PREFACE

This conference was held in Beijing on 1 and 2 March 1999 and was organised jointly by the Bank for International Settlements and the People's Bank of China. The purpose of the conference was to bring together speakers who would not only be familiar with the experiences of many different countries, but who could also approach these policy issues from many different angles. Several pressing issues were addressed and the discussions, both in the conference itself and in the fringes of the meeting, were lively and frank. Its success owed much to the dedicated and very professional preparation by staff in the Training Centre and in the International Department of the People's Bank of China.

With the financial system undergoing radical reform, the authorities in China face important policy choices, both strategic and technical. In his opening address, *Governor Dai Xianglong* outlined the main issues facing China, explaining that (i) a healthy macroeconomic environment was indispensable; (ii) the nature of supervision of the financial system depended on a country's specific circumstances; and (iii) the developing financial industry had given rise to certain risks which the authorities were addressing in a forward-looking way. He outlined the important reforms of the administrative organisation of the People's Bank of China. He told the delegates that the discussions would be of great help to China's policy-makers in framing policy.

The pervasive linkages between macroeconomic policies and the banking system provided the focus for the first session. *Nicholas Lardy* traced the roots of the bad debts that weigh heavily on China's banks and said that recapitalisation raised several issues: how the underlying causes that had generated bad loans are being addressed; whether enough public funds are being devoted to deal with the true scale of the problem and how could this be financed; whether enough competition is being injected into the banking system; and, finally, what can be done to reduce the taxation of banks. *Rudi Dornbusch* and *Francesco Giavazzi* echoed Lardy's questions about the true size of bad loans in China and argued that restructuring should be accompanied by the development of a deeper national capital market for both debt and equity. Enunciating a number of principles for successful bank restructuring, they stressed three needs: the need to separate money and credit creation from the finance of public sector deficits; the need for not-too-gradual reform; and the need for a strengthened supervisory system to precede any significant opening up of the external capital account. *Lawrence Lau* explored various ways of strengthening banks' balance sheets and suggested that China had adequate fiscal resources for this task: even including the entire stock of banks' non-performing loans, the public debt/GDP ratio would still be well below that in many other countries. He argued that banks should be wary of maturity mismatches and that they should balance long-term loans with long-term sources of finance. *YK Mo* argued that additional resources needed to be devoted to removing bad and doubtful loans from banks' balance sheets.

Lu Baifu stressed the need for self-development in a stable social and political environment. He said that macroeconomic powers belonged to the central government able to take decisions concerning the big picture but that microeconomic decisions could be decentralised. *Wu Jinglian* discussed policy options in the light of the macroeconomic conjuncture. But he put the emphasis on supply-side, rather than demand-stimulatory, measures: to encourage the development of small and medium private business; to strengthen the financial system; and to reform the state-owned enterprises.

The second session examined certain microeconomic issues, including the appropriate framework for financial supervision. *Chen Yuan* explained what the State Development Bank was doing to mitigate policy-oriented financial risks. He said that the SDB's project appraisal had been improved and more projects were now being rejected. *Roberto Zahler* drew on his experiences in Latin America, suggesting that the opening of capital markets had to be gradual. The speed, timing, intensity and sequencing of liberalisation policies made all the difference to success. *Jeffrey Carmichael* drew on Australia's recent experiences in redesigning its framework for financial supervision to argue that the regulatory structure should fit the country's stage of economic development. *Andrew Sheng* looked at financial supervision in a risk management framework and emphasised the dangers of leverage in finance. Stressing the importance of taking full account of financial institutions' vulnerability to macroeconomic risks that are hard to control in a global economy,

he raised the need to develop systems for national and sectoral risk management.

The third session examined the methodology of supervision of the financial sector. *Cai E-sheng* highlighted four major areas for attention: the unsound governing mechanisms of many financial institutions; the need to educate investors about financial risks; the quality of supervisory staff; and the mechanisms for problem institutions to exit. *Carol Sergeant* outlined the main causes of bank difficulties (e.g. management strategies that were misconceived, business that was not understood and organisational structures that did not work) and said that a supervisory system had to make sure that risks were properly managed. She suggested that the removal of "policy lending" from China's state banks was crucial if these banks were to operate on a commercial basis. *Michael Pomerleano* argued that off-site supervision had an important role to play and that there were many ways open to supervisors of verifying information about credits. *Danièle Nouy* explained some of the methodological issues raised in the Basel Committee's "Core Principles of Effective Banking Supervision". She said that a world-wide survey had shown that the shortage of skilled human resources was the most acute problem to be addressed and that supervisory agencies needed to be autonomous. *Nicholas Ketcha* summarised the FDIC's experiences with designing a deposit insurance scheme. Any insurance system, he warned, had to be designed to minimise moral hazard risks. *Brian Peters* focused on two risks particularly important for small and medium-sized institutions: credit risk and operational risk. He outlined the principles that can serve to evaluate a bank's internal control system.

The fourth session focused on the management of banking crises. *Kazuo Ueda* explained the difficulties that had beset policy-makers in dealing with Japan's bad loan problem: he warned about the dangers of undue delay. He argued that policy-makers had to choose between achieving a market-friendly regulatory framework (e.g. allowing bank depositors to lose money) and the maintenance of short-run stability in the financial system. *Yung Chul Park* analysed banking reform in Korea, and delineated several of the dilemmas that the Korean government is grappling with: he said that bank restructuring required effective corporate restructuring, which was proving difficult. He warned that the privatisation of commercial banks could lead to the foreign dominance of the banking system, raising sensitive social and political issues.

Stijn Claessens drew some general lessons from the experiences of Eastern Europe, Latin America and Scandinavia and outlined some of the constraints on systemic bank restructuring in China. *Liu Shiyu* examined China's experiences in the resolution of difficulties of small and medium financial institutions: he presented two case studies, one involving closure and the other financial assistance and rehabilitation.

A panel discussion chaired by *Tommaso Padoa-Schioppa* summarised perspectives on options for China's financial system. *Edgar Meister* considered several important requirements for effective bank supervision and suggested that a Central Credit Register could enhance transparency. *Akira Nagashima* repeated Kazuo Ueda's admonition that China avoid repeating the mistake of delay that Japan had made; he also said that foreign creditors of failed financial institutions should be treated transparently and equitably. *Roberto Zahler* warned that China should reform its banking system and develop a deeper capital market before further economic development led to a more open capital account. *John Heimann* explained how the Financial Stability Institute would work to help strengthen supervisory processes world-wide. He pointed out that foreign financial institutions could contribute much to China. *Xie Ping* outlined the key choices facing China including the ownership structure of financial institutions, the degree to which bank deposits by households should be guaranteed and the means of disposing of bad assets. *Dai Genyou* fully recognised the scale of the problems China faced but drew comfort from three favourable elements – the scope for strong and effective action by the State, China's dynamic growth rate and the high rate of private saving. The key task was to use these savings productively. *Tommaso Padoa-Schioppa* said that the effective supervision of banks was essential in a market economy and that the priority in China was to stop the losses of state-owned enterprises that produced the bad loans for banks.

Speaking at the closing of the conference, *Andrew Crockett* drew several conclusions. Dealing with the problem of non-performing loans required a comprehensive strategy that combined the willingness to use fiscal resources to clean up banks' balance sheets with the determination to make banks fully responsible for future lending. If reform and restructuring is pursued quickly and effectively, he was confident that the Chinese economic miracle would continue. In reply, *Liu Mingkang* thanked both Andrew Crockett, who had sponsored and initiated the meeting,

and the speakers for their rich contributions. He said that the seminar had been very valuable for those responsible in China for banking reform, who would have to combine what they could learn from foreign experiences with what they knew of China's specific situation. In describing the challenges supervisors faced, he underlined China's strong commitment to the Basel Committee's Core Principles. "China tomorrow", he said "can be better only if we think harder, we learn harder and we respond quicker".