The Core Problem of Financial Reforms in China

By He Qinglian[1*]
Excerpted from *We Are Still Watching the Stars Above* (2001)

China's announcement of a structural overhaul in their banking system on February 21, 2000 evoked intense international concern and led to many speculations.

I believe that, although installing a group of fresh leaders well equipped with modern financial know-how and well aware of international financial operations would no doubt bring the leadership more in tune with the modern times, people should not be over-optimistic and expect too much from this new blood. The simple reason is that people are only slaves of systems. Premier Zhu Rongji's personal clout had been over-estimated internationally, and his predicament in 1999 proved that with the previous generation of political giants passing away none of the present leaders had the power to confront and resist a system. Therefore, they have only been able to chip away at the system in small measures in their reforms, but they have never managed to massively transform the underlying layers of the structure.

China's financial system has been plagued with deep-rooted, chronic maladies. Here, I will only talk about the things we should pay attention to in the next stage of financial reforms:

In the past, the Chinese Government has managed its financial sector through the following approaches: 1) maintaining 100% control of the banks; 2) directing banks to give out loans to designated projects, e.g. state-owned enterprises, at subsidized rates; 3) using administrative measures to interfere with the maximum and minimum limits of banks' interest rates; 4) categorizing banking information as state classified information and intentionally leaving depositors in the dark about any relevant banking information. Their monopolized position has enabled China's banking departments to carry on normal operations, even if their own assets have dropped to a mere 3% of the capital.

Under this kind of management, many problems in China's financial sector surfaced. First, the "bubble" burst prematurely. Especially in the higher risk industries of stock, insurance and investment trust there have been severe over-speculations. Second, there is

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[1*] *Ms. HE Qinglian is a visiting scholar at the University of Chicago. She left China unannounced in June 2001 in the face of widespread, government-sanctioned harassment of scholars. She is the author of two books:* China's Pitfalls *(1998) and* We Are Still Watching the Stars Above *(2001). The latter was published and immediately banned by the Chinese government. Both books document the dark side of China's economic reforms and address issues such as corruption, inequalities and the breakdown of the social fabric previously weaved by China's state-directed economy. Ms. He holds a master's degree in economics, and most recently worked in China as a reporter for the* Shenzhen Legal News. *This article is reprinted with permission.*

little transparency in the banking operations. This problem is a result, first of all, of the lack of information inside the banking system. For instance, banks are not well informed of the true ability and willingness of their borrowers to pay back loans. This has in turn led to the long-standing high number of financial frauds that amount to 30% of China's total economic fraud cases. In some areas this figure goes up as high as 50%. On the other hand, the depositors are also ignorant of the financial health of those institutions and unaware of problems such as their management flaws and other fraudulous financial deals in the institutions. Thirdly, after banks take deposits from the public, they have taken totally unethical risks in using the capital to make multiple, profitable investments. For instance, at present, major stock traders are encouraged to do high-risk margin trading, which means the banks will gain all the benefit, while depositors and deposit insurers will bear the consequence of all the risk including bankruptcy of the banks.

When China enters the WTO, its financial mechanism will have to operate in line with international rules and regulations. This will force large-scale reforms in China's financial services, and the direction they will take will inevitably be to give them free reign. There are two ultimate goals: 1) to strictly monitor and control the banking institutions and the capital market. One point here that is worthy of attention is that from last year to this year the over-speculated stock market has been solely the result of the government manipulating the market. The government has allowed many state-owned enterprises, which are deeply in debt, to repackage themselves and list on a stock exchange, aiming to create funds on the stock market and dissolve risks for the banks. This approach is entirely against the principle of the government as a financial monitor. 2) To make the central bank so independent that it can be in a position to resist attempts by the central government to dip their hands into the two moneybags of the central bank and central finance. But before the reforms can achieve their goals two problems must be addressed: one is the timetable of the reforms, i.e. proper banking regulations have to be in place with a proper financial monitoring mechanism before it can be in line with the international financial market and be given free reign. The monitoring mechanism is especially important to China. Secondly, there has to be the right balance between financial freedom and safety precautions and measures. According to studies by The American Development Bank, the reason that reforms in most Latin American countries have fallen into difficulties is that the timetable for reforms were backwards, and there was a lack of balance between liberated financial systems and safety precautions.

Judging by China's track record of legal precedents, we can see that China has easily published laws and regulations but those laws and regulations have been easily twisted and distorted when being carried out. So China should place special emphasis on strengthening the effective monitoring mechanism and turning those chapters on paper into practice in life.