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WILLIAM RHODES

Beijing must press on with its banking agenda

Most participants in China's financial markets are optimistic about the long-term prospects for the country's economy. That optimism is based, however, on the important assumption that China will continue to improve its financial system in coming years.

China needs better financial intermediation, by both banks and capital markets, if capital is to be allocated efficiently and strong economic growth sustained. The reform of China's stock market appears to have slowed and it will take time to develop domestic bond markets. In the foreseeable future, therefore, continued successful reform of the country's banks – which still account for more than 80 per cent of China's financial assets – will be critical for sustaining strong growth and preventing serious dislocations in the economy.

Building a modern banking system has been one of the country's priorities since the late 1980s. Prior to that, capital had been allocated through the fiscal system and central planning, which was highly inefficient. Much progress has been made, but more remains to be done. The biggest challenges that remain include strengthening capital adequacy, improving corporate governance, disposing of non-performing loans and, most importantly, avoiding the creation of a new non-performing loan problem.

Banking issues of the sort China is facing today are not new. In a number of Asian countries during the 1980s and 1990s, newly liberalised banking systems, combined with weak supervision and implicit guarantees, created rapid domestic credit expansion with little regard for borrowers' credit-worthiness. This laid the basis for the Asian financial crisis of 1997-98. Much has been learnt from the mixed results achieved in the response of different countries in the region to this crisis, and from Japan's experience with its banks in the 1990s.

A sound financial system requires deeper and broader domestic bond and equity markets as an alternative to bank intermediation

Experience has shown that a five-pronged approach is the best way for banking institutions to deal with such problems. First, they must recognise that there is a problem and promptly size up the amount and severity of the bad loans in the system. Second, they need to take steps to write-off, sell down or otherwise recognise the losses incurred as soon as possible. Third, they must recapitalise and rebuild reserves as quickly as they can. Next they should promptly reorganise the underlying lending processes and create a strong credit culture. This may be the most important step of all, and should include establishing formal policies and procedures for risk management and for loss recognition and provisioning. There is also a need to invest heavily in training and development of staff at all levels. Last, banks must strengthen their internal audit systems and establish checks and balances for all their main operations. These should report directly to the board of directors or another body independent of management.

A sound banking system and efficient capital markets require transparency, international accounting standards, an effective legal system and a strong regulatory structure. A sound financial system also requires less dependence on banks alone. Deeper and broader domestic bond and equity markets must be developed as an alternative to bank intermediation for savings and investment.

The rapid extension of new credit into state-owned enterprises, an overheated real estate market and expansion of industries that already have excess capacity still pose a risk to the economy and the banking system. In addition to the administrative measures being used to control excessive credit, the government must not neglect its reform agenda. Among the most important elements of this is further development of professional lending policies and practices. Banks need freedom to select their own customers and to adjust their own priorities and prices to reflect the level of risk involved. These measures should also include full implementation of market-based interest rates, as seen in the recent rate increase by the People's Bank of China, more aggressive opening of the capital account and – crucially – a more flexible exchange rate policy.

I believe China's current leaders understand the need to move forward aggressively with this reform agenda. They have established priorities for implementing it on a timely and prudent basis, and have also reinforced this commitment by adopting specific initiatives to accelerate the pace of reform. It is certainly in the best interest of China to do so.

The writer is chairman of Citicorp and Citibank and senior vice-chairman of Citigroup