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Rule of Law in China: Chinese Law and Business

The Chinese Banking Sector

Trapped in Transition but not Spinning Out of Control

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Executive Summary

- As Minxin Pei has pointed out, senior Chinese leaders remain determined to maintain control over China's massive banking sector, using it to accomplish a host of policy and political outcomes. By the benchmark of government ownership, the Chinese banking sector remains one of the most unreformed in the world.

- Nonetheless, there have been substantial improvements. The creation of non-performing loans (NPLs) has slowed substantially. In 2001, the official (NPL) ratio stood at 25 per cent. Today it is a little more than 7 per cent. Recent improvements in the banking sector have stemmed from three main sources. Robust economic growth and a favourable trade balance have made costly re-capitalization manageable. Due to spectacular growth in the financial sector, intervening in even limited segments of the banking sector affords elite politicians access to considerable funds. Leninist organizational solutions have given rise to much stronger regulatory mechanisms.

- Despite these fixes, slowing growth in the future will necessitate more fundamental reforms of the financial sector. The Chinese Communist Party (CCP) has, however, shown a great reluctance to initiate any fundamental restructuring. The domestic private sector remains more or less barred from the financial industry. Recent regulations allowing full foreign access to the Chinese banking sector contain numerous provisions that potentially limit the expansion of foreign competition. These provisions only allow the largest foreign financial institutions to establish a foothold in China.

- Ultimately, the well-being of the financial sector remains intimately linked to the continual effectiveness of the Communist Party state. Thus, the key indicators for the future of China are political: tracking the strains facing the CCP regime.

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An overview of developments in China's finance sector

Minxin Pei's argument has many political merits. However, the latest developments do not quite fit the application of his argument of gradualism to the financial sector. His argument concerning the pitfalls of gradualist reform comprises two parts. First, since the Chinese Communist Party (CCP) elite cares about the survival of the regime, it is not willing to give up key parts of the economy (Pei 2006, p. 96). Thus, reform in key sectors is compromised. I agree with this assessment.

An important aspect of Pei's argument, however, is that 'gradualism ultimately becomes untenable because of rent dissipation by insiders' (p. 33). Contrary to this expectation, the state has managed to constrain growth in the overt siphoning of financial assets to a much slower rate than that at which it recapitalized the banks. Thus, overall, we are witnessing an improvement of the bank balance sheets in China.

Although recent 'fixes' in the banking sector can to a great extent be attributed to China's large foreign exchange reserve, the slow-down in the creation of non-performing loans (NPLs), at least in comparison with the mid-1990s, is also an important factor. The rapid growth of the financial sector and institutional changes, centring on the formation of the China Banking Regulatory Commission (CBRC), are responsible for the slow-down in the creation of NPLs. These improvements attest to the continuing strength and adaptability of Leninist institutions; although relying on Leninist institutions carries fundamental risks.

Stagnation of financial sector reform

Pei argues compellingly that in key components of the economy, including the financial sector, the CCP regime has engaged in rent protection in order to preserve its ability to distribute rent to key supporters of the regime (p. 96). To a large extent this explains the stagnation of financial sector reform relative to reform in other sectors, for example, light industry.

The roots of reform stagnation in the financial sector can be traced to the early 1980s, when top leaders were pleasantly surprised by the sudden growth in bank deposits as a result of the initial round of rural and urban reforms. At that time, both State Council technocrats and local officials enthusiastically supported the 'budget-to-loan' transformation, in which budgetary disbursements to state owned enterprises (SOEs) were transformed into bank loans to SOEs. As senior leaders of all persuasions grew accustomed to using the banking system for policy and political purposes, it became an indispensable tool for the CCP elite. This led to increasingly sizable defaults by SOEs and other state borrowers, which required several rounds of massive recapitalization. Such recapitalization continues today.

In general, Pei's logic is compelling. Similar to technocrats in other developing countries such as Korea, the Philippines, and Mexico, Chinese technocrats care more about their own careers and income than about reforming the economy. In the case of China, they are motivated by the desire to consolidate and improve their positions in the Party by way of administrative accomplishments (*zhengji*). They are also motivated by money, which provides a powerful tool for achieving these goals, in an increasingly monetized economy. Examples are the Three Gorges Dam, the resolution of the triangular debt problem, the SOE restructuring plan, and the 'Go West' campaign, all of which required massive funds, most of which, directly or indirectly, come from the banking sector.

Centralization and state dominance

It is worth noting that two major efforts to mobilize bank deposits for administrative purposes took place after the banking 'reform' in 1998, which centralized the banking system for the most part. Chinese Premier Zhu Rongji centralized administrative control of the People's Bank of China (PBOC) and the 'big four' banks: the Agricultural Bank of China (ABC), the Industry and Commerce Bank of China (ICBC), the Bank of China (BOC), and the China Construction Bank (CCB). Afterwards, under the State Council, he launched the 'Three Years Out of Difficulties' programme for SOEs, and the 'Go West' campaign for the western provinces. Zhu gladly mobilized the newly centralized banking system to deliver the massive funds required. For example, western China received some 600 billion RMB in loans between 2000 and 2002, which was twice the figure for the period 1997 to 1999 (Shih 2004).

With the exception of the few remaining communist regimes, China continues to have the most state-dominated banking sector in the world. All but two banks, the Minsheng Bank and the Shenzhen Development Bank, are majority controlled by the state or state-holding companies. The 'big four' state banks, which still control over 50 per cent of the banking market, are controlled by holding companies under the PBOC, or by the Ministry of Finance. Despite some relaxation of regulations governing foreign ownership of Chinese banks, foreign entities still cannot hold individually more than 20 per cent of Chinese bank shares, as shown by Citibank's failed bid for majority control over the Guangdong Development Bank.

Finally, senior officials in all of China's major banks continue to be members of the CCP. They continue to meet regularly in Party committee and group meetings to make important decisions. The dominance of the CCP in banking institutions means that top bankers are motivated more by aspirations for promotions in the regime than by profitability. They continue to receive instructions from the State Council and the Central Committee about funding priorities. Premier Wen has called for the financial sector to support rural development, a hallmark of his leadership. This stands in direct contradiction to the announced goal of commercializing the banking sector. Beyond minor changes to raise additional capital for banks, there is little sign that the state will withdraw substantively from the banking sector in the medium term.

Analysis of China's banking sector

The quality of assets and state recapitalization

While the incentive to mobilize the banking system for policy and political purposes is still in place, the quality of the assets in the financial sector has greatly improved since just a few years ago. In 2001, the official NPL ratio stood at 25 per cent, while the estimated NPL ratio stood at 40–45 per cent, equivalent to over 50 per cent of GDP. Today, the official NPL ratio of the entire banking sector is a little more than 7 per cent of all loans outstanding, a steep decline since 2003. In absolute terms, NPLs declined from 2.5 trillion RMB in the first half of 2003 to 1.25 trillion RMB by the end of 2006.

The greater part all of this contraction was the result of several rounds of massive state recapitalization, beginning with the transfer of 1.4 trillion RMB in NPLs to the asset-management companies (AMCs) in 2000, followed by transfers of NPLs totaling 600 billion RMB to the AMCs as the BOC and the CCB prepared for listing. The world was astonished by the transfer of US$45 billion from China's foreign exchange reserve to the CCB and the BOC in preparations for their listings, followed by an additional US$30 billion, half from the foreign exchange reserve and the other half from the treasury, to recapitalize the ICBC. As the ABC prepares for restructuring and listing, it will require an injection of over 500 billion RMB to reduce its NPL ratio to less than 5 per cent.

Although high, the 3.1 trillion or so that China spends on recapitalizing the big four banks was only 15 per cent of GDP in 2006. Even if one were to add up the hidden costs of recapitalization, including the cost of PBOC re-lending to the AMCs, bank write-offs of NPLs, the recapitalization costs of the rural credit cooperatives, and the smaller joint-stock and city commercial banks, it is unlikely to surpass 25 per cent of GDP. Premier Zhu made a gamble in the late 1990s that China's economy would grow out of the NPL problem. By many indicators, he gambled right. As Pei (p. 167) puts it, this is the result of a fortunate combination of conditions rather than government policies, which have tended to put a negative drag on the economy. Nonetheless, the government got a few crucial policies right in the early stages, which enabled robust growth for the rest of the reform.

Thus, the recent improvement in the banking sector is mainly due to a serendipitous combination of high growth, large foreign exchange reserves, and rising international confidence in China. It had less to do with fundamental improvements in the banking sector itself. Additionally, China's high savings rate and its relatively effective capital control have largely prevented depositors from withdrawing from the state banking sector and seeking higher returns abroad, despite some of the lowest interest deposit rates in the world.

The performance and role of bank loans

The banking sector is in a far better situation than in the late 1990s. The same torrent of NPLs is no longer being generated. Examining the growth of NPLs, Fan Gang (2000) estimated that between 1990 and 1995, NPLs grew by 429 per cent from 200 billion to nearly 1.1 trillion RMB. We are no longer seeing NPL growth rates in this proportion. Even Ernst and Young's estimate of NPLs growing by US$225 billion in the past five years indicates a far slower rate than in the late 1990s.

The Ernst and Young estimate is problematic since it assumes that all special-mention loans are in reality non-performing, which is an extreme assumption, even for China. According to official figures, the absolute level of NPLs has fallen almost continuously since 2003. NPL creation, though still alarming by global standard, has slowed substantially since the late 1990s. And the Ernst and Young figure is still less than one year's accumulation of foreign exchange reserves.

There is, however, a major caveat in the assumption about the current slow-down in NPL creation: it remains unclear what share of long-term loans made in the past few years will become non-performing. In 1999, the share of medium- and long-term loans was 18.9 per cent of total loans. But by the end of 2006, the share of medium and long-term loans was nearly 30 per cent. The growing share of long-term loans stems from the large number of government construction projects, which were often financed by long-term loans with terms of 20 years or more. Due to the initial capital requirement of 30 per cent for these projects, provided by the local and central budget, these projects often repay only interest on the loans for the first few years. It remains unclear how many of these loans will be fully recoverable. Large-scale default is however unlikely, since west China is showing more robust growth, due partly to the construction of transportation infrastructure crucial to moving goods to the coast.

Growth in the Chinese economy: the banks and political intervention

Why did the growth of NPLs fall to a manageable level? First and foremost, loans outstanding in the period, 2002-2006, grew by over 10 trillion RMB. This is due to the spectacular growth in China since late 2002, sustained by healthy exports and high domestic investment. The banking sector itself did not change much. Because other parts of the economy are doing so well, new problems in the banking sector seem comparatively minor.

Secondly, due to relatively low inflation, construction projects cost essentially the same today as ten years ago. For the same period, however, the Chinese banking sector grew four-fold. Thus, even intervening in limited segments of the banking sector gave elite politicians access to as many, if not more funds than they had in the past. This meant that the top technocrats gained international credit while spending the same amount of money on policy and political projects. The affluence of the Chinese financial sector created a strange situation where nothing had changed fundamentally, but a smaller share of bank assets were subject to political intervention.

A prime example of limited intervention is the sudden mobilization of the China Development Bank (CDB) for political purposes in the past few years. The CDB, headed by Chen Yuan, was extremely conservative in its lending before 2003. However, CDB loans grew at an annual rate of well over 20 per cent between 2003 and 2005. By the end of 2006, CDB's loan portfolio stood at some 2 trillion RMB or US$256 billion. Governor Chen Yuan allocated numerous packages of loans ranging between 30 and 90 billion RMB to provinces, ministries, and large SOEs. This was either because he wanted a promotion at the seventeenth Party Congress, or because he was ordered to do so by more senior politicians.

His generosity was even extended to the State Council Taiwan Affairs Office, which was given a loan agreement worth 30 billion RMB to encourage Taiwanese investment in mainland China. Likewise, Wen Jiabao and Hu Jintao's call for the 'New Socialist Countryside' is likely to require hundreds of billions in bank loans. Yet the ABC and the Agricultural Development Bank of China are sufficient to finance rural developmental ventures. With the vast sums available in the three policy banks and in the ABC, CCP leaders have less need to directly intervene in the other banks; although all banks in China are still encouraged to lend to major government projects and large SOEs.

Regulation and reform era measures

The case can be made that the formation of the China Banking Regulatory Commission (CBRC) in 2003 was an independent constraint on the accumulation of NPLs. While by no means improving the honesty or quality of banking officials in China, the creation of the CBRC gave a sub-set of technocrats an incentive to constrain NPLs. Even if we assume that technocrats in the CBRC are completely self-serving, this agency was vested with the mandate to reduce NPLs in China. Their career prospects depend on the reduction of NPLs in China's banking sector.

For much of the reform era, the People's Bank of China's (PBOC) missions included inflation prevention, growth maintenance, bailing out illiquid financial institutions, and, finally, regulating depository institutions. The last task often took a back seat to preventing inflation and promoting growth from the 1990s into the Zhu administration.

The CBRC, in contrast, has the single task of reducing the NPL ratio in China's financial institutions. The chair of the CBRC, Liu Mingkang, must carry out that task fully or face a dismal future career. Regional CBRC officials, likewise, have the same incentive to monitor local financial institutions. Although it remains a relatively weak bureaucratic player compared with the PBOC and the National Development and Reform Commission, its zealous lobbying and frequent monitoring have reduced the pervasiveness of bad lending practices. The strict imposition of NPL reduction quotas has inevitably led to some false reporting by local bankers and local CBRC officials. But, overall, the scale of false report seems limited.

At the micro-level, an unprecedented survey conducted by Xie Ping, a veteran central banker and the current managing director of the Central Huijin Company, shows there was pervasive corruption in the banking sector, even in the period 2002–2003. Over 80 per cent of respondents, from both within and outside of the banking sector, perceived corruption to be pervasive (Xie and Lu 2003).

However, partly due to the CBRC, the responses do not add up to a banking collapse. Although as the survey suggests, every branch probably had its fair share of corrupt loans, current growth rates in NPL ratios do not suggest that the majority, or even a substantial minority, of loans made in that period became NPLs. This was not the case in the mid-1990s, when nearly half of all loans became non-performing or overdue. The Xie study surmises that the bribes served as a kind of premium interest rate on loans, ranging between a modest 3 to 6 per cent.

The entry of foreign banks

Beyond the formation of the CBRC, other regulatory changes, such as WTO compliance, have not had a substantial impact. In compliance with the WTO, China enacted regulations on the 'administration of foreign-funded banks' at the end of 2006. Although these rules nominally bring China closer to WTO compliance, they also erect numerous barriers to entry. For example, foreign banks must have assets totalling over US $10 billion before entering the Chinese market. Furthermore, foreign banks wishing to set up a Chinese subsidiary must undergo a potentially time-consuming preparatory approval process, lasting up to nine months. Final approval can last up to two months. This is followed by another approval process by the local industry and commerce bureau, before a subsidiary can open for business.

The 'rules', issued by the CBRC, further stipulate onerous regulatory steps, such as a requirement that all documents related to the parent bank be notarized by the home country of the bank, and authenticated by the Chinese embassy or consulate in the home country. They further stipulate that a foreign applicant must first submit all material to the provincial branch of the CBRC for approval in both the preparatory and the final approval stages, before submitting material to the CBRC headquarters. There are effectively four stages of approval conducted by the CBRC, both locally and centrally. Finally, the Chinese government retains the ultimate veto over foreign banks via such stipulations as a foreign bank's host country having a good working relationship with the CBRC, a 'good reputation' in the banking sector, and a good social image. The stipulation a bank has 'no record of serious violations of laws or regulations' also provides ready means for the authorities to reject a foreign applications.

Only the largest banks, including HSBC, Standard Chartered, Citibank, and Deutsche Bank, which already have close working relationships with the authorities, have a fair chance of gaining smooth access to the Chinese banking sector. Furthermore, foreign banks will not dare challenge the authorities directly, since they know they conduct business in China with the government's grace. Indirectly, however, many of the foreign banks gain access through hiring children, relatives, or friends of senior government officials. If anything, this informal process will increase the leverage of major foreign financial institutions, further opening up the Chinese market for these few institutions.

Escaping trapped transition in the financial sector?

Financial stability and confidence

Compared with most developing countries, China's growth performance has been spectacular, even if the realities of the banking sector have made its performance less than a miracle. This begs the question: did China embark on the right path in its financial reform? Should its financial reform have been more rapid?

A few years ago, I would have answered in the affirmative on the grounds of the non-commercial logic dominating the Chinese banks. But the more I find out about other developing countries, the more I think that the price of inefficiency may have been a necessary one, at least up to this point. China's banking system is corrupt and inefficient, and China is paying for the colossal misallocation of funds in various ways.

However, strong state institutions and tensions among the elite have minimized much of the financial volatility faced by many developing countries. Unlike countries in Latin America and Africa, China has largely evaded both hyper-inflation and capital flight. Although systematic evidence is as yet unavailable, it seems that China's ability to avoid these two dangers has given it a firm foundation on which it can prosper. Financial stability reduces transaction costs for the whole economy. More importantly perhaps, investors, both domestic and foreign, have confidence in a country that can credibly preserve financial stability. This would not have been accomplished without a relatively strong state, with the means to control the banking sector, and to maintain capital control.

Private sector domestic investment

One of the greatest puzzles in China is why domestic private entrepreneurs seemed so willing to pour their savings into domestic investment, even in the 1980s, when the CCP still actively discriminated against the private sector. Perhaps they knew that the CCP was nonetheless a powerful organization capable of guaranteeing the necessary degree of financial stability. Perhaps, they also knew that the central bureaucrats had a strong incentive to rescue the regime from financial disasters, even if the repairs were short-term fixes. Perhaps that was enough for China's growth, when combined with powerful advantages of China's rich endowment in labour, and government policies, which allowed labour to flow from agricultural to industrial production.

Financial sector reform and liberalization

As China's growth continues, however, the stable foundation for growth maintained by the CCP regime will become increasingly brittle. The financial sector will have to undergo fundamental reform. As labour costs in China increase, China's export-led growth is likely to slow down. Regardless of the source of the slow-down, if growth in non-performing loans outstrips GDP growth, it may fundamentally undermine the confidence of depositors and investors in the Chinese financial system.

This may be easily accomplished. The financial assets of the banking sector financial institutions totals some 44 trillion RMB today, or over twice GDP. If both financial assets and GDP grew by 5 per cent this year, but a tenth of new financial assets became non-performing, this would erase 20 per cent of the year's growth in GDP. The situation would become more serious if GDP growth were slower: if GDP growth were only 3 per cent, 5 per cent growth in banking financial assets, accompanied by 10 per cent non-performing assets, would erase over a third of the year's GDP growth.

This drag on the economy is likely to have a feedback effect on non-performing asset creation. This means that, even if NPL creation remains at a relatively modest level by Chinese standard, say around 5 to 10 per cent of new financial assets, it will be a substantial drag on a slowing economy. The vicious cycle between deteriorating financial assets and slow growth can persist for several years, as was the case in Japan in the 1990s.

Beyond slow growth, if China decides to liberalize, the current repressed financial system will end, prompting savers to invest their money abroad. This would also create a crisis in the financial system that would demand more fundamental reform. Past experience shows that the immediate post-liberalization period is the most dangerous for any financial system. Thus, without a serious crisis of some sort, the government would be very reluctant to liberalize capital accounts.

Conclusions: political considerations revisited

As Pei suggests, the urge to protect rent remains too strong today to allow for fundamental financial reform. Ultimately, this means that the well-being of the financial sector remains linked with the Communist Party state. Beyond massive write-offs, the decline in the NPL ratio in recent years was to a large extent a product of traditional Leninist institutions that held individual officials, and party and state organs responsible for policy failures.

These traditional Leninist measures have been relatively effective, precisely because the state still controls the bulk of the financial sector. Without a major exogenous disruption, there is little incentive for anyone to upset the equilibrium. However, if a major economic or political shock either strained the economic balance or led to the sudden withdrawal of the CCP, the entire edifice would collapse. As CCP institutions are being undermined over time by the increasing pervasiveness of official corruption, the fundamental risk faced by the entire system will increase.

If only economic or financial indicators are observed, the gradual rise of this fundamental risk will not be detected. Both theoretical and empirical works on centralized political systems show that they face fundamental risks caused by elite predation, sudden changes of leadership, and social unrests, or separatist tendencies, due to the lack of mechanisms to incorporate heterogeneous preferences. Thus, as implicitly suggested by Pei, the primary indicators observers should look out for, even if they are only concerned with economic or financial performance, are political. The discovery of corruption rackets, unrests, military involvement in politics, and the emergence of organized oppositions are all indications of Leninist institutions under strain.

The role of the domestic private sector

In preparation for the day when the party-state no longer holds everything together, comparative research suggests two crucial steps that will make banking restructuring less costly.

Firstly, deposit insurance and monitoring mechanisms on banks must be put in place. While the latter is more-or-less implemented, the former is not. Secondly, the Chinese government must allow the domestic private sector into the banking business. Although joint-stock banks exist, the large shareholders of these banks continue to be government entities.

If the government one day became cash-strapped, the main buyers of banks would be foreign financial institutions and large domestic private firms. If domestic firms are to be prepared for the financial sector, they must be allowed to form increasingly large financial institutions. The authorities continue to worry that large private shareholders would pressure a bank to lend to other firms owned by the shareholders. But that would be no worse than the situation today, where banks are under government pressure to lend to government projects.

Transnational experience shows that over time, financial institutions, monitored by investors and the regulatory authorities, move away from insider lending. Finally, banks run by local entrepreneurs would know the local market much better than the big four state banks.

The formation of private banks and decentralization

Indeed, the formation of private banks, both at the local level, where such banking services are much needed, and at the national level, has been a topic of fierce debate for nearly two decades. Yet, central technocrats remain unwilling to allow a sizable portion of financial assets to flow from the grasp of the central government. In fact, financial assets have been consolidated in recent years, with the formation of the Huijin Company to take over distressed securities and investment companies all over China. Rather than privatizing these entities, the central government opted to consolidate control over them and place them under Leninist control.

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