

Chapter 5

THE ECONOMIC AND FINANCIAL ENVIRONMENTS OF CHINA

5.1. *The Macroeconomic Outlook*

The current economic prosperity of China has come through a long tough way. China is an agriculture based economy, therefore, the first economic reform started in 1978 from the villages. Land was contracted to the peasants in a system called "contractual responsibility system". In the first time that system has recognized the virtue of the private ownership, though the land yet to be owned by any private. but work more will get more for yourselves rather than for all had given great incentive to the peasant, in two decades time China not only managed to produce enough grain to feed its 1.3 billion population but export some of its excess production to other countries as well.

The rural reformed followed by the Village and Township Reform, especially in its coastal cities. China gradually build up many "experimental sites" in the name of "Special Economic Zones" (SEZs) there many peasants managed to set up their Village Township Enterprises (VTEs) which were set free to the market force. The enormous success of these VTEs had driven the government to be more determined to the economic reform. It was until 1992, when the paramount leader of China Deng Xiao Ping launched a visit to Southern part of China, he bravely stated "poverty is not socialism, the prosperity of the SEZs show the reforming strategy taking by China is right". From then the price reform followed, the whole economy is geared towards industrialization, export has being termed as the engine of the growth. China has leaped to the 7th export nation in the world.^{18 15}(see table 3 for details)China even recorded trade surplus with Japan.

Beside that, the currency control is gradually eased and exchange rate was slowly adjusted towards convertibility to world market. And the government is pledged to drop restrictions on the currency exchange in five years hence the

foreigners repatriate their profit easily then. A dual exchange system was formed, one is government rate another is Foreign Exchange Adjustment Center rate. In two decades time China has achieved what the west need hundred years to achieve. Not only China managed to eradicate massive poverty in its country but also it has developed a unique economic system suitable for China environment. The Chinese leaders has shown such excellent economic skills that some of them being name "economic Czar" by the foreigners^e.

Table 5.1. World top ten import and export nations (billions US\$)

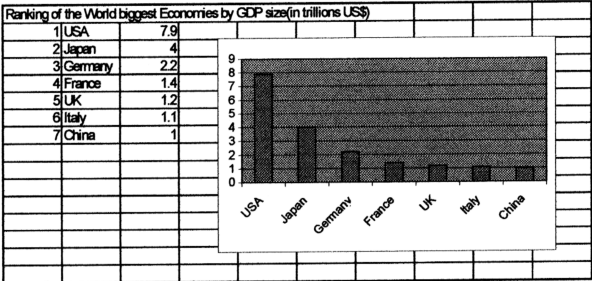
	import	% world export	rank	export	% world import	rank
US	1258	18.9	1	782.4	12.3	1
Germany	500.1	7.5	2	551.6	8.7	2
Japan	379.5	5.7	3	479.3	7.5	3
UK	331.7	5	4	280.1	4.4	5
France	305.4	4.6	5	298.1	4.7	4
Canada	249.1	3.7	6	277.2	4.3	6
Italy	233.3	3.5	7	234.6	3.7	8
China	231.5	3.3	8	256.1	4.1	7
Hongkong	214.2	3.2	9	202.4	3.2	10
Netherlands	197	3	10	211.7	3.3	9

Source: WTO report 2000.

Since the reform, the GDP growth rate of China has being much higher than the world average. The average GDP growth rate between 1990 to 1995 recorded double digits. Form year 1990 to year 2000 the GDP size of China has grown 382% and has passed US\$1 trillion mark in year 1999 making it the seventh largest economy after the US, Japan, Germany, France, UK, and Italy. (see table below)

^e This is the praise to the premier Zhu Rong Ji who was formally the governor of the People's bank of China

Figure 5.1 Ranking of the world biggest economies by GDP size (trillions US\$)



Source: BBC News 29 December 1999.

Like many other countries, China's economic reform is by far not a perfect one. The problem of state owned enterprises and regional economic development imbalance are some of the most serious problems need to take urgent measures. The bias development strategy taken by the central government has caused great regional imbalance. This imbalance has caused numerous protests and riots in different regions. The problem in Tibet and Xing Jiang are partially due to the economic problems. The regional disparities especially in terms of basic infrastructure have caused gap in FDI and conceptual distance between the coastal cities and inland cities. China is now forced to develop its west parts, this is due to the increasing cost of investment in the coastal cities and the growing tension of unhappiness in the inland regions. It is estimated that if China keep the current development strategy, it will take 36 years to reduce the gap between the high income region and low income region just half(Wei hou kai, Liu kai, Zhou mingliang, Yang dali, Hu wuxian 1997)^{16, 14} This pressure however, indirectly gives China another development option. For it now can use its developed coastal regions as high-tech bases while the resource rich west as the labor intensive centers.

5.2 Financial Reform of China

Despite of the impressive economic growth of China in past two decades, the area of banking and finance has being legged far behind. In fact it is the toughest parts of China ' s reform. For long time the banks in China just serve as the lending machine of the states, the banks do not have discretion to lending, credit granting, interest rate setting and also the foreign exchange dealings. The banks were ordered to grant credit to the money loser State Owned Enterprises(SOEs) most of them fall into the trap of inter-enterprise debt or triangular debt. In fact, by the international rating standard none of the banks in China is viable. The lucky things for the banks in China are that the saving rate of the China is extremely high, rough 40% of the GDP. The four state-owned banks, namely Bank of China, Agricultural bank of China, China Construction Bank, Industrial and Commercial Bank of China, have enjoyed the state level credit rating because the government ensures the viability of these banks. would there any thing goes wrong in these banks the government will bailout them. These facts give the banks some grace period to reform and consolidate. Reform of the financial system consist of three parts:

1. to converts the present people's bank of China into a central bank in sense to establish a policy bank.
2. gradually to convert the present specialized banks into real commercial banks , so as to separate policy lending and commercial lending.
3. to reform the management system of interest rates and exchange rates and to relax control over the market, will be established in place of official fixed rate so as to transform the Chinese Renminbi(yuan) gradually into a convertible currency.

The very urgent need for China in its cause of financial reform is to develop a very good capital market and also to reform its fiscal policy. The rural

development fund which was officially closed by the central government should be reopened and encouraged. The idea of such fund is not the problem, the problem rather lies on the implementation and the management. If asset management is allowed to set up in the different level than the excessive fund can be better utilized in the more productive way. The problem of the financial reform in China is centered at open up and decentralization. If the state empower the banks to run by themselves then many of them have no choice but declare insolvency. If they base their business purely on commercial sense then they will push very hard to the state enterprises to repay the debt which will make most of them close down. The government is already very headache about the retrenchment of the workers and the social instability caused thereby. Whether the government will lease the power to the banks or not will depend on a great extent the fate of the state own enterprises.

5.3. Problems in Banking Industry of China

Since 1997 the Chinese government has adopted a number of measures to deal with problems with its banking industry. These problems including non-performing loans (NPL), weak capital base, liquidity problem, and limited and inefficient banking service.

The exact figure of NPL in China's banking industry is hardly known, but 15% of total asset or roughly US\$1.2 trillion, can be the conservative guess, while the upper assumption can as high as 30%. The estimated NPL cost about 14% of China's 1999 GDP. Most of these NPL arise from the banks lending to the money loser state owned enterprises(SOEs). At the end of 1999, Over 80% of Chinese bank lending amounting 9.3 trillion yuan (US\$/Yuan=8.25) went to SOEs in various form. The curb with this NPL the government relies on two measures, one is so called "Debt-to-Equity" swap, under which some asset management companies are used to buy the problem debt at discount and cover the debt as much as possible. The other measure is the government injection of money to the banking system. In 1998, China

government raised 270 billion Yuan by issuing bond and injected the money to the four state owned banks. These measure has helped banks to maintain a better capital/total asset ratio(see table 5.2). However the government now increasingly feels the pressure of fiscal deficit the Revenue of the government is decreasing in percentage.

Table 5.2. Total Assets vs. Equity Capital in China's largest four banks* (in billion yuan)

		1997			1998	
	Total Assets	Equity Capital.	Total Assets/ Equity Capital	Total Assets	Equity Capital.	Total assets/ Equity Capital
ICBC	2937.8	96.9	3.3	3238.7	183.9	5.68
ABC	1573.9	39.8	2.53	2022.4	134.8	6.67
CBC	1681.8	49.6	2.95	1923.6	100.5	5.22
BoC	2231.7	87.7	3.93	27245.4	139.6	5.64

Source: China financial Society 1999

*Industrial and Commercial Bank of China, Agricultural Bank of China, China Construction Bank, Bank of China.

China's gradual reform strategy has proven to be successful. China will continue to use such approach. The financial market construction will slowly emerge into one which is fully compatible to the world financial markets.. The excess saving can now be diverted by the government to the development of its west part. In contrast to the coastal cities the west part of China is rich in natural resource but poor in basic infrastructure. Setting up of the proper financial intermediaries not only allow the government to raise the capital needed for the development of the west; but in the same time can attract the domestic and foreign investment to the west. Such development strategy can ease the tension of the illegal migrant from interior provinces to the coastal cities. The imbalance caused by the rather bias policy also can by bridged.

The promises made by China to enter into WTO however, will leave China no much time to open up its financial market to the foreigners though it will be on a gradual base. By the year 2002 China will open its banking sector to the foreigners, and by 2005 permit the foreign banks to perform the local currency (Renminbi) transactions. This is a serious challenge to the banks in China, but it will be a great opportunity for the Muslims to middle in. Since more liberalized banking industry will accommodate various kind of financial products. If interest rate also set free to the market force, which soon or later will be a fact then all financial institutions will compete based on the comparative advantages. Islamic financial instruments will surely catch the niche market of Muslims. The feasibility of implementing the Islamic financial instruments in China will be more a technique mater rather than a political or legal mater.

5.4. China's Capital Market

It has been said that sustainable economic growth requires efficient capital markets in order to effectively utilize the capital resources of a country. China has far realized this therefore in the process of economic reform China does not ignore the development of its capital market.

China launched its two stock exchanges, Shen Zhen Stock Exchange and Shanghai Stock Exchange in December 1990 in its Special Economic Zone Shen Zhen and commercial center Shanghai respectively. The growth of capital markets in the past 10 years has been most impressive by any standard. The total market capitalization at the end of March 2001 reached RMB 5 trillion (USD619 billion). The average daily turnover on both exchanges for the year 2000 was RMB 25 billion.(USD3.05 billion) This made China market the third largest in Asia after Tokyo and Hong Kong. There are 1,100 listed companies, 101 securities firms, over 100,000 practitioners, and over 60 million investor accounts. In addition, 54 of China enterprises are listed in Hong Kong as H-share companies, a few with dual listing status in New York and London. There are also 69 "red chip" companies listed in Hong

Kong which are Hong Kong companies controlled by Mainland interests. In total, H-shares and red chips represent almost 28% of Hong Kong's market capitalization at the end of the year 2000.

There is huge potential for China's capitals market since the saving rate of China is one of the highest in the world at about 40% of GDP. If 5% of China's total population invest in the stock market, it will amount to 60 million investors. Mobilize such vast savings of the population to the capital markets is both exciting and challenging to China Government.

The WTO accession increasingly has put China on the map of international finance. In the year 2000, Chinese companies raised a total of US\$20 billion from foreign equity investors, the recession in US has triggered slow economic growth in elsewhere except China. Many international investors have shifted some of their investment capital to China. The potential growth of China's domestic economy and the further restructure of financial industries will continue to attract international institutional investors.

For historical reasons, the majority of current listed companies were restructured and transformed from previous state-owned enterprises or other government controlled entities. Although some of these companies have successfully embraced the discipline of the capital markets, in many cases the transformation was more in form than in substance. The state is still the largest and the controlling shareholder in many of the listed companies. At the end of the year 2000, 54% of the total shares in China's stock market were held by the state. While the state is the largest shareholder of listed companies in the country, the interest of the state as a shareholder is not always represented. This often results in the listed companies being controlled by the management, which does not always act in the interests of the shareholders.

In addition, there is sometimes unclear segregation of assets, management and businesses between the listed companies and their parent companies.

Connected transactions between the listed companies and their parent companies or controlling shareholders are common occurrence, sometimes with severe conflict of interests to the detriment of the minority shareholders of the listed companies.

In many cases, the supervisory board duplicates the authority of the board itself but without corresponding responsibilities. In fact, the presence of supervisory board may give the illusion of certain checks and balance in the listed company when none existed.

To improve the quality of listed companies, the standards of corporate governance must be firstly set.

5.5. China securities Regulatory Commission(CSRC) and Corporate Governance

The basic principle of corporate governance is to protect shareholders' rights. However, the concept of corporate governance has not been well developed or understood in China. This may be partly due to its transitional stage from a planned economy to a market economy, and partly to the entanglement of ownership rights with management responsibilities. To practice good corporate governance, the rights and interests of the state and the controlling shareholders must be segregated from those of the listed companies and their shareholders. The management are held responsible and accountable for their action in the company, and that shareholders are provided with sufficient and timely information on the company's affairs.

Although there are already rules governing many aspects of the corporate behavior of China's domestic companies, there is still a great deal to be done. The CSRC is committed to champion the rights of the investors and shareholders, and to improve and safeguard the standards of the markets. And it has being mandatory to improve transparency and focus on the behavior and accountability of the board and the management of the listed

companies. The CSRC has specified clearly the expected conduct of the respective parties to create incentives for companies to engage in good corporate practices and deter those which do not do so.

The CSRC has started the process of revising some of China's current rules and regulations to address issues peculiar to the markets. to align its good corporate requirements with international standards. It also updating the mandatory provisions of the articles of association of listed companies; drafting guidelines for shareholders' meetings of listed companies. And is planning to spell out specifically the rights of the shareholders in various corporate actions and in shareholders' meetings; and introducing different voting methods to facilitate the exercise of voting rights by shareholders.

Most importantly, a set of core principles and standards of corporate governance for listed companies in China has being worked on. Guidance notes on the proper conduct of the board of directors, on the relationship between the listed company and its controlling shareholders, on the issuance of stock options and other incentive programs by listed companies, on the establishment of remuneration and audit committees, and on the requirement of independent directors in listed companies are also worked on. While Mainland companies listed in Hong Kong and the US have already appointed independent directors, such mandatory requirement will be a first for companies on the domestic markets.

In terms of transparency in the market, listed companies are required to publish unaudited quarterly reports in order to provide investors with more up-to-date financial information. To ensure that the listed companies do not just pay lip service to the requirements, they have to state in their annual reports particular measures of good corporate governance which they have engaged in the previous financial year. Listed companies will need to explain the differences between its corporate governance and the core principles and standards, and the reasons for such differences. Any plans for future action to address the differences shall also be stated in the annual report. Listed

companies will also be required to disclose detailed information on the share ownership status of controlling shareholders and connected persons, so that any special relationship between the parties are brought to the attention of the shareholders.

As the bridge between the markets and the investors, intermediaries have the fiduciary duty to safeguard the money entrusted to them by their clients the investors. Yet there is much room for improvement in the management and corporate governance of many of securities and fund management companies in China.

Currently many intermediaries suffer the same problems as listed companies: i.e., insufficient internal control, and entanglement of the interests of the controlling shareholders and those of the shareholders and investors. To address these issues and to improve regulatory oversight, CSRC will promulgate codes of best practice and conduct for intermediaries. and will step up supervision programs to ensure appropriate internal control and risk management in intermediaries, and that any increase in business will be accompanied by corresponding risk management and systemic control. Securities and fund management firms will be required to strictly segregate their front and back office functions, as well as to separate clients' accounts from the securities firm's own accounts. Fund management companies are required to appoint independent directors as well.

As China's markets gradually open up to foreign participation, and domestic investor population continue to increase, it is only a matter of time that there will emerge in China institution investors like those of the developed markets. With their collective investment in the markets, such institution investors would be able to pressure the listed companies and intermediaries to improve their corporate governance.

The future of China's capital markets is enormously bright. By adapting sound corporate governance, Chinese companies are able to meet the discipline of

the international capital markets. There is a now a collective will on the parts of the Government and the corporate sector alike to continue and indeed to speed up the changes and reforms in the financial markets.

Chapter 6

ATTEMPT OF ISLAMIC BANKING AND FINANCIAL INSTRUMENTS IN CHINA

6.1. Macro-Environment For Islamic Banking And Finance In China

Islamic banking and finance have got ground in many of the Islamic countries where Islamic law has being in place of social economic settings. In many none-Muslim countries Islamic banking and finance also got ground. Islamic banks are quite active in US, UK¹ and even the Philippines also have adapted some Islamic banking and finance. Dow Jones even launched Islamic Market Index (DJIM), UK has FTSE South Africa Islamic Index, and the Philippines has (Philippines Amanah Bank). While some Islamic scholars suggest that implementation of Islamic banking system has to take revolutionary approach, i.e. financial reform has to go hand in hand with introduction of Islamic law. For them Islamic banking can not be well implemented in a none-Islamic society. Some scholars argued, that practically speaking some countries can not be an Islamic country, the Muslims there however can not be denied from using Islamic banking services. Therefore, instead of revolutionary approach the evolutionary Islamization approach has to be adapted, Islamic banks can be equally efficient in the none-Islamic banking system.(Abudul Gafoor 1998)¹⁷. In our real world Iran, Pakistan took the revolutionary approach while Malaysia, Egypt and many other countries took gradual Islamization approach.

¹ According to the Islamic Banker issue no 62 march 2001, there are more than 20 Islamic financial institutions and dedicated units in the United Kingdom