China's Banking: How Reforms Lost Momentum

Leo F. Goodstadt
Hong Kong Institute for Monetary Research
Hong Kong Institute for the Humanities and Social Sciences
University of Dublin

October 2014

Summary

China's leaders have advocated the creation of a modern and competitive banking system, with market-driven interest rates, since 1979. Yet, announcements of reform measures repeatedly prove to be 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. This paper examines the gap between policy commitments and their implementation and how these delays can occur in a state where power is so concentrated in the leadership of a single, highly-experienced political party.

China's leaders have an abiding commitment to Marxist and Maoist principles, this paper explains. They do not accept that the state can relinquish an active role in managing the economy and rely instead on the free market's 'invisible hand'. After 1978, the state turned to the banking sector to cover the political and costs of the retreat from central planning. The banks provided the bridging finance to enable state-owned enterprises to avoid bankruptcy and worker lay-offs as market competition and profitability replaced state allocation of finance and state procurement and distribution of output.

The leadership has since come to depend on the banks to fund urgent national policies which could not be financed on commercial terms (the 2008 USD586 economic stimulus package, for example, and the 2011 USD766 billion affordable housing programme). Banks are also compelled to use their lending policies to achieve expansion and contraction of specific industries as directed by the State Council, regardless of the impact on bank balance sheets.

Thus, banking modernisation continues to be postponed because this industry has become the state's last lever of economic control. The World Bank has warned that reforms cannot be delayed indefinitely except at serious cost to China, and this paper suggests that globalisation of the RMB will raise global market pressures for more open and competitive banking to levels difficult for China to resist.