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**RISKS AND DOCUMENTARY CREDITS IN CHINA'S  
INTERNATIONAL METALS TRADE**

**Ian Dickson**

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*About the author*

**Ian Dickson** is at the

Department of Economics  
Chinese Economies Research Centre  
The University of Adelaide  
ADELAIDE SA 5005  
Australia

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## ABBREVIATIONS IN TEXT.

CFR, C&F	Costs and freight.
CIF	Cost, insurance and freight.
CIS	Commonwealth of Independent States.
D/A	Documents against acceptance.
D/P	Documents against payment.
EFIC	Export Finance and Insurance Corporation.
FEC	Forward exchange contracts.
FIE	Foreign Invested Enterprise.
FOB	Free on board.
FTC	Foreign trade corporations.
GDP	Gross domestic product.
I/E	Import and export.
IMF	International Monetary Fund.
JISII	Japan Iron and Steel Importers Institute.
LC	Letter of credit.
Minmetals	China National Metals and Minerals Import and Export Corporation.
MMI	Ministry of Metallurgical Industry.
MOFTEC	Ministry of Foreign Trade & Economic Cooperation.
PBOC	People's Bank of China.
RMB	Ren Min Bi.
SAEC	State Administration of Exchange Control.
Sinochem	China National Chemicals Import and Export Corporation.
VA	Voest-Alpine.

## BIBLIOGRAPHIC ABBREVIATIONS.

<i>AMM</i>	American Metals Market.
<i>AWSJ</i>	Asian Wall Street Journal.
<i>FEER</i>	Far Eastern Economic Review
<i>FT</i>	Financial Times.
<i>HKS</i>	Hong Kong Standard.
<i>MB</i>	Metal Bulletin.
<i>MBM</i>	Metal Bulletin Monthly.
<i>NAB</i>	National Australia Bank.
<i>NKS</i>	Nihon Keizai Shimbun.
<i>SCMP</i>	South China Morning Post.
<i>SJD</i>	<i>Shijie Jinshu Daobao</i> (World Metals).
<i>SWB</i>	BBC Summary of World Broadcasts.
<i>WB</i>	World Bank.
<i>YCHJ</i>	<i>Yejin Chanpin Hangqing yu Jiage</i> (Metallurgical Products Market Situation and Prices).

## CURRENCY.

US dollars where “\$” sign is used.

## INTRODUCTION.

China's international trade in ferrous and non-ferrous metals products is not risk free. This paper provides anecdotal evidence showing why China might be considered to have a higher-than-average risk profile in the metals trade arena.

Of course, international trade, regardless of which countries are involved, is never entirely risk free, and practitioners are naturally concerned to adopt measures to mitigate those risks. The various measures adopted differ in terms of the way they distribute risk between the importer and the exporter. As described below, the polar examples are pre- and post-shipment payments, under which the importer or the exporter respectively assume the majority of risk. In between, there are a variety of instruments which distribute risks more evenly between the two parties. In practice, *Documentary credits* (otherwise known as *letters of credit*, herein abbreviated "LCs") are one of the standard instruments employed.

It is well known that LCs are not "fail-safe", but foreign steel traders selling product to China have been saddled with a greater degree of risk than would "normally" be the case (say, for example, in comparison with LCs employed in trade with other Asian markets). Whilst there is no conclusive statistical evidence to prove that the number of contract disputes is higher for trade with China than for trade with other Asian countries, anecdotal evidence suggests that for the metals trade such may indeed be the case, at least for the 1993 to mid-1996 period.

As the tone of the above paragraph suggest, this paper investigates risk issues primarily from the perspective of the foreign exporter to China (although the position of foreigners importing *from* China is also examined). When viewed from this standpoint, why have LCs provided a less-than-expected level of performance?

This paper discusses some of the credit and transfer risks involved. Problems sometimes stem from the reliability of Chinese business partners — some Chinese enterprise managers apparently consider it acceptable to "short change" contract partners if need or opportunity arises. But there are also more fundamental issues at

stake. Systemic reasons affecting the contract performance of Chinese partners include the partially reformed nature of China's banking, trade and foreign exchange regimes. The sorry state of the banking system, the tendency of the Chinese government to revert to administrative decrees, together with insufficient currency convertibility of the RMB Yuan (at least, prior to 1996), not to mention the difficult operating situation of state owned enterprises, may all be considered factors behind the less-than-perfect functioning of LCs in China-bound trade.

New developments are occurring in these areas all the time, and the situation is fluid, so the necessary caveat is that conclusions reached in this paper are relevant for the period 1993-1996, but not necessarily thereafter.

Discussion herein takes LCs as the centrepiece, but incidental reference is also made to other payments mechanisms, such as *documentary collections* and *clean remittance*. A brief outline of payments mechanisms is provided in the next section, as some background information about these mechanisms is useful to understanding points to be made later, and in order to avoid repetitive explanations.

### INTERNATIONAL PAYMENTS MECHANISMS.<sup>1</sup>

The most simple payment methods involve *clean remittance*. If *pre-shipment payment* is required, the importer remits payment at the same time as making the order or sales contract, which preferable from the exporter's point of view, since full payment is secured before any work is done towards supplying the order. Under *post-shipment payment*, payment occurs after delivery. Post-shipment payment is preferred by the importer since (a) a period of payments grace is granted after the goods have been received, and (b) delivered goods can be checked for problems before payment. Clean remittance is illustrated in FIGURE 1. The importer remits payment at point A if pre-shipment payment is required, or at B in case of post-shipment payment.

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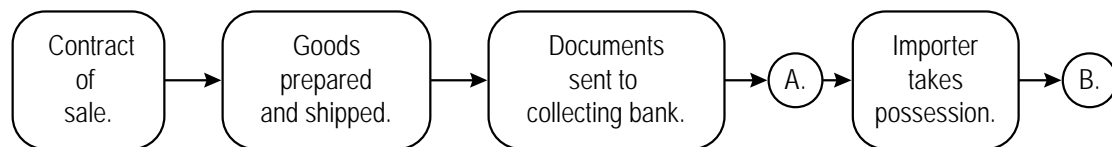
<sup>1</sup> Details in this section may be familiar. Readers may also refer to *Finance of International Trade*, published by the National Australia Bank (NAB).

FIGURE 1. *Clean remittance.*



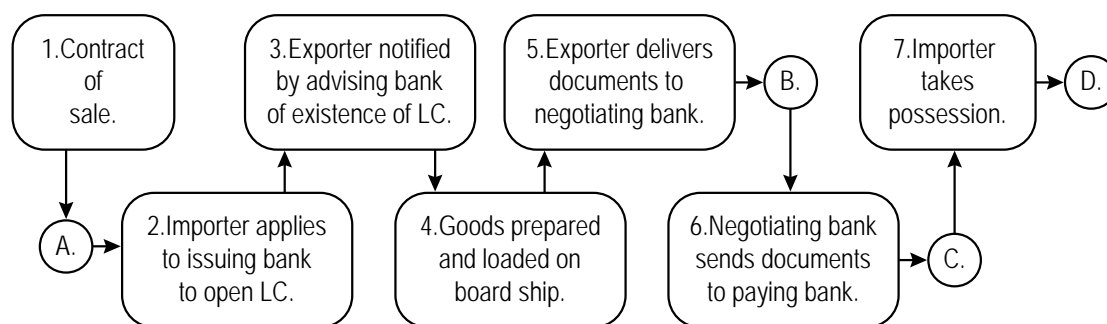
International payments could also occur after presentation of a stand-alone *bill of exchange*. Under this method, a nominated bank releases shipment documentation necessary for customs clearance to the importer (1) after payment (*documents against payment* or “D/P”) or (2) after agreement to terms specified by the exporter (*documents against acceptance* or “D/A”). These two methods are illustrated in FIGURE 2. In the chain of events, the importer makes payment at A in case of documents against payment, or if documents against acceptance of terms is specified, at a fixed date B. These methods differ from letters of credit in that banks merely hold, rather than cross-check, documentation (until such time as payment is made or terms are accepted).

FIGURE 2. *Documentary collections.*



Of greater interest here than the payments methods outlined in FIGURES 1 and 2 are *letters of credit*. LCs form the mainstay of this paper. One reason for this concentration is that unlike consumer merchandise, international trade in metals often involves six figure sums. “Because each consignment of steel materials involves millions of US dollars, payments are made by means of LCs” (*SCMP*, 25 Jul 1993). LCs are somewhat more complicated than either clean remittance or documentary collections, and involve the following approximate chain of events, summarised in FIGURE 3:

FIGURE 3. *Documentary credits.*



Unfortunately, a simple diagrammatic presentation such as FIGURE 3 fails to do justice to the complex alternatives available for letters of credit. No instructive shortcuts are available, so steps 1 to 7 in FIGURE 3 are explained further below. A few points may be noted here, however. Firstly, in theory, LCs are structured so that the exporter can wait until notified of the existence of the credit before preparing or manufacturing the goods to be shipped. However, due to time constraints, the exporter may not have the luxury of waiting, and must anticipate the LC by commencing manufacture at point A.<sup>2</sup> Secondly, if a sight LC is specified, the exporter could expect to receive payment at B, although if so, the exporter may retain a “with recourse” liability with the negotiating bank until the importer has paid, at point C. Alternatively, if the exporter grants terms (*usance* LC), both sides of the import transaction will remit and receive payment after a specified time interval, at point D. More detailed explanations for these items and for steps 1 to 7 in FIGURE 3 are as follows, although explanations remain, of necessity, abbreviated.<sup>3</sup>

(1) Importer and exporter negotiate order or sales contract details. They agree that payment will be by means of LC, and on the type of LC to be used. After the contract is finalised, the exporter may begin to manufacture the required goods. However, the manufacturer might prefer to wait until the LC has actually been received before commencing manufacture. This could occur if the exporter believed there was a risk that the prospective importer will change his mind after the order has been placed but before opening a letter of credit.

<sup>2</sup> Such problems can be avoided if the contract of sale specifies a latest date by which the exporter must receive the LC. See page 21.

(2) The importer applies to a bank (termed the *issuing bank*) to open an LC. LCs are very flexible instruments, and can be structured to grant a variety of possible financing options to both importers and exporters. So far as the importer is concerned, the bank could demand payment at the time documents are presented (at *sight*) or at a later date after payment of interest. If not banks, then exporters themselves may wish to grant credit (or *usance*) terms to importers. The myriad of ways LCs can be structured to provide financing essentially revolve around (a) the time at which the banking system remits payment to the exporter in relation to (b) the time at which the importer repays the issuing or paying bank.

(3) If application is approved, the LC is sent to the exporter (usually through the medium of an *advising bank*). Essentially, the exporter is *beneficiary* of a notification that the issuing bank has established funds that will be rewarded upon fulfilment of specified terms and conditions, namely, that correct documents are provided. Details on these documents must be consistent with details nominated in the LC. For example, one document invariably required is the *bill of lading*, which proves that the required goods were actually loaded on board ship.<sup>4</sup> Possession of a sea bill of lading also conveys ownership rights to the goods being shipped.

(4) The exporter receives the LC. The exporter (beneficiary) will check to see that terms specified in the LC are the same as those originally negotiated. If satisfactory, the exporter may commence manufacture, or if manufacture has already been completed, proceed to ship the goods. The actual level of service or transport provided by the exporter will depend upon the price basis, be it FOB, CFR or CIF.

(5) After shipment, the exporter will present required documentation to a *negotiating bank* (often the same bank as the advising bank). The negotiating bank will scrutinise documents to ensure consistency with requirements specified in the LC. If consistent, and presuming the exporter is demanding payment on *sight*, then payment will be made

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<sup>3</sup> For a more detailed treatment, readers may refer to *Finance of International Trade* (NAB, 1996).

<sup>4</sup> An *air waybill* is used for air freight.

to the exporter. However, if paid on sight, the exporter usually remains liable in the event that the issuing bank does not repay the negotiating bank. In other words, the exporter may have to repay money to the negotiating bank if, at the end of a chain of bank transfers, the importer fails to pay-up.

(6) The negotiating bank passes documents to the original or issuing bank, which in turn conducts its own checks to ensure consistency with stipulations in the LC. The importance of documents checking by the banks cannot be over-emphasised. One of the most frequent causes of payments difficulties relates to inconsistencies between documents and the LC, under which circumstances the bank may not remit payment without consent from the importer. A typical inconsistency relates to time periods or expiry dates. LCs will stipulate both (a) latest date for shipment and (b) latest date for presentation of documents. It is not uncommon for shipments to be slightly delayed, but this will create a technical breach of the LC (*AWSJ*, 7 Aug 1993). If the exporter anticipates a delay, an extension of the LC could be sought. The main point to note, however, is that in trading practice, technical discrepancies could quite easily come to light, which either the importer or the issuing bank could exploit if they so choose.

(7) Finally, if documents are consistent with the LC they are released to the importer (if inconsistent, the consent of the importer will be required). The importer is required to pay the issuing (or *paying bank*, if different) in accordance with originally negotiated terms and conditions — see (1). The importer can then use the documents to claim title to the goods and to complete customs procedures.

A number of other important features of LCs deserve explanation. Firstly, LCs can be *revocable or irrevocable*. The latter is the most common form, and means that as soon as the LC has been opened, it may not be changed or cancelled without the beneficiary's permission. So long as documents are consistent, the importer must accept the shipment and make payment in accordance with agreed terms.

Secondly, LCs can be *confirmed* by an independent bank. This provides an additional layer of security for the exporter. By nature, LCs provide security by removing payments decision making power away from the importer and vesting that power in a

supposedly neutral third party, namely, the issuing bank. However, there may be circumstances in which the exporter feels that even this third party is not reliable enough. Under these circumstances, the exporter might require a letter of credit which has been confirmed by yet another bank. The latter underwrites the LC.

LCs provide security to the exporter. But they also provide assurance to importers. Payment to the exporter will not be released by the banking system until the exporter can demonstrate that the required goods have *already* been shipped in accordance with stipulations in the LC. A note, however, about the role of banks. Their role is to scrutinise *documents* and not *goods*. If documents are consistent with the LC, payment to the beneficiary is released. But documents in proper order do not necessarily guarantee that the goods will arrive in satisfactory condition. LCs guarantee that shipment has been made and that the goods shipped are those specified, but LCs cannot guarantee the absence of quality problems.

### RISK ISSUES.

It may be noted that LCs are not fail-safe. Amongst the dangers that the importer faces when *sight* LCs are used is that the actual condition of landed goods may be disappointing. When a sight LC is used, the importer has no opportunity to check goods for quality problems prior to making payment. So far as exporters are concerned, a principal source of risk results from requirement that the merchandise be loaded on board ship before payment can be secured. If problems eventuate, shipment may actually arrive at the foreign port whilst the exporter still awaits payment. This may result in unexpected port and storage fees. If delay turns into default, then the exporter will be forced to make arrangements to sell the shipment to another buyer or else bring the goods home. More generally, the risks faced by exporters and importers in the day to day conduct of international trade can be classified as follows.

Transit risk. This is the risk that goods will be damaged in transport or whilst at sea. Marine insurance is used to cover this risk. This type of risk is not the province of this paper, although in the couple of places it is alluded to, it has mainly been an issue for *Chinese* importers, in contrast to the general angle taken in this paper, which views

risks from the perspective of foreigners contemplating business with China. Chinese importers have complained about landed quality of steel sourced from CIS countries.

Market risk. This is the possibility of loss due to fluctuations in market prices. It is not of prime importance here, suffice to note that importers often take on market risk by virtue of the fact that they will be responsible for selling the imported goods in their own market. Importers may find, for example, that domestic market prices fall below import costs. However, if the importer is only *agent* or *sales representative*, or taking goods on a *consignment* and not title-basis, the exporter may continue to bear market risk. Market risk might also become an issue for the foreign exporter in instances where Chinese importers believe they have the right to renegotiate contracts in the event of price falls.

Exchange risk. This is the risk of adverse currency rate movements, and can be viewed as a special case of *market risk*. Exchange risks can be managed by application from the importer or exporter (depending on whose currency is nominated in the contract and LC) for a forward exchange contract (FEC), hedge contract or currency options. Other ways to manage exchange risk include foreign currency savings accounts. Anecdotal evidence suggests that on occasion Chinese importers did not make adequate use of exchange risk mitigation instruments, and were thus exposed to adverse currency rate movements. The extent to which such instruments are available, and used by, Chinese traders is an interesting question, and may bear some relation to the evolving issue of convertibility of the RMB Yuan. The question is not answered here, however. In fact, whilst important foreign exchange issues do crop up in relation to China's international trade, on closer inspection many cases turn out to be *transfer risks* and not exchange risks.

Transfer risk. It may be impossible to remit the importer's payment to the country of choice. This generally occurs when the LC specifies payment in a currency other than that of the importing country. Difficulties in transferring payments may result from exchange controls, restrictions on capital outflows, from intervening political or economic circumstances, or from tardiness on part of the issuing bank. This type of risk seems important in China's case.

Credit risk. Conceptually, perhaps the simplest type of risk to understand is credit risk. This is the risk that the importer will delay or default on payment to the exporter. LCs and documentary collections are designed to mitigate credit risks. Insurance providers (in Australia, EFIC) can also provide insurance against certain forms of credit and transfer risks. Along with transfer risk, credit risk is the issue of primary interest here.

It is necessary to bear in mind features of LCs and the nature of risks that exporters face in what follows next. Discussion now turns to a more particular description of the Chinese situation.

### RISKS IN TRANSITION ECONOMIES.

Risks associated with doing business with pre-1978 China were minimal. In common with the Soviet Union and other communist governments, China maintained a good payments record. Partly this reflected a desire to foster self-sufficiency and a suspicion that accepting foreign credit or imports would lead to dependency. As a result, international transactions were kept to a minimum, but those transactions entered into were scrupulously observed. Close state supervision and ownership of enterprises also carried an implicit government guarantee that payment would be honoured.

After the onset of the “open door” policy, and in pace with an enormous increase in international transactions, risks have become a more serious problem. This tendency is also true of the other transition economies, such as Russia,<sup>5</sup> although reasons why risk

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<sup>5</sup> Evidence of the Russian situation is contained in the statement that “Payment three weeks or a month late is considered punctual in Russia. Sometimes payment is up to three or four months late” (*MBM*, Dec 1993: 21). Also: “... sourcing of steel from the CIS can be a tedious affair, as contracts are generally not worth the paper they are written on until one is ready to understand the prevailing conditions at the mill in question. This means that those working in the region must be patient and flexible. The risks of trading with the CIS remain high...” (*MB*, 14 Dec 1995: 23).

issues have become more pertinent in China and in Russia do not entirely coincide. For example, in Russia, turmoil associated with privatisation of state owned steel mills has led to: “changes in management every two or three weeks, making it difficult to maintain reliable contacts” (*MBM*, Dec 1993: 19). In contrast, China’s state-owned enterprise situation seems to be more stable (if stagnant). On the other hand, risk issues stemming from the mentality of managers and prevailing business culture seem to be shared by both Russia and China. Both countries seem to have a larger-than-normal proportion of managers and enterprises who opportunistically dishonour contracts if something better emerges or if adverse circumstances intervene.

Perceptions of changing risk in transition-era China have been heightened by a number of incidents. One well-publicised incident, although not trade related, was the suit brought by the US banking firm Lehman Brothers in November 1994 against two Chinese enterprises, China United Petroleum (Unipec) and a subsidiary of Minmetals, the Minmetals International Nonferrous Metals Trading Company (*SCMP*, 16 Nov 1994). Lehman Brothers alleged that the two Chinese concerns had reneged on swap and forward foreign exchange deals. Another example emerged with news in September 1995 that Sinochem<sup>6</sup> would require deposits on all domestic oil product import orders so as to avoid payment problems afflicting Western firms selling to Chinese customers (*HKS*, 9 Sep 1995). (Sinochem would be acting as an import agent between domestic customers and western suppliers). According to the news reports, advanced deposits required by Sinochem amounted to 20 percent of order value. China’s foremost ferrous metals import and export company, Minmetals, also requires mandatory deposits from its domestic customers ( *MB*, 8 Nov 1993: 17).

#### ANECDOTAL EVIDENCE OF RISKS IN CHINA’S METALS TRADE.

*Non-ferrous metal exports.* The author gained an impression that risks associated with China were abnormal in a conversation in late 1994 with a representative of

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<sup>6</sup> Sinochem, the China National Chemicals I/E Corporation, is China’s highest profile international trading house. It enjoys exclusive and lucrative rights in trading certain products, viz. petroleum and chemicals.

Glencore, a Swiss-based non-ferrous metals company.<sup>7</sup> Problems have often related to *exports* by Chinese suppliers. Metals and ferro-alloys involved included tungsten, antimony, cobalt, ferro-chromium and ferro-molybdenum. Conflicts have been a symptom of the boom in the Chinese economy, with domestic producers changing their mind when they realise domestic prices are preferable to those achievable under the existing export contract. As a *Metal Bulletin* editorial quipped: “Confucius may have said a lot of sensible things, but ‘you may renege on your contracts in a rising market’ was certainly not one of them” (*MB*, 3 Apr 1995: 9). The journal also noted that international traders were “incensed over the level of renege contracts” (*MB*, 21 Apr 1994: 3).

*Non-ferrous metal imports.* On the imports side, a Reuters wire story on 2 August 1995 reported that American scrap copper merchants were experiencing financial difficulties stemming from payments defaults by Chinese customers. Further investigation by the industry newspaper *American Metals Market* revealed the wire story may relate in the main to small US scrap copper dealers who had little prior experience of selling to China and who failed to take necessary precautions. Such precautions would include insistence on appropriate payments mechanisms, including, as a first option, pre-shipment payment. As one copper merchant stated: “We don’t sell anything to China that we don’t get our money in our hand before the trailer leaves the yard” (*AMM*, 10 Aug 1995: 7).

The second option is documents against payment (D/P). This method provided security by ensuring the seller maintained title to the goods even after shipment to the foreign country. Experienced copper merchants stated: “The important thing is to determine who has title to the goods. [If] documents are sitting in a bank waiting for payment, the title sits with the seller. The worst you can do is sell [the goods] to somebody else who pays you before release or you bring [the goods] back.” (*AMM*, 10 Aug 1995: 7). However, this worst case scenario will still be an unpleasant surprise

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<sup>7</sup> The representative was, however, philosophical about above-normal risks, believing these to be the cost of getting a foothold in China, and that profits would be made over the long-haul.

for the exporter, involving costs not originally budgeted for. Therefore, the D/P method may still present an unacceptably high level of risk for the exporter.

The third option is to use a letter of credit. Usually, an *irrevocable* documentary credit not only guarantees that title rests with the exporter until receipt of payment, as with the D/P method, but better than that, also guards against the possibility of having to divert distressed shipments. Even if the importer had a change of heart, arrangements are irrevocable, and the issuing bank would still be obliged to make payment upon verification of documents (the issuing or paying bank would subsequently insist on payment from the importer). However:

“...if you take a letter of credit opened on a mainland China bank, it is very likely that you are going to have a problem if you use it for two reasons: they will look for discrepancies not to pay the bill,<sup>8</sup> and they will look to cancel the letter of credit” (*AMM*, 10 Aug 1995: 7).

Furthermore, “...in the past Chinese government banking institutions have cancelled letters of credit *even though they are irrevocable*” (*ibid.*, italics added). These problems were not confined to minor or obscure Chinese financial institutions, but were perpetrated by the main four state “specialised” banks, such as the Bank of China and the Industrial and Commercial Bank of China, both of which were “delaying payments on letters of credit for as long as several months” (*AWSJ*, 7 Aug 1993). American copper traders therefore argued that additional precautions would have to be undertaken when using LCs with China. For instance, exporters could insist that LCs be opened only on banks outside of mainland China. If not (ie. if the LC was still issued by a Chinese state bank) then “the only safe way” would be to get the LC *confirmed* by outside banks, for example, “in the United States, Hong Kong or Singapore” (*AMM*, 10 Aug 1995: 7).

The propensity of Chinese state banks to look for discrepancies may relate to (a) the fact that LCs are essentially a western or European invention, and culturally, the Chinese banks are not completely comfortable with the mechanism, so that where European banks are blasé, Chinese banks may be unduly fastidious about cross-checking. However, more convincing explanations relate to (b) the liquidity of

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<sup>8</sup> See point (6) in text, page 9.

Chinese banks, (c) credit risks of the Chinese traders applying for LCs and

encompassing the activities they are engaged in, (d) the desire by China's State Council to regulate certain forms of economic activities, and (e) foreign exchange issues. These points are addressed later.

*Ferrous metals exports.* Contract difficulties have also been a feature of China's steel trade. For example in 1995, Hong Kong traders claimed that purchasing steel from Chinese producers was "becoming dangerous" due to breaches of contract caused by delayed shipments (*MB*, 16 & 20 Mar 1995: 34, 23). These traders believed risks attended to purchases from *all* Chinese steel mills, large or small, and were compounded by the fact that no practicable legal recourse existed in the event of *delayed* delivery. The costs of litigation will often out-weight the costs of delay, and due to the high threshold costs of formal dispute resolution mechanisms, the customer may have no choice but to accept at face value Chinese promises to deliver.<sup>9</sup>

Of course, when reports of increasing numbers of contract difficulties coincide with booming Chinese steel export sales — as was the case in 1995 — this situation implies that there must at least be some satisfied customers. (On the other hand, a decline in 1996 steel export volumes may in part be attributable to experiences in sourcing steel from China during the 1995 boom year).

A Japanese arrangement publicised in early 1995 is evidence of (a) growing attractiveness of procuring steel from Chinese suppliers but also of (b) awareness of concomitant risks. Five member companies of the Japan Iron and Steel Importers' Institute (JISII), including Taisei International Corporation and Wazai International Ltd, banded together in order to import steel from China (*NKS*, 11 Jan 1995). Their plan was to start with the import of 10,000 tons of hot rolled coil from Wuhan during March and April 1995. The firms undertook a cooperative approach because they were cognisant of the risks of doing trade with China on an individual basis, the motto evidently being "safety in numbers".

Comparison with domestic steel contracts. As an adjunct to the above-mentioned claim by Hong Kong traders that steel exports from the mainland were “becoming dangerous” to handle, it is worthwhile to examine the internal situation within China itself. The claim made in Hong Kong that risks attended to deals with *all* Chinese steel mills, whether large or small, suggests systemic reasons may exist to explain why Chinese steel producers were delaying or defaulting on export supply contracts. If problems are widespread, there may be more serious issues at stake than merely errant behaviour of one or two suppliers.

Comparison with *domestic* supply contracts sheds some light on why iron and steel enterprises were not meeting export contracts on time. Contract difficulties were not the sole preserve of international export contracts, but also afflicted domestic supply relationships. Indeed, at times, the Chinese government has even been worried that state-owned steel enterprises will not fulfil their obligations under the state command plan according to schedule. Enterprises such as Baoshan Iron & Steel Corporation, with a state-plan completion rate of 100%, have been held up as praise-worthy models (*bangyang*) for other state-owned steel makers to follow.

Official sources note that in mid-1993 steel enterprises typically agreed to orders way beyond actual production capacities (*chao nengli dinghuo*), so that contract delays for some customers were the inevitable result (*YCHJ*, Jul 1993: 28). Rapid escalations in steel prices during 1993 provided an inducement for over-booking of steel orders. There may have been an element of opportunism here — enterprises may have deferred earlier contracts to cash-in on higher price contracts coming along at a later stage. Chinese steel industry sources provide a more charitable self-explanation for over-booking of orders: during the peak demand conditions of 1993 steel enterprises were unwilling to turn down orders due to reasons of “face” (*gangtie qiye aiyu mianzi*).

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<sup>9</sup> Neither China’s evolving international trade arbitration system, nor more adversarial litigation mechanisms for resolving disputes are addressed here. Discussion in this paper centres on risks at the first instance rather than on the question of how disputes are ultimately resolved.

When Maanshan Iron & Steel Co. launched a self-investigation of contract activities in mid-1993, it found that there were many overdue contracts on the books (*YCHJ*, Jul 1993: 25). In order to “rectify” (*qingli*) pre-May 1993 contracts, for which many customers had already made full or part payments, Maanshan decided to suspend signing any new contracts, except those requested by the government as part of the mandatory plan. Maanshan hoped to be able to honour the outstanding contracts by the end of June 1993. If over-booking of contracts recurred in future, Maanshan managers vowed not only that customers would be compensated for any delays, but also that vigorous investigations would also be carried out to determine which divisions and staff within the enterprise were responsible for over-bookings. Maanshan’s Communist Party Committee also undertook to formulate 8 rules for the “incorrupt establishment” (*lianzheng jianshe*) of the company, to guide and discipline the process of contract agreement and fulfilment.

Senior managers of steel enterprises were not always in full control, and occasionally did not realise that particular divisions and personnel at lower levels within the enterprise were taking unilateral — even corrupt — actions to break or hold-over contracts with customers. According to Wang Fuliang, of the Ministry of Metallurgical Industry East-China Inspection Group (*Yejinbu Haudong Diaocha Zu*), enterprises such as Baoshan Iron & Steel, Maanshan Iron & Steel Co., as well as firms under the control of the Shanghai Metallurgical Bureau, began to take steps to investigate their own in-house practices in May 1993. MMI’s East China Inspection Group itself launched an investigation of enterprises within its jurisdiction during 11-24 June 1993 (*YCHJ*, Jul 1993: 24).

Problems were found to reside in enterprise divisions which were “windows” (*chuangkou bumen*), that is, divisions which had significant dealings outside the enterprise. Sales and transport departments were prime candidates. Upon self-investigation, for example, the various enterprises under the Shanghai Metallurgical Bureau (such as No.1 Factory, No.3 Factory, No.5 Factory etc) discovered that in activities to load and unload scrap steel, some drivers tried to extort “small fees” from customers, and that collections or deliveries would be held-over if favours were not extended (*YCHJ*, Jul 1993: 25). Enterprises were warned to ensure that individual

staff did not jeopardise contract execution by trying to extort “favour fees” (*haochu fei*), underhand “commissions” (*huikou fei*) or “thank-you rewards” (*xinku fei*) from customers. Such activities are part of the wider problem in China known as “chaotic fee charging” (*luan shou fei*).

Sometimes contract defaults were due to organisational problems. Breakdown in communication between sales and production divisions of steel firms, or failure to properly consolidate information about customer orders, were typical of the mistakes being made. In early 1993, Baoshan went to great lengths to secure its reputation for contract fulfilment after one such incident. In late 1992, due to “changing production conditions”, Baoshan manufactured larger than expected amounts of cold-rolled steel materials, causing in-house demand for hot-rolled coil to exceed projections. The consequence was that Baoshan was unable to fulfil, by the end of 1992, orders for some 200 thousand tonnes of hot-rolled coil. At a loss to the firm of more than 200 million RMB Yuan, Baoshan scrambled to fulfil these orders in early 1993. The outstanding orders were met at the original contract prices, regarded as particularly commendable by Chinese leaders since steel prices were subject to significant price de-control in January 1993 and were now experiencing rapid increases. (Although it should be pointed out the Baoshan’s decision not to attempt to exploit these price increases on the unfulfilled contracts was in any case its legal obligation — such praise testifies to the problem at hand). As a result of this episode, senior managers of Baoshan were keen to emphasise to lower level staff that Baoshan’s reputation had been secured by “buying it at the cost of 200 million Yuan”, and that all departments in the enterprise had the duty to ensure that such costly mistakes were not repeated again in the future.

There were other factors beyond the immediate control of enterprise managers which affected contract execution. One was (and still is) the poor state of China’s railway transportation system. As a result, even when factories manufactured the required steel quickly, delivery to the customer could not be guaranteed on time. According to the Shanghai Metallurgical Bureau, the gap between the required number of railway cars and the number actually provided was large. Likewise, the numbers of railway cars demanded for Guangzhou, Guiyang, Kunming and Chengdu “always increased”,

as did the numbers of cars which could not be provided. Prices paid for railway cars in South China were said to leave people “speechless” (*ling ren zhashe*) (*YCHJ*, Jul 1993: 27).

China’s own command planning system also injected a note of disorder, at times, into the task of completing contracts on time. The situation arose because dictates of planning bureaux were often incompatible with actual user requirements. To take one anecdote: in 1993, Maanshan Iron and Steel Co. complained that production schedules had been seriously disrupted by inappropriate state planning directives (*YCHJ*, Jul 1993: 27). Maanshan was China’s sole producer of some 20 thousand tonnes annual national output of a type of steel ring used in the chemicals industry, and in tall construction cranes. At a state-plan ordering meeting organised in part by the Ministry of Internal Trade, China’s energy industry was allocated some 1,000 tonnes of the total output. This included allocation to the local Maanshan electricity-supply bureau. The latter, however, had no use for this variety of steel, and had no choice but to request that Maanshan Iron and Steel supply a different kind instead. Switching types to satisfy the local electricity bureau was of serious inconvenience to Maanshan’s regular steel production, delaying contract fulfilment for other customers.

Another reason cited by steel enterprises for contract problems in 1993 is that domestic customers themselves were tardy with payments. As steel firms pointed out, contracts embody not only the obligation on the part of factories to supply, but also the right to be paid. Payment delays affected the ability of steel firms to supply other customers on time, because payment delays meant that working capital was not always available when needed — a vicious circle inherent in the triangular debt problem (*san jia zhai*).

In summary, there were a variety of reasons why steel enterprises might have defaulted on export contracts. The business culture and opportunistic mind-set of some Chinese managers or enterprises staff, who “worshipped money” (*baijin zhuyi*) and desired to make a quick dollar, was partly to blame. But reference to the situation faced by domestic Chinese customers, including those under the state plan, demonstrates that there were also systemic reasons beyond the immediate control of enterprise managers, reasons which were likely to have snared international export contracts as well.

Ferrous metals imports. Steel imports into China have not been immune from contract problems. As with exports, incidents were part and parcel of booming volumes, particularly during the 1993 import frenzy. In 1993, European traders were reported to be experiencing unusually high numbers of distressed cargoes and cancelled orders in trade with China (*MB*, 21 Jun 1993: 17). For example, in late 1993, a trader at Voest-Alpine Intertrading, an Austrian company dealing in CIS-produced steel, claimed that: ‘The situation with China is a catastrophe for all steel trading companies. It has been a culture shock, it’s like another world. Contracts have not been kept and letters of credit have not been honoured’ (*MBM*, December 1993: 19). Another reported example was a Chinese trading company’s refusal to accept shipment of 10,000 tonnes of steel billets supplied by Balli Trading Company of the United Kingdom. The shipment was slightly delayed, leading to a technical breach which was exploited by the end-user or by the Chinese bank. Eventually the cargo was sold to another buyer although at a “substantially lower price” (*AWSJ*, 7 Aug 1993). In fact, reports of cancellations during the mid-1993 period were “many and varied”:

“One Hong Kong based trader is re-offering 25,000 tonnes of Romanian sections at \$377 C&F free out China main port. An Italian trading house which did not receive a letter of credit is also re-offering Italian sections at \$285 per tonne FOB. According to market sources, representatives from Poland’s Stalexport recently went to China to resolve problems over the non-delivery of LCs” (*MB*, 21 Jun 1993: 17).

It is worth pointing out that traders in the above quote were apparently not taking proper precautions. Their behaviour defeats the purpose of documentary credits. They had apparently shipped the steel *before* having received LCs. Admittedly, the traders still maintained title to the goods, as failure to receive LCs implied that they still held, and had not yet sent, all of the necessary documents. But this is only part consolation, because traders would have suffered costs or price discounts associated with disposing of distressed cargoes. One piece of advice these traders could follow to avoid recurrence of problems in future is contained in the following quote:

“Exporters may experience difficulty with buyers who are tardy in arranging for documentary credits to be issued. In such cases the exporter is faced with the decision whether to ship the goods without adequate protection. The exporter’s position will be clearer if the contract of sale includes a latest date by which the exporter must receive the credit” (*NAB*, 1996: 87).

Estimates of the total quantity of steel affected by LC default or contract cancellations in mid-1993 amounted to approximately 1 million tonnes (*MB*, 21 Jun 1993: 17). Possibly some of this tonnage is figurative only, in the sense that manufacture did not commence before the order was cancelled. In addition, the estimate of 1 million tonnes must be placed in the context of a total of 30.46 million tonnes of finished steel imported into China for 1993. Thus, to an extent, payments problems were a by-product of vigorous trade, and not every transaction was affected. But this is not to say that problems simply merged into the background of overall volumes.

In fact, problems were so evident that even large and normally reputable Chinese trading houses were delaying or cancelling orders (*AWSJ*, 7 Aug 1993). For example, delays affected the trading relationship between large Japanese steel producers and Minmetals, China's largest and oldest ferrous metals I/E corporation. Under normal circumstances, Minmetals is regarded as a very reliable customer: "Minmetals is treated with considerable respect by the Japanese because it can and does deliver" (*MB*, 13 Jan 1994: 19). However, in December 1993, the Japanese producers became concerned at: "mounting stockpiles of steel at docks and mills, estimated at about 500,000 tonnes, for which Minmetals had not opened LCs. However, Minmetals apparently assured the Japanese that it was making every effort to take delivery of the remaining stock as soon as possible" (*MB*, 23 Dec 1993: 17). In other words, Minmetals had placed *orders* with Japanese steel mills, who responded by making and stocking the specified steel, but actual shipment to China was delayed by Minmetals' failure to open LCs. The *Asian Wall Street Journal* reported that Minmetals asked for "shipment delays or even cancelled orders because end-users lacked the cash to pay" and that in some cases the firm used "technical discrepancies as a pretext for cancelling orders" (7 Aug 1993).

Another reported problem (from the foreign perspective) during late 1993 was that Chinese banks were not prepared to *extend* existing LCs whenever it transpired that shipment deadlines were approaching but orders had yet to be fulfilled (*MB*, 21 Jun 1993: 17). In other words, foreign suppliers still sought to meet the order if given extra time, but found to their dismay that financial assurance would not be renewed.



## REASONS FOR LC REJECTIONS.

Why were international steel suppliers encountering difficulties in using LCs during 1993? One immediate explanation relates to the credit worthiness of the importer. Even when foreign exporters are paid out by negotiating banks in their own country, the negotiating bank will often retain recourse to the exporter in the event that the importer defaults (as explained previously). Whilst it would be incorrect to impugn all Chinese enterprises, during recent years, China has experienced an relatively large number of reliability problems. China's commercial and industrial licensing system, which circumscribes Chinese enterprises' legal capacity to contract to the provision of goods and services where the enterprise has definite competency, is a tacit admission of reliability problems, as is the system of trade canalisation. See Dickson (1996: 11-12) for more information on this point. Recently, China introduced a registration scheme for steel imports. One prerequisite for registration is that RMB funding for the steel imports already be secured (Dickson, 1996: 9), which may prevent fly-by-nighters from entering the international steel market. Such rules may reflect government awareness of the potential for import-related payments problems to sully China's reputation. Finally, the fact that Sinochem and Minmetals require advanced deposits from customers also reflects the prevalence of credit-risk problems.

Another reason for LC defaults relates to quality problems, particularly associated with imports of CIS steel. Comments on the poor quality of imported Russian steel are often reported in Chinese publications (eg., *SJD*, 24 Jun 1996; *YCHJ*, July 1993: 13). However, according to a German-based trading firm, Coutinho Caro & Co Trading: "The actual [Russian] product is fine but the packaging is insufficient which means that by the time the consumer gets the steel it is not useable" (*MBM*, Dec 1993: 19). But regardless of reasons, the evidence is that the quality of material ordered from Russia often disappointed Chinese consumers.

It was not just Russian steel that failed to meet Chinese expectations. For example, the Chinese newspaper "World Metals" (*Shijie Jinshu Daobao*) reported that of 216 thousand tonnes of imported steel rails inspected in 1994 by China's State Administration of Import and Export Commodity Inspection, some 38.8 percent was

found to be sub-standard. Of 175 thousand tonnes of imported rails inspected in 1995, 42.8 percent was considered unsatisfactory. The newspaper also cited particular examples, involving steel rails imported from Canada and Spain respectively. In both incidents, a high proportion of the rails were considered defective and potentially hazardous if actually used in track-laying. In the Canadian case, compensation negotiations had already commenced with the Canadian supplier ( *SJD*, 15 Apr 1996).

Arguably, Chinese customers are quite justified in refusing to pay for steel which fails to meet their expectations. But even if so, such refusals would constitute a technical breach of contract. As previously noted, LCs are designed to ensure that *documentary* requirements are met. Actual quality of the delivered goods is left for the importer to cope with, for example, by lodging an *ex-post* claim. Thus, if payments were refused, this must have involved (a) cancellation of the LC despite its *irrevocable* nature or (b) consultation between bank and importer to find a technical or documents-related pretext with which to reject shipment. Failure to hold Chinese importers to making payment on grounds of quality problems would suggest that banks in China are not always impartial.

By way of introducing other reasons for the high incidence of LC defaults, it is interesting to note that complaints were mainly concentrated in second-half 1993, particularly after June.<sup>10</sup> For example, the afore-mentioned Voest-Alpine claim that “the situation in China is turning into a disaster for all steel trading companies” came only *after* a buoyant first-half situation in which China accounted for 30-50 percent of Voest-Alpine’s sales of CIS material (*MBM*, Dec 1993: 19). Another trader reported: “China was the basis of our steel business but...midway through the year the market virtually disappeared” (*ibid.*). It is not merely coincidence that Chinese government macro-economic control efforts were stepped-up in and after June 1993, with Vice-Premier Zhu Rongji assuming Governorship of the People’s Bank of China (PBOC) in

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<sup>10</sup> Thus, referring to pp.21-22, it is appropriate to view the reported 1m tonnes of affected steel against the backdrop of import figures for June to December of 21.98 million tonnes, rather than against the total annual figure for 1993 of 30.46 million tonnes. This bolsters the proposition that disputed steel imports were a relatively noticeable problem, as disputes were concentrated in the 2nd half.

July 1993. Indeed, these events have a particularly important role to play in explaining *transfer risks* in China's metals trade.

As the Chinese government stepped up efforts in June 1993 to control inflation by curbing credit, a consequence was that the large state specialised banks found themselves increasingly starved of cash. The PBOC under Zhu Rongji imposed measures which included the recall of \$17.5 billion worth of short-term state bank loans and the curbing of interbank lending (*Time*, 29 Nov 1993: 24). These measures threw down the gauntlet to a banking system overly reliant on the PBOC to meet short term liquidity needs. As Joe Zhang, in a report for W.I.Carr Indosuez Capital, has noted: "In terms of liquidity management, the banking industry today relies too heavily on the People's Bank to solve its 'emergency' needs" (Oct 1995: 13). In other developing countries with greater financial market and capital account openness than China, banks with poor liquidity often "live on money markets". The curbs introduced by Zhu Rongji on the money market of interbank lending must have shocked Chinese bank cash balances.

How did banks respond to curbs on interbank lending and to consequent liquidity pressures? Some interesting tactics, which essentially involve delaying liabilities, have been used in the past by China's banks in order to cope with short term cash deficits. For example, bank branches have resorted to rejecting depositor withdrawals, or at least, asking depositors to wait a few days. On occasions, bank branches have literally locked their doors to pre-empt withdrawals (Zhang, Oct 1995: 10-11). Thus, it seems entirely plausible to suggest that Chinese banks sought to delay or cancel LCs for the same reasons. In sum, foot-dragging on letters of credit by Chinese state banks was, in part, a survival-tactic in response to short term liquidity pressures.

China's banks are not merely state-owned organisations at arms length from the government. As with the PBOC, the four "specialised"<sup>11</sup> banks carry an institutional status within the central government itself. Whilst the PBOC ranks as a "ministry", the four major banks carry "deputy-ministerial" rank (Zhang, Oct 1995: 18). The institutions which control the lion's share of China's banking are all amendable to government control. Control be exerted through formal decree, but could just as well be exercised by verbal commands or by pressures of an informal nature. The ability of the state to control these institutions in a less-than-transparent manner is worth bearing in mind. (Note, however, that the Commercial Bank Law of mid-1995 may in fact change the institutional status of China's large banks). The next paragraphs focus on the question of whether central government directives might be a factor behind the difficulties being experienced with LCs.

Indeed, in 1993 there was speculation amongst traders that China's supreme governing body, State Council, had actually ordered state banks to stop issuing LCs for steel imports. This included state bank branches located outside of mainland China, such as in Hong Kong. In 1993, the main reason put forward was that the government sought to control an over-heated real estate sector, a problem which was becoming rapidly apparent by June of that year (*SCMP*, 25 Jul 1993). The attempt involved starving off supplies of reinforcing bar and structural sections used in construction and property development. This also keys with reports that *long* steel products were the variety most affected by international payments problems (*MB*, 21 Jun 1993: 17). A related explanation concerns the fact that long-product imports compete directly with domestic Chinese production, which is skewed towards long rather than flat products production. A State Council command to banks to stop issuing LCs on long products imports would afford the import competing sector a measure of protection.

Risk considerations form another reason why banks began to restrict LCs in 1993. Chinese steel prices were largely de-controlled by 1 January 1993. However, steel

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<sup>11</sup> In fact, it is now a misnomer to label these banks as "specialised". Originally, the four major banks possessed distinct functions. Nowadays, each aims to provide a full range of commercial services. However, "specialised"  
(*continued*®)

prices subsequently experienced considerable volatility. In part, this was due to speculative activities. Evidence can be found in a report prepared by a study group affiliated with the Ministry of Metallurgical Industry for a conference organised by the Research Institute of State Council in 1994:

“There are relatively large fluctuations in the demand and supply gap in our country’s steel market, which is also a hot-spot for domestic speculative capital (*touji ziben*) ... the entry of speculative capital will warp and inflate demand for steel, creating excessively tight supply and demand relations and suddenly lifting raging waves (*tu xian kuanglan*) in what was originally a calm market. The explosive rise and fall of the market for construction steel in 1993 provides evidence of the threat posed by speculative capital...” ( *YCHJ*, Sep 1994: 6).

Although it may be asked whether Chinese authorities are excessively preoccupied with behaviour which in western countries is accepted as normal market arbitrage, nonetheless, in 1993 speculation in steel products did indeed involve inordinate risks. This is confirmed by the fact that not only were Chinese banks reassessing risks associated with issuing LCs for steel imports, but “foreign banks have also tightened up trading facilities” (*SCMP*, 25 Jul 1993). So one reason for cutting new LCs issues for steel imports was strictly on the basis of commercial risk considerations. As one banker stated: “Speculation in these materials has been active and the prices unstable. It is only natural that we should take a cautious attitude” (*SCMP*, 25 Jul 1993).

### FOREIGN EXCHANGE ISSUES.

Foreign exchange issues are an important source of transfer risk. An importer may have a perfectly good credit standing, and possess the required sums of money, in local currency, ready and waiting to pay to the foreign supplier. The problem is that due to government controls, there may be no way to change domestic currency into the foreign sums required by the supplier. These controls can be of a temporary or permanent nature. It is usually assumed that where issuing banks have already agreed to issue an LC to a foreign beneficiary that the required foreign currency will also be made available. Nonetheless, this has not always been the case in China. The

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remains the recognised term.

following sections examine sources of foreign-exchange related risks, including but not limited to exchange- and transfer-risks.

Management of currency reserves. It is generally known that: “Weakness in the economy of a buyer’s country, a country’s low level of external reserves and balance of payments problems, all point to the possibility that transfer difficulties may occur” (NAB, 1996: 83). China in some respects is the very antithesis, given that its foreign currency reserves reached \$100 billion by the end of November 1996, the fourth largest in the world. Nonetheless, the Chinese government has in the past reacted sharply to balance of payments problems. 1993 was the only year this decade in which China recorded a merchandise trade deficit. Coincidentally (or perhaps not so coincidentally), 1993 also saw significant problems and payments delays on LCs issued to foreign steel traders.

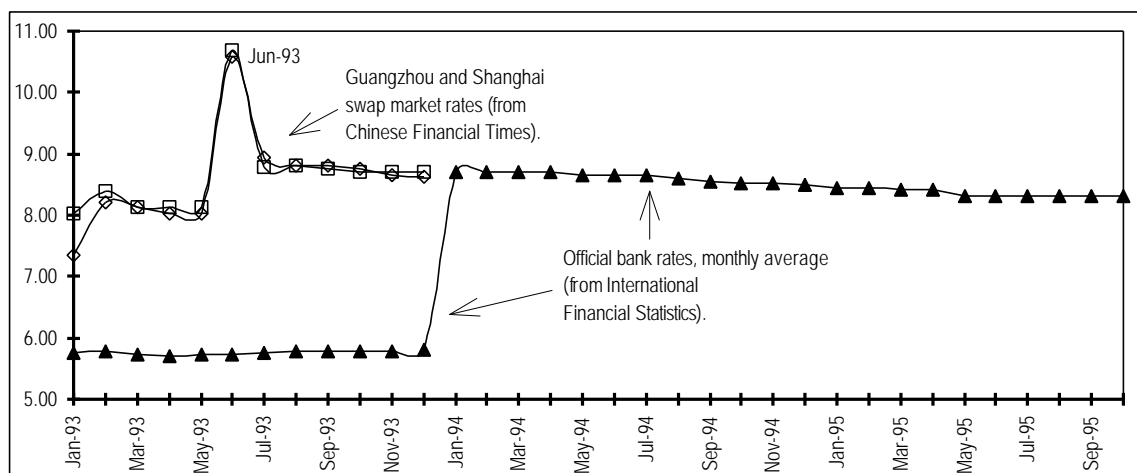
The China News Agency has reported the present PBOC Governor, Dai Xianglong, as saying that “a strategic position should be taken when examining the fast growth in foreign exchange reserves”. According to Governor Dai, a high level of reserves was necessary for (a) managing further trade and currency convertibility reforms, (b) in the interests of Hong Kong’s financial stability after it reverted to China in mid-1997, and (c) to provide guarantees in the face of China’s large foreign debt, “currently standing at \$110 billion” (SWB 10 Jul 96: WG1). On the other hand, some commentators have doubts about the wisdom of accumulating such a high level of reserves (see *FEER*, 7 Nov 1996: 92). Nonetheless, given the high priority the Chinese government places on maintaining reserves, not inconceivably, as part of a deliberate strategy to manage currency outflows, the PBOC, or more particularly, its State Administration of Exchange Control (SAEC) division, may on past occasions have ordered the banking system to restrict issuing, or delay payments on, letters of credit.

Passing on exchange risks to foreigners. FIGURE 4 shows that the RMB Yuan to US dollar exchange rate has not always be stable, particularly under the pre-1994 dual exchange rate system. Chinese merchants who signed import contracts in early 1993 and who expected to obtain foreign exchange from “swap markets” would have received a rude shock if settlement was due in June 1993 (see the “spike” in FIGURE

4). This may have resulted in payment delays to foreign steel suppliers. In the face of such currency movements, Chinese importers “wanted to wait for a more favourable rate” rather than meet contractual obligations on time (AWSJ, 7 Aug 1993).

Chinese reports pay great attention to the impact of exchange rate variations on costs of importing steel. For example, in August 1993, Guangdong Commodity Price Research Institute mentioned that: “...during the year, national foreign exchange adjustment prices have risen, greatly increasing the difficulty of increasing steel imports...” (YCHJ, Aug 1993: 8). Other comments focus not so much on the *rate* paid by purchasers of foreign exchange, but rather, the *availability* of foreign exchange,<sup>12</sup> as in: “...because national spot exchange reserves (*guojia xianhui chucun*) have fallen, foreign exchange is increasingly scarce, and this has increased the difficulty of organising steel imports”. When foreign exchange becomes difficult to obtain, or when exchange rates change adversely, a frequent response of Chinese importers may be to delay payments or else request that contracts be renegotiated. As one German trader said: “It’s not that they [Chinese importers] do not want the steel but there is just not enough foreign currency to pay for it” (MB, 21 Jun 1993: 17).

FIGURE 4: Swap market and official exchange rates (RMB / USD).  
January 1993 to October 1995.



Sources: (Chinese) Financial Times, International Financial Statistics.

Note: Swap market and official rates unified 1 January 1994.

<sup>12</sup> Although, of course, the two aspects, rates and availability, are virtually always closely connected. Prices tends to rise in the face of scarce supply.

Forward exchange contracts. Earlier it was mentioned that international traders use forward exchange contracts to mitigate exchange risk. Yet reports of shipments already having arrived at ports in China even as Chinese importers and their banks were delaying payment on account of unfavourable foreign exchange rates suggests that the importers concerned were not making use of forward exchange contracts. Forward exchange contracts have been available in China at least since 13 February 1988, when the SAEC promulgated “Regulations for managing spot and forward foreign exchange sales and purchases by financial organisations on behalf of customers” (these regulations were previously approved by State Council on 13 December 1987) (SAEC, 1995: 407-9). These regulations require prospective forward exchange purchasers to obtain forms from the SAEC or branch divisions to be used by banks in processing forward exchange contracts. In addition to approval from SAEC or branches, those seeking forward exchange contracts must also post some form of performance guarantee with the issuing bank. Despite the existence of forward exchange provisions, the interesting question remains: how widespread in practice is the use of exchange-risk mitigation instruments, such as forward contracts, by Chinese import merchants? The question is not answered here, but is of great relevance considering that foreign exporters sometimes become the ultimate victims of exchange risks faced by Chinese importers.

Convertibility for import purposes. At present, China restricts, or at least supervises, RMB Yuan convertibility for both current and capital-account related transactions. According to a letter sent by PBOC Governor Dai Xianglong to the International Monetary Fund in November 1996, China will, by the end of 1996, fully comply with current account convertibility provisions of Article VIII in the IMF’s Articles of Agreement (FT, 29 Nov 1996). SAEC spokespeople have stated that compliance with Article VIII “will oblige China to remove all restrictions on enterprises’ payments for imports and labour services, repayment of the interest of foreign debt, and repatriation of profits by foreign business people in China” (SWB, 5 Dec 96: S1/6).

There is no indication that China will introduce new regulations governing foreign exchange payments for imports, so that it is probably safe to assume that the latest batch of regulations, introduced on 30 August 1996, represent the extent of China’s

commitment in this respect. In fact, China's claim to complete convertibility by the end of 1996 seems to rest not so much on any new developments related to import transactions, but rather, because there was new progress in other areas.

For example, new consolidated foreign exchange control regulations came into effect on 1 April 1996. China also eliminated the last vestiges of a "dual" currency system: although dual exchange rates were eliminated at the beginning of 1994, the fact is that foreign invested enterprises (FIEs) were still subject to a differential set of exchange regulations. FIE exchange regulations were technically restrictive, although not uniformly applied in practice, and apparently included perpetuation of the pre-1994 system of swap markets for exclusive use by FIEs. These "multiple currency" practices, an infringement of IMF Article VIII Section 3, were eliminated on 1 July 1996, when Chinese authorities placed FIEs under the same exchange control regulations governing domestic enterprises. As it happens, the latest regulations for access to foreign exchange to finance imports, published 30 August 1996, reflect these changes: the definition of "importer" in the new regulations includes not only state trading corporations, but is specifically extended to encompass FIEs (*MOFTEC*, 30 Aug 1996: 6).

Thus, whilst there were many important developments during 1996, amongst the most prominent of which was the integration of FIEs into the mainstream system, but it seems that extensive changes to controls governing imports were not amongst the new developments. China appears satisfied that currently prevailing freedoms to swap RMB into foreign currency for trade purposes already meet IMF requirements.

The cautionary tale here is that claims that current account convertibility has been achieved must not be misconstrued or exaggerated. For instance, does "current account convertibility" imply that henceforth Chinese exporters will no longer be subject to provisions requiring that foreign-denominated export receipts must surrendered into local currency? (Foreign exchange retention quotas were abolished early 1994, although trading companies can avoid compulsory sale of foreign currency if they deposit into special foreign currency accounts held with the state banks).

Vice-Premier Zhu Rongji has pointed out that China has no time-table for full *capital* account convertibility. He says: “The free convertibility of the RMB I mentioned covers the *current* accounts; it doesn’t mean completely free convertibility” (SWB, 11 Dec 1995: S1/1). If China intends to divide currency transactions into “current” and “capital-account” groups, then *both* types of transaction may need to be scrutinised and, to some degree, controlled. If supervision were absent, how would China ensure that enterprises changing currency to finance imports (a current transaction) not use the foreign currency to invest overseas (a transaction on the capital account)?

The 30 August 1996 regulations (MOFTEC, 30 Aug 1996) indicate how the SAEC intends to monitor use of foreign exchange obtained for import purposes to ensure that the final use is indeed, as stated, to acquire imports. The regulations extend the “cancellation after verification” (*he xiao*) system already in effect.

The “cancellation after verification” system involves completion of a certificate to be stamped by the bank actually providing the foreign exchange, proving that foreign exchange was used for the professed purpose of acquiring particular imports. Banks obtain blank certificates to be filled-in by the importer from the SAEC or its branch divisions. Importers presented completed certificates to the relevant bank for verification up to 30 days after buying exchange from the bank for purposes of remitting payment to the foreign supplier. Customs declaration forms (*jinkou huowu baoguan dan*) are the most important piece of evidence importers need to provide before banks can give their stamp of approval on completed certificates.

For import transactions of value greater than \$500,000 banks are required to seek direct verification from the customs authorities themselves, rather than relying only on the documentary evidence. Banks, moreover, are required to check that the type and total value of the declared goods exactly conform with those specified by the importer when he or she originally applied to the bank to obtain foreign exchange. If the importer fails these verification procedures, he or she may be required to refund, or at least account for, the whereabouts of any surplus exchange not used.

If the importer has not submitted the verification certificate to the bank by the end of the 30 day time limit, banks are required to issue a warning. If the warning is not heeded, then during the first 8 days of every month, the bank is required to report infringements to the local foreign exchange bureau, which will undertake investigations and / or punishment of the offender.

Importers have only two avenues to obtain foreign exchange for financing imports. State trading corporations and FIEs alike must either (a) apply to approved banks to swap currency, or (b) make use of foreign currency accounts. As with applications to swap currency, withdrawals from foreign exchange accounts to finance imports are also subject to the “cancellation after verification” procedures.

The implication of these various rules is that although China may meet the technical requirements of IMF Article VIII so far as trade-related convertibility is concerned, the system adopted by China nonetheless remains centralised within the state banking system. Foreign currency export receipts must be sold back to the state banks or deposited into accounts held with state banks. Import payments must be “cancelled after verification”. Importers must lodge *application* to obtain foreign exchange, and whilst this application may under present circumstances be fairly straight-forward and automatic, the situation could easily change were China to run into balance of payments problems — it has already been noted that transfer problems on LCs in 1993 may have been connected with an emerging current account deficit during that year.

Some authors have argued that: “Under the central planning system, there is a limit to the amount of foreign exchange that is made available for the purchase of steel imports, which effectively imposes a quota on steel imports into China” (*Labson et al*, 1995). The above discussion suggests that as the situation currently stands, such an argument is incorrect. Centralisation of transactions within state-owned banks allows China to retain informal discretionary control over trade related payments, but there are no hard quota limits on foreign exchange availability (quota limits would blatantly infringe the provisions of Article VIII).

Informal discretionary control retained by the government, with the underlying possibility of intervention, may work to increase general *transfer risks*. Foreign exporters must live with the risk that the Chinese government may issue internal circulars or informal commands to state-owned banks to stop currency outflows by refusing applications to change currency.

Lastly, to return to Zhu Rongji's comment that free convertibility of the RMB yuan does not extend to capital account transactions. An implication of the need to monitor exchange transactions — using “cancellation after verification” procedures and the like to prevent unauthorised capital-account movements — is that the system may discourage wider uptake of exchange risk-mitigation instruments. Leung (1995: 8) has noted that hedging instruments available in international currency markets, such as Singapore or Hong Kong, may be out of reach to Chinese enterprises, particularly “when knowledge of financial hedging is limited so that officials administering capital controls are unable to distinguish between speculative capital movements and genuine requirements on the part of domestic firms to undertake financial hedging”. This quote further underlines the issue about whether, in practice, financial risk-mitigation instruments are available to, or utilised by, Chinese steel importers.

#### CONCLUSION: TRADE BARRIERS AND TRANSFER RISKS.

This paper has provided anecdotal evidence indicating that China's metals trade has in the recent past suffered an abnormally high degree of risk. The main classifications include transit risk, market risk, exchange risk, transfer risk and credit risk. Transit risk is not, by and large, addressed in this paper, although mention is made of quality problems experienced by Chinese importers of Russian-made steel (considered passable at the time of manufacture but rusty after shipment). So far as exchange and market risks are concerned, these are often faced by the Chinese-side due to possible under-utilisation of risk mitigation instruments and to the volatility and speculative nature of Chinese commodity markets during certain periods (steel in 1993). Credit and transfer risks can be elaborated in greater detail as follows.

Credit risks stem in part from a business style which allows contracts to be broken should favourable opportunities or adverse circumstances intervene. Adverse circumstances may include, for example, changes to domestic market prices or exchange rates which go against the interests of the Chinese importer. The result, ironically, is that the foreign supplier is not insulated from the market and exchange rate risks faced by the Chinese importer. These risks are “passed-on” to the supplier in the form of credit risks, since if market rates go the wrong way, the Chinese importer may “conveniently” default. The availability in China of instruments to mitigate market- and exchange-risks, and their rate of acceptance and use by Chinese contract partners, should be therefore be of great interest to foreign suppliers.

This paper has also endeavoured to show how export contracts may be affected by the same opportunistic mentality. Chinese steel and non-ferrous metal suppliers have sometimes delays contracts to foreign purchases because higher price contracts come along at a later stage. Thus the sarcastic quip from *Metal Bulletin* editors that “Confucius never said that contracts could be abandoned in a rising market” (*MB*, 3 Apr 1995: 9). However, it also true that steel producers in China have had to cope with systemic problems not necessarily of their own making, problems which have affected international and domestic customers alike (including domestic customers covered by mandatory state-plan contracts).

Transfer risks. The chief source of transfer risk is Chinese government manipulation of foreign exchange and banking regimes. China is not unique in this respect, but in countries which do have such controls:

“As a general rule, the issuing of a documentary credit is evidence that remittance of foreign currency in payment for the goods will not be delayed, but this remains uncertain in some countries.” (*NAB*, 1996: 127).

At least during the first half of this decade, China was one of the countries where this rule was uncertain, because it could not be taken for granted that LCs guaranteed payment without delay. Transfer difficulties on remittances for steel import LCs in 1993 testify to this point, as do warnings from American copper dealers to the effect that “Chinese banks were not to be trusted”, and that LCs issued by Chinese state banks should be confirmed by overseas banks. This paper has suggested that one of

the chief reasons for transfer problems resided with the sorry situation of state banks. To the extent that the banking system in China remains unreformed, transfer difficulties may persist in future.

Another direct cause of transfer problems relates to foreign exchange convertibility. During 1996, great efforts appear to have been made, and China has informed the International Monetary Fund that the RMB Yuan will be fully convertible for current account purposes by the end of 1996 (*AWSJ*, 29-30 Nov 1996). However, it remains to be seen what this pledge will mean in practice and whether it will actually eliminate exchange-related transfer problems in the traded goods sphere. It is noteworthy that the government retains administrative control over foreign exchange availability, and could easily restrict availability if so desired. The extent threat of government “internal directives” to the state banks leads to transfer risks.

It is also interesting to note the effect of government rules and regulations, such as import licensing or registration requirements, especially when these requirements lack transparency:

“The proper completion of import licensing and exchange control formalities by the buyer in the importing country is of paramount importance and it must be acknowledged that the exporter relies largely on the buyer’s assurances that all the necessary steps have been taken. This emphasises the need to ensure that overseas buyers, in addition to being financially sound, are experienced and highly reputable” (*NAB*, 1996: 128).

This quote serves to highlight the fact that trade barriers have ancillary effects beyond their immediate or stated purpose. The stated intention may be to impose discretionary controls, quantitative limits, or a tariff cost impost. But indirectly, ingrained systems of trade protection also create credit and transfer risks. There is always a chance that a Chinese customer with whom the foreign supplier negotiated in good faith may fail requirements necessary for remitting payment in foreign currencies. For instance, the Chinese customer may not be an approved trading organisation, or may not meet licensing or registration requirements.

Risks in and of themselves inhibit trade. Overseas suppliers may no longer be able to provide quotes competitive with local suppliers due to the need to factor risks into

cost calculations. Suppliers will go to lengths to *confirm* LCs, paying extra bank charges involved, or else pay premiums for credit insurance with national organisations (such as EFIC in Australia).<sup>13</sup> Another possible response to regulatory-induced risks might be to seek intermediation in trade with China. For example, Japanese steel producers have for many years relied on Minmetals to facilitate their exports to China, as they are aware that Minmetals has inside knowledge of Chinese trade rules and regulations, as well as privileged access where licensing or registration requirements are concerned. The effect of such intermediation may be to push up costs of the trading transaction, and again, this may make the foreign supplier less competitive. Finally, there may be a more categorical reason why credit and transfer risks inhibit trade, namely that some potential exporters may simply place China in the “all too hard basket”.

Finally, two important qualifications to discussion in this paper. First, due to ever-changing rules and regulations, and due to the rapidly changing mores, practices and understandings of Chinese business partners, most conclusions in this paper are reasonable for 1993-1996, but not necessarily thereafter.

Second, risk has been discussed from the perspective of foreign and not Chinese traders, but this is not to deny that the latter is also exposed to credit risks from the former. Indeed, a recent report from the China News Agency notes that Chinese firms are currently owed “a staggering” \$9 billion in outstanding payments from overseas business partners (*SWB* 19 Jun 96: WG/1). However, it is instructive to note that 50 percent of the accounts receivable are attributable to overseas Chinese-funded firms.

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<sup>13</sup> On the other hand, it is also recognised that if exporters do not use *usance* LCs or the D/A methods in trade with China due to fears of excess risk, then export prices would not include the interest charges associated with these methods.

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*AWSJ*, Asian Wall Street Journal, Hong Kong.

*FEER*, Far Eastern Economic Review, Hong Kong.

*FT*, Financial Times, London.

*HKS*, Hong Kong Standard, Hong Kong.

*MB*, Metal Bulletin, London.

*NKS*, Nihon Keizai Shimbun, Japan.

*SCMP*, South China Morning Post, Hong Kong.

*SJD*, *Shijie Jinshu Daobao* (World Metals), Beijing.

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