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China Still Has a Long To-Do List on Banks

By Bob Davis and Lingling Wei

BEIJING — Less than 20 years ago, China's financial system was rotting and crippled by bad debt.

After waves of reforms, the country's banks have been transformed into some of the world's largest and most-profitable corporations. Big problems remain, however. Among other issues, the banks take their cues more from politicians than from customers, and they focus their lending more on hidebound state-owned borrowers than the private companies that have turned the Chinese economy into an economic powerhouse.

But now, the financial system is on the verge of another big change: forcing the banks to compete for customers by offering the best deals for depositors.

"As with other financial-market reforms, deposits-rate liberalization is a welcome move, with long-term benefits, but poses some short-term risks, given all the other distortions that plague the financial system," said Cornell University China specialist Eswar Prasad.

Beginning in the 1990s, China spent hundreds of billions of dollars cleaning up the banks' balance sheets, a move that eventually led to the initial public offerings of the country's top four lenders, including Bank of China Ltd. and Industrial & Commercial Bank of China Ltd. The Chinese government, though, remains the biggest shareholder in the vast majority of the country's banks, including Bank of China and ICBC.

Now, the state-dominated banking system is moving steadily to adopt market principles while permitting the creation of privately funded banks as competitors. Last summer, Beijing scrapped controls over lending rates so that banks can price loans themselves. Following that, it began to permit banks to issue certain kinds of certificates of deposit aimed at big institutional investors, a move analysts say could pave the way for the launch of CDs aimed at ordinary Chinese savers.

As it gradually relaxed its control over interest rates, Beijing also moved toward a more market-based exchange-rate system, albeit at a much slower pace. Beginning in 2003, China gave foreign investors some limited ability to buy Chinese stocks in a plan that was expanded nine years later. In 2012, Beijing also freed the yuan to trade more freely against the dollar, although the government keeps a close hand on how much the currency can move day to day. In addition, it has promoted the use of the yuan in cross-border trading in the past five years.

Full liberalization of the currency, though, remains years away. Chinese officials say they worry that liberalizing cross-border fund flows too fast could lead to cash quickly leaving the country in the event of a crisis, potentially destabilizing China's financial system.

Zhou Xiaochuan, the country's central banker, acknowledged that full liberalization of the yuan, also known as renminbi, remains a more-distant goal. "We have a lot of homework to do before renminbi becomes an international currency," he said at a press conference Tuesday. Part of that homework, he said, is to make the yuan a free-floating currency.

And overhanging all the change is a deeper issue: Will liberalization of interest rates and capital flows accelerate credit growth? China's debt level already is expanding at a rate comparable to those in the U.S., Europe, Japan and South Korea before credit bubbles in those countries popped, throwing their economies into deep recessions.

Mr. Prasad, the Cornell economist, says new liberalization requires more-effective financial regulation, a tall order in a country where regulatory agencies often see one another as competitors, not colleagues. "The question remains whether the regulatory framework is capable of managing the transition to a more open and market-determined financial system," Mr. Prasad said.