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Financial Stability Report

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Financial Stability Analysis Group of
the People's Bank of China



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Governor's Address

Finance is the kernel of the modern economy. Maintaining financial stability ensures sound economic development and lasting social stability. According to the World Bank statistics, from the late 1970s to early 21st century, the world has suffered 112 systemic banking crises in 93 countries. These crises not only ruined many years' economic achievements in the affected countries, but also widened the gap between the rich and the poor, and triggered social conflicts. The 1997 Asian Financial Crisis and its powerful shock waves on the world economy have brought financial stability unprecedented attention. It has also heightened the awareness of the general public towards the inherent significance and ramifications of financial stability.

The central bank of a country has a natural role in maintaining financial stability, as it is the lender of last resort and plays an important role in maintaining liquidity in financial system and ensuring stable operation of the payment and settlement systems. Indeed, this role of maintaining financial stability has been strengthened throughout the last few decades, given that it is complementing the other important function of a central bank in formulating and implementing monetary policies . The practice in other countries and regions shows

that the actual role and responsibilities of the central bank in financial stability are far greater than that defined in theory. International financial organizations have attached great importance to financial stability. The IMF and the World Bank jointly introduced the “FSAP” in May 1999, aiming at strengthening the assessment and monitoring of the financial vulnerability of their member countries and regions so as to minimize the possibility of financial crises occurring. At present, more than 80 economies have completed the FSAP. The IMF has also stepped up evaluation of the global financial stability and releases the *Global Financial Stability Report* on a regular basis. In addition, there are various international forums on financial stability to promote exchanges and cooperation among various countries on this issue.

As China's economic and financial strength grows, its financial stability is of great significance not only to China, but also to Asia and the rest of the world. Since the 1997 Asian Financial Crisis, Chinese government has been paying great attention to financial stability and took a series of measures to restore financial order and eliminate potential financial risks. These measures included; reinforcing financial monitoring and performance assessment of key state-owned financial enterprises; issuing special treasury bonds worth RMB270 billion yuan to re-capitalize the SOCBs; setting up the AMCs to dispose of the NPLs of the four SOCBs; closing down a number of insolvent financial institutions; and enhancing financial regulation, adopting prudent accounting principles, five-category classification of

loan quality and bank information disclosure methods, etc.

A Decision of the CPC Central Committee on Issues Regarding the Improvement of the Socialist Market Economic System (referred as *Decision* below) is a guiding document for China to maintain financial stability in the new era. Since 2003, Chinese government has taken further measures on the basis of the *Decision* to deepen financial sector reform and maintain financial stability. A regulatory framework based on the principle of separating the regulation for banking, securities and insurance businesses has been put in place. The *Law on the PBC* has been amended, clarifying and reinforcing the function of the PBC to fend off and mitigate financial risks and maintain financial stability. As required by that law, the PBC is actively working on defining the objectives, missions and means to maintain financial stability.

In the reform of financial institutions, the shareholding reform of the SOCBs is achieving very good results. During this reform process, a modern corporate governance structure is being set up in BOC, CCB and ICBC, and they have all substantially improved their CAR, asset quality, risk provisions, profitability and other financial indicators. The banks' ability to defend financial risks has improved substantially. Major progress has been made in the deepened reform of the RCCs, and the business performance of those cooperatives in the pilot regions is improving and their financial strength is rising rapidly. The successful IPOs of CCB, BOCOM, PICC Property and Casualty, China Life Insurance and China Ping An Insurance

(Group) in the overseas market have upgraded their corporate governance and sharpened their international competitiveness.

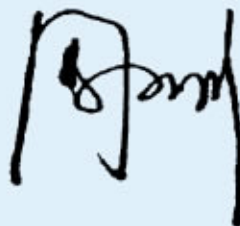
In the development of the financial market, Chinese government pays special attention to build a mechanism whereby money, capital and insurance markets are integrated, so as to maintain stable operations of the financial market and prevent systemic risks. In recent years, China's money and insurance markets have been increasingly improving, with more diversified market participants and products, and the gradual emergence of innovative cross-market financial products. The *State Council's Opinions on Promoting Reform, Opening up and Stable Development of the Capital Market* (referred as *Opinions* below) issued in early 2004 introduced a comprehensive platform for the development of the capital market and reform of the securities industry. The development of the capital market is a strategic step in China's economic development, and we hope that the deep structural problems in the capital market could be solved properly.

In the next few years, the PBC will continue to work with other government agencies to (1) explore new approaches and methods to maintain financial stability; (2) improve the effectiveness of financial regulation through better coordination among the central bank, the MOF, and the regulatory authorities for banking, securities and insurance; (3) establish and improve the deposit insurance scheme, securities and insurance investor protection system; and (4) set up a rapid reaction mechanism to deal with unforeseen events which could trigger financial instability.

Generally, China has achieved financial stability through deepening reform. However, due to the huge historical legacy problem and accumulated financial risks in the transformation of the economic system, it will encounter some new financial risks in building up socialist market economic system. Currently, China has a disproportional relationship between direct and indirect financing. The ratio of bank loans to GDP is too high, and financial risks are concentrated in the banking institutions. There is still potential pressure on its currency stability and the exchange rate formation mechanism needs further improvement. With regard to China's financial institutions, their ability in risk control and corporate governance is still inadequate, and their capacity for financial innovation is limited. In terms of restructuring of financial institutions, it remains a difficult task to prevent moral hazards. The financial ecosystem needs to be improved further. Following the change in China's economic growth pattern, with the adjustment of its industry structure and the changing international environment, the increasingly open financial system of China is bound to face more internal and external shocks and pressure. It is a tough job to maintain financial stability, a job that requires close cooperation among different government agencies, and attention and support from the public as a whole.

A comprehensive assessment of the stability of China's financial system is important in the sense of judging the status of the financial situation, removing financial risks in a timely manner and maintaining financial stability effectively. The State Council has explicitly requested that the PBC should step up

monitoring and prevention of systemic financial risks and ensure effective assessment of financial stability. The PBC has decided that, from 2005 onwards, it will release the *China Financial Stability Report* on a regular basis. The publication of this report is important to the PBC's endeavor to achieve greater financial stability. The aim of the report is to present China's policies and principles on financial reform, its opening up and timely development, demonstrate China's progress on financial stability in a transparent way, and enable the general public, market participants and international community to better understand China's financial stability and gain confidence in China's financial system. It should become a significant platform for communication and cooperation between the PBC and all relevant domestic and international parties on financial stability.

A handwritten signature in black ink, consisting of stylized, flowing characters that appear to be '周' (Zhou) and '正' (Zheng), likely representing Zhou Xiaochuan.

Governor of the PBC

September 15, 2005

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¹ The English edition is an unofficial translation of the *China Financial Stability Report 2005*. In case of any discrepancies, the original language shall govern.

Preface

A thorough assessment of the stability of the financial system is fundamental to a country's efforts in fending off and mitigating risks, promoting financial reform and safeguarding financial stability. In 1996, Bank of England took the lead in conducting an overall assessment of the stability of the financial system in Britain, and issued a *Financial Stability Review*, the first of its kind in the world. Since then, the central banks of France, Denmark, Sweden, the Republic of Korea and Singapore have held regular assessments of the stability of their financial systems and released financial stability reports.

The PBC pays special attention to the assessment of China's financial stability. To make the policies for financial stability more transparent and forward-looking, the PBC decided to issue the *China Financial Stability Report* regularly starting from 2005. Governor ZHOU Xiaochuan has given specific instructions to ensure that the report be of the highest quality. Therefore, a Financial Stability Analysis Group was set up within the PBC, with Deputy Governor WU Xiaoling as the Head and Assistant Governor LIU Shiyu as the Deputy Head, and leading officials from the Financial Stability Bureau, Legal Affairs Department, Monetary Policy Department, Financial Market Department, Financial Survey and Statistics Department, Accounting and Treasury Department, Payment System Department, International Department, Personnel Department, Research Bureau, Credit Information System Bureau, Anti-Money Laundering Bureau, and SAFE as core members. *China Financial Stability Report 2005* is the result of a proper division of labor, in-depth research and several revisions. Special acknowledgement is given to China Financial Publishing House for its tremendous efforts in publishing the report. The English version is an unofficial translation of the *China Financial Stability Report 2005*. Great appreciation is extended to Credit Suisse First Boston's assistance, especially Mr. Vincent Chan, to translate the report into English. In case of any discrepancies, the original language shall govern.

The current issue of *China Financial Stability Report 2005* is composed of five parts. Part I gives a general description of financial stability in China; Part II

analyzes the impact of macroeconomic and financial operation on financial stability; Part III discusses the relationship between the development of financial market and financial stability; Part IV explores the development and reforms of financial sector, with an emphasis on the problems and reform measures on financial institutions which have a direct impact on financial stability; Part V analyzes the financial infrastructure and financial ecosystem, discussing how to improve the financial ecosystem and safeguard financial stability from the perspective of payment system, legal environment, corporate governance, accounting standard, credit environment, anti-money laundering and financial safety net construction etc. The report also contains eighteen “boxes” that provide in-depth analysis on major issues and case studies relating to the financial stability in China.

The report is a reflection of piloting efforts made by the PBC in conducting an overall assessment of China’s financial stability. We have tried our best to analyze the theoretic and practical issues regarding China’s financial stability. Because of the authors’ inadequate knowledge and limited experience in making such an assessment, the report is by no means perfect. We welcome suggestions for improvement in future editions.

Financial Stability Analysis Group of the PBC

September 15, 2005

Abbreviations and Acronyms

ABC	Agricultural Bank of China
AMC	Asset Management Corporation
BCCI	Bank of Credit and Commerce International
BIS	Bank for International Settlements
BOC	Bank of China
BOCOM	Bank of Communications
CAR	Capital Adequacy Ratio
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CCPC	Prefecture City-level Clearing and Processing Center
CHIBOR	China Inter-bank borrowing rate
CIRC	China Insurance Regulatory Commission
CNAPS	China National Automated Payment System
CPC	Communist Party of China
CPSS	Committee on Payment and Settlement System
CSRC	China Securities Regulatory Commission
CUP	China Union Pay
DVP	Delivery versus Payment
EAG	Eurasian Group on Combating Money Laundering and Financing of Terrorism
ECB	European Central Bank
EPS	Earnings Per Share
ETF	Exchange-traded Fund
FATF	Financial Action Task Force

FSAP	Financial Sector Assessment Program
FDI	Foreign Direct Investment
FSI	Financial Soundness Indicators
GEM	Growth Enterprise Market
HKD	Hong Kong dollar
ICBC	Industrial and Commercial Bank of China
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
JSCBs	Joint-stock Commercial Banks
LOF	Listed Open-ended Fund
LVPS	Large Value Payment System
MOF	Ministry of Finance
NCCT	Non-cooperative Countries and Territories
NDRC	National Development and Reform Commission
NPC	National Processing Center
NPL	Non-performing Loans
OECD	Organization for Economic Cooperation and Development
OFIs	Other Financial Institutions
PBC	People's Bank of China
QFII	Qualified Foreign Institutional Investor
RCCs	Rural Credit Cooperatives
RMB	Renminbi
RPS	Retail Payment System
SAC	Securities Association of China
SAFE	State Administration of Foreign Exchange
SCNPC	Standing Committee of the National People's Congress
SMEs	Small- and Medium-sized Enterprises

SOA	Sarbanes-Oxley Act
SOCBs	State-owned Commercial Banks
SOEs	State-owned Enterprises
TICs	Trust and Investment Companies
UCCs	Urban Credit Cooperatives
USD	US dollar
WTO	World Trade Organization
y-o-y	year-on-year

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