



**Stanford**  
Center for International  
Development

**Working Paper No.  
202**

**China's Emerging  
Domestic Debt  
Markets**

by

**Pieter Bottelier\***

January 2004



Stanford University  
John A. and Cynthia Fry Gunn Building  
366 Galvez Street | Stanford, CA | 94305-6015

\*Adjunct Professor, School of Advanced International Studies, Johns Hopkins University

## China's Emerging Domestic Debt Markets: Facts and Issues

Discussion paper for a Conference on Chinese Economic Policy Reform organized by  
The Center for Research on Economic Development and Policy Reform, Stanford  
University, 18 – 20 September 2003

Pieter Bottelier<sup>1</sup>

### *Abstract*

*In spite of the exponential growth of Government bond issues in recent years, China's debt markets remain relatively narrow, illiquid and segmented, while the aggregate supply of tradable bonds appears low relative to market demand. Domestic demand for bonds has soared in recent years, partly as result of a sharp decline in equity prices. The range of bond instruments in terms of issuers, maturities and yields needs to be broadened, while new financial instruments, such as asset-backed securities need to be developed. The Government should discontinue using the domestic bond market exclusively or primarily for fiscal purposes. Domestic debt markets have to play a larger role in corporate finance, in meeting the requirements of institutional investors and in facilitating a market-based process of non-performing loan clean up, which remains a huge challenge. To accelerate development of more diversified domestic bond markets, the Government should permit high-quality domestic and foreign firms as well as multilateral development banks to enter the primary market as issuers, both in local currency and in foreign exchange (forex). In due course, issuing rights should be extended also to selected provinces and municipalities. Permitting the simultaneous issue and trading of bonds in multiple markets with full arbitrage between them would reduce market segmentation. Government should develop and perfect as rapidly as possible the legal and institutional framework for domestic debt markets, including bankruptcy and foreclosure laws and procedures, reliability and efficiency of courts, independent rating agencies and enforceability of court decisions. To avoid market disruption and unhealthy competition, domestic interest rates, still largely Government-controlled, should only be liberalized gradually. As financial sector reforms, including state bank recapitalization and listing, progress, controls on interest rates and on capital account transactions can be relaxed. It is to be expected that yield curves for RMB-denominated bonds, which are remarkably flat compared to yield curves for US Treasuries, will gradually become more upward sloping as domestic capital markets in China develop and interest rates begin to reflect market realities.*

---

<sup>1</sup> The author served as Chief of the World Bank's Resident Mission in China from 1993 to 1997. He teaches graduate courses on China's economy at Johns Hopkins University and at Georgetown University. The paper has benefited greatly from feedback by Oliver Fratzscher of the World Bank. Any mistakes are the author's responsibility. A list of abbreviations used is included at the end.

## 1. Introduction

The pace of financial sector development in China has accelerated as a result of membership in the World Trade Organization (WTO), but capital market reform continues to lag behind developments in the real economy. Within capital markets, debt markets lag behind equity markets. A rapid broadening and deepening of domestic debt markets is needed to:

- meet corporate financial needs. Chinese enterprises are overly dependent on bank credit;
- assist lower level governments in the financing of local infrastructure;
- satisfy the need of institutional investors for a broader range of financial instruments;
- facilitate central bank open market operations (OMO) and other aspects of macroeconomic management;
- facilitate resolution of non-performing loans (NPL) issues through financial markets; and
- facilitate a gradual opening of China's capital account.

This paper presents a *tour d'horizon* of relevant data and issues, not an in-depth analysis of particular debt markets. It identifies a number of institutional and policy changes needed to ensure that domestic debt markets will better serve China's broader economic modernization and reform objectives.

China's debt market has become quite large in the past five years, but remains highly segmented, dominated by Government bonds (GB) and in other respects underdeveloped. The secondary market for GB is dominated by repurchase contracts (repos); the spot market is relatively small. Because of China's growing fiscal deficits and the requirements of a rapidly growing number of institutional investors, both the primary and secondary markets for GB are likely to grow fast in the years ahead and the range of maturities offered is likely to widen. There is also a need to broaden and deepen the market for corporate bonds (CB) and to give access to that market to non-state enterprises. Provincial and municipal bonds as yet do not exist - at least not officially - but should be introduced to facilitate the financing of local infrastructure.

Non-bond debt markets began to emerge only recently. They remain essentially limited to the recycling of NPLs by four state-owned asset management companies (AMCs) and two associated joint ventures (JV), one with Goldman Sachs and another with Morgan Stanley, two American investment banks. A secondary market for such other non-bond debt instruments as trade bills and receivables does not yet exist, but will undoubtedly develop in the years ahead. Direct loan sales (including of NPLs) by the banks should also become possible. There are potentially significant synergies between debt market development, NPL resolution (which remains a huge and largely unresolved problem in China) and market-oriented economic reforms in general. Without a significant deepening of financial sector reform, it is hard to see how China's massive remaining NPL problem can be resolved and rapid growth sustained.

## 2. Debt Markets in the Broader Context of Financial Sector Development

In China's home-grown, incremental approach to economic transition, financial market reform did not become a priority until the liberalization of markets for goods and services had advanced quite far. The state-owned commercial banks continued to act mainly as agents of the State, implementing the national development and credit plans, until the mid-1990s. Some local, unofficial and unregulated markets for bonds and equity shares began to develop spontaneously in the 1980s.<sup>2</sup> It wasn't until after the opening of stock exchanges in Shanghai and Shenzhen (December 1990) that the Government began to pay serious attention to the regularization and supervision of such markets. By initially keeping the financial sector fully under state control and using state-owned commercial banks as fiscal agents, China was able to maintain fast growth with social stability and full (urban) employment during the initial phases of transition. In this way China bought time so that people could adjust and institutions be developed. Delayed reform of state-owned enterprises (SOEs) and delayed liberalization of the financial sector were central to this cautious, gradualist approach.

Things began to change in the early 1990s when China once again experienced high inflation due to excessive credit expansion for investment financing. This time, however, the economy was already semi-marketized. New policy instruments were needed to deal effectively with the macroeconomic instability of those days. The introduction of formal central regulatory controls over the two stock exchanges<sup>3</sup> was combined with the beginning of financial market liberalization and state bank reform. The Government also subjected itself to stronger market discipline by denying itself the option (from 1994) to borrow from the People's Bank of China (PBC – the central bank) for fiscal purposes. This measure was part of a complex set of financial sector reforms that included *inter alia* exchange rate unification, formal establishment and regulation of the interbank market (IM) for short-term loans, an interbank foreign exchange market, three specialized policy banks, and the start of OMO by the PBC. A Central Bank Law and a Commercial Bank Law had been under preparation since 1993, and the National People's Congress (NPC) passed them in 1995. Altogether, the measures of 1994/95 gave a powerful boost to developing the domestic market for GB, both primary and secondary. There was as yet no market for non-bond debt instruments. Trading of GB on the IM was introduced in August 1997.

Financial sector reform moved center stage after the Asian financial crisis of 1997/98. The crisis in neighboring countries made China's leaders more keenly aware of the potential vulnerability of the country's financial system, in particular the state-owned

---

<sup>2</sup> Stephen Green, *China's Stock market. A Guide to Its Progress, Players and Prospects*. The Economist 2003.

<sup>3</sup> The China Securities Regulatory Commission (CSRC) wasn't established until late 1992, about two years after the stock exchanges of Shanghai and Shenzhen started operations under local government supervision, the former with the official blessing of the Central Government, the latter without (Stephen Green *op. cit.*).

commercial banks (SCB), which had accumulated huge volumes of unrecognized NPLs during the years that they served primarily as fiscal agents of the State. Four state-owned AMC's were established in 1998 to assist in the process of NPL clean up, which started in 1999. This marked the beginning of a non-bond debt market in China, focused initially exclusively on NPLs. Corporate bonds have been issued since the mid-1980s, initially without a regulatory framework. Since formal regulation was introduced in the early 1990s, the primary CB market has been reserved for a few selected SOEs and developed unevenly. The primary and secondary markets for CB have remained very small. There is now an urgent need to broaden the financial base of Chinese corporations, both state and non-state, to reduce their currently excessive dependence on bank loans and exposure to the risk of higher interest payments as lending rates are gradually being liberalized. Debt market development is also required to broaden the range of instruments in which institutional investors can invest.<sup>4</sup>

### **3. The Market for Central Government Bonds**

In most market economies, Government bonds are the foundation for broader domestic debt markets. The GB market offers pricing benchmarks for other types of debt instruments such as corporate and municipal bonds and it serves as the arena for OMO by the central bank. Therefore, the logical way to start a review of China's emerging domestic debt markets is to look at the market for GB. Thus far, GB have dominated China's debt markets, which in 2002 accounted for about 95 percent of all traded debt excluding NPLs. The total amount of GB issued and traded has grown very rapidly during the past decade, especially since 1998 when China started a fiscal stimulus program aimed at preventing a sharp economic slow-down in response to the Asian financial crisis of 1997/98. Compared to more developed market economies, however, China's domestic GB market, though rapidly growing, is small relative to the needs of the country's burgeoning institutional investors and managed funds.

Table 1 shows for year 2000 the distribution of financial assets among three financial asset groups, other than cash, for China and selected comparator countries. Bank deposits continue to dominate the picture in China, but the shares of bonds and tradable equities are rising rapidly. With regard to equities, the comparison in this table is limited to tradable instruments; in China about two thirds of all shares listed on the two stock exchanges are owned by the Government or its agents and are currently not tradable.

---

<sup>4</sup> An excellent overview of China's rapidly growing institutional investor base is provided in Yongbeom Kim *et.al.*, *Developing Institutional Investors in People's Republic of China*. World Bank Country Study Paper, September 2003.

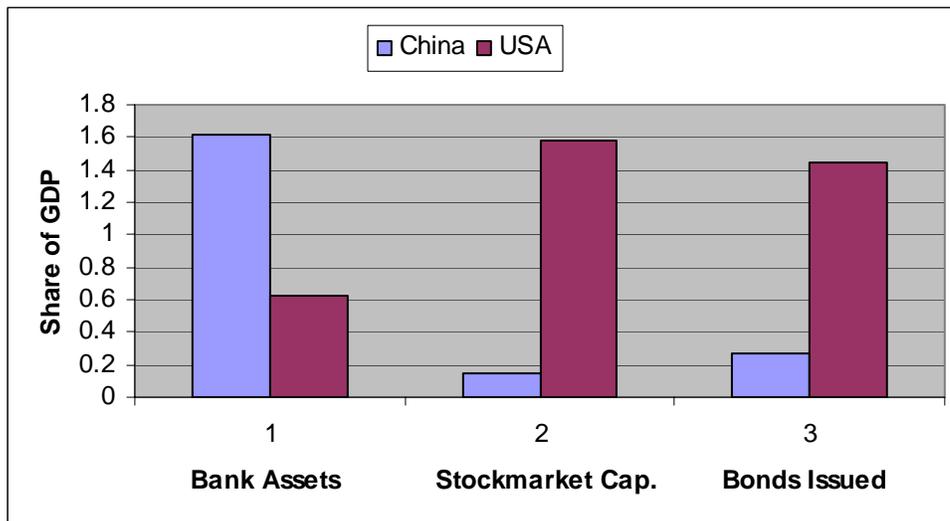
**Table 1: Distribution of Financial Asset Groups Other Than Cash in 2000.**  
(percent, total equals 100)

Country	Deposits	Bonds	Tradable equity
China	77.0	13.3	9.7
South Korea	39.4	41.4	19.2
Thailand	60.2	21.8	18.0
Brazil	14.9	49.0	36.1
Chile	28.4	11.3	60.3
South Africa	19.7	17.3	63.0

Sources: IMF and World Bank statistics

Chart 1 shows the relative immaturity of China's financial system compared to that of the US in the year 2001. Bank deposits still dominate China's financial system. As a percentage of GDP they are almost three times as important as in the US. By contrast, tradable equities in the US are, in relative terms, almost ten times as important as in China. The volume of bonds issued in the US is more than five times as large, relative to GDP, as in China. Moreover, Chinese enterprises are excessively dependent on bank loans for their financing. The share of equity and CB in the financing of Chinese enterprise is typically quite small.

**Chart 1. Three Groups of Financial Assets in China and the US.**  
(as share of GDP; 2001)



Sources: China Statistical Yearbook, US Federal Reserve.

### *History of China's GB Market.*

Domestic borrowing by the Chinese Government between 1949 and 1981 was sporadic and the amounts involved were small. The aggregate amount borrowed during this 32-year period (in 1950, and during the 1954-58) was only RMB 3.85 billion yuan.<sup>5</sup> During the Mao period, there was no trade in government debt. Since the start of market-oriented economic reforms (December 1978), the Government has issued bonds every year beginning in 1981. In the 1980s, issues were small and in essence a form of taxation; they were part of the national credit plan. The GB were force-placed on the basis of administrative quotas and payments for bonds were often deducted from payrolls or withdrawn from bank accounts.<sup>6</sup> State banks were not allowed to trade in GB, but individuals and non-bank agencies spontaneously began to trade government paper in unofficial curb markets. Thus, much like equity markets, unofficial bond markets started in China in the 1980s without explicit government authorization and without a legal or regulatory framework.

Even today, China's legal and regulatory frameworks for government debt issues and secondary market trading are very limited. There is as yet no government debt law. The Treasuries Regulation issued by the State Council in 1992 governs new GB issues. Secondary market trading is regulated by the PBC for the IM and by the China Securities Regulatory Commission (CSRC) for the two stock exchanges. The Securities Law, which was passed by the NPC in December 1998 and became effective in July 1999, does not cover government debt. It does require, however, that listed bonds traded on the stock exchange must be traded through centralized competitive bidding.

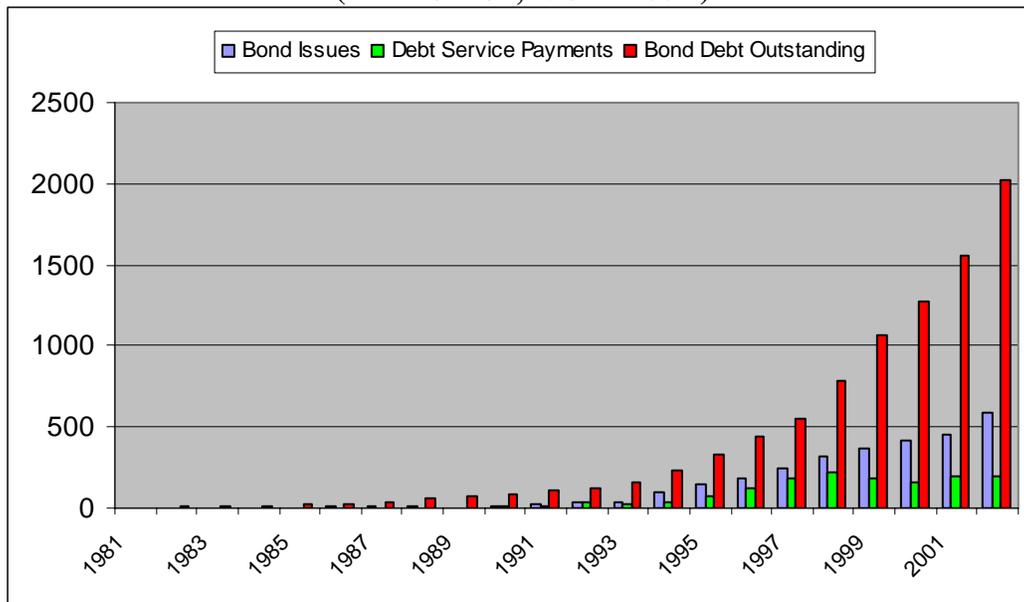
In response to market pressures, the Government gradually legalized bond markets in the late 1980s and began to tailor new issues to market preferences; shorter maturities were introduced and coupon rates increased to make bonds competitive with bank deposits. The secondary bond market developed more quickly after the opening of stock exchanges (which could list bonds) in Shanghai and Shenzhen. The first voluntary placement of GB occurred in 1991. However, captive markets have remained part of the system. The now defunct Wuhan Securities Exchange Center, established in 1992, was for some years China's largest bond trading center, until the stock exchanges in Shanghai and Shenzhen absorbed this function in the mid-1990s. The next major development was the Government's policy decision to stop borrowing from the PBC for fiscal purposes. From 1994, the Government financed all budget deficits through borrowing in capital markets. Domestic GB issues jumped from RMB 31.5 billion yuan in 1993 to RMB 102.9 billion yuan in 1994 and rose steeply every year thereafter (Chart 2). About 55 percent of the proceeds of new issues during the past ten years was used to service existing bond debt (principal and interest).

---

<sup>5</sup> Shuanglin Lin, *China's Government Debt: How Serious?* In *China: An International Journal*, Vol. 1, No. 1, March 2003

<sup>6</sup> A. Kumar *et.al.*, *China's Emerging Capital Markets*. FT Financial Publishing Asia Pacific, 1997.

**Chart 2. Central Government Domestic Bond Issues, Debt Service Payments and Outstanding Domestic Government Bond Debt (RMB billion; 1981 – 2002.)**



Source: MOF, Finance Yearbook of China. Please note: this Chart excludes forex-denominated GB and bonds issued by state-owned financial organizations such as policy banks and the four AMC's.

The second largest issuer of tradable domestic bonds in China (not shown in Chart 2) is the China Development Bank (CDB), one of the three “policy banks” created in 1994 to facilitate the commercialization of the SCB.<sup>7</sup> The CDB specializes in financing infrastructure projects with long gestation periods, for example, the Three Gorges project. In 1995- 2002, the CDB issued RMB 1,203 billion yuan worth of domestic bonds (44 percent of the amount of GB issued during the same period). According to the CDB’s Annual Report for 2002, the amount of securities outstanding at the end of the year was RMB 860.5 billion yuan (42.4 percent of the amount of GB outstanding at that time). As the Government does not formally guarantee CDB bonds, they are therefore excluded from official Government debt statistics.<sup>8</sup> For the analysis of China’s public finances, however, CDB bonds should be regarded as semi-official Government debt. Many of the CDB’s loans are invested in Government-sponsored projects and at the Government’s behest. Moreover, price differences between comparable CDB and Government bonds in the secondary market tend to be very small, which suggests that the market expects CDB securities to be substantially backed by the Government. In September 2003, the CDB successfully issued US\$ 500 million worth of bonds in the domestic market. It was the first dollar-denominated bond issued by a public agency in China. The only other policy bank to have issued bonds in the domestic market is the Export-Import Bank. Its bond debt outstanding at the end of 2002 stood at about RMB 119 billion yuan.

<sup>7</sup> The other two are the Agricultural Development Bank of China and the China Export-Import Bank.

<sup>8</sup>The CDB was the first public agency in China to issue long-term floating rate debentures, subordinated debt, strip bonds, and other new instruments contributing to capital market development and diversity in China.

The third largest issuer of domestic bonds is the group of four state-owned AMCs established in 1998 to help recycle NPLs of SCBs and the CDB. The estimated face value of AMC bonds issued is RMB 1,162 billion yuan. These bonds, which are held by the banks that sold NPLs to the AMCs, carry a below-market interest rate and are not traded. (See section 6 below for a discussion of relevant facts and issues.)

In the primary GB market, the Government began to experiment with market-based distribution systems through specialized underwriters and primary dealers in 1994. This has gradually become the rule. An over-the-counter (OTC) market for bearer bonds has existed since the late 1980s.<sup>9</sup> There is another, more recently established OTC market, which is part of the IM, for the trade in book-entry bonds and policy bonds (bonds issued by policy banks) between institutional investors.

In August 1997, the GB market was split between the IM and the stock market. This was the result of a PBC decision to ban commercial bank trading on the stock exchanges and lending to securities firms (usually on the basis of repos) in an effort to curb speculative stock trading. Short selling by securities firms has been a recurrent problem in China. In February 1995, the futures market for GB essentially collapsed when Shanghai Wanguo, then a leading securities firm, sold short RMB 211 billion yuan of GB without collateral.<sup>10</sup> Short selling was officially prohibited in June 1997. However, using repos to get leverage has remained a big problem and market fragmentation, combined with unequal standards for different categories of market participants, has created opportunities for rent seeking.<sup>11</sup>

A fourth market<sup>12</sup> for GB was created in February 2002 when the Central Bank allowed the trading of certificate bonds (also called savings bonds or savings certificates, and issued from that time onward) held by individuals and institutions. Such bonds had been non-tradable until then and carried a higher interest rate than tradable bonds for that reason. They used to be held by the buyer until maturity. Certificate bonds issued prior to February 2002 are still not tradable, at least not officially. When newly issued certificate bonds were made tradable the premium interest over long-term deposit rates was removed. The negative consequences for China's GB market resulting from GB market fragmentation and unequal standards are currently the subject of much government attention and corrective policy action. The World Bank is providing technical assistance to China in these matters. In summary, the development of China's GB market and the parallel emergence of a regulatory framework occupied four distinct periods:

---

<sup>9</sup> For example, the Ministry of Finance (MOF) announced on 18 August 2003 that it would issue RMB 46 billion yuan worth of book-entry bonds between August 20 and 26. Of this amount, RMB 36 billion yuan was to be sold through the IM and the stock market, while RMB 10 billion yuan was reserved for OTC sales to individual investors through banks around the country.

<sup>10</sup> This is referred to in China as "Incident No. 327."

<sup>11</sup> For example, banks and institutional investors can deal in repos up to 12 months while securities firms can normally only deal in repos up to 7 days. (Source: Oliver Fratzscher.)

<sup>12</sup> The other three are the stock market (for bond trading), the IM and the OTC market.

**(1) 1981-86:** The Government issued all GB through mandatory placement with agencies of the State. All bonds had a zero-coupon structure and were non-tradable. The term was usually five years. Total annual issues were very small and debt-service payments did not start until 1986.

**(2) 1986-93:** The Ministry of Finance began to issue tradable bearer bonds, which gradually became accepted by the public and traded in the OTC market. Special financial agencies were set up in provinces and counties to facilitate the initial sale and trading of GB throughout the country.

**(3) 1993-97:** After the introduction of a self-imposed ban on government borrowing for fiscal purposes from the PBC in 1994, the primary and secondary markets for GB took off while new bond instruments, including certificate bonds, were introduced. Book-entry bonds could be traded on the stock exchanges, but certificate bonds were non-tradable (until February 2002, when newly issued certificate bonds were made tradable for the first time). From 1993, underwriting syndicates and auctions were used to sell new issues.

**(4) 1997-present:** Trading of GB among banks was shifted to the IM in an effort to curb harmful speculation on the stock exchanges by securities firms and others who obtained loans from the banks on the basis of repos. To reverse the negative effects of reduced liquidity and transparency resulting from market fragmentation, the Government broadened access of non-bank financial institutions to the IM for GB trading, and established an IM-based OTC market for that purpose. Between 1997 and 1999, the Government did not issue any GB through the stock exchanges. During those two years, most issues were in the form of non-tradable certificate bonds. The issuance of tradable book-entry bonds was resumed in late 1999. Since that time, the Government has typically sold about 25 percent of new issues through the stock market and the remainder through the IM. There were no bearer bond issues from 1998 through the first half of 2002. The total amount of new GB issues has increased very rapidly, especially after 1998 when China started a multi-year fiscal stimulus program (Chart 2).

The market turnover of GB, overwhelmingly in the form of repos, has increased exponentially, from RMB 34 billion yuan in 1991 to about RMB 13 trillion yuan in 2002. The share of the stock markets in GB turnover is roughly the same as their share in handling new issues, about 25 percent; the remainder is traded in the IM and the two OTC markets. The fact that spot trading in GB in China is so small relative to repo transactions (less than three percent of turnover on the IM and only 20 percent of turnover on the Shanghai stock exchange, the main center for GB trading outside the IM<sup>13</sup>) suggests a shortage of tradable GB in the market relative to demand. Another reason for the preponderance of repo trading over spot trading is fiscal: capital gains on bond sales are highly taxed in China whereas profits earned in derivative trading (e.g. repos) are tax exempt.

---

<sup>13</sup> By contrast, almost all GB trading on the Shenzhen stock exchange, a much smaller market for GB than Shanghai, is spot.

Domestic demand for GB, especially from the growing number of institutional investors, has expanded faster than supply. This proposition is supported by the observation that yields on tradable GB in the secondary market tend to be relatively low. Institutional owners of tradable GB generally prefer to use those instruments for liquidity management through repos and keep them, rather than to sell them outright when they need cash. Another striking feature of China's domestic market for GB is that a large component (certificate bonds) is non-tradable; moreover, households hold an even larger proportion of outstanding GB -- about 60 percent by the late 1990s, according to Stephen Green, *op. cit.* In more developed market economies, banks and institutional investors usually hold most government debt.

### *Government Bonds and Open Market Operations*

The PBC undertook OMO for the first time in 1994. All OMO now takes place in the IM. In September 2002, the PBC converted outstanding repos into central bank bills for a total of RMB 193.75 billion yuan. From April 2003, the PBC has exclusively issued its own bills for OMO; it had run out of GB in earlier attempts to slow the growth of base money. The total amount of such bills outstanding at the end of September 2003 was RMB 440 billion yuan.<sup>14</sup> Almost all are of short maturity in order to fill a market gap. Because of the continuing rapid inflow of foreign exchange (much of it in capital account transactions that might be related to market expectations of RMB appreciation), the volume and frequency of central bank bill issues to sterilize excess liquidity is likely to remain high in the near-term future. The People's Bank has effectively sterilized most of the potential increase in the money supply due to reserve accumulation from January through August 2003.

The PBC currently conducts OMO through 43 primary dealers. It uses GB, bonds issued by policy banks, and central bank bills for this purpose. Repos and reverse repo transactions (using securities as collateral) are an integral part of OMO and represent about 97.5 percent of IM turnover. All OMO instruments used are tradable and all transactions are voluntary. The range of GB maturities has been gradually increased from 1 year to 30 years<sup>15</sup>. Until a few years ago, all GB had long maturities, which complicated the construction of a yield curve for such securities. There continues to be a great shortage of short-term bonds; but even long-term bonds are in short supply, partly because the decline in stock prices since the middle of 2001 has shifted demand to bonds. The MOF is considering the introduction of three-months and six-months instruments, which would make the range complete. This would make it possible to construct more meaningful yield curves for GB. The maturity of central bank bills is usually a year or less. The maturities of repos and reverse repos range from seven days to a year, with a concentration around 14-day transactions.

---

<sup>14</sup> PBC statistics.

<sup>15</sup> Maturities offered by the MOF since early 2002 include 1, 2, 3, 5, 7, 10, 15, 20 and 30 years.

### *Making GB Trading More Efficient*

Although the volume of new issues and market turnover has increased sharply over the past decade and improvements in the regulatory framework are underway, China's GB market remains partially fragmented and relatively thin. The secondary market is illiquid as spot trading is very limited. The relative illiquidity is due, in part, to fiscal discrimination against spot trading, and a lack of market makers. While much progress towards greater market efficiency has occurred in recent years, there is much room for further improvement:<sup>16</sup>

- 1) The three kinds of GB: (a) book-entry bonds (usually held by financial institutions and traded in the IM as well as the stock market), (b) certificate bonds (usually held by individual investors and, since February 2002, tradable in the stock market), and (c) bearer bonds (usually held by individual investors and enterprises, and tradable in the OTC market) could perhaps be merged into a single or at most two instruments. This would facilitate market integration while improving transparency and liquidity.
- 2) Since the ban on commercial bank lending to securities firms and trading on the domestic stock exchanges (1997) there have been three separate markets for GB: the IM, the stock market and the OTC market. The scope for arbitrage between these markets is widening, but further measures could be taken to promote market integration. For example, new GB issues could be sold in a single auction to which all market participants have access.
- 3) Clearing and settlement processes for stock exchange trading remain relatively inefficient, which reduces liquidity. As market participation by institutional investors for whom liquidity is especially important is rapidly growing, a further streamlining of relevant procedures is desirable.
- 4) Regulation and supervision of the GB market is at present divided between three agencies: the MOF for new issues, the PBC for trading in the IM, and the CSRC for trading in the stock markets. A harmonization of policies and standards would contribute to market integration and transparency.
- 5) Although China has six licensed rating agencies, it still lacks a truly independent and authoritative bond-rating system.

Trading in GB on China's stock exchanges is largely concentrated in Shanghai. In 2002 it accounted for a dominant share (about 80 percent) of all securities traded on the Shanghai exchange. Since the decline (in prices and market turnover) of equities in China that

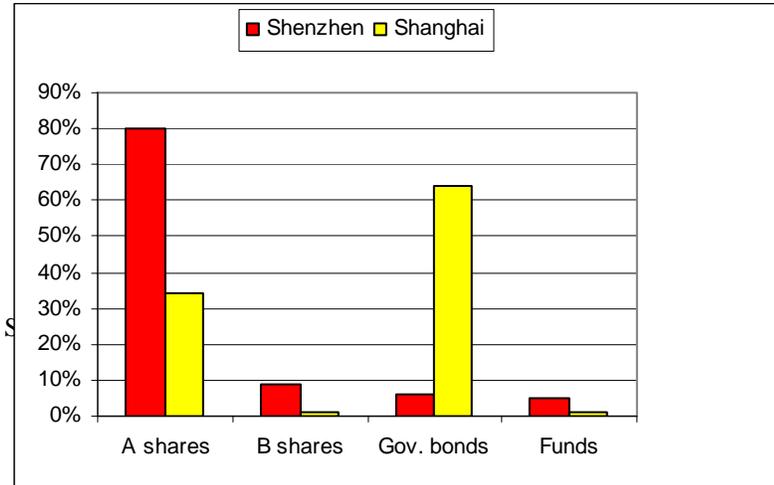
---

<sup>16</sup> Some of the suggested changes are based on a Conference Report by Justin Sommers dated 9 May 2002 on the conclusions of a conference sponsored by the Asia Society on "*Investing In China's Capital Markets: Where Will WTO-Sparked Reforms Lead?*" [www.asiasociety.org/publication/capitalmarkets02](http://www.asiasociety.org/publication/capitalmarkets02), and on Takeshi Jingu, *Moving Forward in Reforming China's Capital Market*. Nomura Research Institute paper No. 40, 1 January 2002.

started in 2001, investor demand has shifted towards bonds thus driving down yields. This market shift may reverse again if and when real interest rates fall and/or equity prices resume an upward trend. In the meantime, in terms of market turnover, the Shanghai exchange has become more important as a (repo) GB market than a stock market. By contrast, GB trading accounted for only six percent of the securities traded on the Shenzhen stock exchange in 2002.

Differences in the composition of market turnover between the two exchanges are illustrated in Chart 3 below. Although in recent years bond turnover on the Shanghai exchange has become much larger than stock turnover, stock trading remains much more important as a source of income for the exchange and for Shanghai Municipality. In terms of stock turnover, during the first ten months of 2003, the volume in Shanghai was about 80 percent larger than in Shenzhen. The total supply of tradable domestic bonds in China at the end of June 2003 stood at about RMB 3.4 trillion yuan (US\$ 411 billion), as detailed in Table 2. The aggregate supply of tradable bonds at that time was the equivalent of about 32 percent of GDP. The corresponding average percentage for developed market economies is around 100 percent.

**Chart 3. Composition of Market Turnover at the Shanghai and Shenzhen Stock Exchanges, 2002**



**Table 2. Supply of tradable bonds in China(end-June 2003; RMB billion)**

Type of instrument	Total	of which:
Bonds traded in the IM	2,740	
GB		1,480
Policy bank bonds (mainly CDB)		1,020
Central bank bills		240
Bonds traded in the stock markets	363.5	
GB		330.8
CB		32.7
Bearer bonds traded in the OTC market	300	
Total	3,403.5	

Source: PBC, China Monetary Policy Report, Q2, 2003, except for the number for bearer bonds, which is the author's estimate.

### *Yields on GB, Interest Rate Liberalization and Capital Account Opening*

Although China's bank deposit and lending rates remain largely state controlled, gradual interest liberalization is nonetheless progressing. Since the introduction of bond trading on the stock exchanges and the adoption of auctioning for the placement of new issues, bond prices and yields have increasingly reflected market realities and market expectations. However, full interest liberalization cannot be safely pursued while significant elements of the financial system, such as the four large SCBs, remain seriously undercapitalized or otherwise unreformed. Full liberalization furthermore requires the availability of meaningful benchmarks in the bond market. As long as interest rates in China remain government controlled and as long as there is an inadequate supply of short maturity GB, yield curves for such bonds are of limited use as a guide for the pricing of other instruments such as CB (i.e. benchmarking). This is one of many factors pointing to the urgency of further interest rate liberalization in China as a key element in domestic capital market development.

The objective of interest rate liberalization has to be pursued in tandem with other reforms. A premature liberalization would probably lead to unhealthy price competition that could damage bank earnings and trigger massive SOE bankruptcies. The protection of social stability requires a gradual approach. This implies that GB yields and yield curves will continue to show some abnormalities compared to international rates and patterns for some time. It also means that China cannot afford to do much more to open its external capital account until domestic financial sector reform has been substantially completed.

An analysis of recent market transactions in Table 3 shows that the yield on three of four selected GB (two global US\$ denominated issues and two domestic RMB issues) is close to the yield earned on US Treasury bonds of the same maturity. The average yield for these three GB is only 29 basis points (BP) higher than the yield on US Treasuries of the same maturity. The fourth GB, however, shows a yield that is much lower (-151 BP) than the yield on US Treasury bonds of the same maturity.

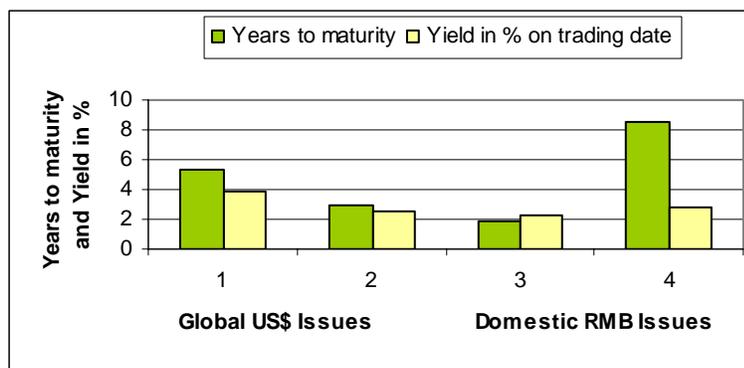
**Table 3: Yields on Selected China Government Bonds Compared to Yields on US Treasuries of the Same Maturity**

Selected Government of China Sovereign Bond Issues	Currency of Issue	Years to Maturity	Yield on Transaction Date (percent)	Transaction Date	Yield over US Treasuries of Same Maturity (in basis points)
1. Global	US\$	5.3	3.898	8/19/03	+32
2. Global	US\$	2.9	2.548	8/19/03	+9
3. Domestic	RMB	1.9	2.274	8/15/03	+46
4. Domestic	RMB	8.6	2.788	8/15/03	-151

Source: Bloomberg transaction sheets.

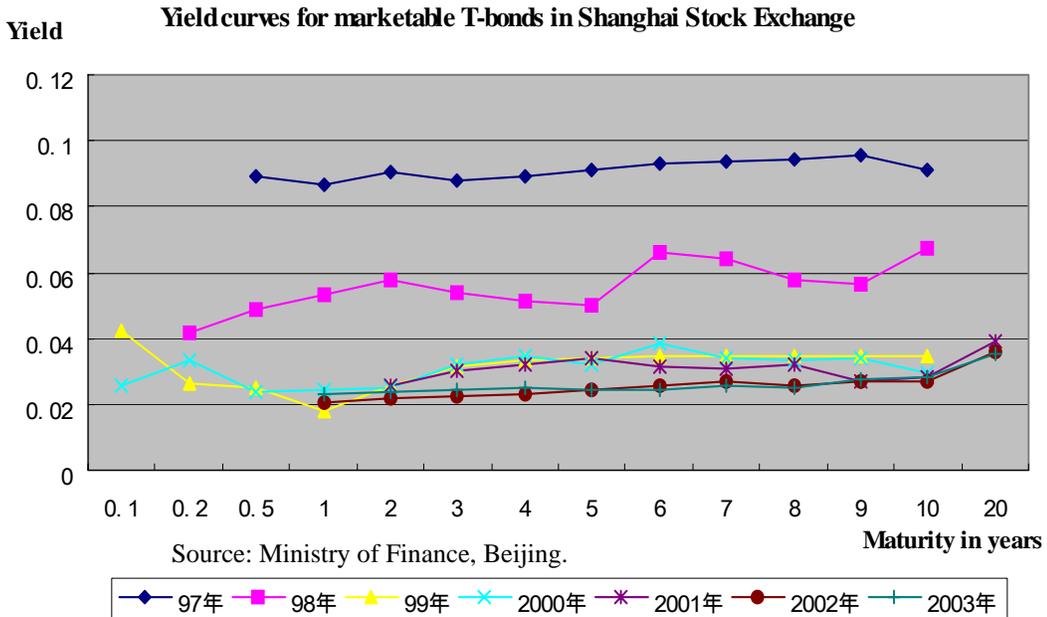
The relationship between yield and years to maturity of Table 3 is graphically presented in Chart 4. Since all four bond types in Table 3 and in Chart 4 enjoy a sovereign guarantee and the same credit rating, the surprisingly modest yield on the domestic RMB issue with 8.6 years to maturity suggests a shortage of such long-maturity instruments in the market. The four observations suggest that yield curves for global US\$ issues show a more normal pattern than yield curves for domestic RMB issues. This is confirmed in Chart 5, which shows the yield curves for a greater selection of GB traded on the Shanghai stock exchange in early September 2003. It shows that GB issued since 1997 all have a yield curve that is remarkably flat and in some cases highly irregular, i.e. rising and falling with increasing years to maturity with no apparent explanation.

**Chart 4. Relation Between Years To Maturity and Yield for Four Sovereign Bond Issues**



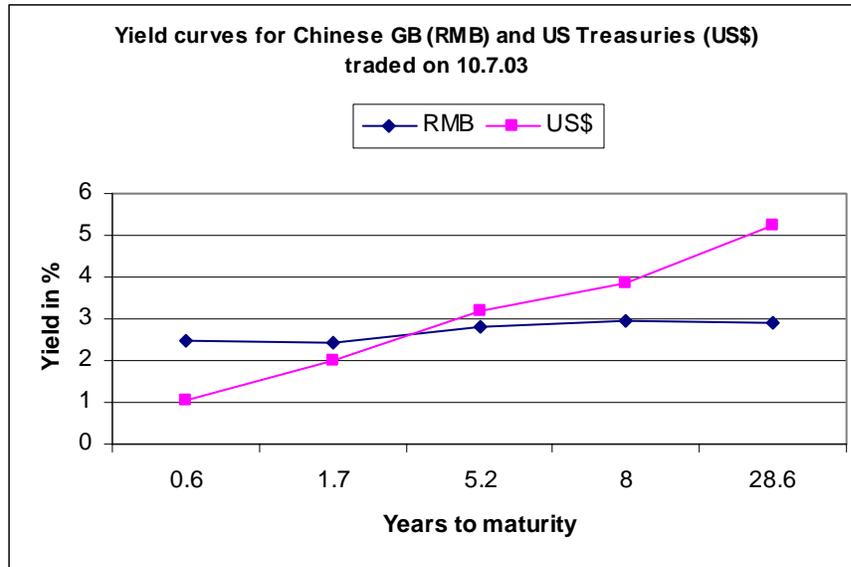
Source: Table 3

**Chart 5.**



The different shapes of typical yield curves for Chinese GB and US Treasuries are illustrated in Chart 6. The data are for actual market transactions on 7 October 2003 as reported by Bloomberg. The relative flatness of the curve for Chinese GB (similar to the shape of the curves in Chart 5) reflects the fact that interest rates are government controlled and that there is little or no correlation between coupon rate and the maturity of new bonds at issue for Chinese GB (see also Chart 8 for CB). Hence, the market for Chinese GB is very different from the market for US Treasuries in that years to maturity have little influence on yield for the former, whereas for US Treasuries yields rise with years to maturity, as is normally to be expected in a developed capital market. The current abnormality of yield curves for GB suggests a strong vulnerability of the financial system to rising inflation.

**Chart 6.**



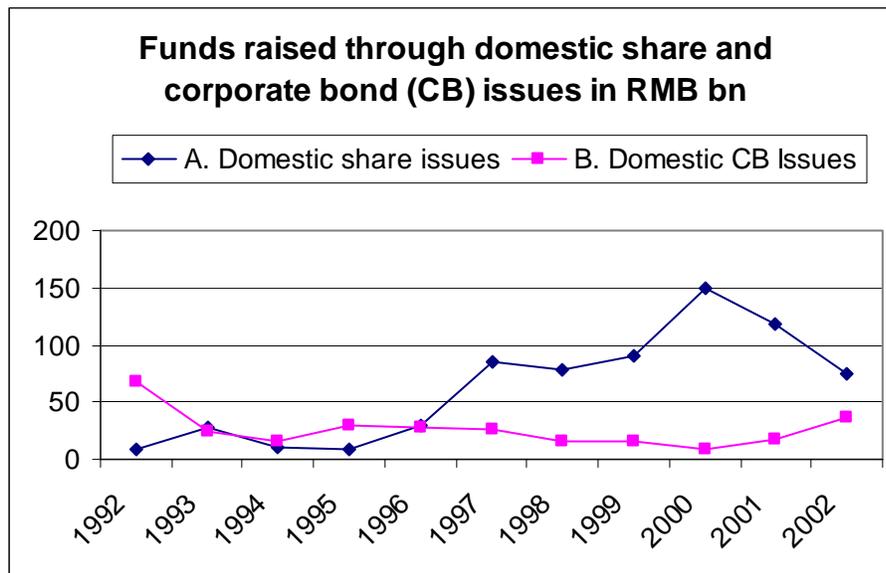
#### 4. Domestic Corporate Bond Market

China's corporate bond market is still quite small and much less developed than either the market for GB or stocks. From 1984, local enterprises were allowed to issue CB with the permission of the PBC. Issuers were initially allowed to pay interest 40 percent higher than bank deposits. Since the public regarded CBs as (almost) equally secure as treasury bonds, this led to reduced demand for GB and a drain on long-term bank deposits. To correct these problems, the Government decided to lower the permitted interest margin and to set annual quotas for CB under the credit plan.<sup>17</sup> Like the informal equity markets that developed in the mid-1980s, local CB markets remained largely unregulated and unsupervised until the early 1990s. After the opening of the Shanghai and Shenzhen stock exchanges in late 1990, new CB issues soon began to decline relative to share issues. However, in 1992 the amount of funds raised through CB issues was still considerably larger than through equity issues. After 1996, the emphasis shifted decisively in favor of equity issues through the stock markets (Chart 7). Enterprises preferred to issue stock rather than bonds, perceiving equity as a less expensive way of raising funds in China. This market perception, which was probably correct at the time, began to change in recent years as a result of the sharp drop in stock prices in 2001 and improved regulation and supervision of capital markets in general. New share issues dropped sharply in 2001 and 2002 while CB issues rose (from RMB 4.9 billion yuan in 2000 to RMB 35.5 billion yuan in 2002). Still, the amount of CB issued in 1992 (RMB 68 billion yuan) was almost twice as high as in 2002.

<sup>17</sup> Hassanali Mehran e.a., *Monetary and Exchange Rate Systems in China: an Experiment in Gradualism*. IMF Occasional Paper, No. 141. 1996.

The record amount of CB issued in 1992 (mostly by locally-owned SOEs) was part of the widespread financial sector irregularities that contributed to overinvestment and high inflation at that time. From 1993, the then State Planning Commission was made responsible to control the amount of new bond issues. It did that through a quota system that is still in force today. Chart 7 shows the relationship between the amounts of new corporate finance raised through the domestic stock exchanges and through the sale of CB from 1992-2002. The market for CB has so far been reserved for selected large SOEs.

**Chart 7.**



Sources: Shanghai and Shenzhen stock exchange reports and CSRC.

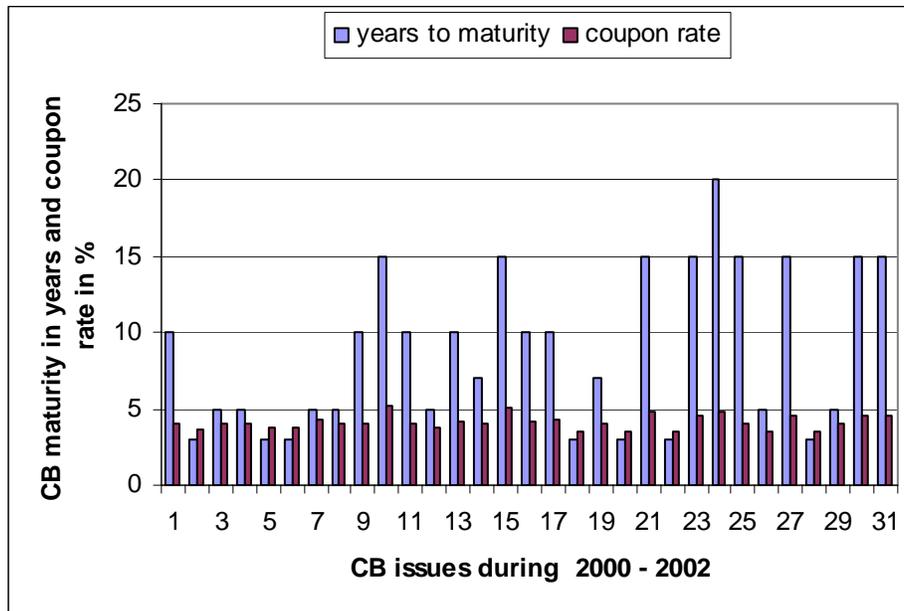
During 2000–2002, nineteen SOE sold bonds for a total of RMB 58.3 billion yuan in 31 separate issues.<sup>18</sup> All CB except China International Trust and Investment Company’s (CITIC) are guaranteed by another agency of the state or a SCB, not by the Government. Maturities range from 3 to 20 years. Coupon rates are generally between 150 and 250 basis points above the state-mandated 1-year bank deposit rate. At the end of 2002 some 20 CB were listed on the stock exchanges, but secondary market trading is very limited. Nine listed CB are convertible.

As in the case of GB, the relative illiquidity of CB is a reflection of relative supply scarcity (holders prefer to avoid selling) and fiscal discrimination against spot trading. Chart 8 shows that there is no clear relationship between bond maturity and coupon rate, an anomaly that can also be observed in the market for GB in China. Almost all listed

<sup>18</sup> Among the prominent SOEs that have been allowed to issue bonds in recent years are the Three Gorges Corporation, Shanghai Baosteel, China Mobile, CITIC, China Ocean Shipping, China Guangdong Nuclear Group and the State Power Corporation. The Three Gorges Corporation accounts for almost one quarter of new issues since 2000.

CB carry a domestic AAA credit rating, with a few bonds rated AA or AA+, reflecting the presumption of a government guarantee.<sup>19</sup> At the end of 2002 there were six licensed domestic credit rating agencies of which Chengxin is the oldest and most independent. International credit agencies only rate China's internationally traded, sovereign, forex-denominated, bond issues, not domestically traded RMB issues. China's sovereign global bonds typically enjoy high international credit ratings.

**Chart 8. Maturity and Coupon Rate of Corporate Bonds Issued in 2000 – 2002.**



Source: China Chengxin International Credit Rating Co., Ltd.

Issues of CB continue to be rationed by the State Development and Reform Commission, successor to the earlier State Planning Commission. This arrangement has become somewhat atavistic, reflecting the facts that financial market reforms in China are still incomplete and that direct state influence remains strong. Since the national credit plan was abolished in 1998, the power to regulate CB issues should be shifted from the national planning agency to the financial authorities. Emerging corporate financial needs, both in the state and non-state sectors, require a significant broadening and deepening of the market for CB. A fortunate coincidence for China is that this urgent corporate need is mirrored in the sharp increase in domestic market demand for CB. Since the decline of equity prices in China from around the middle of 2001, households and institutional investors have been eager to diversify their portfolios into CB (as well as GB). Anecdotal evidence suggests that people are willing to wait many hours in line for the opportunity to buy CB.

<sup>19</sup> Source: China Chengxin International Credit Rating Co., Ltd.

If equity prices in China remain depressed relative to Chinese expectations,<sup>20</sup> as seems likely for the near-term future, a relatively significant portfolio shift from stocks to bonds will occur *if* the supply of GB and CB is expanded in line with demand. To increase the supply of new issues of CB, the Government should relax current issue restrictions and quotas and permit selected non-state companies as well as selected provinces and municipalities to issue bonds in the domestic market to finance local infrastructure. At the same time, the development of a healthy and active bond market in China will require a more effective bankruptcy law, reliable and efficient courts to implement and enforce the law, effective foreclosure procedures, truly independent credit rating agencies, and significant further improvements in disclosure and accounting standards. A complete legal framework for developing China's bond markets is still lacking. This is an opportune time, however, for China quickly to expand the domestic markets for other-than-GB, especially CB.

Trading in CB is largely concentrated on the Shanghai stock exchange, but some CB are listed (or also listed) on the Shenzhen stock exchange. The trade in CB in Shanghai in 2002 accounted for only 0.1% of the total market turnover and 0.16% of the turnover in GB on that exchange. The main reason for the low level of transactions in the secondary CB market is the scarcity of such bonds relative to market demand. Owners of CB prefer to hold on to this relatively "precious" asset. According to the PBC's monetary policy report for the second quarter of 2003, the total amount of tradable CB listed on the stock market at the end of June 2003 was only RMB 32.7 billion yuan (Table 2).

## 5. Lower-level Government Borrowing

Lower level governments in China are officially required to balance their budgets without borrowing, except for selected, Government-approved external bond issues (usually revenue-backed) for infrastructure financing, and for indirect borrowing (through the MOF) from multinational development agencies such as the World Bank and Asian Development Bank (ADB). However, many local governments do borrow, usually indirectly, through corporations or agencies owned by them. They borrow mostly from banks, but sometimes also by issuing informal local bonds. Many local governments borrow unofficially also from workers, pensioners and suppliers in the form of arrears in wage, pension, and/or bill payments. There is no reliable information available on direct and indirect borrowing by lower level governments. The aggregate outstanding is believed to have grown very rapidly in 2003, as much of the extraordinarily rapid domestic credit expansion in that year originated at the local government level.<sup>21</sup>

---

<sup>20</sup> They are only depressed relative to 2000 and the first half of 2001 when P/E ratios were typically over 50. They are not depressed relative to the prices of sister H-shares listed in Hong Kong, and P/E ratios, though much lower than a few years ago, are still generally above 30.

<sup>21</sup> Shuanglin Lin estimates the non-arrears portion of unrecorded local government debt at 2.3 percent of GDP for the year 2001 in *China's Government Debt: How Serious?* China. An International Journal, Vol. 1 No. 1, March 2003.

There is clearly a need for the development of official, non-sovereign provincial and municipal bonds. The current ban on such instruments increasingly conflicts with the needs of sub-national governments for infrastructure financing in a large, diversified market economy with a great deal of decentralized economic decision making. As in the case of CB, the development of provincial and municipal bonds will require a legal and regulatory environment, which at present does not exist, as well as independent rating agencies. Local government access to domestic capital markets could be regulated so that the system promotes and rewards fiscal responsibility.<sup>22</sup> On the demand side, institutional investors need access to a broader range of bond types and bond yields than are currently available in the domestic Chinese market.

## 6. Debt Markets and NPL Resolution – the Role of AMCs

### *The NPL Challenge*

Capital markets, in particular debt markets, will have to play a central role in NPL resolution. The precise magnitude of the Government's NPL-related contingency debt is hard to assess.<sup>23</sup> There are indications that the relative size of the NPL problem has peaked. Officially reported ratios have been dropping since the end of 2001 due to a combination of four factors: (1) dilution due to loan portfolio growth, (2) collections on delinquent loans, (3) write-offs against profit, and (4) portfolio quality improvements on the margin. The aggregate NPL ratio for the four large state-owned commercial banks (accounting for nearly 70 percent of all bank deposits and over 60 percent of bank loans) as a percentage of their aggregate loan portfolio dropped as follows:

December 2001	29.9 percent
December 2002	26.1 percent
March 2003	24.1 percent
September 2003	21.3 percent <sup>24</sup>

Since the most important of the four factors explaining the drop in NPL ratios is undoubtedly the first one (dilution), there is no guarantee that the ratios will not rise again in the future. It all depends on the quality of incremental loan portfolios, which for almost all banks include a rapidly growing proportion of consumer loans, especially for motorcars and mortgage loans. The PBC has set an aggregate target of 15 percent for the NPL ratios of each of the four big banks at the end of 2005. This somewhat more

---

<sup>22</sup> Australia offers an interesting example of a well-regulated and highly developed market for local Government bonds that might be of interest for China.

<sup>23</sup> China's loan classification system for commercial banks was changed in 2001 from four categories (normal, overdue, doubtful and bad) to five (performing, special mention, substandard, doubtful and loss). Moreover, the old system was primarily backward looking while the new system is primarily forward looking. This makes a comparison of NPL ratios before and after the system change difficult. The PBC assigns loan-recovery probability rates, but the banks themselves determine in which category each of their outstanding loans falls. Actual recovery rates are unpredictable and vary with changing circumstances and with collection effort.

<sup>24</sup> Note that by the end of 2003, none of the four large SCBs had been audited by international auditors to international standards. The CCB engaged KPMG for that purpose during 2003. Independent economists have suggested that NPL ratios in China may be higher than officially reported by the banks themselves.

manageable ratio, if achieved, might then permit the full recapitalization of state-owned commercial banks to coincide more or less with the complete opening of China's financial markets for foreign banks under WTO accession terms at the end of 2006. The CCB and BOC have taken initial steps towards listing and partial privatization by engaging international auditors. The Government may decide to recapitalize these two banks first to accelerate the listing process. The ICBC and ABC both will have to wait; their NPL ratios are considerably higher than those of CCB and BOC.

From a macro-perspective it is useful to express the aggregate NPL ratio in terms of a percentage of GDP. The NPL/GDP ratio is falling more slowly than the NPL/loan portfolio ratio for the simple reason that loan portfolios in China are growing faster than GDP. At the end of 2001, the estimated NPL/GDP ratio for the major SCBs was about 24 percent, falling to about 23 percent at the end of 2002.

### *The Role of State-Owned Asset Management Companies (AMCs)*

In the wake of the Asian financial crisis of 1997/98, China created four state-owned AMCs to assist in dealing with NPLs. In 1999 and 2000, the four large SCBs and the China Development Bank (CDB) together transferred RMB 1.4 trillion yuan worth of NPLs (about US\$ 169 billion) to the AMCs in separate transactions.<sup>25</sup> Official statements at the time implied that the transferred NPLs had accumulated prior to 1996. No plan has been announced so far for NPLs accumulated thereafter, but it is likely that problems with more recent NPLs will be tackled bank by bank.

The AMCs have been slow in publishing their accounts and there continues to be some uncertainty as to precisely how their NPL purchases (at par) were financed. An analysis of the available information by researchers for the Bank for International Settlements (BIS) suggests that the purchase was financed as follows:<sup>26</sup>

1. Equity capital (cash) provided to the AMC by the MOF—3 percent;
2. Low-interest People's Bank of China (PBC) credit—14 percent;
3. Low-interest 10-year AMC bonds—83 percent.

Given the objective of the NPL purchases by the AMCs, namely cleaning up the SCBs' balance sheets, and the enormous size of the transaction (US\$169 billion!), the Government's failure to insist on greater transparency in the financing of AMCs is surprising. Because of a legal restriction on the granting of formal MOF guarantees to SOEs (which the AMCs are), the 10-year maturity non-tradable AMC bonds are not the equivalent of sovereign bonds. Moreover, they carry a coupon rate of only 2.25 percent, while the official one-year lending rate at the time that the AMC bonds were issued was 5.31 percent. Nonetheless, the AMC bonds are apparently regarded as quasi-equity by the banks at full face value. Since the AMCs cannot realistically expect to recover more than about 20 percent of the NPLs in cash or equivalent, they will inevitably end up with large losses that the State will have to cover in one way or another. For a variety of reasons,

---

<sup>25</sup> The four AMC are Huarong (for ICBC NPLs), Orient (for BOC), Great Wall (for ABC) and Cinda (for CCB and CDB).

<sup>26</sup> Guonan Ma and Ben S.C. Fung, *China's asset management corporations*. BIS Working Paper No. 115, August 2002.

therefore, the AMC bonds are not tradable and their value as an instrument for (partial) SCB recapitalization remains unclear.

The AMCs are mandated to dispose of their NPL portfolios and wind up their business within ten years of their establishment. Disposal of NPLs takes various forms, including debt/equity conversion, debt rescheduling, debt recovery through legal action, and NPL sales to both domestic and foreign buyers through auctions and otherwise. Substantial debt/equity conversions have been carried out through the issue of shares that are valued by the AMCs (for accounting purposes) at the nominal value of the NPLs exchanged. A total of 580 SOEs were selected for the conversion of RMB 405 billion yuan of NPL (almost 30 percent of the total amount transferred to AMCs) into equity. This action has had two undesirable side effects: (1) transferred shares are not tradable at the conversion price, which means that AMCs' assets are overstated; and (2) the resulting enhanced profitability of participating SOEs (due to a lower interest burden) is more apparent than real.<sup>27</sup> Debt-for-equity conversions have undoubtedly an important role to play in NPL clean up but, if the process is to result in enhanced transparency and better performance of the financial sector, it must be market-based. For a lasting resolution of the NPL problem, an extremely important requirement is that such assets be made tradable at their market value.

The AMCs have also gradually become more active in disposing of NPLs through loan recovery and cash sales. Table 4 shows accumulated cash recovery results at the end of March 2003. Since the best assets were presumably marketed first, the cash recovery rates seem likely to fall over time. The sale of NPLs will probably accelerate as experience is gained and as the two recently approved joint ventures (JV) for NPL clean up (between Huarong and Goldman Sachs, and Huarong and Morgan Stanley) enter the market. Thus far, most NPL sales have been domestic. Through 2003, Huarong was the only AMC to have organized an international auction; it is preparing a second auction for January 2004. Establishment of the two JV was a condition the two foreign partners attached to their bids for NPLs at the first international auction. It took the Government more than a year to approve the joint ventures.

**Table 4. Cash recovery by AMC through the end of March 2003**

AMC	NPL disposed (RMB billion)	Cash recovered (RMB billion)	Cash recovery (percent)
1. Huarong (ICBC)	96.4	21.0	21.8
2. Greatwall (ABC)	110.0	11.1	10.1
3. Orient (BOC)	48.3	12.3	25.4
4. Cinda (CCB/CDB)	88.7	27.2	30.6
Totals	343.5	71.5	20.8 (average)

Source: [www.pbc.org.gov.cn/english/](http://www.pbc.org.gov.cn/english/)

<sup>27</sup> Edward Steinfeld, *China's Problem of Debt-Equity Swaps: Government Failure of Market Failure?* Harvard University conference paper (unpublished) 2001.

### *Strategies for NPL Clean up and the Recapitalization of SCBs*

A massive up-front recapitalization of the four large SCBs, as favored by some,<sup>28</sup> seems sub-optimal because it creates adverse selection and moral hazard problems (reducing bank incentives to collect on delinquent loans and to enhance capital bases through other internal efforts). In China's case, recapitalization of the four SCBs should be conceived as a process, tailored to the needs and circumstances of each bank. In some cases, it may be better to delay full recapitalization; in other cases, bank closure or breakup may be preferable to recapitalization. As already mentioned, the CCB and the BOC are likely to be the first SCBs to be recapitalized by the State and listed on stock exchanges for partial privatization. The Government has the option to use existing state assets or to "fiscalize" the recapitalization burden by issuing new long-term GB.

The Government and agents of the State together own about two-thirds of the shares of SOEs listed in Shanghai and Shenzhen.<sup>29</sup> These shares are at present non-tradable, but they represent a (theoretical) market value of well over US\$ 300 billion at December 2003 market valuations. The problem is that these shares, even if they were made legally tradable, could not be sold in the open market without a significant drop in share values. This presents a major dilemma for the Government. It may be possible, however, to mobilize the (theoretical) value of such shares by using them as backing for bonds or second tier Tracker Fund-type shares.<sup>30</sup> This approach could facilitate the market absorption of NPLs. Another possibility might be to allow the AMC's to issue asset-backed bonds or convertible bonds to purchase additional NPLs from the state banks and achieve their partial recapitalization this way.

The amounts required for the resolution of China's twin financial problem – NPLs and state bank recapitalization – are very large relative to the country's GDP. A viable strategy has to be multi-pronged. To the extent that at least part of the problem can be resolved through the development of non-sovereign debt instruments such as asset-backed securities (ABS), the ultimate fiscal burden on the State will fall. In principle, it doesn't make much difference whether the NPL problem is resolved through the sale of state assets, through their use as collateral for bonds, or through additional taxation. In practice, because China's economy is still in transition, while the ownership role of the state in the economy remains too large, it does make a difference. The Chinese state can make the economy more efficient and solve many internal public debt problems by significantly further reducing its ownership role in the economy. The main point is that the Chinese State possesses a large pool of assets that can be used to recapitalize the state banks.

### *Changes in the Composition of State Bank Loan Portfolios*

State banks are trying to improve the quality of their portfolios through incremental lending for non-traditional purposes to non-state customers, including individual

---

<sup>28</sup> For example, OECD, *China in the World Economy. The Domestic Policy Challenges*. Paris 2002.

<sup>29</sup> In addition, the State owns shares in SOEs that are incorporated in China and listed in Hong Kong (H shares) and shares in Chinese firms that are both incorporated and listed in Hong Kong (red chips).

<sup>30</sup> The Hong Kong Tracker Fund was established to dispose of a large amount of shares purchased by the Hong Kong Monetary Authority on the Hong Kong Stock Exchange in 1998 to counter speculative attacks on the currency during the Asian financial crisis (see [www.trahk.com.hk/](http://www.trahk.com.hk/))

households. In 2002, SOEs received only about half of the net increase in lending by the four major SCBs. Consumer loans, mostly for car financing and mortgages for house financing, along with forex lending to foreign invested companies,<sup>31</sup> are seen as important vehicles for improving loan portfolios. Private car ownership in China is currently growing at 30-40 percent per year and some of this extraordinarily fast rise is due to consumer loan options that became available, in part, as a result of WTO entry conditions.

Private ownership of apartments and houses in major cities has become common in the past five years. In Beijing and Shanghai 65 and 62 percent respectively of the households now own their homes according to a recent report by JP Morgan Chase.<sup>32</sup> This is already higher than the 50 percent rate that is typical in Hong Kong. From almost zero only eight years ago, mortgage loans accounted for over 10 percent of the portfolios of the major state commercial banks at the end of 2002. The Chinese banks have been able to finance this phenomenal increase in mortgage loans without the benefit of Fannie Mae- or Freddie Mac-type refinancing institutions<sup>33</sup> because of their high liquidity ratios and reduced lending to SOEs. Once tradable mortgage-backed securities are developed in China, which will probably take several more years, domestic debt markets will see a quantum jump in volume and depth. The Government is also encouraging state bank lending to domestic private enterprises, so far with limited success.

Whether the rapid increase in the share of consumer loans and mortgage loans in the portfolios of state banks will improve the overall quality of their portfolios remains to be seen. China's credit culture, though improving, is still far from what it ought to be. There have already been reports of serious problems with regard to the servicing of car loans and mortgage loans. Since repossession and foreclosure laws in China remain weak or in practice unenforceable, the actual result of bank efforts to reduce NPL ratios through a shift in lending away from traditional SOE customers remains to be seen. It would be a monumental set back for financial sector reform in China, if the reported decline in NPLs ratios since 2001 were to be reversed in the coming years.

## **7. Concluding Remarks**

In domestic debt market development, probably the most urgent need is to promote primary and secondary markets for corporate bonds and to extend issue rights for such bonds to non-state corporations. At the same time, the Government should accelerate, as much as possible, the liberalization of domestic interest rates to ensure a more efficient

---

<sup>31</sup> Domestic forex lending by state banks has increased so rapidly in recent years that the market share of foreign banks in this line of business declined from 15 percent in 2001 to only 7.4 percent in 2002. Financial Times, 9 September 2003.

<sup>32</sup> Quoted in the Far Eastern Economic Review of 14 August 2003.

<sup>33</sup> These two agencies were established by the US Government in 1968 and 1970 respectively to facilitate the refinancing of domestic mortgage loans and promote homeownership. They finance themselves mainly through the issue of mortgage-backed securities.

allocation of capital and to permit a “normalization” of yield curves for government bonds needed for benchmarking purposes. The high dependency of many Chinese corporations on bank credit is potentially dangerous as lending rates are gradually being liberalized. The development of provincial and municipal bonds for local infrastructure financing is also a priority.

Debt market development is also needed to facilitate the process of cleaning up NPLs, and this has been rendered more urgent by China’s WTO accession terms for the financial sector. State bank recapitalization will require vast amounts of real resources. There is scope for a more imaginative use of the large pool of state-owned non-tradable SOE shares for recapitalization purposes. The creation of asset-backed bonds and Tracker Fund-type second tier equities could facilitate NPL absorption in the economy.

On the demand side, the rapid growth of China’s institutional investor base in recent years and their projected expansion assures that the market will readily absorb a much wider range of debt instruments. Debt market development and interest rate liberalization in China will at the same time facilitate the development of equity markets and permit the gradual further opening of the capital account.

## List of Abbreviations

ABC	Agricultural Bank of China
ABS	Asset-backed security(ies)
ADB	Asian Development Bank
AMC	Asset management company(ies)
BIS	Bank for International Settlements
BOC	Bank of China
BP	Basis point(s)
CB	Corporate bond(s)
CCB	China Construction Bank
CDB	China Development Bank
CITIC	China International Trust and Investment Corporation
CSRC	China Securities Regulatory Commission
GB	Government bond(s)
GDP	Gross domestic product
ICBC	Industrial and Commercial Bank of China
IM	Interbank market
JV	Joint venture
MOF	Ministry of Finance
NPC	National People's Congress
NPL	Non-performing loan(s)
OECD	Organization for Economic Co-operation and Development
OMO	Open-market operations
OTC	Over-the-counter (market)
PBC	People's Bank of China (China's central bank)
RMB	Renminbi (China's national currency)
SCB	State-owned commercial bank(s)
SOE	State-owned enterprise(s)
WTO	World Trade Organization

## Bibliography and Other Sources

Bloomberg, [www.bloomberg.com/](http://www.bloomberg.com/)

China Chengxin International Credit Rating Company, [www.chengxin.com/](http://www.chengxin.com/)

China Development Bank, *Annual Report for 2002*.

China Securities Regulatory Commission, [www.csrc.gov.cn/](http://www.csrc.gov.cn/)

Green, Stephen *China's Stock Market. A Guide to Its Progress, Players and Prospects.* The Economist 2003.

Jingu, Takeshi *Moving Forward in Reforming China's Capital Market.* Nomura Research Institute paper no. 40, 1 January 2002.

Kim, Yongbeom, e.a., *Developing Institutional Investors in People's Republic of China.* World Bank Country Study Paper, September 2003.

Kumar, Anjali e.a., *China's Emerging Capital Markets.* FT Financial Publishing Asia Pacific, 1997.

Lin, Shuanglin *China's Government Debt: How Serious?* China: An International Journal, Vol. 1, No. 1, March 2003.

Ma, Guonan and Ben S.C. Fung, *China's Asset Management Corporations.* BIS Working Paper No. 115, August 2002.  
Ministry of Finance, *Annual Financial Yearbook.*

Moody's Investors Service, *China Banking System Outlook*, October 2002.

OECD, *China in the World Economy. The Domestic Policy Challenges.* Paris 2002  
People's Bank of China, *China Quarterly Monetary Policy Report*,  
[www.pbc.gov.cn/english/](http://www.pbc.gov.cn/english/)

Shanghai Stock Exchange, [www.sse.com.cn/sseportal/en](http://www.sse.com.cn/sseportal/en)

Sommers, Justin *Investing in China's Capital Markets: Where Will WTO-Sparked Reforms Lead?* Asia Society Conference Summary 2002,  
[www.asiasociety.org/publications/capitalmarkets02/](http://www.asiasociety.org/publications/capitalmarkets02/)

Steinfeld, Edward *China's Problem of Debt-Equity Swaps: Government Failure or Market Failure?* Harvard University (unpublished conference paper) 2001