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China's Banking: How Reforms Lost Momentum

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Abstract

This paper investigates China's pattern of decade-plus delays in implementing banking reforms. It identifies the ideological factors involved, particularly the persistent suspicion of 'market forces' as the economy's driving force. The dependence on the banks to finance the economic and social costs of the retreat from state planning is traced, together with the costs to the banks of funding such urgent national programmes as the 2008 economic stimulus package and the current affordable housing drive. The paper argues that liberalisation of the banking industry will continue to be limited because of the banks' role as the national leadership's last surviving lever of control over policy implementation after the demise of the command economy.

Keywords: China, Banking, Reforms, Ideology, Market Forces, State Intervention

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'Reform is also a revolution', declared former President Jiang Zemin, but for China's banks, the revolution has taken place in slow motion.[1] From one decade to another, officials have publicly denounced glaring defects in bank management and performance with very limited effect. Thus, 'despite many years of financial sector reforms', stated a 2012 study of the nation's economic transformation, 'China's banking sector is still dominated by the state-controlled banks that lend disproportionately to local government projects and to firms in the state sector'.[2]

Modernisation of China's financial system and institutions has proceeded piecemeal.[3] Reform measures, even when promulgated at the highest levels of the political hierarchy, have frequently remained statements of intent rather than binding commitments or mandatory directives. Originally, banking had been high on the agenda to modernise the economy launched by Deng Xiaoping in 1978. At a national conference in early 1979 attended by five Deputy Premiers who were the nation's economic and financial overlords, the banks were promised freedom from political interference in their lending decisions and the introduction of market-determined interest rates.[4] Neither goal had been achieved 35 years later.

In 2000, the People's Bank of China (PBOC) had described the financial industry as the last sector of the economy to be 'subjected to market forces'. The PBOC's then Governor set out a sweeping programme of reform initiatives to be implemented over the next six years.[5] Progress proved disappointing, however, and in 2007, his successor highlighted the 'long and painful process [of] rectifying China's unsound credit culture' and the extent to which bank staff were still not free to decide loans on the basis of a professional assessment of credit risks.[6]

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1 President Jiang Zemin speaking as Chinese Communist Party Secretary General, 'Accelerating the Reform, the Opening to the Outside World and the Drive for Modernization, so as to Achieve Greater Successes in Building Socialism With Chinese Characteristics', *Report at the 14th National Congress of the Party* (12 October 1992) URL: http://www.bjreview.com.cn/document/txt/2011-03/29/content_363504_13.htm

It should be noted that all Chinese-language publications cited as references in this article were published under state or Chinese Communist Party control unless otherwise indicated. Wherever possible, the official English version of Chinese-language materials is used.

2 Xiaodong Zhu, 'Understanding China's Growth: Past, Present, and Future', *Journal of Economic Perspectives*, Vol. 26, No 4 (Fall 2012), p. 122.

3 This point has been made of China's financial markets generally. Jianhuai Shi, 'Financial Innovations in China, 1990-2000', *China Centre for Economic Research, Working Paper No. E2001006* (12 October 2001), p. 14. URL: http://en.ccer.edu.cn/download/479-1.doc

4 Reported in *New China News Agency* (*NCNA* hereafter), 8 March 1979.

5 The deadline was implied not specific. Dai Xianglong, PBOC Governor, 'China's Financial Industry at the Threshold of the 21st Century', Stanford University (17 October 2000) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=1

6 Zhou Xiaochuan, PBOC Governor, 'Instability and Evolution of the Financial System' (5 December 2007) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=158; 'Some Issues Concerning the Reform of the State-owned Commercial Banks', 'IIF Spring Membership Conference', Shanghai, (16 April 2004) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=31; 'Improve corporate governance and develop capital market', *Euromoney* 'China Forum: Capital Market and Corporate Governance' (1 December 2004) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=68; Wu Xiaoling, PBOC Deputy Governor, 'Remarks', International Seminar on the 10th Anniversary of the Asian Financial Crisis (21 June 2007) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=138.

The financial sector, a recent study declared, has remained 'the least reformed in the economic realm'.[7] This slow progress has been very largely a deliberate decision by the Chinese Communist Party, which remains heavily influenced by its ideological legacy and protracted misgivings about the introduction of a market economy. The long shadow cast by history was highlighted by the Party in its official explanation for the decision in 2013 to 'deepen its economic reform to ensure that the market will play a "decisive" role in allocating resources'.

> For quite a long time after 1949, the idea of market had been a taboo associated with capitalism. Even after the reform and opening up in 1978, the country had struggled to define the market and some dogmatists still questioned whether socialism could accommodate the market economy. It was not until [1992] that a socialist market economy became a consensus [and] the Party agreed that the market, under state macroeconomic control, should be the basic means of allocating resources.[8]

After 1992, it had taken another 11 years for the market to be promoted from a 'basic' to a 'decisive' role. But even in 2014, President Xi Jinping was careful in his role as head of the Chinese Communist Party to protect the state's continuing dominance. He told a Party 'summit' that the balance between state and market had become 'the core issue in economic reform'. While he pledged that the government would 'refrain from intervening in microeconomic activities', he emphasised that 'the decisive role of the market cannot replace or negate the role of the government'. The reality was that despite so many reform decades, he said, 'market vitality is still shackled by many institutional flaws'.[9] This presentation will show that banking remains an exception to President Xi's commitment to stay clear of microeconomic intervention and to put market forces in command. Banking is also the sector in which 'institutional flaws', it will be argued, are at their most serious.

This paper has relevance for contemporary policies and performance. Its findings include the growing reliance of China's leaders on control of the banking system to ensure that key national policies are not thwarted by lack of funding and that national priorities will prevail, if the leadership chooses, even against market forces and commercial interests. Thus, the emergence of a banking system which is fully market-driven is unlikely to be achieved in the short-run. At the same time, however, the conclusions note that China's plans to globalise the currency and to end foreign exchange controls can be expected to make international business sentiment and investor confidence much more sensitive to China's policy commitments and their outcomes than has been the case in the past.

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7 Galina Hale and Cheryl Long, 'What are the Sources of Financing of the Chinese Firms?', *HKIMR Working Paper No.19/2010* (July 2010), pp. 1, 2.

8 'CPC acknowledges markets "decisive" role', *NCNA*, 12 November 2013.

9 President Xi's remarks at a Chinese Communist Party Politburo 'collective study' session were reported in 'Xi stresses market-gov't coordination', *NCNA*, 27 May 2014.

1. The Politics of Postponement

The main concern of this paper is with the slow pace of banking reform: the gap between policy commitments and their implementation and why these delays have occurred — and are tolerated — in a state where power is so concentrated in the leadership of a single, highly-experienced political party. No attempt will be made to review the full history of the nation's banking reforms. Instead, the focus is on the principal obstacles encountered by the more crucial policy initiatives.

A special feature of contemporary China, it will be argued, is the politics of postponement. Serious problems are revealed, and urgent remedies are put forward. Years, or even decades later, much the same proposals reappear as national priorities with minimal acknowledgment of how long they have already lingered unenforced on the government's agenda.[10] The practical consequence of this phenomenon of deferred reforms is that announcements of reform measures are no more than declarations of good intentions. The timing of their implementation depends, almost entirely, on how long the current, defective arrangements can continue to be tolerated, which may only become clear years later.

In the case of the banks, their right to make independent lending decisions has been repeatedly constrained. No matter what the changes in the structure of the economy caused by sustained high-speed growth and the rise to dominance of the private sector, this paper will show, the banks have been used by the nation's leaders as their most powerful lever in both financing and enforcing key programmes that would otherwise have failed if left solely to market forces. In retrospect, a well-defined pattern is visible in which the banks have been compelled to finance solutions for the economic and social threats that arose over the last four decades while the command economy was giving way to market forces.

The presentation begins with an overview of the politics of postponement illustrated by a case-study of the repeated deferment of the introduction of market-based interest rates. There follows an account of the ebbs and flows in the level of autonomy granted to the banking industry since the start of economic reforms in 1979. The political discomfort and economic disruption that followed the switch from central planning to market forces have repeatedly forced the suspension of promises to liberalise the banking system, it will be argued. The discussion also explores how the leadership's dependence on control of the banking system increased as the scope of central planning shrank and the banks became the state's last remaining lever of economic power in contemporary China. The financial losses incurred from the state's role in banking are summarised. Finally, ideology is shown to have complicated the introduction of reforms of crucial importance to the banking sector.

[10] This pattern of policies deferred can affect any area of public administration. For example, in 2003, both the nation's President and its Premier promised an end to the 'rampant' practice of withholding the wages of almost 100 million workers for a year or more. The eventual deadline set in 2012 for achieving this goal was 2015. 'President Hu stresses need to raise farmers' income', *Renmin Ribao* (*RR* hereafter), 18 December 2003; 'Gov'ts urged to clear up payments in arrears', *NCNA*, 19 March 2004; 'Gov't to ensure migrant workers' wages', *NCNA,* 6 January 2014; Yin Weimin, Minister of Human Resources and Social Security, 'China to tackle woes of unpaid migrant workers: minister', *NCNA*, 7 March 2012.

The paper focuses, almost entirely, on domestic developments, principally because the continuing tight state control of both banking and the currency has proved an effective buffer against imported financial instability. During the 1997-99 Asian financial crisis, for example, the losses of China's financial institutions were very limited and borne principally by offshore investors. Indeed, the crisis itself 'gave China an opportunity to make another leap forward, which it seized', according to Andrew Sheng, a leading authority on China's financial system.[11] For the reform advocates, the crisis proved a boon. The Chinese Communist Party awoke to the political case for financial reforms after banking and currency collapses undermined credibility among the governments of several Asian states.[12] In Beijing, the central bankers argued successfully for urgent measures to clear the banks' crushing burden of non-performing loans (NPLs) which had mounted in the 1990s, it is explained below, together with a commitment to sweeping changes in the regulatory and legal systems, as well as in management.[13]

The 2007-09 global financial crisis also inflicted little direct damage on China. But its indirect impact on the nation's financial policy was far from benign. This paper will show that the emergency policies adopted to counter the potential impact of world recession disrupted and reversed measures taken since the Asian crisis to reform the banking sector. (China's domestic financial crisis triggered by flawed policy decisions, particularly at the local administration level, is reviewed in the companion paper, 'The Local Government Crisis 2007-2014: When China's Financial Management Faltered', HKIMR 27/2014.) But state controls continued to provide ample protection against imported contagion.

In the attempt to identify the major political and economic factors that influenced the decision makers, this paper draws heavily on Chinese Communist Party and government discussions published in the official media at the time a policy was adopted, disputed, amended or delayed in implementation.

2. Interest Rate Reforms – 35 Years and Counting

The most instructive and, arguably, most important case study of the politics of postponement is provided by the policy time-line for market-led interest rates — a fundamental building block for a competitive, commercial banking system.

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11 Andrew Sheng, *From Asian to Global Financial Crisis: An Asian Regulator's View of Unfettered Finance in the 1990s and 2000s* (New York: Cambridge University Press, 2009), p. 302. Nevertheless, misconceptions about the Asian crisis persist. Note, for example, the claim of' 'Chinese export (*sic*) seriously affected' in 1997 although the official trade statistics show exports increased, an error to be found in Hu Xiaolian, PBOC Deputy Governor, 'Managed Floating Exchange Rate Regime is an Established Policy' (15 July 2010) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=194A

12 On the political impact on Chinese official thinking, see Injoo Sohn, 'Learning to Co-operate: China's Multilateral Approach to Asian Financial Co-operation', *China Quarterly*, No. 194 (June 2008), p. 316.

13 Zhou, PBOC Governor, 'Instability and Evolution of the Financial System'; Wu, PBOC Deputy Governor, 'Remarks'.

- 1979: Five deputy premiers endorsed this measure.[14]

- 1988: The PBOC Deputy Governor made a vigorous case for gradually introducing a floating interest rate system.[15]

- 1996: An official announcement was made that initiatives to reach this goal would be launched within that year.[16]

- 2000: The PBOC Governor promised that 'in the coming years, China will enhance its reform efforts of interest rate liberalization'.[17]

- 2002: President Jiang promised 'steadily to deregulate interest rates to leave them to market forces'.[18]

- 2013: The PBOC Governor admitted that 'efforts' were still needed 'to realize a full interest rate marketization and put in place a sound market-based interest rate macro-control mechanism'.[19]

- 2014: Premier Li Keqiang promised measures 'granting lenders more control over loans and interest rates', which would mean in practice, according to the PBOC Governor, that 'China is very likely to ease its grip on bank deposit rates within one or two years'.[20]

The original delays in meeting the commitment on rates could be justified contemporaneously by the inflation which suddenly overtook China between 1985 and 1995 for the first time in a generation.[21] This event was particularly alarming because the Chinese Communist Party's original right to rule had been based in part on its success in ending the hyper-inflation that had discredited the former Guomindong regime. According to Chen Yaoxian, then a rising star at the PBOC, the price stability that had reigned uninterrupted since the 1950s meant that senior bankers now had to struggle to

14 *NCNA*, 8 March 1979.

15 Liu Hongru, PBOC Deputy Governor and Central Committee Alternate Member, 'Progress of Financial Structural Reform in China', *Gaige,* No 2 (10 March 1988), p. 22.

16 'China's state-owned commercial banks to enjoy greater autonomy this year', *China News Service*, 25 March 1996.

17 Dai, PBOC Governor, 'China's Financial Industry at the Threshold of the 21st Century'.

18 President Jiang, 'Build a Well-off Society in an All-Round Way and Create a New Situation in Building Socialism with Chinese Characteristics', *Report at 16th National Congress of the Chinese Communist Party* (8 November 2002). URL: http://news.xinhuanet.com/english/2002-11/18/content_633685.htm

19 Zhou, PBOC Governor, 'Road map for financial reform', *China Daily* (*CD* hereafter), 18 December 2013. The original version appeared in *Renmin Ribao*.

20 Premier Li Keqiang quoted in Wu Yiyao, 'Broad changes coming in finance, premier says', *CD*, 6 March 2014; Zhou, PBOC Governor, 'China to free deposit rates within two years', *NCNA*, 11 March 2014.

21 Linda Wong, *Marginalization and Social Welfare in China* (London: Routledge, 1998), p. 154.

learn from day-to-day experience how to control the money supply to suppress inflation.[22] The post-1978 bank reforms themselves came under suspicion. There was a belief that the development of competitive banking — even though still tightly controlled — created inflationary pressures and undermined the efficient allocation of resources.[23] As a result, the PBOC President insisted, China could not realistically afford to leave interest rates to market forces in this period.[24]

In retrospect, the delays in implementing interest rate reform have become tolerable, it can be argued, because alternative financing at market-driven interest rates has reached levels which meet at least the minimum requirements of the economy. The reform goal has been partially achieved, it can be claimed, thanks to the creation of an alternative money market which is closely linked ‘informally’ and often illegally to the banking system. ‘By now, about half of all financing activities are conducted through wholesale money and capital markets and at market-determined interest rates’, Hong Kong Monetary Authority researchers reported in 2013. The best that could be said of the banking industry itself, they noted, was that ‘market-determined interest rates have already started to play a significant role in influencing banks’ pricing decisions, although loan size does not appear to be sensitive to movements in market interest rates’.[25]

3. Autonomy’s Rise and Fall

Historically, China’s national leaders and central bankers have made the case for banking autonomy as the remedy for two malpractices which they regard as a threat to efficient management of the banking industry and to the nation’s financial resources. Both were initially side-effects of a centrally-controlled economy and a Marxist political system which deprived banks of commercial freedom, thus impairing their ability to make loans on the basis of the borrowers’ creditworthiness, the PBOC Governor explained in 2007.

- *‘Policy’ lending*: banks are compelled to finance projects or enterprises because they meet the requirements of a state plan or policy; and

[22] This banker was a future PBOC Deputy Governor and China Securities Regulatory Commission Vice Chairman. Chen Yaoxian, PBOC, ‘Monetary policy and selecting the tools for macroeconomic control’, *Caimao Jingj*, No. 4 (12 April 1988), pp 45-7.

[23] Ha Lixin, ICBC Xian Branch, ‘Issues in mobilising finance from the public’, *Jingji Guanli*, No 7 (April 1989), pp. 72-4.

[24] See Wang Jienan and Ding Xilin, interview with Chen Muhua, PBOC President, *Wen Hui Bao*, 28 March 1987.

[25] Dong He and Honglin Wang, ‘Monetary policy and bank lending in China — evidence from loan-level data’, *HKIMR Working Paper No.16/2013* (October 2013), p. 1. On the controls over bank interest rates, see Dong He, Honglin Wang and Xiangrong Yu, ‘Interest Rate Determination in China: Past, Present, and Future’, *HKIMR Paper No. 4/2014* (February 2014), p. 3.

- *'Relationship' lending*: banks are unable to reject loan applications which are sponsored by a high-ranking official.[26]

3.1 1981: Autonomy Proclaimed

The 1979 banking summit mentioned earlier was followed by a State Council decision in 1981 which seemed to offer an unconditional guarantee of the future autonomy of the banks by banning both 'policy' and 'relationship' lending. New regulations defined the banks' autonomy. There was to be no interference with the banks' freedom to make their own lending decisions and to recover overdue loans. The banks were not to be used to cover an enterprise's financial shortfalls. There was a total prohibition on 'diversion of working capital funds to capital projects [or] of bank loans to cover operating losses, employee earnings and bonuses … or for staff welfare'.[27]

But these goals were quickly suspended, particularly the ban on banks subsidising enterprises and their work forces. As Deng Xiaoping's reforms came into force, it soon became apparent that dismantling state controls would lead to a 'mixed' economy. Initially, the assumption was that state planning would continue to set output targets, allocate resources and fix prices for major industries. However, the private sector in which demand and supply would dominate grew faster than expected. Throughout the 1980s, this mixture of planned and quasi-market sectors of the economy became increasingly difficult to manage. But China's reform economists, led by Xue Muqiao (then the most respected reform advocate), had come to the conclusion that there was no choice but to persist: state-controlled prices were directly undermining efficiency and encouraging irrational behaviour among enterprises, while doing nothing to promote productivity and innovation. How to resolve the conflict between administered and market prices proved daunting, these economists acknowledged.[28]

As market forces were unleashed from 1979, the state sector and its plans were at risk of failing. Once enterprises were made responsible for their own business performance, business survival was supposed to depend on profitability. For managers of industrial plants in the state sector, in heavy industry especially, the new situation was no less arbitrary and frequently more unrealistic than the central planning of the past. Entire production lines were rendered redundant by the new reform policies, and factories were often abruptly deprived of funds and raw materials. To add to the confusion, the planners could not ensure 'orderly' competition from the expanding non-state sector because its output, prices and profit margins were no longer under state control.[29]

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[26] Zhou, PBOC Governor, 'Instability and Evolution of the Financial System'.

[27] The State Council directive was reported in *NCNA*, 12 February 1981.

[28] See, for example, Xue Muqiao, 'Several questions concerning pricing', *RR*, 28 January 1985 and 'Planned and Commodity Economies, Planned and Market Regulation', *Gaige*, No 1 (10 January 1988), pp 17-25.

[29] The challenges faced by management were amply illustrated in Contributing Commentator, 'Struggle to develop industrial production, communications and transport with readjustment as the core', *Hong Qi*, No. 8 (16 April 1981), pp. 2–4, 8.

The impact of the initial measures taken to retreat from the command economy was so rapid and so radical that political and social harmony was in serious danger. State-owned enterprises (SOEs) were facing bankruptcy but could not be allowed to collapse because of the political and social unrest that might follow. These not only made work for the bulk of the urban labour force. They had the added responsibility of providing housing and social services for their employees and their families, literally from childbirth to the grave. The government lacked the capacity to take over the SOEs' welfare role. Yet, these found it hard to remain competitive, and even to pay wages, while funding their state-dictated welfare packages, as the President of the Industrial and Commercial Bank of China (ICBC), Zhang Xiao, lamented publicly.[30]

Previously, state planners had been able to allocate a virtually free supply of funds to SOEs, with no effective repayment or interest obligations, an arrangement that was no longer sustainable.[31] As the state shrank its direct financing of industry and commerce from 75 per cent of total working and investment capital in 1978 to only 30 per cent in 1986, the banks were made responsible for meeting the shortfall.[32] Servicing these bank loans was a challenge to which many SOEs could not adjust very quickly. The banks had to abandon proper credit procedures in order to bail out businesses which operated at a loss and to rescue construction projects which had run out of funds. Only in this way, explained Jing Xuecheng, the PBOC's Deputy Director of Research, could extensive bankruptcy be prevented among SOEs and the rural communes, thus reducing the serious risk of the public discontent that would follow if large numbers were thrown out of work or suffered severe falls in their earnings and benefits.[33]

But this 'bailout' policy was to have damaging, longer-term financial consequences. As SOEs' profitability fell, government revenues also declined, leading to budget deficits, to cover which the banks, once again, were regarded as the lenders of last resort.[34] During the first reform decade, a deficit was deliberately incurred every year except 1985.[35] The strains on the financial system became alarming. Inflation returned to China for the first time in thirty years. Between 1985 and 1995, consumer prices rose by 330 per cent in the cities and by 190 per cent for the rural population.[36]

30 Zhang Xiao, ICBC President, 'Reform of the financial system cannot be achieved in a single step', *Jingji Ribao*, 19 March 1988.

31 Yang Peixin, 'A review of the establishment of a socialist capital market in China', *RR*, 7 April 1985.

32 See Premier Zhao Ziyang's observations in *NCNA*, 25 March 1987.

33 The above analysis draws heavily on Jing Xuecheng, PBOC Research Department Deputy Director, 'Some opinions on better links between banking and finance', *Caimao Jingji*, No. 1 (12 January 1988), pp. 50-3.

34 The fiscal and financial deterioration is well described in Jing Xuecheng, PBOC System Reform Unit, 'Numerous opinions on how to reform the relationship between finance and banking', *Caimao Jingji*, No 1 (12 January 1988), pp. 50, 51-53.

35 Yu Xiaoping, Ministry of Finance Financial Science Research Institute, 'We cannot follow a policy of deficit finance', *Qiushi*, No 3 (1 February 1989), pp 12, 21.

36 Linda Wong, *Marginalization and Social Welfare in China*, p. 154.

3.2 1984: The Unacceptable Costs of Autonomy

The Chinese Communist Party regarded the social and political costs of permitting enterprises to become insolvent as unacceptable. In consequence, state regulations were introduced in 1984 to limit a bank's freedom both to reject loan applications and to penalise breaches of loan agreements.[37] The banks were left with a desperate dilemma. Their loan books were no longer funded by state plans, and they were responsible for their own profits and losses. But the state required them to provide a variety of credit facilities below cost. These were not business loans in fact, ICBC's President insisted, but state subsidies financed by the banks.[38]

These bank-funded subsidies were not confined to the industrial sector. There is a widespread assumption that, in the rural sector, the reform process was smooth and spontaneous, in marked contrast to the complex urban experience of reform. Abolition of the rural people's commune from 1978 and the liberalisation of agricultural markets in the 1990s left China, it has been claimed, with 'one of the least distorted domestic agricultural economies in the world' and which achieved dramatic increases in productivity.[39] In reality, the switch from state allocation of commodities to market transactions could be both clumsy and costly, as the grain business demonstrated. The banks were called on to make the introduction of market competition tolerable to the public by providing generous credit facilities to grain producers while cushioning the urban consumer against price rises. To make matters worse, inflation had returned to China, as noted earlier.[40] The banking system provided the funds that enabled local governments to carry the losses created by political and social pressures to hold down urban retail grain prices.[41]

Although professional bankers still clung loyally to their conviction that autonomy was crucial for the creation of a modern banking system, banking remained firmly under state control in marked contrast to the rapid liberalisation of industry, agriculture and commerce generally.[42] The state could not surrender control over bank allocation of funds, two leading official economists had explained in 1984, as long as the share of the state and collectively-owned sectors in the economy remained significant.

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[37] State Council, 'Provisional regulations on changing investment expenditure on capital construction in the state budget from appropriations to loans by the State Planning Commission, Finance Ministry and the China Construction Bank', *Zhonghua Renmin Gongheguo Guowuyuan Gongbao*, No. 3 (10 February 1985), pp. 71-7.

[38] Zhang, ICBC President, 'Reform of the financial system cannot be achieved in a single step'.

[39] Xiaodong Zhu, 'Understanding China's Growth: Past, Present, and Future', *Journal of Economic Perspectives*, Vol. 26, No 4 (Fall 2012), p. 113.

[40] Wong, *Marginalization and Social Welfare in China*, p. 154.

[41] In 1989, grain enterprises borrowed RMB 74.5 billion to cover unpaid accounts, while Shanghai municipality reported that grain loans accounted for some 40 per cent of the city's total commercial lending. Sun Yong, 'A question inspired by defaults on grain payments', *Jingji Ribao*, 15 September 1989; Mou Ling, 'An inclusive approach is required to manage indebtedness', *Jinrong Shibao*, 12 September 1989.

[42] *e.g.*, PBOC Sichuan Provincial Branch, *Sichuan Ribao*, 7 July 1980; Zhang, ICBC President, 'Reform of the financial system cannot be achieved in a single step'; Liu Hongru, 'Progress of Financial Structural Reform in China', pp. 21 and 22.

'All banks' in China's socialist economy must accept implementation of the state's policies and programmes as their primary obligation, they declared.[43]

3.3 1987: Autonomy Reaches its Limit

The limitations which the economic reforms placed on the banks' own freedom to break free of state intervention were lucidly summarised by Liu Hongru, an outstanding PBOC official who held senior rank in the Chinese Communist Party. The state had no intention of abandoning control over the economy or surrendering its authority to market forces. However, the retreat from central planning had reduced direct state control over economic activities, he said. Thus, the state had to find alternative levers of power.

In theory, this authoritative commentator observed, state control of prices, taxation and earnings should give the government ample leverage over economic trends. However, this group of levers, he pointed out, could not be manipulated abruptly or arbitrarily without endangering the overall stability of the economy. Much more flexible were financial levers: lending policies, interest rates, exchange rates and exchange controls. No sector of the economy could escape the impact of these levers. Banking was thus the industry in which central planning and state regulation ought to be strengthened while the rest of the economy was being liberalised and mandatory planning dismantled, he went on.[44]

PBOC Governor and State Councillor Chen Muhua explained frankly in 1987 why further liberalisation of the banking industry would not be permitted. 'Since banking is an important life-line of the state economy', she insisted, 'it must be kept firmly in the hands of the state'.[45] Her highly cautious attitude seemed all the more warranted by developments in the Soviet Bloc. The inflation and economic disruption attributed to mismanaged price reforms that Eastern European governments complained of during this period were cited by Chinese economists as evidence of the need to proceed with great caution in allowing the market to take total control. One review of the reform experiences of these countries ended with the gloomy conclusion that it was highly unlikely that China's economic reforms would be able to avoid the chaotic conditions which these countries were suffering in the wake of the reduction in the role of the state.[46]

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[43] The authors of this article were already well-regarded financial specialists, and they played significant roles in China's financial modernisation. Lu Baifu and Qian Zhongtao, 'Set up a new socialist banking system in our country', *RR*, 1 February 1984.

[44] This study's author was a Moscow graduate who became PBOC Deputy President and Vice Minister of the State Commission for Restructuring Economic Systems, as well as an alternate member of the CCP Central Committee. Liu Hongru, 'Strengthen macroeconomic regulation and control by the central bank', *Jingji Yanjiu*, No 10 (20 October 1986), pp. 36, 37, 38, 40-1.

[45] State Councillor Chen Muhua, PBOC Governor, *NCNA*, 13 January 1987.

[46] Gu Renzhang, 'The lessons of the reforms in Yugoslavia and Hungary should be carefully studied', *Jingji Guanli*, No 7 (July 1989), pp. 37-9.

3.4 1993: Autonomy Pledge Renewed

By 1993, the economy had reached a new stage of development. The private sector's dynamism had become unstoppable. The financial system, it was openly admitted, could no longer 'withstand the pounding' created by market forces or cope with surging economic growth.[47] Deng Xiaoping's response was to persuade the Chinese Communist Party to discard its attachment to planning as an essential Marxist criterion of genuine socialism.[48] The Finance Ministry now lost the right to routinely procure funds from the banking system to cover fiscal shortfalls. A Party Plenum decision that year appeared to renew the original promise of autonomy for the banks. 'Policy' and 'relationship' lending seemed to be about to disappear. Henceforward, a prominent reform economist predicted, the banks would take full responsibility for their profits and losses without interference from either the Chinese Communist Party or state authorities. Furthermore, banks would no longer be obliged to make loans in obedience to state policies when they were not commercially justified.[49]

In 1995, the Law of the People's Bank of China was enacted. Its aim was 'to provide a legal screen to prevent government departments and organisations from defying the regulations for the conduct of banking affairs and interfering with the banks'. (In practice, however, not until November 1997 were 'the central and local governments … prohibited from interfering with loan decisions'.[50]) The 1995 legislation came too late. Fiscal and planning powers had already been delegated to local administrations over which the national authorities were unable to exercise effective supervision. Local government finances were subject to minimal auditing, and local officials could make or break the careers of bank staff in their jurisdictions and so could dictate their lending policies.[51] Consequently, the most damaging state intervention in bank lending was coming from local governments which exploited 'policy' and 'relationship' lending on a scale that allowed considerable abuse and waste of resources.[52] The excessive borrowings by local administrations were responsible, a prominent economist has claimed, for much of the surge in banks' NPLs by the middle of the 1990s.[53]

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[47] See the review of this problem and the reform solutions introduced for the banking industry in response. Li Ning, 'From state treasury to real bank', *Beijing Review*, No. 18, (2 May 1994), pp. 8-12.

[48] Wang Haibo, 'A momentous development — a third commentary on the socialist market economy', *Jingji Guanli*, No. 2 (5 February 1993), pp. 4-5.

[49] This economist was closely involved in the nation's financial reforms. He Dexue, CASS Finance Institute, 'Financial reforms to expand in 1995', *Jingjixue Dongtai*, No. 3 (18 March 1995), p. 14-5.

[50] Zhou, PBOC Governor, 'Instability and Evolution of the Financial System' pp. 2-3.

[51] Fubing Su, Ran Tao and Hui Wang, 'State Fragmentation and Rights Contestation: Rural Land Development Rights in China', *China & World Economy*, Vol. 21, No. 4 (July-August 2013), p. 41. URL: http://dx.doi.org/10.1111/j.1749-124X.2013.12027.x; Guo Shikun, 'The significance of the obstacles to and the solutions for the transformation of the specialised banks into market enterprises', *Jingji Yanjiu*, No. 10 (20 October 1986), p. 22; Liu Suinian, NPC Finance and Economic Committee Chairman, 'Safeguard the PBOC's independent administration', *RR*, 20 October 1995.

[52] Liu Zewei, 'Reflections on the present planning system and its future reform', *Jingji yu Guanli Yanjiu,* No. 1 (8 February 1991), pp. 1-5.

[53] Professor Fan Gung, 'The Chinese economy's secret recipe', *CD*, 24 August 2010.

In any case, the 1995 banking law had not been intended, it should be emphasised, to eliminate 'policy lending'. On the contrary, the National People's Congress had required the PBOC 'to provide active support to the state planning departments' in financing their plans in addition to supporting 'the overall targets of state economic development'.[54] Confusion over the proper financial role for the state was compounded by a decision in 1997 to transform state-owned banks into 'comprehensive, enterprise-like, commercial banks without direct administrative controls'.[55] In practice, the state continued to intervene directly, and 'the Communist Party Committee' within each bank retained an undefined but influential role alongside 'investors, Board of Directors, management and stakeholders', the PBOC pointed out.[56]

3.5 2007: Autonomy in Jeopardy

The PBOC began this century with renewed optimism about the chances of achieving autonomy for the banking system. 'The Chinese government basically [had] stopped administrative intervention in state-owned commercial banks as laws defining banks' lending autonomy were put into place' the PBOC Governor confidently declared in 2004, and 'the government has gradually refrained from asking the state-owned banks to follow policies that favor state owned enterprises'.[57] In the same year, he felt sufficiently assured of the leadership's support to set unambiguous goals for complete autonomy from state controls.

> The ultimate target of reform rests in the establishment of a whole set of market system of incentives and constraint. Emphasis is placed on the investors' interests. It is aimed at completely shattering the 'quasi-bureaucratic system' of state-owned commercial banks, at changing the operational targets which are set based on the officialdom, and at changing state-owned commercial banks into real market participants through rational incentives mechanism based on performance and complete risk control and capital constraint.[58]

At the outset of the 2007-09 global financial crisis, however, the mood changed. The PBOC Governor felt obliged to issue a reminder of the damage done by 'policy' and 'relationship' lending in the past. He emphasised how important had been the 1997 ban on 'both the central and local governments … from interfering with loan decisions'.[59] He seemed to sense that his earlier confidence about the reform agenda for the banking industry was now in jeopardy.

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[54] Liu Suinian, NPC Finance and Economic Committee Chairman, 'Safeguard the PBOC's independent administration', *RR*, 20 October 1995.

[55] Zhou, PBOC Governor, 'Improve the legal system and financial ecology', Chinese Economists Forum (2 December 2004) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=69

[56] Zhou, PBOC Governor, 'Improve Corporate Governance and Develop Capital Market'.

[57] Zhou, PBOC Governor, 'Instability and Evolution of the Financial System'.

[58] Zhou, PBOC Governor, 'Some Issues Concerning the Reform of the State-owned Commercial Banks'.

[59] Zhou, PBOC Governor, 'Instability and Evolution of the Financial System'.

Zhou Xiaochuan was right to feel apprehensive. During the global financial crisis, a retreat began from the 30 years of campaigning for banking autonomy, and the central bank came to accept that the state would continue to impose limits on the extent to which market forces would be allowed to direct the allocation of financial resources. In 2013, the PBOC Governor admitted that 'policy guidance will be strengthened to encourage domestic financial institutions to extend support to the weaker sectors necessary for national economic and social development'.[60]

4. The State's Last Lever of Economic Control

It was now clear 'policy' lending would continue to be a major feature of China's economic management. Credit policies would not be left to decisions made by bankers or investors on the basis of potential profits and risks. State officials would be able to override commercial realities in the pursuit of other national interests. The opportunity costs and the actual losses that had long been recognised as unavoidable consequences of 'policy' lending were passed over in silence by the policy-makers. Bankers themselves voiced considerable anxiety about the government's continuing involvement in deciding which borrowers were entitled to bank loans.[61] They received little attention.

In retrospect, this outcome can be seen to have been almost inevitable. From very early on, it was realised that the end of the state's direct management of the economy would raise the question of how the economy could be steered in the direction chosen by its political leaders. In 1986, for example, this challenge had been analysed in considerable detail. The switch 'from dependence on planned targets to control the economy' did not mean that the state abdicated — or even curtailed — its responsibilities. It would direct 'the market mechanism' through 'principally relying on economic policies and economic levers to regulate and control [including] financial levers such as credit and loans … interest rates, exchange rates'. As a result, the banks' subordination to national policies could not be reduced, Liu Hongru had stated frankly.

> Our country must make use of the market mechanism but should not depend on blind market competition to readjust the economic structure. Viewed from the national economy as a whole, it is necessary to determine a development strategy and formulate an industrial policy. As for the banks, they must arrange their credit and loan plans and formulate a financial policy in accordance with the demands of the development of the national economy.[62]

The successful dismantling of central planning and state controls increased the government's dependence on the banking industry. The temptation for the government to exploit the largest banks in support of lending policies which were unattractive commercially increased as the power to directly control investment decisions and business activity through official decrees diminished because of the

[60] Zhou, PBOC Governor, *CD*, 18 December 2013.

[61] The banking sector's misgivings were reported in 'Bankers concerned over credit risks of SMEs', *CD*, 24 December 2013.

[62] Liu Hongru, 'Macroeconomic regulation and control by the central bank should be strengthened'.

expansion of market competition and the rise of the private sector. The banks had previously been obliged to provide state-owned enterprises and capital projects with whatever credit facilities officials directed, the PBOC Governor complained in 2000, because the government took it for granted that 'the economic risks of the whole society' could be transferred to this sector.[63] And it has proved impossible subsequently for the banks and their regulators to achieve the level of autonomy which is widely seen as essential for the modern banking system which an economy of China's size and complexity requires. Vociferous critics of the stalled reforms include the former head of the Bank of China, the nation's second largest bank, who was subsequently appointed Chairman of the China Securities Regulatory Commission.[64]

In the contemporary world, the key issue for the nation's financial institutions is how far the government will go in setting lending priorities. On some issues — notably on the community's health and safety and on environmental protection — the state is rightly determined to set standards even at the expense of high-speed economic growth. More contentious are decisions about which sectors of the economy to promote and which to discourage and, in particular, how to identify the industries which suffer from 'overcapacity' and thus qualify as targets for eradication. The criteria set by the Central Economic Work Conference in 2013 sounded reasonable enough: 'weak demand and falling prices … outdated production ability, pushing their profitability down to dangerously low levels'.[65] Enforcing this 'economic euthanasia' is far from straightforward, however.

4.1 Forbidden Lending

This form of 'policy lending had been evolving over the previous two decades. It began with drastic measures taken during the 1990s to enforce lending discipline in the rural areas. The justification for this policy was that the supply of credit had been over-extended by the banks under pressure from local governments which were the bankers' political masters.[66] The next stage came in 2000 when the banks found themselves being ordered to enforce state development goals by denying loans to specific classes of borrowers regardless of their credit-worthiness. The PBOC and the State Economic Trade Commission jointly announced 'restrictions or bans on loan-granting' to halt investment in industries with over-capacity and in projects with 'backward productivity, technology and products'. Businesses which endangered the environment would also be deprived of bank funding.

63 Dai, PBOC Governor, 'China's Financial Industry at the Threshold of the 21st Century'.

64 See Xiao Gang, Bank of China Chairman, 'Liberalize interest rates further', *CD*, 7 January 2011.

65 Central Economic Work Conference Statement, 'China vows to tackle overcapacity', *NCNA*, 13 December 2013.

66 On the intensity of the campaign to clean-up rural credit, see Yasheng Huang, *Capitalism with Chinese Characteristics: Entrepreneurship and the State* (Cambridge: Cambridge University Press, 2008), p. 139. For fieldwork insights into the banks' involvement in mismanagement of rural areas and their enterprises in the 1990s, see Jonathan Unger and Anita Chan, 'Inheritors of the Boom: Private Enterprise and the Role of Local Government in a Rural South China Township', *China Journal*, Issue 42 (July 1999), pp. 54, 56-9, in particular.

The PBOC's involvement at this stage was justified on the grounds that lending to borrowers in these categories allegedly had 'seriously affected the quality of banking credit assets'.[67]

In 2004, the banking industry was ordered yet again to comply with sweeping restrictions on its lending. This directive was described as 'stepping up coordination between industrial policies and credit policies to control credit risks'. In fact, the decision to restrict loans was based not on commercial or financial criteria but on national development priorities. Borrowers were to be denied credit facilities if their industry were classified as backward or because of alleged environmental dangers, excessive consumption of energy and raw materials or low-technology. Industries also came under the ban when the national planning agency decided they had excess production capacity or manufactured 'products which should be phased out'.[68]

In 2008, the campaign was reinvigorated, with added emphasis on environmental issues.[69] The following year, the State Council meeting promulgated a list of industries whose activities were deemed not to be in the best interests of the economy and which would be targets for administrative obstruction and tight constraints on their access to bank facilities.[70] The car industry had already been identified in 2006 as suffering from over-capacity.[71] A fresh campaign launched against car manufacturers offers an illuminating example of the gap between state direction and market realities. In 2009, with China now the world largest car market, a vigorous drive to eliminate 'outdated capacity' got underway. According to the powerful National Development and Reform Commission, 'excess capacity would bring vicious competition, and hurt corporate profitability … threatened sustainable economic development and must be "resolutely" stopped'.[72]

The industry was strong enough to challenge this accusation. In its counter-attack, the manufacturers were able to recruit to their side an affiliate of the National Development and Reform Commission, the State Information Centre. This body publicly refuted its parent Commission's allegations of 'excessive capacity'. On the contrary, the Centre insisted, the industry was 'manufacturing at 120 per cent of its

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67 'Financial Credit Says No to Duplicated Construction', *RR*, 30 June 2000.

68 State Commission of Development and Reform, 'Credit support for some projects in 10 industries suspended', *RR*, 17 May 2004.

69 Pan Yue, State Environmental Protection Administration (SEPA) Vice Director, 'More efforts needed to implement environmentally-friendly loan policy', *NCNA*, 13 February 2008; Hu, PBOC Deputy Governor, speech at the Buenos Aires Money and Banking Conference (1 September 2008) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=165; 'China to address overcapacity in emerging sectors', *NCNA*, 26 August 2009.

70 See Premier Wen Jiabao's interview in 'China's overcapacity no relation to central government investment', *NCNA*, 27 December 2009. The State Council's targets included 'electricity, coal, coke, ferroalloy, calcium carbide, iron and steel, non-ferrous metals, construction materials and light industry and textile industry'. 'China to speed up elimination of outdated production capacity', *NCNA*, 21 January 2010.

71 'New moves to steer China's car sector stability', *RR*, 31 May 2006.

72 Chen Bin, National Development and Reform Commission, 'Top planner warns of overcapacity', *CD*, 21 September 2009; 'Official warns of overcapacity under industry recovery', *NCNA*, 3 December 2009.

capacity, and most manufacturers were operating more than 20 hours a day'.[73] The Commission did not abandon the battle, however, but sought to rely more heavily on direct administrative controls.[74]

Faced with a conflict of this sort, the banks faced a serious dilemma. It plainly could not be taken for granted that the state's assessment of an industry and its economic worth would be in line with market realities. In contemporary China, market forces determine the fate of enterprises and industries and cannot be ignored. For the banks, compliance with the state's directives to reduce lending to car manufacturers had an opportunity cost in terms of profit opportunities foregone.

4.2 Forced Lending

A new type of state intervention began in 2008 when banks were ordered to help finance the economic stimulus package that was launched to counter the global financial crisis. The goal was to increase public expenditure by USD586 billion, with some 70 per cent of the funds to be supplied by local governments. Local financial resources were quickly exhausted, and a spate of borrowing from the banks began, the bulk of which involved transactions that were illegal. The list of common but legally prohibited borrowing practices included the following:

> build-transfer (BT) contracts, cash top-ups or guaranteeing financial vehicles illegally and raising money against the law through financial corporations, loan and trust companies and finance leasing firms [and] … illegal credit guarantee by local governments'.[75]

The credit-worthiness of most of the local government borrowings, it will be shown below, became a serious cause of concern.

In 2011, a very similar strategy was adopted to finance a massive affordable housing campaign. A USD766 billion programme was begun to expand the current stock of accommodation by 20 per cent over the next five years. The government quickly discovered that, as in 2008, the available funding was inadequate.[76] Restrictions on SOE involvement in the property market had been imposed previously to counter a surge in real estate speculation. These constraints were now replaced by

[73] The *New China News Agency* covered the car manufacturers' resistance in some detail: Chen, National Development and Reform Commission, 'Unchecked auto industry growth could harm China's economy: official', 4 September 2010; Chen Bin and Xu Changming, State Information Centre, 'China's auto makers reject "excess capacity" warning', 5 September 2010; 'China's auto industry not overheated, industry analysts argue', 17 October 2010; Liu Shijin, State Council Development Research Centre Deputy Director, 'Chinese think tank calls for refocus of auto industry development', 23 October 2010.

[74] The Commission formed an alliance with eight other ministries and commissions in proposing a policy of 'the elimination of failing businesses as a prerequisite to the approval of new projects' in this industry. 'NDRC urges auto industry consolidation', *CD*, 8 November 2012.

[75] 'New local bonds OK'd to pay off old debt', *CD*, 2 January 2014; Professor Lin Shuanglin, Peking University China Center for Public Finance Director, 'The art of maintaining a healthy debt', *CD*, 9 January 2014; 'China contains local government debt', *NCNA*, 17 December 2013; Finance Ministry, National Development and Reform Commission, PBOC and CBRC statement reported in 'China to further check local government financing', *NCNA*, 31 December 2012.

[76] 'Affordable housing highlighted in curbing China's soaring home prices', *NCNA*, 9 March 2011.

directives for SOEs to provide funding and other resources for the programme.[77] And, as with the 2008 economic stimulus package, local administrations were ordered by the State Council to raise the necessary finance for affordable housing projects from 'increased land sale premiums, bond issuances and loans for qualified local government financing vehicles (LGFVs)'.[78]

As a result of the bail-outs provided by local governments for the urgent national policies adopted in 2008 and 20011, their indebtedness became what was described officially as a 'major threat'.[79] Total borrowings by local governments reached USD 1.79 trillion in 2012 and had risen to USD 2.86 trillion by mid-2013.[80] A 'huge number' of the loans had been devoted to projects that 'have not generated any cash flow', it was officially admitted.[81] The cost to the banking system in future NPLs is potentially large though not yet formally estimated.

5. The Bills for the State's Intervention

A pioneering and influential study had earlier argued that 'an implicit guiding principle underlying China's economic reform strategy since 1979 has been that reform should proceed without creating losers' and that this policy had been largely successful.[82] On this analysis, the banks' losses through the NPLs they were forced to incur during the dismantling of the command economy could be regarded as an acceptable price for preventing urban and rural jobs losses and social discontent.[83] Similarly, the 'questionable' loans made to local governments to finance the 2008 economic stimulus package could be deemed a tolerable cost for achieving the government's anti-deflation goals. Nevertheless, the sums involved were substantial burdens on the banking system even if eventually written off at state expense. In 1998-99, USD223 billion worth of bank NPLs had to be written off and a further USD117 billion was spent on liquidating Agricultural Bank of China's NPLs in 2008.

A PBOC study attributed the bulk of the bad debts to state interference with bank lending. An estimated 60 per cent of NPLs were the result of 'intervention by the central and local governments [and]…mandatory credit support to state-owned enterprises', the PBOC stated. A further 10 per cent were caused by the state's 'industrial restructuring' programme and the 'closing down, suspending

77 'News Analysis: China looks to central SOEs to back low-income housing projects', *NCNA*, 5 May 2011.

78 'China's cabinet urges more support for low-income housing projects', *NCNA,* 19 September 2011.

79 'China vows to contain gov't debt risks', *NCNA,* 13 December 2013.

80 'Local debts surge to nearly US$3t', *CD*, 31 December 2013; Wang Bao'an, Vice Minister of Finance, 'Fiscal reforms to ease local govt debt pressure', *CD*, 11 June 2014.

81 'China vows to contain gov't debt risks', *NCNA*.

82 See Lawrence J. Lau, Yingyi Qian and Gerard Roland, 'Reform without Losers: An Interpretation of China's Dual Track Approach to Transition', *Journal of Political Economy*, Vol. 108, No. 1 (February 2000), pp. 122, 134, 135 and 138.

83 For a more critical view of these policies, see Wendy Dobson and Anil K. Kashyap, 'The Contradiction in China's Gradualist Banking Reforms', *Brookings Papers on Economic Activity*, Vol. 2006, No. 2 (2006), p. 104; Yi Lu, Ivan P.L. Png, and Zhigang Tao, 'Do Institutions Not Matter in China? Evidence from Manufacturing Enterprises' (May 2008 Revised), pp. 3, 21-2. URL: http://www.comp.nus.edu.sg/~ipng/research/instn.pdf

operations, merging [enterprises] with others or shifting to different lines of production'.[84] Banking errors or incompetence accounted for only a third of the NPLs.

By 2011, the surge in lending under the 2008 economic stimulus package had made it necessary to protect the banks' balance sheets by 'reclassifying' USD438 billion of bank lending to local governments.[85] A senior bank regulator attacked 'unscrupulous and unhealthy financial institutions' which had exploited the economic stimulus package by seeking 'excessive profits'.[86] But it was hard to blame the bankers for reckless borrowings by local governments when their accountability for credit decisions had been suspended by 'the directives from the government and political leaders'. The banks were in no position to decline to cooperate with official policy. (At the same time, nevertheless, the banks were not entirely reluctant lenders, as the companion paper explains.[87])

6. When Politics Take Command

The decade-long delays between announcement and implementation of major reforms regardless of the political status of their sponsors arose from the nature of the reform process itself. China's leaders have had to constantly adjust to a rapidly changing environment in which, as with all political systems, the solutions for current problems are the triggers for new challenges. Thus, after each round of successful reforms, the prominent American sinologist, Thomas G. Rawski, observed, 'a seemingly endless array of gaps, obstacles, shortcomings and problems comes to the surface'.[88]

Ideology was to prove among the most persistent of these hindrances, this section will explain. The Leninist features of the political system make the direct and continuing involvement of the Chinese Communist Party particularly prominent in the case of banking, a well-researched study has claimed: 'China's financial industry is a major battlefield for the most powerful political and economic actors who try to benefit from their control over state assets'. The ability to control the allocation of funding across the economy, it went on, means 'the banking sector is a key political resource'.[89] Marxist views have been very visible in two crucial areas of policy-making: the proper balance between state controls and market forces and the right to private property.

84 Zhou, PBOC Governor, 'Some Issues Concerning the Reform of the State-owned Commercial Banks'.

85 'China to re-book some local govt loans', *CD*, 15 August 2011.

86 Wang Zhaoxing, CBRC Deputy Chairman, 'Banking regulator urges structural reforms', *NCNA*, 24 October 2010.

87 Christine Wong, 'The Fiscal Stimulus Program and Problems of Macroeconomic Management in China', 32nd Annual Meeting of OECD Senior Budget Officials (Luxembourg, 6-7 June 2011), pp. 12-5, 16. URL: http://www.oecd.org/dataoecd/31/54/48143862.pdf

88 Thomas G. Rawski, 'Reforming China's Economy: What Have We Learned?', *China Journal*, No. 41 (January 1999), p. 156.

89 Sebastian Heilmann, 'Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry', *China Quarterly*, No. 181 (March 2005), pp. 2, 4, 5 and 6.

6.1 Market Scepticism

From a Marxist standpoint, China's reform programme did not involve a rejection of the Chinese Communist Party's ideological convictions. Yet, within the Chinese Communist Party, the opposition to dismantling state controls was both strenuous and protracted.[90] In the first decade of the post-1978 reforms, the Chinese Communist Party found it inconceivable that, left to themselves, the peasants and the commercial and industrial enterprises could flourish through the impersonal and autonomous operations of competitive markets and their 'invisible hand'. How could China rely on market forces to create the environment needed for stable, long-term economic growth? How could the 'invisible hand' be trusted to organise the rapid diffusion of modern technology and management practices and achieve sustained improvement in labour productivity plus protection from inflation?

The achievement of these essential goals would require significant state intervention, the Chinese Communist Party's leading publication, *Hong Qi,* was still insisting at the end of the first ten years of Deng Xiaoping's reforms.[91] Indeed, a powerful argument was made by reformers themselves that even price reforms had to be carefully managed by the state. The market could not left to drive economic reform, Yang Peixin, a prominent reform advocate, insisted in 1988, and price reforms might have to be deferred.[92]

Ideological resistance to allowing the markets to take over from the state continued during the following decade. A striking illustration is provided by President Jiang and his reports to three Chinese Communist Party National Congresses between 1992 and 2002. From one speech to the next, he slowly managed to mobilise support for a very gradual expansion in the role of market forces and free competition at the expense of state planning.[93] In 2014, President Xi was still struggling to create the right relationship between 'visible' and 'invisible' hands in managing the economy.[94]

6.2 Private Property's Perils

Mobilisation of a private sector to act as the principal driving force of the economy's post-1978 takeoff is among the Chinese Communist Party leadership's most striking achievements. Property rights are essential to routine banking business since, according the PBOC, approximately '70 percent of the

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90 See Merle Oberon, *Sowing the Seeds of Democracy: Political Reform in the Deng Xiaoping Era* (Cambridge: Harvard University Press, 1994), pp. pp. 125, 266-7, 297; Kjeld Erik Brodsgaard, 'Paradigmatic Change: Readjustment and Reform in the Chinese Economy, 1953-1981, Part II', *Modern China*, Vol. 9, No. 2 (April 1983), pp. 253-72.

91 Jian Cuomo, 'Various issues concerning market regulation', *Hong Q*i, No 7 (1 April 87), pp. 33-6.

92 Yang Peixin, 'Reforming the economic structure depends on the contract system', *Shijie Jingji Daobao*, 15 February 1988.

93 President Jiang, 'Accelerating the Reform, the Opening to the Outside World and the Drive for Modernization, so as to Achieve Greater Successes in Building Socialism With Chinese Characteristics'; 'Hold High the Great Banner of Deng Xiaoping Theory for an All-round Advancement of the Cause of Building Socialism with Chinese Characteristics to the 21st Century', *Report at 15th National Congress of the Chinese Communist Party* (9 September 1997) URL: http://www.bjreview.com.cn/document/txt/2011-03/25/content_363499.htm; 'Build a Well-off Society in an All-Round Way and Create a New Situation in Building Socialism with Chinese Characteristics'.

94 President Xi, *NCNA*, 27 May 2014.

credit collateral received by commercial banks in [2010] is real estate'.[95] But ideological mistrust of private property ownership has persisted within the Party, blocking efforts to reform the ownership of land in particular. The insistence that land classified as rural remains in collective ownership has been at the heart of the long-drawn out scandal that has overtaken local government finances since 2007 and in which the banks are heavily involved (as the companion paper explains).

A 2003 Party Plenum had pledged to grant recognition of private property rights and equal treatment of the public and private sectors. 'Nearly 10 years of preparation' had already been spent on drawing up the necessary legislation. But the draft law met with 'unprecedented' hostility in the National People's Congress where legislators argued that private property rights should remain inferior to those of state ownership. In 2005, a Peking University law professor was able to halt further progress with an article denouncing the measures as 'mimicking Western capitalism and ignoring the socialist nature of China's economy'. The law was finally passed in 2007 'after repeated revisions' and an 'unprecedented' eight sessions of discussion.[96]

The new legislation provided only a partial solution: rural land was to remain in collective ownership (that is, controlled by local administrations). Zheng Xinli, Deputy Director of the Chinese Communist Party's foremost research institute, explained that the new property law contained this restriction because of the 'historic lesson' which showed that when landlords owned the land, 'peasants were impoverished'.[97] In 2008, the Chinese Communist Party decreed that collective ownership in rural areas would remain unchanged. Individuals could become leaseholders with limited tenure but they would be able to sublet 'their contracted farmland or transfer their land-use rights'. Within the Party, even this modest concession was attacked, with claims that 'the new policy might create a few landlords and many landless farmers who will have no means for a living'.[98]

A 2013 report from the prestigious Chinese Academy of Social Sciences (CASS) argued that the national programme to ensure adequate provision of affordable housing would require drastic changes in the role of local governments in the supply of building land, which should no longer be postponed. Longer term, the report urged, clarification of property rights in land should commence, a complex task which it warned would involve overhaul of 'the tax system, household registration and legislation'.[99]

95 Hu, Deputy Governor PBOC, 'Symposium on Judicial Interpretation of *Law on Real Rights*' (31 May 2010) URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=191

96 Bruce J. Dickson, 'Integrating Wealth and Power in China: The Communist Party's Embrace of the Private Sector', *China Quarterly*, No. 192 (December 2007), pp. 834, 837; 'Landmark property law takes effect', *NCNA*, 1 October 2007.

97 Zheng Xinli, Chinese Communist Party Central Committee Research Institute Deputy Director, 'China won't privatize rural farmland', *NCNA*, 27 December 2007.

98 Chinese Communist Party, 'Decision on... Rural Reform and Development', reported in 'China liberalizes farmers' land use right to boost rural development', *NCNA*, 19 October 2008.

99 Zhang Zhuoyuan, former CASS Economics Institute Director-general, reported in 'CASS advocates better housing security', *NCNA*, 18 December 2013.

In an effort to halt abuses and unlawful land transactions, a national campaign to register rural land rights was launched. But because of the continuing reign of the politics of postponement, registration had been completed in only 150 counties by 2014 and would not be completed in all 1,500 counties until the end of the decade.[100] Until property ownership was fully documented and recorded by state agencies, property owners could have only limited protection from the law. In the meantime, the ownership rights of significant numbers of home-purchasers to the housing they were buying remained in jeopardy, officials admitted.[101]

6.3 Socialists Still

The Marxist legacy has remained a powerful but underrated influence in the current century. An abiding commitment to Marxism was the first item listed in 'the socialist core value system' adopted by the Chinese Communist Party in 2006, followed by 'socialism with Chinese characteristics'.[102] Chinas top leadership, the official media reported in 2013, was currently engaged in 'group study' of 'the basic theory and methodology of Karl Marx's historical materialism'. At the same time, President Xi proclaimed the need to 'make good use of the "living soul" of Mao Zedong Thought'.[103]

With China's leaders displaying a high level of fidelity to the founding fathers of communism, it was not surprising that the advance towards a fully market-driven economy encountered resistance. 'Between 1978 and 2012, it has taken China more years to "reform" the central planning system than it took for it to establish and operate that system from 1949 to 1978', a leading authority on the nation's banks has commented. 'China has moved from central planning to what might be called a commanding-heights economy', he added, 'This is progress, but China is far from completing its transition to a market economy'.[104]

Ideological loyalty and its serious limitations on the effective role of market forces have created an economic environment in which the commanding heights remain firmly in the hands of the Chinese Communist Party, according to a leading American sinologist, Professor David Shambaugh.

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[100] 'China to complete land-use right registration in 5 years', *NCNA*, 25 December 2013. The total number of *county-level* administrations is 2,862, many of which are now urban in character. It should be noted that provincial-level governments needed formal monitoring to ensure that they complied with the new property regulations and policies which were being promulgated. 'China to send teams to inspect property regulation', *NCNA*, 24 July 2012.

[101] Wang Zongya, Minister of Land and Resources, reported in 'China's limited-property-rights housing in spotlight', *NCNA*, 26 March 2012; 'Rural houses to be covered by system', *CD*, 9 January 2014.

[102] The list continued with 'patriotism, the spirit of reform and innovation and the socialist sense of honour and disgrace'. A prolonged national campaign followed to promote these values. See Jia Qinglin, Chinese People's Political Consultative Conference National Committee Chairman, 'Top political advisor stresses socialist core value system', *NCNA*, 13 December 2010.

[103] President Xi reported in 'Xi stresses adherence to Marxist philosophy', *NCNA*, 4 December 2013 and 'Xi: Holding high the banner of Mao "forever"', *NCNA*, 26 December 2013.

[104] Yasheng Huang, 'How Did China Take Off?', *Journal of Economic Perspectives*, Vol. 26, No. 4 (Fall 2012), pp. 167.

> China's economic system … still maintains many elements of the Soviet central planning and investment system. While the state sector of the economy has shrunk significantly (to approximately 30 percent of the national economy), this is deceiving — as the state remains the "invisible hand" dominating the economy — through state banks, state assets, state ownership, state manipulated prices, state cadres, and unpredictable state intervention in various economic sectors.[105]

7. Conclusion: Time is Running Out

Internationally, China's policy shortcomings had only limited impact on market sentiment until relatively recently, and lavish praise was generally heaped on its financial performance. A distinguished British banking economist declared in 2009, for example, that China's banks have 'made enormous strides in reform and deregulation. They have emerged relatively unscathed from the global banking epidemic', he added, 'and the largest of them stand alongside the giants of global banking as first among equals'.[106] The Chairman of the Bank of China — one of the Chinese 'giants' –– was, however, taking a totally different view of the nation's financial performance. The financial system, he said in late 2009, was threatened by 'systemic risks'. Local governments, he went on, had borrowed 'beyond their repayment capacity' to fund the USD586 billion stimulus package launched in 2008 to counter the global crisis.[107]

The International Monetary Fund warned in 2012 that 'the potential conflict between safety and soundness objectives and other objectives … can be more acute in China because of the predominant use of the banking system, much of which is state owned, to achieve economic and social goals'.[108] This critical assessment had little visible impact on attitudes overseas where business opinion seemed to take a genuinely contented view of these shortcomings and of a banking environment in which the state continued to exercise such extensive control and a free and competitive market was still unachieved.

In 2014, the outside world was informed that cautious implementation of the 'open door' policy, which has transformed China's economy as a whole, would be extended to the banking sector. Entry barriers for foreign banks would be lowered, and restrictions on their access to RMB operations

[105] His observations were published in the official Chinese media. David Shambaugh, 'Is there a Chinese model?', *CD*, 1 March 2010.

[106] Kent Matthews, Zhiguo Xiao and Xu Zhang, 'Rational cost inefficiency in Chinese Banks', *HKIMR Working Paper No. 29/2009* (September 2009), pp. 3, 6, 13, 14. URL: http://www.hkimr.org/cms/upload/publication_app/pub_full_0_2_224_WP%20No.29_2009.pdf

[107] Xiao Gang, Bank of China Chairman, 'Top Chinese banker warns of lending risks', *NCNA*, 9 November 2009.

[108] International Monetary Fund, 'People's Republic of China: Detailed Assessment Report: Basel Core Principles for Effective Banking Supervision', *IMF Country Report No. 12/78* (April 2012), p. 12. URL: www.imf.org/external/pubs/ft/scr/2012/cr1278.pdf

eased.[109] Once again, China's initiatives were viewed as good faith commitments, and no complaint was made about similar declarations in the past that remained unfulfilled. For example:

- In 2006, the PBOC Deputy Governor claimed that thanks to China's 'open door' policies, foreign financial institutions had already 'brought competition incentives for their Chinese counterparts to improve and transform business strategies and management'.[110] In practice, measures to introduce direct participation by foreign banks in China's banks proved disappointingly restricted even on the most sympathetic assessment by a well-known foreign expert.[111]

- By 2007, China's entry into the World Trade Organisation was supposed to lead to 'the full opening of the banking system to foreign competition'.[112] Not until 2012 did the state-controlled system allow the share of the nation's total bank assets held by foreign banks authorised to operate on the Chinese Mainland to reach an unimpressive 2 per cent.[113]

There is a growing apprehension internationally, nevertheless, about the further postponement of the nation's banking reforms. In 2013, the World Bank, in close cooperation with China's Ministry of Finance and the State Council's Development Research Centre, published a projection of what China's economy would look like in 2030. This document acknowledged that, in the past, China had been able to delay the introduction of reforms without undermining its growth momentum. 'China could conceivably sustain high economic growth for a while longer even without fundamental reforms in the financial sector', it conceded. But time was running out, the report went on, and the costs were rising in terms of 'distortions and imbalances [which] would undermine social stability, slow productivity growth, and erode competitiveness'.[114]

An important force for change is likely to be the future effects of the traditional politics of postponement on financial sentiment and the business environment as liberalisation of the domestic banking system continues and foreign exchange controls on capital transactions are removed. Once market forces — both domestic and international — are given substantial freedom in the financial sector, the content of China's public policy commitments and the success with which they are

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109 'China reveals 2014 financial reform priorities', *NCNA*, 25 January 2014.

110 Wu, PBOC Deputy Governor, 'Strengthen China's Financial Industry in the Process of Opening up', (14 February 2006), p. 3. URL: http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=106

111 See Katharina Pistor, 'Banking Reform in the Chinese Mirror', *Columbia Law and Economics Working Paper No. 354* (10 August 2009), pp. 15-20.

112 Jonathan Anderson, 'China's New Banking System', in W. John Hoffman and Michael J. Enright (eds), *China into the Future: Making Sense of the World's Most Dynamic Economy* (Singapore: John Wiley & Sons (Asia) Pte. Ltd, 2008), p. 165.

113 People's Bank, *Annual Report, 2012*, pp. 160-3. URL: http://www.pbc.gov.cn:8080/publish/english/960/index.html

114 World Bank and State Council Development Research Center, *China 2030: Building a Modern, Harmonious, and Creative Society* (Washington: World Bank, 2013), p. 117.

implemented will have serious consequences for the domestic economy. Business sentiment and investor confidence will have a powerful effect on the cost of funds and the value of the currency. Will future delays in implementing the long-standing promises of market interest rates, for example, be treated with the same indifference by foreign financial markets as in the past? The Chinese authorities themselves have acknowledged publicly that the measures being taken to develop a more open and competitive financial system — especially through the globalisation of the RMB — will inevitable raise the priority that must be given to financial reforms and increase the penalties for delays.[115]

China's central bankers have long argued that modern banking requires an OECD-style business culture in which firms make decisions in the best interests of their shareholders and are subject to minimum interference from the state. But the analysis presented in this paper suggests that the gap between commitment and implementation in the financial sector will remain significant. It is doubtful, therefore, whether China's leaders will soon end the long-standing delays in completing the liberalisation of the nation's banks. The consequences — and costs — for the banks are predictable, and their seriousness and scale are already very clear from the crisis which has overtaken local governments. The companion paper explains the political, fiscal and banking deficiencies that have made that crisis so difficult to manage.

[115] See, for example, the case argued in 'News Analysis: International use of yuan demands more financial reforms', *NCNA*, 19 February 2012.