had to be expanded.

The austerity program did achieve the goal of controlling inflation, but this was mainly done by a crude credit squeeze. Since many items of expenditure were politically untouchable, the squeeze fell harshly on a few discretionary areas (e.g. the state enterprises). This exacerbated the resource misallocation costs of macroeconomic policy because the most affected sectors also tended to be the most efficient, while inefficient activities continued to obtain scarce credit.

In pre-reform China the government controlled both the level and the allocation of credit. As it tries to influence the supply of credit indirectly by monetary policies, it is also concerned that the scarce credit

¹⁴Several attempts to remedy perverse incentive effects have had a negative impact on government revenue. Enterprises may negotiate their tax contribution for a multi-year period, but this contract system hurt government revenue when inflation accelerated in the late 1980s. In 1991 the government tried to encourage state enterprises by reducing the basic income tax rate to 33%, the same as for private firms and foreign-invested ventures, but this also reduced government revenue in the short-run.

should be efficiently allocated. After all, one of the main failures of physical planning was the misallocation of capital. Enterprise bonds play a role here in that they provide an instrument for creditworthy companies to raise capital, but the government is concerned that their bonds will draw funds away from more desirable projects (as well as from government bonds). Thus, enterprise bonds remain highly regulated because there is not an economy-wide set of market-determined interest rates. Further development of the non-government segment of the bond market awaits reform of the banking system.

IV. The Banking System

Before the 1980s banks in China were simply the administrative channels through which the government distributed funds. For most of the period the PBOC dominated the banking system, but four specialized banks were set up in the early 1980s and the PBOC was transformed into a central bank. With economic reform the scope of the banks changed, especially for the Bank of China which handled external transactions and was able to dominate the growing market for trade finance. The other specialized banks (Industrial and Commercial Bank, Bank of Agriculture, and People's Construction Bank) gradually became more aggressive in seeking deposits, but remained largely in their traditional areas of loan activity.¹⁵ In 1984 they were allowed to pay interest on savings accounts, but interest rate ceilings made the rate unattractive once inflation accelerated in 1988. In 1989 the Industrial and Commercial Bank issued a credit card, the Peony Card, but two years later there were still only 370,000 credit-card-holders among the bank's more than 500 million account-holders.¹⁶ Despite frequent reports of the banks increasing their deposit-taking, there remains a huge amount of cash in the hands of individuals (commonly believed to be anywhere from 200 to 500 billion yuan). Thus, the domestic banks have failed both to remove the cash overhang and to introduce a reasonable interest rate structure into the economy.

Both China's experience during the 1980s and the experience of Eastern Europe since 1989 suggest that banking reform is one of the most difficult parts of the transition from a centrally planned to a mar-

¹⁵The Bank of Communications and the CITIC Bank, created in 1986, are universal banks explicitly allowed to operate in all areas.

¹⁶*China Daily*, 2 December 1991, p. 2.

ket-oriented economy—even though it is one of the most crucial parts. The state banks do not have the experience to act as commercial banks in a competitive environment, and there is little pressure for them to change their behavior. In recent years there have been frequent official statements that the Chinese domestic banks will henceforth operate as profit-maximizing institutions, but nobody believes that the government would allow any of the big banks to go bankrupt.¹⁷ Therefore, more even than any other enterprises in China they face a soft budget constraint, and are not subject to any market discipline. In this situation the banks behave conservatively, favoring established clients, rather than seeking out new opportunities even if they might be more profitable.¹⁸

The Chinese solution to this impasse has been to institute cautious experiments in allowing foreign banks to do business in China. Initially these activities were limited to the Special Economic Zones (SEZ), and several foreign banks have long established branches in Shenzhen; but they cannot do business outside the SEZ, and are of no national significance. Then a limited experiment was begun in Xiamen in 1985. In 1990 foreign banks were allowed to open new branches in Shanghai, ostensibly as part of the Pudong development plan, but in practice they were allowed to conduct business outside Pudong. Then in 1992 a growing number of cities were allowed foreign bank branches.

In 1985 the first banking joint venture was approved. The Xiamen International Bank (XIB) was 60% owned by Panin Holdings of Hong Kong and 40% by three PRC institutions, including the Industrial and Commercial Bank. The XIB's customers are mainly Fujian joint ventures, for whom it provides a range of trade financing and loan services. In 1989 plans were made for the Asian Development Bank and two foreign banks, the Long-term Credit Bank of Japan and Interstate Bank of Hawaii, to take an equity share in the XIB, but the foreigners drew back after June 4th. In addition some foreign banks (e.g. the Hongkong Bank, Standard Chartered, the United Overseas Bank

¹⁷The PBOC itself displays ambivalence between wanting banks to be more market-oriented and fearing financial instability if they compete too freely. The continuing interest rate ceilings are one reflection, although they also serve the government's interest in keeping down the cost of government borrowing on the domestic market.

¹⁸The domestic banks are also constrained by lending dictated through the government's credit plan and by local pressure not to transfer funds across provincial borders.

Group of Singapore, and Credit Lyonnais) have branches in Xiamen, which mainly handle PRC-Taiwan business.¹⁹ On the whole, the Xiamen experiment has been on a small scale,²⁰ but it appears to have convinced the Chinese authorities that foreign banks could make a positive contribution.

In September 1990, as part of a package related to the New Pudong Area, foreign banks were allowed to set up branches in support of Pudong's development. The new branches were allowed to locate anywhere in Shanghai and to conduct their business throughout China. The only restriction on their activity appears to be that they cannot deal in RMB. In 1991 seven branches were approved, and two dozen further applications were in the pipeline.²¹ The full implications of this development are unclear, even to the bankers involved, who are unsure just what their major activities will be, but the number of foreign banks implies a significant increase in competition for trade finance, loans and other banking services. There were immediate spillover effects on other institutions as Sanwa Bank and Banque Indosuez took seats at the Shanghai swap centre, where they cannot compete on commission (these rates are fixed) but can compete on service, especially in changing US dollars into other currencies at competitive rates. There are also rumors that Indosuez and Standard Chartered are seeking seats on the stock exchange. (See next section)

By the summer of 1992 about 230 offices of foreign banks had been established in China. Of these, 190 are representative offices (half of which are in Beijing), which often limit themselves to looking for syndicated loans opportunities for the head or regional office outside China.

¹⁹The CL branch actually reported to CL's Taiwan office until 1992, when it began to report to the Shanghai branch.

²⁰The XIB only had 500 clients at the end of 1991, but it now has a branch in Fuzhou and also owns the third largest bank in Macau, Banco Luso-International. In 1992 the ADB injected \$200 million in cash, for a 25% shareholding, leaving the largest stake with the current Hong Kong partner, Min Xin, equal to 36.75%.

²¹Four banks had maintained their Shanghai branches since 1949, although their scope of business had been severely restricted during the 1960s and 1970s. Of these the Hongkong Bank is the largest, followed by Standard Chartered, the Bank of East Asia and the Overseas Chinese Bank Corporation. In the mid-1980s their scope of business was expanded, and especially the first two captured some of the Bank of China's previous monopoly over trade finance. The seven new branches are Bank of America, Citibank, Credit Lyonnais, Banque Indosuez, Sanwa Bank, the Industrial Bank of Japan and Bank of Tokyo.

Within the SEZs there are sixteen branches in Shenzhen, two each in Zhuhai and Haikou, and one each in Shantou and Shekou.²²

In the second half of 1992 foreign banks were authorized to open branches in more coastal cities, and these branches were intending to serve large areas of China. Banque Nationale de Paris, the largest European bank in Hong Kong, plans to serve northern China, including Beijing, from its Tianjin branch. The Bank of Tokyo and Industrial Bank of Japan branches in Dalian will serve North-east China. The most approvals were in Guangzhou, serving the dynamic area of southern China.²³ The initial focus has been on the coastal provinces, but the rapid proliferation of approved branches suggests it is only a matter of time before foreign bank branches are allowed elsewhere, so that their influence is felt throughout the country.

On current business volume there is little prospect of the foreign banks making substantial profits in the near future. There is also a danger that overregulation will stunt the banking sector's growth; e.g. each of the new Shanghai branches had to deposit \$10 million as cash with the Bank of China, which is a hefty initial reserve requirement.²⁴ Nevertheless, the eager response by foreign bankers to the opening of the Chinese market suggests that they believe there will be business for them in the long-run.

Meanwhile, the diversification which is occurring in the domestic bank's business mainly concerns business in foreign currency. The

²²The figures are from *South China Morning Post, China Business Review*, 30 August 1992, p. 3, quoting Hongkong Bank sources. Zhuhai appears to be being integrated as a financial market with Macau, where the Bank of China is the largest bank and XIB's subsidiary is the third largest. The second largest Macau bank, Portugal's Banco Nacional Ultramarino, is planning to remain in Macau after its return to China in 1999.

²³The branches approved in Guangzhou included Dai-ichi Kangyo, Societe Generale, Bangkok Bank, Bank of East Asia, Kwangtung Bank, and Nanyang Bank; the last one is registered in Hong Kong, but is wholly owned by the Bank of China. Other cities for which approvals were granted are Qingdao, Ningbo and Nanjing.

²⁴One of the banks voluntarily deposited \$15 million to show "good faith." All of the seven approved banks had special links with China, mainly through financing major projects, and there is an impression that it was important to curry official favor. The Bank of Tokyo's approval was actually delayed for some months in retaliation for the bank's opening of a Taiwan branch (*International Herald Tribune*, 16 October 1991, p. 11). Picking favorites is not the route to an efficient system, but as long as the number of branches is large and includes major banks it may not be too harmful.

Construction Bank in particular has started to invade the Bank of China's previous monopoly, raising about a billion dollars worth of foreign exchange deposits in 1990 and about 30% more in 1991 and making hard currency loans. By the end of 1991 over three hundred of the bank's branches handled international business, and in November 1991 it opened its first foreign branch in London. The other specialized banks are also planning to extend the number of branches with international desks, especially in the Shanghai region.²⁵ In this competitive area, the new foreign bank branches must increase the competitive pressure on the domestic banks, even if for the moment the latter are shielded from competition for RMB deposits and loans.

One interesting development is the joint-venture agreement signed in August 1992 between the Banque Nationale de Paris (BNP) and the Industrial and Commercial Bank. These are two banks which missed the boat on the opening up of the Chinese banking system; a joint venture offers an opportunity for BNP to make up for its failure to be included in the first group of branch approvals and for the Industrial and Commercial Bank to gain part of the international banking action from the Bank of China and the Construction Bank. This type of Sino-foreign alliance illustrates the dynamics of change once the reform process has been initiated in the banking sector. The exact scope of business of the joint venture is unclear, but the potential exists for bridging the divide between foreign currency and RMB business.

In sum, the opening up of the banking sector of foreign competition is proceeding rapidly in the early 1990s. The new foreign bank branches must increase the competitive pressure on the domestic banks. Even if, for the moment, the latter are shielded from competition for RMB deposits and loans, the segmentation is likely to be unsustainable in the long-run.²⁶ Increased competition in the banking sector will improve the quality of financial intermediation available to enterprises in China, and hence improve the urban investment environment.

²⁵In July 1992 the PBOC announced that domestic banks would be encouraged to open branches abroad to help raise capital. The early applications included requests by the Construction Bank to open branches in Singapore and Japan and by the Industrial and Commercial Bank to move into Kazakhstan. Meanwhile, the Bank of China received permission to open an office in Seoul (over a month before diplomatic relations were established).

²⁶The move towards increasing de facto convertibility analyzed in section II is a major reason why it will be difficult to isolate domestic from foreign currency business.

V. Equity Markets

As with the secondary bond market, it is difficult to track the origins of share-trading in the PRC. Early in the reform process, some forms of shares appear to have been issued spontaneously as enterprises sought ways to distribute their profits. Oversholt (1991, p. 409) describes an example from a Sichuan village in 1981. These developments were most pronounced in Guangdong, but several of the secondary bond markets referred to above also appear to have included informal share-trading. Part of the confusion is because reports confused stocks and bonds, which in turn led participants in the markets to confuse enterprise bonds with share ownership.

The first reported stock company was the Tianqiao department store in Beijing. During the 1984-85 liberalization period the government began to harness the growth of sharetrading in order to experiment with state enterprise reform, and some enterprises were grouped into new holding companies, authorized to sell shares. Between 1984 and 1988 about six thousand companies issued shares, 2483 in 1988 alone. The shares could be traded through securities companies, and fairly organized markets emerged in Shanghai, Shenyang, Wuhan, Beijing and Guangdong, as well as smaller markets (Lloyd George, 1989, pp. 237-9).

In Shanghai trading took place in one of the banks, and banks began to publish regular reports on the leading share-issuing companies. The market was, however, a rather strange one in that most "shares" were more like variable rate bonds (with the return varying according to the enterprise's profits) and there were no real sellers (just buyers for any new issue, but no secondary trading). There were problems of the lack of standardization, the absence of any guarantee against risk, and the arbitrary asset valuations, but there remained a ready demand for new issues because they offered a better return than the restricted interest rate on bank deposits.

The situation became more formalized in 1990 when two stock exchanges were approved. The SSE opened in December 1990. The SZSE opened on a trial basis in the same month, and opened officially in July 1991.²⁷ Both exchanges had a small number of listings in 1991:

²⁷There have been conflicting reports about plans to open other stock exchanges. When Guangzhou's bond market opened in July 1991 city officials

eight companies in Shanghai (which also trades bonds, see above) and six in Shenzhen. This led to chronic excess demand for shares, especially in Shanghai, which pushed up prices so that PE ratios became very high (from 26 to 437 in November 1991) and valuations bore little relationship to a company's true worth. In both cities an over the counter market continues to exist alongside the official exchange, and in Shenzhen regulation initially caused a fall in prices.²⁸ It is already clear, however, that sale of shares is a practical means of mobilizing domestic savings as well as raising capital for enterprises.²⁹

The emergence of share ownership has also provided a vehicle for foreign ownership of Chinese companies. Shares of companies quoted on the SZSE quickly started to trade in Hong Kong, although this is illegal and had to be done via Chinese friends or relatives.³⁰ Late in

wanted it to trade shares but were unable to get permission from the PBOC. Wenzhou in southern Zhejiang Province has also requested permission to open a stock market, and reportedly has a curb market already (*Business China*, 30 September 1991, p. 142). The mayor of Tianjin on a trip to England in July 1991 announced his city's intention to have a stock exchange. PBOC officials have stated that there will be more approvals, but senior PBOC staff want to keep a tight rein and avoid proliferation of unregulated stock markets. When the Hainan provincial authorities opened a stock exchange in Haikou against the PBOC's advice in March 1992, a vice premier (Zhu Rongji) went to Hainan within less than a month to ensure the closure of the exchange; holders of the three listed shares suffered losses as they scrambled to sell them (*South China Morning Post*, 27 April 1992, p. 1). Xiamen residents queued for the right to buy shares in four local firms in June 1992; under pressure from Beijing the local authorities shelved their plan to open a stock exchange, but continued with the share sales expecting the shares to be listed in Shanghai or Shenzhen (*South China Morning Post*, 30 August 1992, *China Business Review*, p. 3).

²⁸The different situations led to arbitrage as funds from Shanghai went to Shenzhen in the belief that SZSE prices represent better value than SSE prices.

²⁹In both Shanghai and Shenzhen announcement of new issues has led to mass subscription. For one new issue in Shanghai in August 1991, the venue had to be moved from schoolrooms to a sports stadium in order to handle the crowds. New application procedures have been developed since then. For a SZSE issue allocated in November 1991, almost three million application forms were printed and people still queued overnight in order to be sure of obtaining an application form which would go into a lottery to determine who would be eligible to purchase shares. A similar system used for a SSE issue in early December went unreported in the media, but local rumors were of people being seriously injured in the crowd scenes. Finally, the drawbacks of a lottery system were highlighted by the mass influx into Shenzhen in August 1992 and ensuing riots observed by visitors and foreign reporters.

³⁰In 1988 there were several rumors of shares being authorized for sale to for-

1991, however, the PBOC formally approved the sale of shares to foreigners. Designated B-shares are denominated in RMB but settlement must be in foreign currencies. The first B-shares were floated in late November by Vacuum Electron, the largest company listed on the SSE; the shares were sold in Hong Kong and trading on the SSE began on February 21st 1992. At approximately the same time two Shenzhen companies were allowed to issue B-shares.

The Vacuum Electron Company (VE) consists of six factories manufacturing colour picture tubes for TVs and related products. It also has a joint venture with a Hong Kong company, and several subsidiary operations. VE has been one of the more successful state-owned enterprises in Shanghai. When it was formed in December 1986 VE was authorized to issue two million A-shares, of which 500,000 were sold between 1987 and 1989, and the remainder are still held by the state. After now selling one million B-shares, because it is one third foreign-owned it will be given joint venture status which entails certain privileges with respect to taxes, foreign exchange and so forth. Vacuum Electron is likely to provide a blueprint for future plans to reduce the chronically inefficient state-owned sector in China. Admittedly it was a good company to start with because it was profitable, has a modern production line and faces a booming domestic market for its product, but the principles of privatization could be copied by other profitable or potentially profitable state-owned enterprises; their valuation would simply be less.

During the summer of 1992 there were new issues of A and B shares in both markets. In Shenzhen the domestic shares continued to face chronic excess demand, and the violence associated with the distribution of application forms in Shenzhen in early August received wide publicity. In Shanghai, however, the reaction to this news was a 20% fall in prices in two days. The SSE index's continued decline showed that there had been a sign that share prices could go down as well as up.³¹ The Credit Lyonnais A index peaked at 11,145 on May 25; in

eigners, including a Shenyang automobile company and a Shenzhen conglomerate (Lloyd George, 1989, pp. 240-1), but these appear to have been shelved in spring 1989. Some Hong Kong listed companies have almost all of their activities in China (e.g. Tian An or Guangdong Investment), and are in effect Chinese companies which have sold shares to foreigners.

³¹Prices on the SSE had been in decline since late May. On May 21 the 5% cap on daily price changes was removed; prices more than doubled in one day and rose rapidly in the next two trading days before a correction began.

October 1992 it had fallen below 3000. The SSE's B share index performed even more poorly over the summer as eight new issues flooded the market and sentiment among foreign investors shifted towards the position that offer prices were being set too high. Despite concerns about the Shenzhen violence and the market's volatility, these recent developments are signs of greater maturity, at least in the B share market, where foreign analysts are increasingly concentrating on individual companies' prospects rather than recommending indiscriminate buying.

As in the banking sector, artificial walls between foreign and domestic shareholders are likely to be unsustainable.³² Table 1 shows that a significant differential has opened between A and B share prices for the same company. This was highlighted when Vacuum Electron announced a rights issue in September 1992. The offer price was the same for A and B shareholders, but it represented a discount on current A share prices and a premium over B share market prices. Obviously A shareholders would take up the offer and B shareholders would not, leading to a dilution of the latter's stake in the company. In the event the issue was delayed in the face of the protests and by late October the A share market price had fallen so far that the issue had to be abandoned. The episode revealed, however, a potential conflict between domestic and foreign shareholders which could make B shares unattractive unless their holders are granted effective rights.

A related problem is the division between private and public shares; the latter are held by domestic banks and other state enterprises and officially cannot be traded. Underlying these divisions is the fundamental issue of whether private shareholders, and especially foreigners, will ever be allowed to obtain control over a Chinese company, or even a significant voice in management—and if not whether shares in Chinese companies will be attractive to foreigners.³³

³²Once again, however, the restriction is tied to other restrictions, insofar as free exchange of A and B shares would render the yuan's inconvertibility nugatory.

³³Attempts to tap foreign capital by issuing shares have also bypassed the Chinese stock exchanges. In October 1992 China Brilliance Automotive Holdings was listed in New York. This is a Bermuda-registered company, whose underlying asset is a 51% holding in Shenyang Jinbei Auto Co. (Jinbei A shares are listed on the SSE); 28.75% of Brilliance's shares were offered to the public, while Jinbei retained 15.37% and a Chinese state body 55.88%. In 1993 some Chinese companies' shares will be traded directly on the Hong Kong stock exchange.

TABLE 1

SHARES LISTED ON CHINESE STOCK EXCHANGES, 22 OCTOBER 1992.

Shanghai		Shenzhen	
A shares (price in RMB)		A shares (price in RMB)	
Yanzhong (electronics)	85.57	Development Bank	43.00
Vacuum Electron	732.50	Vanke	24.50
Xingye Real Estate	249.78	Gintian Industry	33.80
No. 2 Textile Machinery	120.75	An Da Industrial	24.20
Light Industry Machinery	77.20	Champaign Industrial	9.50
Jiafeng Cotton	81.00	Bao'an Enterprise (Group)	27.20
United Textile	120.68	Properties & Res. (Group)	24.15
Special Steel-tube	98.25	Southern Glass	19.85
Jinbei (Auto)	80.03	Petrochemical (Holdings)	21.75
China Textile Machinery	88.00	Huayuan Industrial	17.80
Dazhong Taxi	140.00	Zhongchu (food & beverages)	16.40
No. 1 Pencil	121.50	Konka Electronic (Group)	21.70
Wing Sung	140.00	China Bicycles	20.60
Rubber Belt	91.15	Victor Onward Textiles Industrial	14.80
Feile Acoustics	245.65	Huafa Electronic	14.90
Aishi	289.50	SEG Dasheng	30.25
Feile (services)	82.30	Zhenye	50.80
Yuyuan (property)	151.00	Jinxing Dev. & Service	19.35
Phoenix Chemical	150.00	Shenbao Soft Drinks	14.90
B shares (price in \$US)		B shares (price in yuan)	
Vacuum Electron B	\$48.00	China Southern Glass B	9.30
No. 2 Textile Machinery B	\$4.95	Konka Electronic B	10.00
Dazhong Taxi B	\$6.65	Properties & Resources B	13.80
Wing Sung B	\$6.00	China Bicycles B	8.00
No. 1 Pencil B	\$5.30	Huafa Electronic B	7.50
China Textile Machinery B	\$4.20	Petrochemical (holdings) B	9.30
Rubber Belt B	\$4.00	Victor Onward Textiles B	5.90
Chlor-Alkali B	\$4.10	Zhongchu B	7.80
Rubber & Tyre B	\$7.95	Shenbao B	4.90

As the number of listed companies increases, China's stock markets should shed some of their casino atmosphere. Domestic securities firms are already planning mutual funds to make shareholding available to less well-informed investors. Foreign financial institutions also have plans to market a Shanghai Fund once a reasonable number of B-shares is trading on the SSE,³⁴ which the Chinese authorities like

³⁴A Shanghai Fund is attractive because it is believed that Shanghai prices will not be highly correlated with prices in the major stock markets, so that

because it promises to bring foreign capital into China without allowing foreigners to again a controlling interest in Chinese joint-stock companies.

The Chinese authorities appear committed to the rapid expansion of the stock market and of supporting services. By October 1992 there were about 250 members of the two exchanges, from 38 cities. The SSE's second floor, opened in December 1992, will allow its membership to triple to around 600, and a third floor opening in 1993 will permit another doubling of numbers, while the new exchange being built in Pudong to rehouse the SSE in 1995 has a capacity for 5-6000 seats. Meanwhile, the PBOC had established the principle that other cities would not be allowed to open stock exchanges, and enterprises from Xiamen, Guangzhou and elsewhere were queuing up to be listed on the SSE or SZSE.

One Major bottleneck is the lack of international-standard accountancy services. The authorities have addressed this by encouraging Ernst and Young, Arthur Andersen, KPMG Peat Marwick, and Price Waterhouse to form joint ventures. In July 1992 the PBOC also appointed seven Hong Kong accountancy firms (including the four just mentioned) to act as auditors of potential cross-provincial listings. These moves, necessary for the credibility of a greatly expanded stock market system, reflect Chinese commitment to allowing full-service financial centres to develop.³⁵

VI. Conclusions

The financial developments described in this paper fall into two cate-

international money managers will want to hold Shanghai Fund shares in order to reduce their portfolio's volatility. The SZSE, on the other hand, is expected to follow the Hong Kong Stock Exchange. Several China funds were set up in the first half of 1992 (by GT Management, Barclays, SHK, and Wardley), but initially they were mostly invested in "China concept" stocks listed on the Hong Kong stock exchange.

³⁵Not only would such a commitment have seemed unbelievable as recently as 1990, but also it reflects a fairly clear conception of what is involved. Even though there remain uncertainties about the Chinese attitude towards such issues as shareholders' rights, there is no doubt that the need to provide reliable information to potential shareholders is appreciated. The ambitious construction plans in Pudong also reflect a concrete commitment to the expansion of Shanghai as a financial centre, even if official claims that it will be the leading financial centre of the western Pacific region by the end of the century are overstated.

gories. International transactions have been substantially freed by the emergence of a more or less market-determined exchange rate which is available for most business transactions. This situation was only really established a decade after the original adoption of the Open Door policy in 1978-79. Although there still remain some restrictions on access to foreign exchange transactions at swap centre rates, they are being whittled away by the end of 1991 and were of little economic importance.

Domestic financial markets have been liberalized much more slowly. The leadership retained through the 1980s a suspicion of entrepreneurial bankers (especially foreign banks) and of securities markets (especially of foreigner shareholders). Thus, although bonds were issued and interest paid on bank deposits, both the bond market and the banking system remained heavily regulated.

As in all Chinese reforms the government prefers to move cautiously, beginning with limited experiments. In the financial sector, however, overcautious reform proposals in the 1980s had minimal effect.³⁶ In the 1990s the pace of reform accelerated. The government needs an active bond market in order to borrow from the public and to manage monetary policy, as well as wanting enterprises to be able to issue bonds and shares in order to tap the build-up in unutilized private savings. Partial command-style approaches lead to a misallocation of funds, because they obscure the role of the interest rate in resource allocation. Banks could also play an important role as financial intermediaries if they would compete for funds and for loans.

In 1990 and 1991 more far-reaching experiments began on three fronts. First, government bonds are being competitively marketed instead of being distributed by compulsion. Second, the two stock markets have been operating since December 1990. Third, in 1991 new

³⁶Comparison with the east European economies emphasizes just how cautious China has been in this area. China's post-1978 reforms in agriculture and foreign trade and investment were more radical than anything in East Europe, and the accompanying financial changes were only adopted later in East Europe. China's removal of sectorial restrictions on the specialized banks' activities in 1984, for example, anticipated similar changes in Hungary in 1987, the USSR in 1988, Poland in 1989 and Czechoslovakia in 1990. Once the Eastern European countries moved to more purposeful economic reform after the 1989 political upheavals, however, they moved much faster. Poland, Czechoslovakia and Hungary are now far beyond China both in banking reform and in the bond market (e.g. they hold treasury or central bank bill auctions), and to varying degrees they have liberalized interest rates.

foreign bank branches were allowed outside the SEZs for the first time since 1949. In banking the limited experiment is to allow competition between Chinese and foreign banks for foreign currency denominated business, while reserving RMB transactions for domestic banks. In financial markets, however, such walls often break down because markets are interconnected.

Chinese economic reforms during the 1980s have been lauded as successful case of gradualism, in contrast to the Big Bang transition strategy adopted in Poland and other Eastern European countries. As China moves to embrace financial reform, the experiments become harder to control and gradualism is likely to become more difficult to sustain. With a modern banking system, bond market and stock exchange system, Chinese market socialism will become increasingly harder to distinguish from other mixed economies.

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