

CLOSING ADDRESSES

Summary remarks by Andrew Crockett

This has been a remarkably productive conference, rich in content and fruitful in its exchange of ideas. It would be impossible to review all the points that have been made. Let me, however, summarise what I personally take away from our discussions, under ten headings.

1. The importance of a strong and efficient banking system

Banking systems play a central role in mobilising and allocating resources in a market economy. This stands in fundamental contrast to a planned economy, where financial institutions play a largely incidental role in resource allocation. China is in the process of transition from a centrally-planned to a market economy. It follows that if its banking system is not made compatible with its expanded role and responsibilities, it will act as a drag on China's economic growth.

2. Non-performing loans are a cancer in the banking system

Initially, non-performing loans (NPLs) may not seem to have serious negative effects. Banks remain liquid, and depositors retain their confidence in the system. Over time, however, the size of the problem grows, especially if banks are allowed to accrue interest on their NPLs. Eventually, the efficiency of the banking system is comprehensively undermined, as the task of making new loans to productive enterprise takes second place to juggling a portfolio of bad loans whose collectibility is very low. The fiscal cost of cleaning up the banking system can become so large as to be itself an obstacle to needed action.

3. The bad loans problem in China is essentially a fiscal problem

Most of the non-performing loans are to state-owned enterprises (SOEs). Credit was extended to them not just to finance production, but to cover a number of quasi-governmental functions performed by the

SOEs. So cleaning up the banks' balance sheet will involve a substantial charge on the state budget. This cannot be avoided, and delay is only likely to add to the cost.

4. The need to limit moral hazard

However, it is important to recapitalise banks in a way that minimises moral hazard. It should be made clear that a one-shot recapitalisation is not a precedent for future operations of a similar kind. Reforms are needed so that banks can be held accountable for their future lending, and are able to base their credit judgements on economic criteria. Where banks have themselves been responsible for bad lending decision, those responsible should pay a price.

5. The need for a comprehensive strategy to deal with the problem of non-performing loans

Several speakers have emphasised the importance of an honest recognition of the scale of the underlying problem. Japan delayed doing this and paid a heavy price. Following an appraisal of the size of the problem, there must be a fully worked out game-plan for resolving it. A piece-meal approach, dealing with immediate issues but leaving the fundamental problem unresolved, will lack conviction and be counterproductive. So it is necessary to remove the burden of bad loans; provide for their financing, strengthen the banks capital base, and implement reforms to prevent the problem re-emerging. The strategy outlined by Governor Dai shows that the Chinese authorities are fully seized of the need for comprehensiveness. Still, much remains to be done, given the ambitious and wide-ranging nature of the economic transformation taking place in China.

6. The need to deal with the flow as well as the stock problem

It would be of limited value to recapitalise the banking system if the underlying source of the problem were not dealt with. In that case, the problem would simply re-emerge, with added moral hazard. To avoid this, it will be necessary to: build a proper credit appraisal capacity within commercial banks; ensure that the economy is not dependent on bank financing for current expenditure (i.e. reform the finances of the SOEs);

provide funds for bank recapitalisation as a "one-shot" rather than a continuing exercise. Nothing would be more damaging to credibility than for the Government to come back with a second recapitalisation.

7. The importance of developing a true "credit culture"

This is naturally difficult in a transition economy where credit appraisal skills are scarce. Bank lending officers are unused to their new, and vastly more important role. Lending should be grounded in the capacity of the borrower to repay, based on an objective review of cash-flow projections. Banks should know their customers and have a fundamental understanding of their business and its risks. Lenders need to insist on adequate information to make an objective credit appraisal, which implies robust accounting techniques. Above all, the development of a credit culture means avoiding the mistakes that weakened banking systems in other countries: connected or directed lending; currency and maturity mismatches; insufficient recognition of problem loans, etc.

8. The importance of infrastructure

A financial system cannot function efficiently in the abstract. It needs a clear framework of contract law and predictable law enforcement. Bankruptcy provisions are particularly important. Also vital are appropriate and transparent accounting conventions; adequate transparency and disclosure; strong payment and settlement systems; appraisal techniques (particularly important in assessing collateral adequacy) and so on. This is all at a relatively early stage in China. Priority must continue to be given to pushing the process forward.

9. Good supervision

Everything I have said so far leads up to the proposition that good financial supervision is of paramount importance. But good supervision is much more than signing up to the Basel Committee's Core Principles. As John Heimann said, the aim of supervision is to create good bankers. This points to the key importance of qualitative factors, such as arrangements for risk management, control and pricing, as emphasised by Andrew Sheng. It was clear from the presentations of western supervisors in our meeting that the key sources of weakness in banks are to

be found not so much in weaknesses in quantitative ratios (important though these are) but in such factors as the absence of a coherent business strategy, weaknesses in the control structure, and so on.

10. Building a strong banking and financial system takes time

Removing current sources of weakness and building a firmly-rooted credit culture cannot be done by administrative decision. This is one reason why it is important to begin the process as soon as possible, and to pursue the task with determination. Mr Ueda made it very clear that Japan suffered from delaying deregulation. And a similar point could be made about many other countries. It would be dangerous to believe that because China still has capital controls and a large state sector, it has the luxury of time.

Conclusion

China is at a critical stage in its economic and financial development. Until now, rapid economic progress has been possible with a fairly rudimentary financial system. As the Chinese authorities realise, sustaining this pace of progress (and avoiding costly setbacks) will depend increasingly on a strong and efficient banking and financial system. The process of restructuring that has been begun will have to be carried forward with determination. If it is, the prospects for a continuation of the Chinese economic miracle are bright.