The risk-analysis of the banking sector in China

Rainer Polster {德意志银行经济学家}
Yanfen Huang {德国埃森大学经济系博士}

Recently some press reports about the insolvency and the debt-repayment of the GITIC have attracted growing international interest in the problems of the Chinese banking sector: What happened in China? Which problems exist in the banking sector? Could these problems trigger a banking crisis in China? The purpose of this article is to analyse the potential risk in the Chinese banking sector. At first we give an overview of the characteristic of the Chinese banking sector. In section 2 we explain some risk-indicators. then we analyse the factors causing those risks. Finally we give some possible risk-scenes.

1. A short survey of the Chinese banking sector

Chinese economic reform is famous for "gradualism ". During the past two decades of economic reforms China 's banking sector has developed remarkably: At first, in 1984 the monobank system was abandoned in favour of a two-tier banking system in which the People 's Bank of China (PBOC) became the central bank and its remaining commercial lending activities were transferred to the four state-owned specialized banks; Second, the banking sector is diversified : besides the four state-owned specialized banks emerged commercial banks, policy banks, trust and investment companies, urban cooperative banks, rural credit cooperatives, finance companies and so on. From 1978 to 1998,while nominal GDP grew 20.95 times, bank deposits increased 67.3 times, so that the bank-deposits/GDP–ratio rose from 35.88% in 1978 to 111.66% in 1998. Moreover the total banking assets/GDP–ratio increased from 8.03% in 1985 to 130.12% in 1998.These measures reflect the rapid "monetarization process " in the Chinese economy in the last 20 years.

The role of the Chinese banking sector is also strengthened through the fiscal deterioration in China. With the decentralization in the course of the Chinese economic reforms the Chinese government 's revenue, as a share of GDP has fallen sharply. Meanwhile the government deficit has rapidly increased. Chart 1 shows the development of the government 's balance as percent of GDP from 1978 to 1998. In 1978 the government 's balance was positive and made up 0.28 percent of GDP. In 1998 this figure was negative, about -1.15 %of GDP. These increasing

国内通信地址: 100037 北京市西城区北营房东里10号楼1501室 黄燕芬

deficits are largely covered by borrowing from the state banking system .(see table 1)

Chart 1:The Chinese government 's balance as a share of GDP

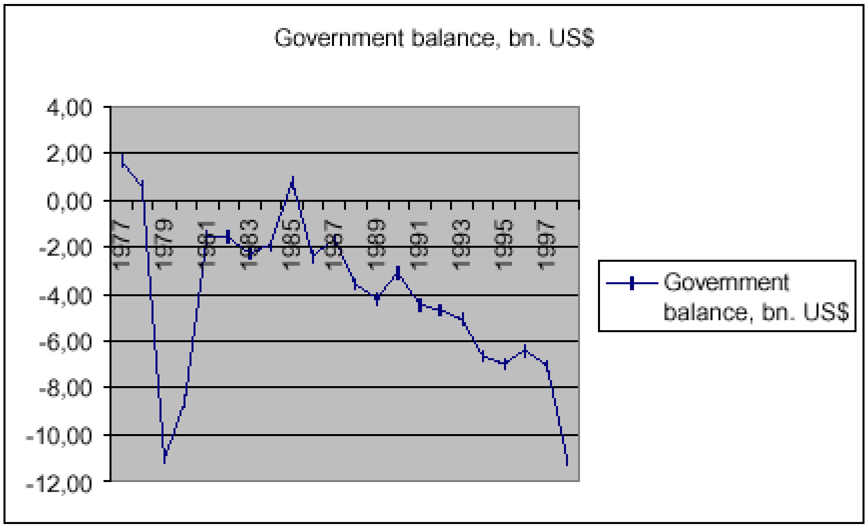

Table **1:**The ratio of fiscal funds and credit funds in Chinese economic construction

(In Billion RMBY)

Year	Fiscal Funds (1)	Credit Funds (2)	Total	Ratio of fiscal funds (%)	Ratio of credit funds (%)
1980	64.13	40.91	105.04	61.1	38.9
1981	51.43	36.48	87.91	58.5	41.5
1982	50.47	31.38	81.85	61.7	38.3
1983	58.47	42.15	100.62	58.1	41.9
1984	73.28	116.98	190.26	38.8	61.5
1985	83.21	99.15	182.36	45.6	55.4
1986	96.65	139.25	235.9	41	59
1987	92.96	158.49	251.45	37	63
1988	98.52	165.62	264.14	37.3	62.7
1989	100.51	204.43	304.94	33	67
1990	113.84	307.5	421.34	27	73
1991	103.54	365.71	469.25	22.1	77.9
1992	110.33	498.51	608.84	18.1	81.8
1993	140.43	662.02	802.45	17.5	82.5
1994	153.6	774.52	928.12	16.5	83.5
1995	181.5	973.59	1155.09	16.7	84.3
1996	205.21	1061.25	1266.45	16.2	83.8

1997	234.904	1283.39	1518.294	15.47	84.53

(1) Fiscal funds include expenditures for capital construction, additional appropriation for enterprises, circulating capital, innovation funds and science--technology promotion Funds, geological prospecting expenses, expenditure for supporting agricultural production and agricultural operating expenses.
(2) Source: China Statistic yearbook 1997,1998,Almanac of China ‘Finance and Banking 1996,1997,1998.

Though significant progress has been made in developing China ‘s banking system, the reform of this sector lags behind the achieved results of the economic reform in the real sector. The main feature of China ’s banking system remained unchanged: the four state-owned specialized banks still dominate the financial sector. The assets of the state banks account for over 70%of the total assets of the whole financial sector(see table 2);by the end of 1997 the four state banks distributed 76.92%of the total bank loans. The state banks still work under soft budget restrictions, as they can not operate according to risk-management considerations. Therefore, Chinese banking sector today is technically insolvent and incompatible with the vibrant market forces that have been released by the reforms in the real sector of the economy.

Table 2:The ratio of the assets of the state banks in the total of the all banking institutions,

Time	Ratio (%)
1995	75.67
1996	71.17
1997	71.998

Source: International financial statistics, IMF. The PBOC quarterly statistical bulletin,1998-4

2. The signs of risk in the Chinese banking sector

Up to now the Chinese banking sector has revealed the following signals of risk:

2.1. Over-borrowing and inefficient use of capital resources

From the macroeconomic view two important indicators for over-borrowing and inefficient use of capital resource are net domestic credit/GDP–ratio and M2/GDP–ratio. In the last 20 years the two quotas in China have greatly increased. From 1978 to 1998 the net domestic credit/GDP –ratio has increased from 51%in 1978 to 112.6%in 1998(see table 3). Meanwhile, the M2/GDP –ratio has risen from 24.5%in 1978 to 132.7%in 1998(see table 4).

Table 3 : The net domestic credit/GDP–ratio in China (%)

year	1978	1984	1988	1990	1991	1992	1993	1994	1995	1996	1997	1998

ratio	51	61.69	76.38	88.8	91.37	90.82	97.47	88.67	86.97	92.6	101.3	112.6

Source: International financial statistics

Table 4: M2/GDP–ratio in China (%)

year	1978	1984	1988	1990	1991	1992	1993	1994	1995	1996	1997	1998
M2/gdp	24.5	50.2	65.3	80.1	87.4	94.1	100.7	99.6	102.3	109.7	120.8	132.7

Source: International financial statistics

When we compare these two quotas in China and other Asian countries, we recognize that in China the two quotas are higher than in some Asian-crisis countries(see table 5 and 6).The M2/GDP–ratio in China stood 109.7%in 1996 and 120.8%in 1997,which is the highest under the five countries. In 1998 this quota in China was only lower than in Malaysia.Net domestic credit /GDP in China is also higher than some Asian countries just a 成 s Indonesia and Korea. This means that the situation of the over-borrowing in China is very serious, even more serious than in some Asian Crisis-countries.

Table 5: The ratio of net domestic credit relative to GDP (%) in 5 Asian countries

Country	1996	1997	1998
China	92.6	101.3	112.6
Indonesia	55.43	61.03	56.78
Malaysia	93.13	103.94	229.1
Thailand	99.97	118.69	115.1
Korea	65.69	73.4	74.18

Source: International financial statistics

Table 6: The ratio of M2 relative to GDP (%) in 5 Asian countries.

Country	1996	1997	1998
China	109.7	120.8	132.7
Indonesia	52.15	55.61	63.49
Malaysia	93.91	99.88	206.51
Thailand	79.47	89.92	103.45

Korea	45.74	48.35	57.52

Source : International financial statistics

These two quotas show that China ’s economic growth depends more on the high investment rates rather than the improvements in the efficiency of the use of capital resources or of productivity. Just as in the most other Asian countries too, the capital market in China is underdeveloped. Bank credits remain the main financing source of Chinese enterprises. Thus, we can conclude that there exists an over-borrowing of bank credit in China as in other Asian Crisis-countries. Of cause, we could also analyse the situation of over-borrowing from the view of enterprise finance, but we can not get the enough reliable data. According to an official survey, the average debt-asset ratio of the SOEs (state-owned enterprises) increased from 18.7%in 1980 to 83.33%in 1994.Therefore, we estimate that the average debt-asset -ratio of the SOEs now is more than 80%.

2.2. The debt-crisis between the state banks and SOEs

A direct result of the over-borrowing and inefficient use of capital resources is the debt-crisis between the state banks and SOEs. As shown above, the state banks provide most of the loans. In addition, the majority of credit-receivers are SOEs .In 1996 only 13 percent of the bank loans were granted to non-SOEs, although non-SOEs produced 64% of the industrial output[1]. According to the estimate of Fernald and Babson[2], more than two-thirds of net bank lending went to the state sector in 1997. Under the credit plan, if a SOE was included in the credit plan, bank must provide its allotted credit, regardless of its creditworthiness. As in the last years a majority of SOEs have become non-profitable, a large number of bank loans can be classified as non- performing in risk of default. It is estimated that over 70%of SOEs are in net debts, they can not pay back their bank-lending. Therefore the over-borrowing and inefficient use of capital resources has caused the debt-crisis between the state banks and SOEs .How high is ratio of the non-performing loans? There is no official figure, because has never been conducted a detailed audit. As estimated by Standard &Poor’s, the non-performing loans amounted to US$200 billion at the end of l997. That represented about 25 percent of the total loans outstanding, or a quarter of China ’s GDP. In January 1999, People ’s Bank of China Governor Dai stated that more than 20 percent of bank loans are non-performing, although he argued that only 5 to 6 percent of loans are unrecoverable. Some economists put the amount as high as 40-50 of the total loans

[1] South China Morning Post, China Business Review, May 14,1998

[2] John G.Fernald and Oliver D.Babson , “Why has China survived the Asian crisis so well? What risks remain? ”

outstanding[3].

2.3. The deterioration of capital levels and profitability in the Chinese state banks

The debt-crisis between the state banks and SOEs has deteriorated the capital levels and profitability of the state banks: The minimum capital adequacy in the state banks are much lower than 8% the standard of the minimum capital adequacy according to the "Basle Core Principles ". Meanwhile, the return on assets of the state banks is also very low: By the end of 1997 the return rate on assets of the Industrial and Commercial Bank of China and Agricultural bank of China were only 0.07535% and 0.0335% respectively. The Bank of China achieved the best return rate on assets in 1997, but this figure was also very low, only 0.176%.(see table 7) In regard of the poor accounting and statistic system some economist estimate that the four state banks have in fact a deficit. The World bank also calculates that the net worth of the four large state banks is probably negative[4].

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Table 7:The return on assets of the four state banks (%)

year	ICBC*	ABC*	BC*	CBC*
1996	0.16	0.1436	0.25	0.3066
1997	0.07535	0.0335	0.176	0.112

* ICBC: Industrial and Commercial Bank of China   * ABC: Agricultural bank of China

*BC: Bank of China   * CBC: Construction Bank of China

Source: Almanac of China 's Finance and Banking,1998,page558-560,571-573

2.4. The collapse of Hainan Development Bank and 3 trust and investment companies

In a whole, the financial situation of other commercial banks and local banks is better than the state banks, since they operate more according to the commercial rules. But such some banks have also many financial problems. Owing to the monopoly of the four state banks there are only very small space of operation remaining for such banks. To improve their profit they have tried to absorb the banking deposit with the high deposit-rate and provide their loans with the high-lending rate[5]. If the macro-performance has changed abruptly, they can not promptly recall some loans and absorb enough banking deposits. Hence, Some banks became illiquid and forced to go bankruptcy. The closure of Hainan Development Bank is an example. Since the mid of the 80's,

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[3] South China Morning Post, China Business Review, May 14,1998

[4] Word Bank, 1996: The Chinese Economy: Fighting Inflation, Deepening Reform,Vol.I,p.32

[5] According to the regulations of the PBOC, the deposit-rate and lending-rate of local banks can be floating between ±20% of the normal deposit-rate and lending-rate for the state banks.

trust and investment companies (TICs) and international trust and investment companies (ITICs) were in China proliferated. Some TICs were established by the local government as vehicles to circumvent the credit quotas, meanwhile, ITICs are served as a conduit for obtaining foreign investments. They make those financial activities under the guarantees of the local government. Because of the bad management, illegal operation and changes of domestic and international situation, many TICs and ITICs are in financial difficulties. In 1998 three trust and investment companies was closed down: China Venture Tech Investment Corporation; China Agri-Business Development Trust and Investment Company; GITIC, Guangdong International Trust and Investment Company.

3. The causes of the possible risk in the banking sector

The possible credit risk in the banking sector is caused by several characteristics of China 's banking system:

3.1. Lack of operational independence of the state banks

In China, not only PBOC, but also the state banks can not operate independent from the intervention of the government. There are more or less governmental or semi-governmental subdivisions. The bank branch networks coincided in the past with the political division of the country, and each local bank branch was under the "dual leadership" of its head office and the local governments. Thus, the PBOC and state banks' asset usage was strongly influenced by the government: The PBOC must provide the state banks the central-bank-lending according to the credit plan; under the pressure of the government the state banks have extended policy-loans to finance investment projects and to keep loss-making SOEs alive. Lending decisions of local branches of the PBOC and state banks were also subject to frequent interventions from local governments.

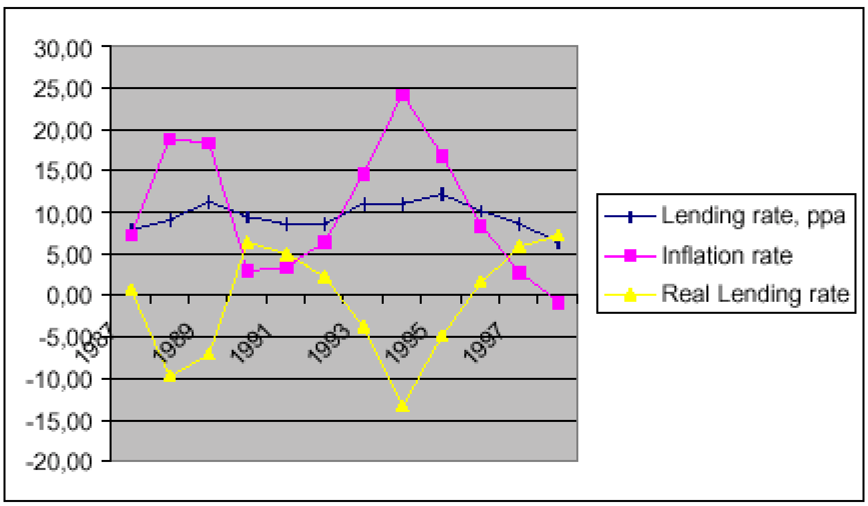
Recently a series of reforms have been taken to isolate the intervention of the government in the banking sector: restructuring the PBOC through building nine inter-regional branches that cut across provincial lines; establishing the policy banks and trying to commercialize the state banks. But under today's Chinese political system, it is impossible for the banking institutions to operate completely free from the intervention of the government.

3.2. Credit plan

The government influences the operation of the banking institutions through the so-called "credit plan". Before 1998 every state banks got a credit-quota from the PBOC. According to the credit plan, then gave the bank-loans to enterprises. The credit plan includes detailed priorities for lending, even in some cases specifying credits for specific borrowers: for example, the policy-loan-assignments to finance agricultural procurements, poverty-alleviation, and working capital loans for the SOEs. The main policy loans in china are the uncollateralized loans (unsecured loans with no mortgage).

In addition, credit plan works together with the regulation of interest rate. The PBOC sets the lending-rate in favour of the SOEs and lower as market-lending-rate. In several years, when inflation accelerated, the real interest rate became negative (see chart 2).One can hence conclude that the role of the interest rate is only supplementary to direct credit controls and that bank credits are near-free funds. In effect, SOEs get very high subsidies from the central government via the banking system.

Chart 2: The real interest rate in China



In 1994, three policies banks were founded to help the state banks reduce their policy-loans. However, the policy banks never have received really sufficient funding to make such loans, which means the state banks have not been relieved completely of this responsibility. In fact there are still policy loans in the 4 state banks. Since 1998 the credit-quota in the state banks is abolished, but the state banks are still subject to the so-called “plan-guiding” and “indirectly regulating”. That is to say, the state banks get a guiding-credit-plan. Although by this guiding-credit-plan the state banks are not compelled to carry out as in the old credit plan, normally, the state banks must still implement this plan, because, whether a state bank has carried out this guiding-credit-plan good or not, is related to the stability and rising of the position of leaders in the state banks.

3.3. Obligations to state-owned enterprises

During the post-reform years, the Chinese government has shifted the budgetary burden of supporting SOEs to the banking system: In 1984,the so-called “loans-for-grants” reform was introduced for the SOEs, which strove to move away from the provision of investment funds on a grant basis from the government budget towards the allocation of working capital and investment funds through the banking system. This reform saddled the state banks with an inherent obligation to support the SOEs.

As shown in the table 8 since the economic reform in China, in contrast to the fast growing of non-state sector, the financial losses of SOEs have increased year by year. Therefore, many SOEs can not pay back the banking loans. Banks non-performance, after all, is just a reflection of SOE’s inefficiency.To keep the loss-making SOEs afloat the state banks are required to provide the SOEs further new banking loans. Thus, the non-performing banking loans in China ’s banking sector are increasing. Now the government is caught in an dilemma: Refusing loans to loss-making enterprises would cause widespread bankruptcies and unemployment, which cause political and social problems, but continuing to provide loans to them would wreck financial reform. Up to now the Chinese government has not found a way out of this dilemma.

Table 8:Total losses of loss-making state-owned industrial enterprises

(In Billion RMBY)

year	1978	1984	1988	1990	1991	1992	1993	1994	1995	1996
loss	4.21	2.66	8.19	34.88	36.70	36.93	45.26	48.26	63.96	79.07

Source: Statistical Yearbook of China, 1997,p.439

3.4. Moral hazard

Moral hazard is closely related to information asymmetries, the fundamental characteristics of finance: The credit-receivers know better how they will use them than the credit-providers. Thus the banking institutions have difficulties to monitor the enterprises. In the Chinese case moral hazard is even worse because of the quasi-operation of the banking system: At first, the state banks were obliged to provide loans for the priority enterprises, as identified by the state, regardless of their repayment capacities, which made the assessment of bank performance more difficult. Consequently, they had neither the ability nor incentive to select and monitor their borrowers. Second, even if the banks are willing to do so, much of the information has to be provided by basic services in accounting and auditing, but China is still lacking a sound accounting and auditing system. At the end, since SOEs have privileged access to low-cost credit, they have little concern for interest costs and investment risks. Moral hazard has given rise to the inefficient operation of the banking system and aggravated the hidden risk in China 's banking sector.

3.5. Poor banking supervision

Banking supervision is still underdeveloped in China. For a long time the PBOC used the administrative methods just as the credit plan to regulate the operation of the banking sector. Therefore the PBOC has not experienced in banking supervision. Moreover, China has lack in the infrastructure of the banking supervision: the law systems are not complete; for example, no “trust law ”, no “cooperative bank law ”are existing. Even if there exist some laws, they are not good implemented. Learning from the lessens of the Asian crisis the PBOC tries to strength the banking supervision: It has established nine inter-provincial branches, each has a department of banking supervision; On 11 December 1997,authorized by the State Council, PBOC created a supervisory committee for the state banks; In order to safeguard the efficiency of financial control, PBOC has issued “Regulations on Financial Controls ”.But at present a sound supervision in China is still impossible: At first, since the state banks have still bad capital levels, asset quality, earnings and liquidity, the PBOC can not carry out the banking supervision according to international standards. Second, until the state banks are not completely commercialized and still provide further policy loans, it is very difficult for the PBOC to implement a effective bank supervision, because it is difficult to judge the performance of the state banks.

4. Some possible risk-scenarios

Up to now we have analysed the signals and the reasons for the possible risk in the China 's banking sector. Could a banking crisis in China happen? The literature on banking crises and panics is quite abundant. Some of the authors have concentrated on domestic factors: Calomiris and Gorton(1991)[6] have pointed out that crises and panics are preceded by recessions and are most likely to occur when the recessions follow a period of substantial increase in credit, which fuels a prolonged expansion in economic activity. When the recession comes, depositors try to re-assess the risk in the banking sector and withdrawing large amounts from all banks. Krugman (1998)[7] has focused on the links between moral hazard and overinvestment (high leverage):

[6] Calomiris,C.W.,and G.Gorton, “The Origins of Banking panics: Models, Facts,and Bank Regulation”,in:G.Hubbard,ed.,*Financial Markets and Financial Crise*s,(University of Chicago Press,Chicago),1991,p109-173

[7] Krugman,Paul (1998),“Was happened to Asia?”, from Paul Krugman’s web page, at

implicit guarantees that governments would stand behind financial intermediaries led to investment based not on expected returns and thus cause overinvestment. By the coming of recession it is possible to provoke a banking crisis. That is to say, close links between the government and the financial intermediaries are an important cause of many banking crisis. Some other economists think, many external shocks may also cause a credit crunch.. For example, Mckinnon and Pill (1994)[8] examine the role of capital flows in an economy with an unregulated banking sector with deposit insurance and moral hazard problems of the banks. What are the possible scenes in China? In this part we give some possible risk-scenarios through the analysis of the possible external and internal shocks in the short and long term.

4.1. The possible external shocks

We think, it is unlikely that in the short term external shocks provoke a crisis, since China 's external accounts remain solid and the capital account in China is still controlled. That is also the main cause why China has survived the Asian Crisis. In the long term the reform of the liberalization of the capital account and the regime of RMB are possible fuse of banking crisis in China.

4.1.1.In the short term

At first, China 's large foreign exchange reserves will help the Chinese banking sector insulate from the possible external shocks. ˜ In 1998 China reported a positive trade balance of $46.61 billion and the current account surplus of $29,323 billion that amounted to 3.09%of GDP in 1998. Struck by the Asian crisis the foreign direct investment in China was down in 1998 comparing to 1997.But with US$43.75 billion China still holds the second place in the world. Furthermore, in 1998 the foreign exchange reserves increased from US$139,89 billion to US$144,96 billion, the second most in the world. ˜ With China 's large foreign exchange reserves its external remains manageable and its external debt is relative low. China had total external debt of $173 billion in 1998,accounted for 18%of GDP and 81%of the foreign exchange receipts from exports. The short-term external debt amounted to $34 billion, made up 19.65 %of China 's total external debt and 23,45%of total foreign exchange reserves. Total debt service payments were $19 billion in1998,or 9%of exports of goods and services. Overall, China 's external debt situation has been a healthy one in terms of both scale and structure. ˜ In the first half of this year China 'external account remained also sound. Although exports fell 4.6%in the

http://web.mit.edu/krugman/www

[8] McKinnon,R.I.,H.Pill, “Credible Liberalizations and International Capital Flows: the Overborrowing Syndrome”,(Stanford University, Stanford),1994

first half of 1999 to US$83 billion, China had still a US$7.99 billion trade surplus. Owning to the recovery of economies near China and the wave of corporate mergers in the developed countries actual foreign investment in the first half of this year was US$18.6 billion, down 9.2% compared to the first half of 1998.But China ’s foreign exchange reserves have still increased, now amounting to US$147.05 billion, about US$2.1 billion more than at the beginning of this year.

Second, China carries out the policy of strict capital control; that means: Restrictions on foreign borrowing by Chinese entities; limitation on portfolio outflow by Chinese citizens and inflows by foreigners; and prohibition on futures trading in RMB. If the capital control is not removed, it is easy for the China ’s banking institution to rule out the external shocks just as speculation of “hot money ”and contagion of crisis from other countries. Up to now China has successfully avoided the external shocks caused by volatile exchange rate fluctuations and capital flight, as happened in Mexico and the southeast Asian countries.

Thus, giving China ’s solid external account and strictly capital control it is unlikely that any conceivable shocks will ignite a banking crisis in China in the short term.

4.1.2.In the long-term

With economic globalization, many countries have opened their capital markets to allocate domestic and international resources rationally, and China is no exception. But opening capital markets is often accompanied by increasing financial risk, as is shown in the Asian crisis.Graciela L.Kaminsky (1996) has examined crisis episodes for a large number of countries and found that financial liberalization often precedes banking crises[9]. Giving an unhealthy banking sector could the reform of the opening capital markets easily trigger the banking crisis in China.

China is now following a very gradual approach to realizing its long-term goal of liberalizing capital account transaction. After the Asian crisis China is more cautious about the liberalization of the capital account and the convertibility of RMB than before. The timing of the liberalization of the capital account and the convertibility of RMB depends on the following factors: At first, when can China join the WTO? Second, whether the domestic economic situation is good enough to make these reforms. At present is the negotiation about China ’s joining WTO deferred because of the bombing of Chinese embassy in Yugoslavia. In Addition, the domestic economic situation in China is not good.(see 4.2.) Therefore, we estimate that the timing of the

[9] Graciela L.Kaminsky, “The twin crises: the causes of banking and balance-of-payments problems ”.

liberalization of the capital account and the convertibility of RMB is at least after year 2000.

If China would abruptly make the reform of the capital account and the convertibility of RMB, could some external shocks provoke a banking crisis in China? These shocks include: A possible speculation against RMB; over-borrowing of the China 's banking institutions from abroad; large short-term capital outflows and so on. We give a possible risk-scenario: If inadequately regulated and supervised banking institutions would be allowed full access to international capital market, they could seek to borrow far more from abroad because of the domestic capital shortage. But many Chinese banking institutions are lack of the experiences in the risk-management and could provide some high-risky loans Given the excessively risky bank-lending these banks might not be able to recall these loans and repay their foreign debts, then a banking crisis could happen. In a word, in the long-term we can not exclude the possibility of a banking crisis caused by external shocks.

4.2.The possible domestic shocks

A possible fuse of banking crisis lies also in domestic shocks. Despite the prevalence of bad loans and other institutional weakness, we argue that in the short term these problems need not lead to imminent banking crisis in China. But in the long term the situation is complicated.

4.2.1.In the short term

At first after the Asian crisis China has lowered the tempo of the SOEs' reform. The solvency of SOEs is no longer encouraged by the government since the solvency of SOEs might cause a liquidity problem in the banking sector. The state banks are required to increase their lending to the state sector. Second, China has took many new measures in the banking reform: reforming the institutional structure of the PBOC to increase its independence; abolishing the credit-ceilings of the state banks; issuing special treasury bonds to boost the capital adequacy ratio of the state banks; establishing the so-called “asset management corporation ”to take over non-performing loans; strengthening the bank- supervision. Third, the banking deposits are still increasing, although the PBOC has reduced the interest rates of deposits seven times since 1996.Therefore,in the short run the China 's banking sector still can operate: Government gives the State banks further the guarantees; with such guarantees the state banks can continue to function regardless of the bad asset level and profitability. Meanwhile, depositors continue to have faith in the banking system, and the deposit base remains sound.

4.2.2.In the long term

As the upper explanation the signals of risk are rooted in China 's banking sector; moreover the reform of the banking sector is related to the reform of SOEs. The failure of the reform of SOEs could be the reason for a banking crisis. From our point of view the possibility of a banking crisis depends on the following internal shocks: Possible political shocks

Since the Chinese banking institutions are subject to the interventions of the government, possible political shocks may influence the condition of the banking institutions. If the political situation was not stable, depositors could lose faith in the banking sector and withdraw the deposits, that might cause some banks to become illiquid. ˜

Radical SOEs reform

If the Chinese government did make the SOEs reform too fast and could not find a good solution of the debt-crisis between the SOEs and the State banks, many SOEs might go bankrupt. This situation might cause some banks to become illiquid. ˜ Abolishing government guarantees. At present government guarantees are the “protection-umbrella ”of the SOEs and the state banks. If government guarantees would be removed, the situation might be as follows: Most SOEs would go bankrupt, causing a liquidity problem of the state banks. In combination with a withdraw of deposits a banking crisis could happen.

Considering the political and social stability the Chinese government may further adopt the current policy of the “gradual reform ”, but the cost lies in which the problems can not be promptly solved and the economy could grow slowly. The current economic situation is the cause for concern: since 1996 the economic growth rate is lower than 10%;in the first 6 months of this year China ’s economy grew only 7.6%;retail prices fell 3.2%during the first half of this year, this is a signal of deflation. Although the PBOC has lowed the interest rate 7 times since 1996,there was no impulse for economic growth, deflation continued to deepen. The government has adopted the fiscal stimulation policy with enlarging the public investment since 1998,but the unemployment rate is still very high. With regard to this poor economic situation the government might be compelled to do some radical reform. This is an actual dilemma: Without reforms the problems could not be solved; but carrying out reforms implies many risks. To take those two aspects into consideration and balance the pros and cons is a difficult task. Therefore in the long term there will exist the possibility of a banking crisis caused by domestic shocks.