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DYSFUNCTIONAL BANKING SURVIVES**

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China's Financial Reforms: Why Dysfunctional Banking Survives

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Abstract

There is a growing consensus that China's banking remains woefully dysfunctional despite almost 40 years of reforms. This paper explores why the government has found this situation both tolerable and affordable. Historically, the state has passed much of the heavy but indirect costs of economic modernisation on to the banks. Currently, the banks are virtually the last effective lever through which the leadership can impose its priorities on a fiscally decentralised state and increasingly market-driven economy. Thus, despite central bank and financial regulators' calls for greater regard for commercial realities, state priorities and political intervention are likely to remain powerful influences on bank lending.

Keywords: China, Reforms, NPLs, Global Crises, Local Administration

A striking feature of China's growth has been the disappointing progress of its financial reforms by comparison with the extraordinary success of its modernisation drive across the overall economy. For half a century, senior officials responsible for China's financial affairs have deplored the losses caused by the chronic failure of state-owned enterprises (SOEs) to repay bank loans. For at least two decades, the state has repeatedly called for the banks' modernisation, particularly through the creation of a competitive, market-driven financial sector. Yet, since 1978, non-performing loans (NPLs) have been a recurrent feature of the Chinese economy. An SOE chairman given a suspended death sentence for corruption in 2009 illustrated why loan defaults proved so intractable. 'I will use the state funds to set up more companies', his diary allegedly recorded, 'If the businesses are good, the profits are mine; if the businesses are bad, the state covers my loss. So many other [SOE bosses] have done that'.¹

The official statistics for 'major commercial banks' reported that the ratio of NPLs to total gross loans dropped from 8.9 per cent in 2005 to 1.1 per cent in 2010. But this improvement was less reassuring than the bald data suggest. The decrease reflected not just a 'a decline in NPL levels' but, in addition, 'was driven by the rapid expansion of credit ... and a RMB 816 billion NPL carve-out from one major bank [Agricultural Bank of China] in 2008', the IMF observed.² The threat to financial stability had actually intensified and was portrayed in alarming terms by Deputy Prime Minister Wang Qishan in late 2011.

... the country witnessed a 10-fold bank lending increase in 2009 from the average from 1998 to 2002... the problems and risks caused by this unbridled lending expansion have brought the country's economy and its financial sector to a very dangerous position. For example, the inflated real estate bubbles and the huge credit risks that domestic commercial banks, the country's local financing platforms as well as the non-governmental credit market are exposed to, if not effectively controlled, could become triggers for a destructive financial crisis.³

Hence, 'one big puzzle' is the relative backwardness of 'the formal financial sector' perceived by 'the vast majority of researchers', according to a 2010 study. Its inefficiencies have persisted despite the government's 'multiple rounds of reforms to help transform the old financial institutions into authentic commercial banks' since the 1990s, the authors point out. The explanation may lie in the role assigned to the banking system in the reform process, the study suggests, which 'has shouldered much of the reform costs in China since the beginning of the reform era'. The 'natural' outcome of this policy was to make 'the financial sector ... the least reformed in the economic realm'.⁴

¹ Wang Guanchao, former board chairman of Beijing Triple Nine Automobile Industrial Co., Ltd. See 'SW China court upholds death sentence for corrupt SOE boss', *New China News Agency (NCNA hereafter)*, 23 December 2011.

² IMF, 'People's Republic of China: Financial System Stability Assessment', *IMF Country Report No. 11/321* (November 2011), 'Table 6. China: Selected Indicators of Financial Health, 2005-10', pp. 27 and 28. URL: <http://www.imf.org/external/pubs/ft/scri/2011/cr11321.pdf>

³ His statement was publicised shortly before the annual Central Economic Work Conference. Yi Xianrong, 'Vice-Premier Wang Qishan: Effective risk prevention', *China Daily (CD hereafter)*, 30 November 2011.

⁴ 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.

1. Few Foreign Partners

The contrast with the pace of modernisation elsewhere in the economy is remarkable. A manufacturing industry has grown up capable of meeting the demands of the world's most sophisticated markets and open to intense on-shore competition. By 2010, China had '698,000 foreign-invested enterprises' with a total paid-up capital of USD1.05 trillion. They accounted for 28 per cent of the nation's industrial value added and 55 per cent of total foreign trade.⁵ No similar transformation took place in banking, where despite Deng Xiaoping's 'open door' policies, foreign banks accounted for less than 2 per cent of the industry's total assets in 2010.⁶

This outcome reflected China's caution in managing the 'internationalisation' of what it considered to be 'strategic industries'.⁷ Its model for banking has since been hailed as 'unique among emerging markets with a recent history of financial sector reform. Rather than privatizing banks and transferring control to foreign investors — the dominant strategy in Eastern Europe and most of Latin America — China sold minority stakes in its largest banks to a group of selected foreign strategic investors'. The four largest banks were converted into free-standing business corporations, accountable to their shareholders and listed on international stock exchanges.⁸ The People's Bank of China (PBOC) has declared that the foreign minority shareholders provided 'incentives for their Chinese counterparts to improve and transform business strategies and management' and adopt 'business concepts and management skills so as to further improve the corporate governance of domestic banks'.⁹

The extensive benefits claimed for this limited involvement by foreign banks have been widely disputed. A Shanghai research project concluded in 2011 that not only were the four dominant state-owned banks badly run, they also discriminated so severely against private sector businesses — 'the pillar of economic development' in contemporary China — that these were largely excluded from the formal financial system.¹⁰ The nation's policy-makers found this state of affairs tolerable, it will be

⁵ 'Full text of Chinese Vice President Xi Jinping's speech at World Investment Forum 2010', *NCNA*, 7 September 2010.

⁶ Song Jingli, 'Foreign banks' assets share in China slides again', *CD*, 6 April 2010. The Chinese Banking Regulatory Commission (CBRC hereafter) listed 84 foreign banks as operating in China in 2010. URL: <http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=2045>. Foreign banks also had access to only a minuscule share of securities market business. Simon Rabinovitch, 'Chinese "hoop" hold back foreign banks', *Financial Times*, 19 December 2011.

⁷ Margaret M. Pearson, 'The Business of Governing Business in China: Institutions and Norms of the Emerging Regulatory State', *World Politics*, Vol. 57, No. 2 (January 2005), p. 313.

⁸ Katherine Pistor, 'Banking Reform in the Chinese Mirror', *Columbia Law and Economics Working Paper No. 354* (10 August 2009), p. 2. URL: SSRN-id1446930. A good overview of the costly frustrations of banking reforms in the former Soviet Bloc when China was embarking on its own reforms can be found in Gary Gorton and Andrew Winton, 'Banking in Transition Economies: Does Efficiency Require Instability?', *Journal of Money, Credit and Banking*, Vol. 30, No. 3, Part 2 (August 1998), pp. 621-50.

⁹ Wu Xiaoling, PBOC Deputy Governor, 'Strengthen China's Financial Industry in the Process of Opening up', (14 February 2006), pp. 3, 4. URL: <http://www.pbc.gov.cn/english/detail.asp?col=6500&ID=106>. This message was repeated by Vice Chairman Jiang Dingzhi, CBRC Vice-chairman, 'Reform and development of China's banking industry in the past thirty years', CCISSR Forum, Peking University (10 April 2008) URL: <http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=2008042417574602F56CDDD2FF3D0F1898FBD800>

¹⁰ Feng Xu'nan, 'Dividends and tunneling: evidence from family firms in China', *China Finance Review International*, Vol. 1, No. 2, 2011, p. 155. DOI 10.1108/20441391111100732

argued, because from the start, the main priority in their programme for expanding relations with foreign banks was the development of China's own international financial business. The relevance of overseas practices to the modernisation of domestic banking was much more limited.¹¹ China was able to adopt this narrow focus because its export sector — the main source of sustained, high-speed growth — has been able to rely on Hong Kong.¹² Since the establishment of the People's Republic, the city has consistently met the needs of the Mainland's foreign trade and investment partners for financial services and facilities that match in scale and quality those of the world's principal financial centres.¹³ Hong Kong is also the ideal location in which to use international competition to modernise selected Chinese financial institutions. Research shows that the Hong Kong market compels Mainland participants to improve management performance and match international standards.¹⁴ Thus, modernisation of the domestic banking industry did not seem to require the rapid and radical reforms that were so impressive in other sectors of the economy.¹⁵

2. The Policy-Makers' Perspective

The contrast between modernisation policies and banking performance suggests that the 'unreformed' banking industry must offer certain advantages in managing the economy. The paper begins with a review of the somewhat eclectic research findings that together offer a rationale for China's tolerance of grossly inefficient banks. This evidence could be used to argue that sustained economic growth was actually facilitated by the banking industry's defects. (Subsequent sections will demonstrate very clearly how these short-term gains created recurrent crises which eventually became grave threats to overall financial stability that intensified from one decade to the next.) Next comes a section which describes the special ideological and 'Cold War' complexities that shaped the evolution of China's reform strategy — in which banking was to receive little attention.

There follow separate sections which recount the mostly adverse impact on the banking industry's solvency and integrity of each stage of the retreat from central controls and state planning. In each

¹¹ An early illustration of this attitude can be found in an analysis of overseas banking relationships and their benefit to China which is virtually silent on their domestic impact. He Dexu, CASS Finance Institute, 'Financial reforms to expand in 1995', *Jingjixue Dongtai*, No. 3 (18 March 1995), p. 16.

¹² 'Over half of China's exports and imports have either gone through or come from Hong Kong [since 1978], and so it is with the capital influx ... Without Hong Kong, the Chinese mainland could not have accessed the global market and sent its commodities to every corner of the world as smoothly as it has for the past 20 years'. Li Ruihan, Chinese People's Political Consultative Conference Chairman, *CD*, 7 November 2000.

¹³ Cynthia Leung and Olaf Unterberdoerster, 'Hong Kong SAR as a Financial Center for Asia: Trends and Implications', *IMF Working Paper WP/08/57* (March 2008), pp. 6, 9 and 13; Leo F. Goodstadt, *Reluctant Regulators: How the West Created and China Survived the Global Financial Crisis* (Hong Kong: Hong Kong University Press, 2011), pp. 87-94.

¹⁴ 'Public listing in Hong Kong seems to have more positive and persistent effects on bank performance'. Bin Liu, 'The Effects of Public Listing on the Performance of Banks in China' *HKIMR Working Paper No.07/2011* (February 2011) pp. 17-18, 20. In general, ;Hong Kong-listed enterprises achieved better standards of corporate governance than firms with Mainland listings only, and enjoyed higher market valuations. Jiang Yu Wang, 'Regulatory competition and cooperation between securities markets in Hong Kong and Mainland China', *Capital Markets Law Journal*, Vol. 4, No. 3 (July 2009), p. 396.

¹⁵ The Hong Kong factor was identified very early in the modernisation process. 'China has a special advantage in importing foreign capital, namely Hong Kong which ranks third among the international financial centres of the Asia-Pacific region'. Yang Peixin, 'A review of the creation of China's socialist capital market', *Renmin Ribao* (*RR* hereafter), 7 April 1986.

decade, national leaders deplored the coercion of the banks to lend money for policy or political reasons. In practice, however, the banks proved irreplaceable in funding the indirect costs of dismantling the urban 'command economy' and in meeting the mounting fiscal shortfalls of local administrations after financial decentralisation, especially in the rural sector. The links between the 1997-98 Asian financial crisis and the 2007-09 international financial crisis are reviewed, and the retreats from reform recorded. Finally, the prospects are discussed of freeing the banking industry from acting as the government's 'paymaster', a role long deplored officially as a source of unacceptable mismanagement of China's financial resources.¹⁶

The primary focus of this paper is the policy-makers' choices; how far they were (or could have been) aware of the deficiencies of their decisions; and to what extent their retreats from bank reform can be viewed as unavoidable outcomes of modernisation and rapid growth in the rest of the economy.

3. The Case For Unsound Banks

The inefficiency caused by the failure to embark on radical reforms has been highlighted in several studies. A particularly well-informed critic warned in 1998 against neglecting to implement the radical reforms that then appeared to be high on the agenda of a leadership which had 'an acute understanding' of the 'underlying structural problems' of the banks 'Delay is an almost certain path to a lower pace of economic growth', he declared.¹⁷ Growth did not slow, nevertheless, even though NPLs proliferated. The state found the level of write-offs tolerable although they became uncomfortably large but not unaffordable in the run-up to the Asian financial crisis and, later, in the wake of the 2008 economic stimulus package. And there was never any danger of a loss of depositor confidence or a banking collapse. Arguably, China's performance since 1978 is evidence that institutional reforms are not essential to economic success.¹⁸

A second but more debatable proposition is that NPLs have been positively beneficial. Delinquent loans seemed a reasonable price to pay for avoiding the popular unrest and social deprivation that was so damaging to former Soviet Bloc states when moving rapidly from subsidised state enterprises to full market competition.¹⁹ On this view, the banks' losses were a means of subsidising the modernisation process and of providing cheap investment funds to what the state considered 'strategic' — politically and socially — sectors while the 'command economy' was being dismantled.

¹⁶ A sound analysis of the origins of this practice is Tang Shuangning, Construction Bank Shenyang Branch, 'China Investment Risks', *Jingji Yanjiu*, No. 11 (20 November 1986), pp. 48-9.

¹⁷ Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington: Brookings Institution Press, 1998), pp. 181, 221-2.

¹⁸ For a critical overview of this problem and its impact on industrial efficiency, see the discussion and data in 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>

¹⁹ But, it has been claimed, the Chinese economy has paid an excessive price for such prudence. 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.

State planners no longer allocated finance and other resources directly to enterprises, and large numbers of enterprises were made insolvent by the switch from a 'command economy'. What was in fact non-recourse bank funding saved them from closure and protected jobs, pensions and welfare benefits. Moreover, NPLs have been less provocative than outright subsidies in promoting export industries.²⁰ Overall, any additional profits such non-recourse finance generated for the economy as a whole could be recovered, in theory at any rate, through taxation.²¹ This state of affairs encouraged the long-term bias of bank lending in favour of the state rather than the private sector.²²

The positive role of the banks' write-offs as an indispensable source of state funding has been argued persuasively in the context of China's fiscal problems and the drastic reduction in the central authorities' capacity to fund investment as a share of GDP from the 1980s. Without the loans that local officials were able to extract from local banks, economic and social development would have come to a halt in many regions, an impressive World Bank paper has claimed.²³

A pioneering and influential study declared: 'An implicit guiding principle underlying China's economic reform strategy since 1979 has been that reform should proceed without creating losers'.²⁴ The absence of losses was possible because they were absorbed as NPLs by the banks in obedience to state policies and officials' personal intervention. These losses were anonymous and appeared to be victimless because the write-offs were for the account of state-owned banks and achieved through state-funded refinancing and restructuring exercises. The sums involved were not trivial, however.

- The state refinanced USD223 billion worth of bank NPLs in 1998-99.
- It spent US\$117 billion on clearing up Agricultural Bank of China's NPLs in 2008 to prepare it for an international IPO in 2010.

²⁰ This scenario is derived from the analysis in Gordon, Roger, and Wei Li, 'Puzzling Tax Structures in Developing Countries: A Comparison of Two Alternative Explanations' (March 2000), pp. 9, 11, 23. <http://www.econ.ucsd.edu/~rogordon/philippines3d.pdf>. This paper is an earlier and longer version of the author's well-known NBER publication in 2007.

²¹ *ibid.*, p. 22. But the gain was theoretical because China had a special system of 'self-assessment' for taxing business enterprises, in each of which a Chinese Communist Party branch was invariably functioning. Its duties included 'to monitor the taxable activity of the firm'. In the extensive reforms of 1994, this system remained intact, apparently, although the reporting level of the Party official responsible was altered. Roger Gordon and Wei Li, 'Puzzling Tax Structures in Developing Countries: A Comparison of Two Alternative Explanations', in Takatoshi Ito and Andrew K. Rose (eds), *Fiscal Policy and Management in East Asia, NBER-EASE*, Vol. 16 (Chicago: University of Chicago Press, 2007), f.n. 16, pp. 17 and 22. URL: <http://www.nber.org/chapters/c0365.pdf>

²² Roger H. Gordon and Wei Li, 'Taxation and Economic Growth in China', (May 2002), pp. 2, 5, 10. URL: <http://www.econ.ucsd.edu/~rogordon/hongkng4.pdf>. The authors' analysis remains illuminating despite the fact that their view of the 1990s bank reforms was unrealistic in its optimism and their description of the pre-reform era taxation system and its impact is open to challenge. See, for example, Leo F. Goodstadt, 'Taxation and Economic Modernization in Contemporary China', *Development and Change*, Vol. 10, No. 3, July 1979, pp. 403-421.

²³ See Achim Fock and Christine Wong, 'Financing Rural Development for a Harmonious Society in China: Recent Reforms in Public Finance and Their Prospects', *World Bank Policy Research Working Paper 4693* (August 2008), pp. 36-7. URL: http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2008/08/14/000158349_20080814090712/Rendered/PDF/WPS4693.pdf

²⁴ This assertion is based principally on the abolition of the rural communes and a benign view of the ban on enterprises laying off workers or going bankrupt. Lawrence J. Lau, Yingyi Qian, 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.

- It reclassified USD438 billion of potential bank NPLs in the form of local government finance vehicle (LGFV) loans in 2011.

These were not just accounting exercises. They involved the destruction of substantial financial resources in a nation which was and remains a very low-income society with all the handicaps which that status brings, a point regularly made by China itself.²⁵ The 1998-99 refinancing, for example, saw the transfer of NPLs to special asset management companies set up to handle them. The World Bank and other foreign experts had predicted a recovery level of 40 per cent or more. The PBOC has lamented publicly that the actual rate achieved was less than 20 per cent.²⁶

It should be emphasised that the failure to create a fully competitive and commercial banking system was not the result of scepticism among central bankers and financial regulators about the considerable benefits that modern banking would bring. The PBOC's Governor, for example, has preached moral hazard vigorously and has argued publicly that banks should pay the price for their business errors and not rely on bail-outs. After the United States sub-prime mortgage collapses, he criticised the backlash against 'securitized products and other derivatives' and warned against regulatory initiatives that could stifle future growth of financial services.²⁷ The limited progress towards total modernisation that has been achieved will be shown below to be the outcome of deliberate choices made by China's political leadership. These decisions involved restricting the full implementation of the extensive programme of reforms that began in 1983-84 with the establishment of the PBOC as a central bank and the allocation of its former banking operations to four institutions that were expected to become both commercial and competitive.²⁸ Not surprisingly, the reforms' results have been unsatisfactory, and a 2009 IMF study described 'the correlation between efficiency and profitability [as] close to zero for Chinese banks'.²⁹

An unfortunate consequence of the sorry record of the banks was that the government had little confidence in the ability of their executives to improve their performance, according to the PBOC Governor. He denounced the local managers whose loan default rates were so high that they could not be trusted to handle more than 'one or two loan businesses per year'. Costly state bail-outs in the

²⁵ Note the official summary of the nation's economic and social situation: 'China's per capita GDP in 2010 was about USD4,400, ranking around the 100th place in the world. China's capacity for independent innovation is weak, and it is at the low end of the value chain in both international division of labor and trade. The standard of living of the Chinese is not high, and China's social security system is inadequate, lagging far behind those of the developed countries'. Information Office of the State Council, 'White Paper on China's Peaceful Development', *NCNA*, 6 September 2011.

²⁶ Zhou Xiaochuan, Governor PBOC, 'Improve Legal System and Financial Ecology', *Chinese Economists Forum* (2 December 2004), pp. 8-9. URL: <http://www.pbc.gov.cn/english/detail.asp?col=6500&ID=69>

²⁷ Zhou Xiaochuan, 'Instability and evolution of the financial system' (5 December 2007), URL: <http://www.pbc.gov.cn/english/detail.asp?col=6500&ID=158>. Banking regulators shared a similar outlook. China Banking Regulatory Commission, *2008 Annual Report*, 'Box 2: Lessons from the global financial crisis', p. 32. URL: <http://zhuanqi.cbrc.gov.cn/subject/subject/nianbao2008/english/zwqb.pdf>

²⁸ The main reform initiatives are conveniently summarised in IMF, 'People's Republic of China: Financial System Stability Assessment', 'Table 3. China: Financial Sector Reforms — Selected Benchmarks', p. 20.

²⁹ Tarhan Feyzioglu, 'Does Good Financial Performance Mean Good Financial Intermediation in China?', *IMF Working Paper WP/09/170* (August 2009), pp. 13, 17. URL: <http://www.imf.org/external/pubs/ft/wp/2009/wp09170.pdf>

past, he said, led to the industry's poor standing with the public and to government reluctance 'to remove unwarranted controls and encourage financial innovation'.³⁰

4. No Substitute For Socialism

After the death of Mao Zedong in 1976 and the subsequent discrediting of his radicalism and of the 1966-76 Cultural Revolution in particular, the Chinese Communist Party could no longer depend on its citizens to accept the austerity and self-sacrifices which had contributed so much to economic growth in the past.³¹ However, the Party's commitment to 'socialism' could not be jettisoned overnight, nor free markets espoused in its place.³² China's 'extremely limited' private sector and its extensive rural 'semi-subsistence economy' made it impossible for central planning to give way to capitalism, it was claimed. Yet, the best that state planners now seemed able to achieve was a surge in investment but only through reviving the discredited and dangerous tactics of the 1958 'Great Leap Forward'. 'Opening' to the outside world seemed no less perilous, because a programme to accelerate growth through importing advanced plant and equipment had begun before Mao's death but had proved excessively ambitious and unaffordable.³³

The obstacles to finding a radical solution diminished in 1978. The Chinese Communist Party abandoned its former ideological rigidity and adopted the principle, 'practice is the sole criterion for testing truth'. This simple slogan caught the mood of the time, with its note of common sense in place of the endless inspirational rhetoric of the three previous decades.³⁴ But when Deng Xiaoping persuaded the Party later that year to adopt his modernisation programme, there was still no comprehensive strategy. As a well-known economist subsequently commented, 'China ... [had] a leadership which is impatient for reforms but which lacks the necessary theory and blueprints'.³⁵ Deng himself had no idea of how overwhelming was the reform momentum that he was unleashing.³⁶

³⁰ Zhou Xiaochuan, 'Reform of the internal control and internal incentive systems of the commercial banks', Beijing Finance Expo (1 September 2005) URL: <http://www.pbc.gov.cn/english/detail.asp?col=6500&ID=85>.

³¹ These strains, especially the bitter disputes over material rewards for the labour force, are well described in Lowell Dittmer, *China's Continuous Revolution: The Post-Liberation Epoch 1949-1981* (Berkeley: University of California Press, 1989), pp. 146-8, 268-9.

³² For a good summary of the political and practical bottlenecks — and their costs immediately after 1978 — created by the legacy of Soviet and Maoist economic preconceptions and practices, see 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. 253-272.

³³ Xue Muqiao, 'The current readjustment and reform of the Chinese economy', *Shijie Jingji Daobao*, No. 35 (1 June 1981).

³⁴ An important account of this debate by a participant can be found in Ruan Ming, *Deng Xiaoping: Chronicle of an Empire* (Boulder: Westview Press, 1994), pp. 29-37.

³⁵ Cyril Chihren Lin, 'The Reinstatement of Economics in China Today', *China Quarterly*, No. 85 (March 1981), p. 4.

³⁶ Deng predicted in 1985 that even 'after 20 to 30 years' of economic reforms, the state sector would still control 90 per cent of the national economy. Deng Xiaoping, *Fundamental Issues in Present-day China* (Beijing: Foreign Languages Press, 1987), pp. 55, 123. By 1991, the private sector's share had already risen to 60 per cent. Joseph C. H. Chai, *China: Transition to a Market Economy* (Oxford: Clarendon Press, 1997), pp. 179-80.

In 1980, a leading economist summed up the widespread uncertainty about how best to manage the reform process.

China does not have a complete and mature reform programme. All we have are the views and initial suggestions collected during discussions in various departments and some small-scale, experimental and incomplete reforms.³⁷

The drawbacks of this situation soon became very visible. The absence of 'a comprehensive strategy' and detailed 'working plans' meant that 'proposals were sound but failed to achieve results', according to a penetrating review in 1982.³⁸ A crucial feature of this initial confusion was a reluctance to look abroad for solutions.

- *Soviet socialism*: Leading Chinese economists had previously urged serious study of the Soviet Union's repeated efforts to overcome the shortcomings of a 'command economy'.³⁹ Sino-Soviet rivalry led to bitter condemnation of these suggestions, however, and Moscow's reform initiatives were denounced as a betrayal of basic Marxist principles and contrary to China's criminal laws. And in the struggle against Soviet heresies, the Party allocated an important role to the banking and monetary systems.⁴⁰
- *Western capitalism*: Mao Zedong had long preached fiscal conservatism.⁴¹ China was wedded ideologically to 'self-reliance' and 'a balanced budget with a small surplus' from one year to another which accumulated 'huge sums for large-scale construction'.⁴² The international financial system, with its deficit finance and foreign loans, was viewed with grave suspicions.⁴³ Furthermore, the United States was widely regarded as beset by acute problems attributable to the innate defects of capitalism.⁴⁴

³⁷ Professor Liu Gouging, Peking University, and CASS Institute of Economics Deputy Director, 'Seminar on China's economy in the 1980s', *Wen Wei Po*, 8 March 1980.

³⁸ Yang Jisheng, NCNA Tianjin, 'Theories, blueprints, experiments and environment: research and review of the obstacles to reforming the economic structure', *Jingji Yanjiu*, No. 4 (20 April 1982), pp. 20-1.

³⁹ These issues were surveyed with considerable authority early in the reform era by Lin, 'The Reinstatement of Economics in China Today', pp. 2-4, 6-9, 11-8, 20-1 especially. The most prominent Chinese advocate of an overhaul of the 'Stalinist' planning techniques throughout these decades was Sun Yefang who was demonised during the Cultural Revolution as 'China's Liberman' (the leading Russian reform economist).

⁴⁰ For the arguments advanced on the eve of the reform era for rejecting Soviet experience, see Xia Liji, 'Monetary transactions and the current class struggle', *RR*, 16 June 1975. There is one, exceptional example of 'learning' from Soviet reforms. A 1982 analysis of the way ahead for China's banks recalled how they had followed the Soviet model and thus, apart from rural, collective and small-scale enterprises, 'provided only credits for fixed capital assets'. Soviet policy-makers had realised the defects of this practice and were providing considerable volumes of circulating capital. Zhao Haikuan, 'Expanding the banks' role in economic adjustment', *Jingji Yanjiu*, No. 4 (20 April 1982), p. 64.

⁴¹ For example: 'We should make quite sure that the issuing of notes by the state bank is based primarily on the needs of economic development, and only secondarily on purely fiscal needs'. *Selected Works of Mao Tse-tung* (Beijing: Foreign Languages Press, 1965), Vol. I, pp. 144-5.

⁴² On these principles in the pre-reform era, see *NCNA*, 23 September 1974.

⁴³ Examples of Soviet and Taiwan 'misjudgments' were reported in *NCNA*, 6 and 16 September 1976.

⁴⁴ This viewpoint is brilliantly dissected in David Shambaugh, *Beautiful Imperialist: China Perceives America, 1972-1990* (Princeton: Princeton University Press, 1993).

China's own growth experience subsequently seemed to prove that its socialist strategy conformed to the guiding maxim 'practice is the sole criterion for testing truth'. Thus, there was a persistent refusal to believe that China stood to gain from replacing socialism with capitalism, or that the state ought to surrender its active involvement in managing the economy.

- At the end of the first reform decade, one of China's best-known economists insisted that the new measures (especially in agriculture) were part of 'the production process for improving efficiency in a socialist economy'. Socialism had not failed or been rejected by the industrial or rural workforces.⁴⁵
- After the collapse of the Soviet Bloc in 1989, the Chinese Communist Party could now acknowledge candidly the substantial benefits enjoyed by a competitive economy.⁴⁶ Nevertheless, the Party declared itself capable of remaining socialist even after public ownership was diluted and state planning gave way to market forces.⁴⁷
- An abiding commitment to Marxism was the first item in 'the socialist core value system' adopted by the Chinese Communist Party in 2006, followed by 'socialism with Chinese characteristics'.⁴⁸ Only in the following year, and in the face of fierce opposition, was the right to private property given formal political endorsement and full legal recognition.⁴⁹

5. Party Priorities

In this ideological climate, rapid adoption of the legal, regulatory, corporate and other processes seen elsewhere as essential to a flourishing, competitive, market economy was neither a universal nor a self-evidently desirable goal. The importation of business models, institutional arrangements and legal and regulatory systems would depend on the economy's practical needs in any particular period. Ideological and historical reservations about the benefits of imitating foreign models were reinforced by abiding mistrust of alien business ethics. Despite Deng's 'open door' initiatives, there were still considerable misgivings a decade later among local officials in Guangdong province about the Hong Kong entrepreneurs who were transforming its fortunes.⁵⁰ In 1991, government departments were

⁴⁵ Justin Yifu Lin, 'The Household Responsibility System in China's Agricultural Reform: A Theoretical and Empirical Study', *Economic Development and Cultural Change*, Vol. 36, No. 3 (April 1988), pp. S219-20.

⁴⁶ Zheng Bijian, 'Pen talk on arming the whole Party with Comrade Deng Xiaoping's theory of Building Socialism with Chinese Characteristics', *RR*, 11 December 1992, part 1. The author was a member of the Chinese Communist Party Central Committee and Vice President of the Chinese Academy of Social Sciences.

⁴⁷ Zheng Bijian, 'Pen talk on arming the whole Party with Comrade Deng Xiaoping's theory of Building Socialism with Chinese Characteristics', *RR*, 12 December 1992, part 2.

⁴⁸ The list continued with 'patriotism, the spirit of reform and innovation and the socialist sense of honour and disgrace'. On the continuing campaign to promote these values, see Jia Qinglin, National Committee of the Chinese People's Political Consultative Conference Chairman, 'Top political advisor stresses socialist core value system', *NCNA*, 13 December 2010.

⁴⁹ 'The law approved by the national legislature in March after repeated revisions and unprecedented eight readings ... had met with doubts and opposition from people who argued private property should not be leveled with state property'. 'Landmark property law takes effect', *NCNA*, 1 October 2007.

⁵⁰ Hu Junkai and Mei Minhui, 'He Chunlin, State Council Special Economic Zone Office Director, comments on the creation of China's Economic and Technological Development Zones', *Liaowang* (overseas edition), No. 16, (20 April 1987).

reported to be deliberately unhelpful to foreign-owned enterprises on the grounds that they were a form of 'national betrayal', whose benefits were appropriated entirely by their overseas owners.⁵¹

This hostility extended to banking. A member of the Shanghai Institute of International Studies complained of the profit-driven, unethical and unscrupulous behaviour typical of foreign businessmen. But he also acknowledged that the city needed overseas capital and knowhow for its 'development as an export-based economy' and 'to recover its status as Asia's financial centre'. For this reason, more international banks should be attracted to the city albeit subject to 'careful supervision' including measures to prevent them from exploiting their superior commercial and financial strength to undermine China's own banks. There was no question, this article made clear, of any sort of integration into the global financial system. Foreign access to China's financial markets was strictly to meet current shortfalls in the nation's own banking industry.⁵² As a result, China did not follow the pattern of banking liberalisation that was widely adopted elsewhere in this period. Its policy-makers did not convert to the growing consensus worldwide that freeing financial markets from bureaucratic restrictions was the most effective way to accelerate growth rates, expand credit facilities and promote investment.⁵³

6. Reinventing the Wheel

Banking reform and modernisation commanded little attention from China's leaders during the period in which the nation started first to open to the outside world and then to embark on liberalisation and other reforms, according to the Chinese Communist Party's own historians. They set the starting point for this modernisation process as January 1972 when Mao Zedong and Zhou Enlai brought to an end 'China's prolonged exclusion from the outside world'.⁵⁴ They recorded the subsequent deliberations and decisions on every aspect of the nation's economic policy and institutions. But their account of 1970-90 barely noticed the role of banks in this period of dramatic change.⁵⁵ Independent academic

⁵¹ Zheng Baoyin and Han Qi, 'Management problems in foreign trade', *Guoji Maoyi Wenti*, No. 2 (28 February 1991), pp. 10-11.

⁵² Xu Xinli, Shanghai Institute of International Studies, 'Analysis of the efficiency of enterprises using the "three [i.e., foreign] capital sources" in Shanghai', *Caijing Yanjiu*, No. 1 (3 January 1991), pp. 22-3. The author was a respected researcher who specialised in the United States and had well-known views on the nature and problems of that country's capitalists.

⁵³ Among the influential examples of the ample research presented in favour of such views are Mark J. Flannery, 'Using Market Information in Prudential Bank Supervision: A Review of the U.S. Empirical Evidence', *Journal of Money, Credit and Banking*, Vol. 30, No. 3, Part 1 (August 1998), pp. 297-8; Romain Ranciere, Aaron Tornell and Frank Westermann, 'Decomposing the Effects of Financial Liberalization: Crises vs. Growth', *National Bureau of Economic Research Working Paper 12806* (December 2006).

⁵⁴ Party History Research Centre (compilers), *History of the Chinese Communist Party — A Chronology of Events (1919-1990)* (Beijing: Foreign Languages Press, 1991), p. 356.

⁵⁵ There were only four relevant references by December 1990 (which marked the end of the Seventh Five-year Plan and of the first phase of modernisation). *ibid.*: p. 399 (creation of the Financial and Economic Commission 1979); pp. 453 and 489 (monetary stability 1985 and 1987); p. 473 (invigoration of rural banking 1987).

researchers have also given scant attention to the banks' contribution to the economy's take-off.⁵⁶

Not surprisingly then, the first five-year plan of the reform era assigned a relatively modest role to the banking system. Out of the total RMB360 billion to be invested in capital construction and to 'update equipment' between 1981 and 1985, the banks were expected to provide only 15 per cent.⁵⁷ These unambitious targets seemed very realistic, because the first challenge for the industry was not the modernisation of its management and regulatory arrangements or the extent to which the market should replace state control. The most pressing issue was the fact that the nation had no financial infrastructure to support market activities except at village or street level.

The banking industry was able to rise to this challenge. It had never totally lost its professional skills, thanks to an important but often overlooked feature of the mass campaigns of the Maoist era. These had placed considerable stress on self-reliance in solving local problems,⁵⁸ and the official media had lavished praise on local initiatives to promote sound credit and accounting practices.⁵⁹ Nevertheless, conventional banking had virtually ceased to exist and needed to be rebuilt almost from scratch.

As the shift away from central planning got under way, enterprises could no longer rely on state plans for the information they needed about the costs and availability of their inputs and on potential demand for their output. In 1980, Shanghai had organised an economic information network that covered six provinces. Its first step was to identify market prospects for consumer products, particularly electronics and white goods.⁶⁰

Previously, the bulk of the nation's industrial output had been distributed through state agencies. There had been no need for a banking infrastructure to handle payments to suppliers or to finance consignments to purchasers. Now enterprises had to negotiate their own contracts with their suppliers and customers and to arrange the financing involved. In 1980, the People's Bank began to create a payments system. Shanghai was authorised to provide the equivalent of letters of credit to cover the city's business transactions.⁶¹ These arrangements facilitated the introduction of economic

⁵⁶ In an authoritative account of the first reform decade, banks were mentioned only incidentally apart from some discussion of the emergence of individual cities as financial markets with their own institutions and products. Dorothy J. Solinger, *China's Transformation from Socialism: Statist Legacies and Market Reforms 1980-1990* (Armonk: M. E. Sharpe, Inc., 1993), pp. 88, 184-8, 213 especially.

⁵⁷ *The Sixth Five-Year Plan of the People's Republic of China for Economic and Social Development 1981-1985* (Beijing: Foreign Languages Press, 1984), pp. 34, 38.

⁵⁸ The case for such populism was summarised cogently in 'China's Peasants Advance Valiantly Along the Road Pointed Out by Chairman Mao', *Peking Review*, Vol. 9, No. 48 (25 November 1966), pp. 6-9. See also 'The foolish old man who removed the mountains', *Selected Works of Mao Tse-tung* (Beijing: Foreign Languages Press, 1967), Vol. III. The Maoist conviction that the 'masses' could solve their own problems (provided that the Party provided correct ideological leadership) reached its zenith with the overthrow of almost all normal organs of government at the start of the Cultural Revolution. Roderick MacFarquhar, *The Origins of the Cultural Revolution, 2: The Great Leap Forward, 1958-1960* (Oxford: Oxford University Press, 1983), p. 335.

⁵⁹ Significant 1972 initiatives to develop lending strategies to upgrade China's technology were recalled in He Zisu, *NCNA*, 3 August 1981.

⁶⁰ *NCNA*, 11 June 1981.

⁶¹ *NCNA*, 1 November 1980.

agreements between provinces, regions and cities as the scope of central planning shrank.⁶² The financing of these deals had a great deal in common with barter, compensation trade, investment project finance and joint ventures that were being adopted to expand China's foreign trade in this period.⁶³

Under the 'command economy', China had been 'demonetised' not only as a consequence of state planning (which minimised the volume of monetary transactions within the economy) but also by an ideological conviction that the role of money ought to be reduced in order to limit the opportunities for capitalist activities and attitudes.⁶⁴ As state plans gave way to the market, the expansion of banking services was dramatic.

- In 1978, total bank lending was RMB210 million. By 1990, the total was RMB1.5 billion.
- In 1978, there were only 5,650 retail savings outlets. By 1990, the total exceeded 50,000.
- The contribution of the financial system to GDP growth rose from 52 per cent in 1979 to 80 per cent in 1990.⁶⁵

The banks' processing and communications systems had difficulty in coping with growth on this scale. The backward state of the nation's telecommunications was a considerable obstacle. Banks could not easily transfer funds between branches and head office, it was claimed in 1986, so that the banking system had substantial balances which remained underutilised.⁶⁶ Customers' transactions were equally constrained. Cheque facilities had disappeared in the mid-1950s. This service was reintroduced very tentatively in 1984, with an official warning that the nation lacked the facilities to handle cheques on a national basis in the near future even for business enterprises.⁶⁷ Until October 1986, depositors could only withdraw funds from the branches where they had been paid in because there was no way to remit money from one branch or city to another. The creation of a national payment and remittance system for the public began with the Industrial and Commercial Bank when a handful of its 20,000 outlets were provided with direct telephone links to head office instead of relying on 'the public post offices telegraph service'. Previously, its customers had 'to carry large bundles of cash' to settle transactions.⁶⁸

⁶² For examples of these initiatives, see Leo Goodstadt, 'Banking on Change', *Asiabanking* (June 1986), p. 28.

⁶³ Hou Yunchun, 'Improve regional cooperation by making the best use of local conditions and retaining advantages while eliminating disadvantages', *RR*, 2 August 1985.

⁶⁴ See Xia, 'Monetary transactions and the current class struggle', *RR*, 16 June 1975.

⁶⁵ Li Maiqi *et al.*, People's Bank Finance Institute Task Force (Wuhan Branch) 'Reflections on financial reform in China in the 1990s', *Jingji Yanjiu*, No 7, (20 June 91), p. 55.

⁶⁶ Liu Hongru, 'Strengthen the central bank's macroeconomic regulation and control', *Jingji Yanjiu*, No. 10, 20 October 1986, p. 39.

⁶⁷ According to the People's Bank. *CD*, 30 October 1984.

⁶⁸ *NCNA*, 29 September 1986.

Only at this point did it become practical to focus on management issues. Effective head office management of branch operations is imperative in this industry. For China in the 1980s and early 1990s, this goal was virtually unattainable, the PBOC Governor was to admit in 2004, because of the backward state of the nation's telecommunications.⁶⁹

7. Banking without a Blueprint

Throughout the period in which banking was reinventing itself, the industry was left without a blueprint for its future modernisation. State Councillor Chen Muhua, Chairman of the People's Bank, admitted openly that 'there is no standard model that can be followed' in reforming the nation's banks. On this topic, she explained, opinions were bitterly divided between conservatives who urged caution and critics who claimed that the banking system was in serious need of radical overhaul. Chen identified two features of the banking industry which limited the level of liberalisation and deregulation to which it could aspire.

- *Foreign experience*: While acknowledging that 'China needs advanced foreign experience in improving its banking system', it was not possible to adopt 'ready-made models' from abroad. (This constraint was in marked contrast to manufacturing whose breakneck growth depended on the importation of foreign knowhow as well as capital).
- *Liberalisation*: There would be only limited scope for reducing state controls over the banks. 'Since banking is an important life-line of the state economy', she insisted, 'it must be kept firmly in the hands of the state'.⁷⁰

In the following decade, banking reform remained constrained. Liberalisation could not go as far as in manufacturing for example, it was decided, and the state rather than the market would control the banks' priorities and, in practice, their profits as well. This policy was defended as necessary to counter financial instability and inflation. In 1992, for example, monetary stability was portrayed as the primary duty of the banking sector, whose priority ought to be 'strict control' of the money supply and 'governments at all levels should ensure that lending plans are strictly enforced by local banks'.⁷¹

The start of the Asian financial crisis in 1997 provided banking reformers with compelling evidence that stability and integrity mattered because, the PBOC Governor later pointed out, a 'fragile financial regulatory system was the main reason behind the financial crisis'. The former 'command economy'

⁶⁹ Zhou Xiaochuan 'Improve Legal System and Financial Ecology', Chinese Economists Forum (2 December 2004), p. 2.

⁷⁰ Wang Jienan and Ding Xilin, *Wen Hui Bao*, 28 March 1987; State Councillor Chen Muhua, People's Bank, *NCNA*, 13 January 1987.

⁷¹ Zhang Jinsheng, 'Strengthen and improve control over the macroeconomy', *NCNA*, 24 December 1992.

had left a legacy of 'enormous financial risks' in the form of non-performing loans which amounted to perhaps as much as 50 per cent of the state-owned commercial banks' total assets.⁷²

Whatever the arguments for putting monetary affairs first, the lack of a blueprint for the reform and modernisation of the banking industry had unfortunate consequences. Although China's banks had met the demands for new services generated by market-driven, high speed economic growth in the previous two decades, the industry's unsolved problems were now too menacing to be ignored any longer. The banks had rightly given first priority in the 1980s to recreating a conventional banking system and financial infrastructure. They had been given almost total freedom to do so, even when they were reintroducing financial practices previously anathema on ideological grounds. The seemingly logical next stage would have been a reform programme to respond to the emergence of a market economy and a burgeoning private sector and the creation of the new legal and regulatory structures needed to achieve stability and efficiency in banking operations.⁷³

Indeed, the original intention had been to do so. In 1980, Deng Xiaoping himself had identified the absence of formal rules and regulations as a major shortcoming for the conduct of public administration at every level.⁷⁴ A PBOC Deputy Governor has pointed out that from 1979, there was a spate of legislative initiatives for the financial sector and its regulation. These measures were designed, however, for 'emerging markets and the transitional period' of economic takeoff. But as the transformation of the economy gathered pace, he complained, the 'inadequacy and incompatibility of our legal rules' became serious hazards for financial institutions and markets.⁷⁵ Part of the problem was that the banks' shortcomings were concealed from outside scrutiny. Institutionally, they seemed to be initiating positive changes, and 'many detailed rules and regulations' were issued by the banks themselves. Up to 1993, these were 'a means of shirking responsibility', the PBOC Governor has recorded, and mainly for show because head offices knew that they would not be implemented.⁷⁶

Attention was distracted from this defect, apparently, by other, much more alarming problems that followed the transition from state planning to market forces. In the late 1980s and early 1990s, the nation's central bankers have pointed out, the cost and profit arrangements for manufacturing and

⁷² Zhou Xiaochuan, Governor PBOC, 'Some Issues Concerning the Reform of the State-owned Commercial Banks', speech at the IIF Spring Membership Conference, Shanghai (16 April 2004) URL: http://www.pbc.gov.cn/publish/english/956/1940/19407/19407_.html

⁷³ Significantly, as late as 1996, the need for legislative and regulatory measures was not recognised in an otherwise probing Asian Development Bank review of banking developments. Christine P. W. Wong, 'Part One: People's Republic of China', in Pradumna B. Rana and Naved Hamid (eds), *From Centrally Planned to Market Economies: The Asian Approach*, Vol. 2 (Hong Kong: Oxford University Press, 1996), pp. 175-80. Similarly, a very useful historical overview of innovation and modernisation pays almost no attention to the chronic obstacles to improved performance by the banking industry. Jianhuai Shi, 'Financial Innovations in China, 1990-2000', *China Centre for Economic Research, Working Paper No. E2001006* (12 October 2001), pp. 3-29 URL: <http://en.ccer.edu.cn/download/479-1.doc>

⁷⁴ Zheng Lin, 'Overhaul administrative law and strengthen the socialist legal system: learning from the "Selected Works of Deng Xiaoping"', *Faxue Yanjiu*, No. 2 (23 April 1984), p. 10.

⁷⁵ Xiang Junbo, PBOC Deputy Governor, 'Improve the Legal System to Prevent Financial Risks', speech at the '2005 High-level Forum of China's Financial Reform' (26 April 2005) URL: <http://www.pbc.gov.cn/english/detail.asp?col=6500&ID=75>

⁷⁶ Zhou Xiaochuan, 'Improve Legal System and Financial Ecology', p. 3.

commercial enterprises had become so grossly distorted that average profitability in China was among the highest in the world. A drastic overhaul of 'accounting standards and general financial rules' was inaugurated in 1993, which commanded urgent political and administrative priority.⁷⁷

At the same time, the banking industry remained particularly vulnerable to the adverse consequences of inadequate financial and corporate structures throughout the economy, a Chinese Academy of Social Science researcher argued in 1995. There was no excuse for the continued delay in releasing the draft legislation to establish modern, commercially-based systems, he declared, while NPLs were mounting, with a significant proportion already beyond hope of collection.⁷⁸ In this decade, progress was held up principally by a reluctance to learn from capitalism. The introduction of modern business corporate structures was delayed for six years by misgivings within the Chinese Communist Party,⁷⁹ and a Party Plenary Session did not approve a proposal that 'shareholders, Board of Directors, management and employees' should be involved in running enterprises until 1999.⁸⁰

8. 'Policy' and 'Relationship' Lending

Nevertheless, the immediate transformation of China's banking performance did not require a complex, comprehensive programme. The remedies were simple, long-accepted, well-understood and ideologically correct. Their introduction had been repeatedly promised since at least the 1960s, and they had been endorsed at the highest levels. All that has ever been required is an end to a flawed system for allocating bank loans. The fundamental problems that China's banks have faced in the current century are little changed from the chronic weaknesses that perturbed the nation's financial overlords well before 1978. The banking industry has continued to be plagued by two lending practices that undermine integrity and stability and which the PBOC Governor publicly highlighted.

- *'Policy' lending*: Banks are compelled to provide loans in compliance with state directives or planning targets instead of on the basis of a proper credit assessment.
- *'Relationship-based' lending*: Banks feel obliged to decide loan requests on the basis of a borrower's official or Party status.⁸¹

⁷⁷ Zhou Xiaochuan, 'Capital Return of State-owned Enterprises', Annual Meeting of China Enterprises Leaders (11 December 2005), p. 3. URL: <http://www.pbc.gov.cn/english/detail.asp?col=6500&ID=102>

⁷⁸ He Dexu, CASS Finance Institute, 'Financial reforms to expand in 1995', *Jingjixue Dongtai*, No. 3 (18 March 1995), pp. 4, 14-5 especially.

⁷⁹ The ideological clashes are summarised in Qin Qiaoping, 'Roundup of opinions on shareholding systems', *Gaige*, No 3 (20 May 91), pp. 59-65.

⁸⁰ Zhou Xiaochuan, 'Improve Corporate Governance and Develop Capital Market', pp. 1, 2.

⁸¹ Zhou Xiaochuan, 'Instability and Evolution of the Financial System', (5 December 2007), pp. 2-3.

Historically, the industry had consistently set its face against both 'policy' and 'relationship' lending.⁸² Even when state control had been paramount, bank staff had regularly refused to offer blind obedience either to planning directives or senior officials. Thus, before the end of the Cultural Revolution and its radicals' disdain for technical expertise, professional banking standards were reappearing, and sound financial management and associated skills were being lauded as essential for the efficient use of financial resources, increased productivity and the prevention of fraud and malpractices.⁸³ In retrospect, it seems clear that in the 1970s, the banking industry's potential contribution to modernisation and economic growth was being recognised on a scale unprecedented since 1949. The industry used its rising status to campaign against both 'policy' and 'relationship' lending.⁸⁴

Within weeks of the launch of Deng Xiaoping's reforms in 1978, a national conference of bank managers was convened and attended by the five deputy premiers responsible for China's entire state planning and economic control apparatus.⁸⁵ The conference highlighted the immediate policy priorities.

- *'Policy' lending*: Enterprises should no longer qualify for banks loans simply because they were included in the state plan. Lending should be based on the borrower's efficiency and ability to service the loans.
- *'Relationship' lending*: The past practice that 'if leading comrades expressed support for a loan, banks normally felt powerless to refuse' should end. For the future, 'if a leading comrade recommends a loan contrary to credit regulations, the bank should not hesitate to resolutely exercise its authority and reject it.'⁸⁶

9. Reforms Come at a Price

Despite the participation of China's economic and financial overlords in the reform forum, its well-publicised endorsement of autonomy for the banks in making loans proved a dead letter, and 'policy' and 'relationship' lending flourished unchecked in the 1980s. The expectation had been that 'responsibility for overall planning should belong to the State Planning Commission while responsibility for policy decisions would belong to the Construction Bank'. In this way, the 'policy' lending fostered by central planning and state controls could be drastically reduced. The bank would

⁸² An early example of resisting 'policy' and 'relationship' lending was hailed in 'Editorial: Red banner on the financial and banking front', *RR*, 8 January 1960.

⁸³ The need for sound banking practices was a regular theme in local broadcasting, for example, even when the bitterest opponents of Deng Xiaoping were at the height of their power in 1975. See, for example, provincial radio services: Guizhou, 23 December 1975; Liaoning, 8 June 1975; Hupei, 15 July 1975.

⁸⁴ Commentator, 'The Construction Bank must guard the passes well', *RR*, 4 July 1978.

⁸⁵ Of this group, four headed the State Planning, State Economic, State Capital Construction and State Agricultural Commissions while the fifth became Vice Chairman of the Financial and Economic Commission set up later in 1979.

⁸⁶ This summary of the conference is based on the report in *NCNA*, 8 March 1979.

decide on the credit worthiness and general commercial viability of the individual borrower.⁸⁷ The rise of market forces proved too rapid and disruptive for this model to work, however.

In the urban areas, the first, tentative steps towards permitting factories and commercial organisations a measure of autonomy were frequently traumatic. State enterprises and agencies were completely unprepared for a world in which their survival would depend on achieving profitability rather than output targets, for winning market share rather than meeting procurement quotas. Management frequently found the new environment no more rational or efficient than the 'command economy' of the past. The reforms often left entire production lines idle, and factories were abruptly deprived of funds and raw materials.⁸⁸ The banking system was generally forced to absorb the immediate losses incurred in the retreat from central planning, with disastrous consequences for its solvency.⁸⁹

An added complication was that planning was being dismantled in the 1980s but not abandoned. A mismatch between the plan and market forces became acute. Officials and their plans and directives remained in overall control, but these could not easily adjust the national product mix to changing demand, especially at the retail level. Thus, state-owned factories could be compelled to meet specific output quotas but the public could not be forced to buy their products at the official prices.⁹⁰ At the end of the first decade of reform, stockpiles of unsalable products were mounting, and industrial enterprises faced substantial losses 'because their products could find no market'. The planners' inability to respond rapidly to changing market trends was said to be particularly serious in the export sector.⁹¹ To a large extent, the banks were saddled with the continuing cost of covering the losses created by the state plans.⁹² In 1990, 70 per cent of lending went to poor-performing enterprises in this category, with a further 15 per cent certain to default from the outset.⁹³

Reforms also transformed the balance between central and local finances. In the 1980s, an astonishingly swift and sweeping devolution of financial power from Beijing to local governments got underway, whose costs would be passed on to the banking industry.

⁸⁷ The proponents of this solution were careful to state that the Construction Bank's decisions would be subject to State Council approval. Yang Peixin, 'A review of the creation of China's socialist capital market', *RR*, 7 April 1986.

⁸⁸ For an analysis of the strains on management as the planned economy shrank, see Contributing Commentator, 'Strive to develop industrial production, communications and transport with readjustment as the core', *Hongqi*, No. 8 (16 April 1981), pp. 2-4, 8.

⁸⁹ 'It was the financial industry that carried the burden of cost of reform. One outcome was that the banking industry accumulated immense NPLs'. Zhou Xiaochuan, 'Some Issues Concerning the Reform of the State-owned Commercial Banks'.

⁹⁰ For a review of this phenomenon, see Chen Yumin and Lu Lijun, 'Why official prices do not prevail', *Jiage Yuekan*, No 1. (15 January 1991), pp. 27-30.

⁹¹ An insightful contemporary review of this and related problems caused by continuing state control of the economy is Zhang Yanning, 'Facilitating the circulation of production factors to strengthen economic restructuring', *Jingji Guanli*, No. 12 (5 December 1990), p. 5. It should be noted that the phenomenon of warehouses filled with products for which no markets could be found had been denounced frequently during the previous era of total state planning.

⁹² This burden on the banks had become standard in the 1980s. Xue Muqiao, 'Postscript to the Japanese Translation of the Revised Edition of 'China Socialist Economy'', *Jingji Yanjiu*, No. 10 (20 October 1986), p. 33.

⁹³ Li *et al.*, 'Reflections on financial reform in China in the 1990s', p. 57.

- In 1984, the State Planning Commission had been responsible for financing 63 per cent of total capital investment within the state-owned sector.
- By 1988, the State Planning Commission's share had fallen to 25 per cent.

A new and alarming complication occurred. At the local levels, central planning was not replaced by market forces. Instead, local governments filled the vacuum. The result was 'a rise in regionalism and powerful local economic interests... regional blockades and duplication of construction projects'.⁹⁴

Even more drastic was the impact of the rural reform programme. The dismantling of state controls over agriculture after 1978 had a dramatic effect on the nation's overall fiscal system and was particularly disruptive of rural finances. The transition from a peasant society to a modern, urban, industrial economy required increased investment in local infrastructure projects and public and social services. Local governments in rural areas were allowed considerable autonomy both in raising revenue and in managing their expenditure, which encouraged a rapid rate of economic development.⁹⁵ Local officials controlled the local economy and its resources. They were free to direct bank lending within their jurisdictions.⁹⁶ They could determine the fate of projects to which the branch had lent money. The careers and living standards of bank staff were at their mercy.⁹⁷

The macro-economic costs of the financial autonomy acquired by local governments proved high. In the 1990s, prices soared, and the 21 per cent surge in 1994 was the highest increase in 30 years. 'The main cause of overheating', according to a distinguished Mainland economist, 'was over-borrowing by local governments'. 'A great deal of local debt ended up as non-performing loans', he added, 'which amounted to 40 per cent of total credits in the state banking sector in the mid-1990s'.⁹⁸ Non-performing loans had reached alarming levels by 1998, and USD33 billion was injected into the four largest banks. The following year, USD170 billion worth of these banks' non-performing assets were transferred to four special asset management companies.⁹⁹ (The impact of this local government autonomy and the 'collateral damage' it has inflicted on the banking sector since 2008 in particular, are discussed in a companion working paper.¹⁰⁰)

⁹⁴ Liu Zewei, 'Reflections on the current planning system and future reforms', *Jingji yu Guanli Yanjiu*, No. 1 (8 February 1991), pp. 1-2.

⁹⁵ Zhou Lianshi, 'Asymmetry of Local Sharing Tax System in China', Department of Economics, Shanghai Administration Institute, pp. 8-9. URL: http://www.kalf.or.kr/new_kalf/data/datafile/06_1.pdf

⁹⁶ 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.

⁹⁷ The subordinate status of the banks and the extent of local economic autonomy are reviewed in Lance L. P., Gore, 'The Communist Legacy in Post-Mao Economic Growth', *China Journal*, Issue 41 (January 1999), pp. 37-8.

⁹⁸ Professor Fan Gung, 'The Chinese economy's secret recipe', *CD*, 24 August 2010. 'International accounting standards' were the criterion for this estimate according to Zhou Xiaochuan, 'Instability and Evolution of the Financial System', p. 2.

⁹⁹ Zhou Xiaochuan, 'Improve Legal System and Financial Ecology', pp. 8-9.

¹⁰⁰ Leo F. Goodstadt, 'China's LGFV Crisis 2011: The Conflict between Local Autonomy, National Interest and Financial Reforms', *HKIMR Working Paper No. 3/2012* (January 2012).

10. Bank Loans and National Crises

In 1997, China's leaders, alarmed by the 'financial scandals in China and the shocking demonstration effect of the Asian financial crisis', intervened directly to end the political impotence of bank personnel. A new system for appointing financial executives was introduced which was intended to restrict the influence of local governments on state-owned institutions. Disastrously, it left unchanged the subordinate status of management in the provincial and lower-level financial vehicles that were mushrooming.¹⁰¹ Overall, local officials still retained far more control over the management of local financial affairs than their banking counterparts even after these initiatives. The PBOC Governor later admitted, for example, that local administrations had proved 'more powerful than the market' in clearing up NPLs. Their officials had superior political leverage and could ensure favourable legal outcomes and cut costs for firms in trouble, he said, as well as arranging that local bankers agreed to the restructuring of outstanding bank loans.¹⁰²

The Asian financial crisis marked a turning point in China's banking development, nevertheless. There was convincing evidence of how toxic was official interference with the banks' lending autonomy. A PBOC investigation into the causes of the state-owned banks' NPLs estimated that 70 per cent fell into the categories of 'policy' and 'relationship' loans.

- 60 per cent of the NPLs were the result of lending in response to 'intervention by the central and local governments [and]...mandatory credit support to state-owned enterprises'.
- 10 per cent were 'write-offs' caused by the retreat from state planning and the subsequent 'industrial restructuring' which led to 'closing down, suspending operations, merging [enterprises] with others or shifting to different lines of production'.
- 10 per cent of delinquent loans had to be written off because of the 'poor legal environment and weak law enforcement'.
- Only 20 per cent of non-performing loans could be attributed to inefficiency and managerial incompetence.¹⁰³

China's central bankers were able to convince the nation's leadership that the elimination of 'policy' and 'relationship' lending was crucial for financial stability and to build a modern banking system. In November 1997, both were formally banned once more, and 'the central and local governments... prohibited from interfering with loan decisions'.¹⁰⁴ The largest banks would adopt 'corporate transparency ... and supervision based on international accounting standards and external audit

¹⁰¹ This analysis is based on Sebastian Heilmann, 'Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry', *China Quarterly*, No. 181 (March 2005), especially pp. 6, 9, 14-5.

¹⁰² Zhou Xiaochuan, 'Improve Legal System and Financial Ecology', pp. 8-9.

¹⁰³ Zhou Xiaochuan, 'Some issues concerning the reform of the state-owned commercial banks', and 'Instability and Evolution of the Financial System'.

¹⁰⁴ Zhou Xiaochuan, PBOC Governor, 'Instability and Evolution of the Financial System', pp. 2-3; 'Some issues concerning the reform of the state-owned commercial banks',

requirements' so as to be able to launch international IPOs. Banking, together with the insurance and the securities industries, would be subject to new regulatory commissions.¹⁰⁵

These reforms did not prevent the emergence of a new stage in 'policy' and 'relationship' lending. Predictably, the threat to financial and monetary stability came from local governments. By the 1990s, many areas had found that their new local industries were no longer competitive, and they faced budgetary crises. Local officials had to turn increasingly to illegal, extra-budgetary financial arrangements in order to ensure their own political survival.¹⁰⁶ Technically, these bodies had no legal power to borrow money directly or through providing guarantees for the borrowings of other entities (including their own special purpose vehicles). Local governments found it impossible to comply with the law because they lacked the revenue resources to supply essential public services and to promote economic and social development badly needed by their local populations.¹⁰⁷

Beijing has made repeated efforts in this century to reform local government finances with mixed results. In many areas, these governments were either already or almost insolvent, either through real poverty or mismanagement. Funding from the national budget was not enough to cover their deficits, and they found it virtually impossible to shrink their payrolls in the absence of social security and a shortage of alternative job opportunities. In effect, local administrations have been allowed a degree of financial autonomy — both legally and informally — which has been beyond their capacity to manage.¹⁰⁸ The national leadership had to tolerate this state of affairs, it has been argued, as part of the price to be paid for continuing rapid economic development. In addition, a powerful case has been made that banking reforms failed to take drastic enough action to alter the political arrangements which allocate control over finances and decision-making to local officials. Their autonomy has been almost never challenged 'except for scandal-driven discipline enforcement in individual cases'.¹⁰⁹

11. Reforms Reversed

The onset of the 2007-09 global financial crisis saw a deliberate revival of 'policy' and 'relationship' lending. In an urgent effort to counter the effects of world recession, a USD586 billion stimulus package was announced in 2008. The central authorities provided less than 30 per cent of this funding, and local governments were expected to finance much of the outstanding balance. But

¹⁰⁵ The regulatory developments are summarised in Hui Huang, 'Institutional structure of financial regulation in China: Lessons from the global financial crisis', *Journal of Corporate Law Studies*, Vol. 10, Part 1 (April 2010), pp. 222–3.

¹⁰⁶ Mingxing Liu, Zhigang Xu, Ran Tao and Fubing Su, 'Rural Tax Reform and the Extractive Capacity of Local State in China', pp. 8-11. URL: <http://www.princeton.edu/~pcglobal/conferences/beijing08/papers/Liu.pdf>

¹⁰⁷ Era Dabla-Norris, 'Issues in Intergovernmental Fiscal Relations in China', *IMF Working Paper WP/05/30* (February 2005), p. 15.

¹⁰⁸ Ran Tao and Ping Qin, 'How Has Rural Tax Reform Affected Farmers and Local Governance in China', *China & World Economy*, Vol. 15, No. 3 (2007), pp. 28-30.

¹⁰⁹ Sebastian Heilmann, 'Policy-Making and Political Supervision in Shanghai's Financial Industry', *Journal of Contemporary China*, Vol. 14, No. 45 (October 2005), pp. 643-68.

expenditure on this scale was totally beyond their resources.¹¹⁰ Nevertheless, in 2008, the global financial crisis and China's fear of imported recession were so menacing that local governments were publicly and authoritatively encouraged to ignore the legal prohibition on raising loans.¹¹¹ The Ministry of Finance hoped that local governments would raise additional funds through issuing bonds but only a mere USD29 billion could be raised in this way in 2009-10¹¹² because of the miserable credit status of such borrowers.¹¹³ The Ministry then gave consent to the sale of publicly-owned land by local governments, reversing the previous policy of ending their dependence on land sales. By now, however, these land receipts were the only hope of repaying their swollen borrowings,¹¹⁴ and local governments 'constantly violated state law' to fuel the property boom, according to China's Auditor General, Liu Jiayi.¹¹⁵

The losses, bubbles and malpractices that occurred between 2008 and 2010 have been dissected both by China's regulatory bodies and by the IMF. In 2010, the extent to which local governments had funded their share of the 2008 economic stimulus package through unlawful transactions involving real estate was denounced. The legality of local governments' expropriation and sale of sites in rural areas was usually dubious and provoked serious political and social unrest, according to the official media.¹¹⁶ The scandals uncovered in the financing of the economic stimulus package provided disturbing evidence of: how damaging corruption had become.¹¹⁷ The Chinese Communist Party and the state have now identified financial reform and banking regulation as essential in 'the long-haul, complicated and arduous... undertaking of combating corruption and building a clean government'.¹¹⁸

The bills for the misjudged policies and the financial excesses mounted rapidly, just as they had done after the Asian financial crisis. In 2011, PBOC responded to fears about the adequacy of the banks' capital provisions by allowing USD438 billion of their loans to local government financial vehicles

¹¹⁰ They had run out of both cash and credit before the end of 2009. National Development and Reform Commission, 'NDRC to review status of stimulus driven projects', *CD*, 18 September 2010.

¹¹¹ Mu Hong, National Development and Reform Commission Vice Director, reported in 'Top official: Severe challenge for China to stop slowdown in economic growth', *NCNA*, 14 November 2008.

¹¹² 'Local bonds of Liaoning, Tianjin set for sale', *RR*, 14 April 2009; '9b yuan Sichuan province local bond sale to open on Wed.', *NCNA*, 8 April 2009; 'China to sell local gov't bonds next week', *NCNA*, 18 June 2010.

¹¹³ Jing Ji, 'Local govts may be allowed to issue bonds', *CD*, 23 October 2008.

¹¹⁴ Details were extensively reported in *CD*: e.g., Wang Zhuoqiong, 'Officials punished for misuse of funds', 16 October 2009; Hao Yan, 'Local govts "want land sales" to pay back loans', 23 June 2010; 'Proceed cautiously on land-based funds', 13 October 2009.

¹¹⁵ 'China's local gov'ts 3 trillion yuan in red with infrastructure, stimulus spending', *NCNA*, 23 June 2010.

¹¹⁶ See the critical observations of Professor Ye Jianping, Renmin University and Huang Xiaohu, China Land Science Society Vice President, reported in *RR* and *NCNA*, 27 December 2010; Ministry of Land and Resources, 'China stresses rightful use of rural land, protection of farmers' rights' and 'Chinese supreme court pledges to protect citizens' rights in demolition cases', *NCNA*, 16 February 2011; Liu Jiayi, National Audit Office Auditor General, *NCNA*, 23 June 2010; State Council, 'Chinese central government says no to forced eviction of farmers', *NCNA*, 3 April 2011.

¹¹⁷ Wen Jiabao, 'Chinese premier stresses clean governance amid economic slowdown', *NCNA*, 24 March 2009; He Guoqiang, CCPCC Commission for Discipline Inspection Head, *NCNA*, 25 November 2011.

¹¹⁸ White Paper, *China's Efforts to Combat Corruption and Build a Clean Government* (Beijing: State Council Information Office 2010), chapter v, 'Prevention of Corruption through System Reform and Institutional Innovation'.

(LGFVs) —about a third of the total — to be reclassified.¹¹⁹ ‘Policy’ lending had returned with much the same adverse consequences as had been denounced in the immediate aftermath of the Asian financial crisis. But there was an extra dimension. The China Banking Regulatory Commission held the banks themselves responsible. They were free agents and willing partners in the illegal but temporarily tolerated transactions. They were motivated by the ‘excessive profits’ offered by ‘a widening gap between lending and deposit rates’. The Commission pledged that tighter regulation and market reforms would now be introduced to eliminate ‘unscrupulous and unhealthy financial institutions’.¹²⁰

In consequence, there was a renewed awareness of the continuing threat from China’s two intractable banking defects, and a vigorous demand for the autonomy to monitor and supervise professionally — which is the same goal that inspired opposition to ‘policy’ and ‘relationship’ lending in previous decades..

- *‘Policy’ lending*: The most ambitious call was for state controls on interest rates to be abolished which would set the banking industry free to compete directly for business. This demand was justified by the resilience with which the banks came through the global crisis, according to Bank of China’s Chairman, Xiao Gang.¹²¹
- *‘Relationship’ lending*: ‘Supervisory authorities must have and should have the mandates and independence to do their jobs and to resist any relaxation of supervisory and regulatory standards over time’, the China Banking Regulatory Commission has asserted, and ‘supervisory practices should be invasive and interactive’.¹²²

12. Will History Repeat Itself?

Currently, a new form of ‘policy’ lending is on the horizon. China, it might be argued, has entered a ‘post-reform’ era. The problems encountered in implementing the 2008 economic stimulus package described above demonstrate how limited is the state’s power to directly manage economic activities. The banking system is now becoming the state’s last lever in enforcing national planning goals and policy directives. In some cases, the official objectives involve social, environmental and other ‘non-economic’ benefits. In other cases, the objectives may be mixed. ‘Policy’ lending has been modified accordingly, and now has two forms.

¹¹⁹ ‘China to re-book some local govt loans’, *CD*, 15 August 2011.

¹²⁰ ‘Banking regulator urges structural reforms’, *NCNA*, 24 October 2010.

¹²¹ Xiao Gang, Bank of China Chairman, ‘Liberalize interest rates further’, *CD*, 7 January 2011.

¹²² Liu Mingkang, CBRC Chairman, ‘Six Things that Make Us Concern[ed]’, Keynote Speech at the 16th International Conference on Banking Supervision, Singapore (23 September 2010) URL: <http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=201010120E599F9AB245D490FF5BE7AD5A279B00>

12.1 Lower Profits, Slower Growth

The first type does not increase the volume of NPLs. The losses come in the form of missed profit opportunities and economic growth foregone when banks are instructed to restrict lending to particular sectors of the economy. The notable example is the government's drive to halt expansion of the car industry. Between 2007 and 2010, state and PBOC directives were issued to promote the 'environmentally-friendly loan' and to halt lending to 'high-energy consuming and polluting industries' and industries with 'excess production capacity'.¹²³ Among the targets was the car industry which China's planners had asserted as early as 2006 to be suffering from serious over-capacity.¹²⁴

By 2009, China was now the world's largest market for cars, and renewed attention was given to 'eliminating outdated capacity' in this industry.¹²⁵ The National Development and Reform Commission's planners declared that this industry's 'excess capacity would bring vicious competition, and hurt corporate profitability... threatened sustainable economic development and must be "resolutely" stopped'. The industry mounted a successful counter-attack, citing State Information Centre data which refuted allegations of 'excessive capacity' and asserted that the industry was 'manufacturing at 120 per cent of its capacity, and most manufacturers were operating more than 20 hours a day'.¹²⁶ Output and sales continued to boom.¹²⁷ Whatever the social and environmental case for limiting the growth of car ownership, the economic grounds for calling on banks to cut their support for this industry were open to dispute.

12.2 Deficit Finance

The second type is more serious, and involves the state's intervention in the property market where social, banking and macroeconomic interests are in conflict. In 2010, the state was making valiant efforts to bring under control the property bubble triggered by local governments' financial crisis. To curb speculative activities, state-owned enterprises were directed to liquidate their property holdings

¹²³ Pan Yue, State Environmental Protection Administration (SEPA) Vice Director, 'More efforts needed to implement environmentally-friendly loan policy', *NCNA*, 13 February 2008; Hu Xiaolian, 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>. The industries affected were steel, cement, plate glass, coal chemical, poly silicon, and wind power. 'China to speed up elimination of outdated production capacity', *NCNA*, 21 January 2010. The People's Bank called for 'strict controls on market access, reinforced environmental supervision, and tougher controls over land use. *Banks were ordered to lend money for these sectors in strict accordance with present industrial policies*' (emphasis added). 'China to address overcapacity in emerging sectors', *NCNA*, 26 August 2009. Similar examples could be cited from other policy areas, including relocation of existing manufacturing facilities from Shanghai and Guangdong to Western provinces and pricing policies for fuel and power.

¹²⁴ 'New moves to steer China's car sector stability', *RR*, 31 May 2006.

¹²⁵ 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.

¹²⁶ The State Information Centre is an affiliate of the National Development and Reform Commission. *NCNA* covered the car manufacturers' resistance in some detail: Chen Bin, 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', *NCNA*, 23 October 2010.

¹²⁷ 'China faces challenges as auto sales continue to expand in September', *NCNA*, 12 October 2010.

within a fortnight.¹²⁸ In 2011, a new formula for damping down property prices was adopted. The current stock of living space would be increased by 20 per cent through the construction of 36 million units of 'affordable housing' over the next five years, with work on 10 million units to start immediately. The ban on state-owned enterprises in the property market was revoked. They were now ordered to provide funding as well as other resources for the affordable housing programme, a policy U-turn officially reported as causing 'confusion' among the public.¹²⁹

The state-owned enterprises were not the only institutions whose respectability had to be restored. Initially, the government believed — just as it had done in launching the 2008 economic stimulus package — that adequate funding existed to cover the USD766 billion cost of the five-year housing programme.¹³⁰ And as in 2008, local administrations were found to be an indispensable source of funding. The State Council ordered them to increase their support for affordable housing with additional finance to be raised from 'increased land sale premiums, bond issuances and loans for qualified local government financing vehicles (LGFVs)'.¹³¹ Very much the same tactics had been used in 2008-09, and the subsequent LGFV crisis was still not over when this directive was issued. There was no reason to believe that the banking industry would be able to escape significant exposure to local government risk in the urgent drive to fund the affordable housing programme.

13. Conclusions

The scope for clashes between the commercial merits of a loan proposal and state policy had been recognised implicitly in 2009 when the banks were directed to make lending comply with policy in support of the economic stimulus package. 'Market forces' should not be ignored in influencing investment, it had been laid down officially. But, the official statement made plain, the main leverage would be administrative and thus a new form of 'policy' lending'.¹³² The 12th Five-Year Programme is set to expand the scope for such conflicts. The new plan demands 'a complete change of GDP-obsessed mentality'. The 2011-15 goals will be: 'to boost economic growth while improving people's livelihood, noting economic growth should not be realized at the cost of environment and resources'.¹³³ Apart from cars, official discrimination and restricted access to bank loans have already

¹²⁸ '15 days for state firms to plan property withdrawal', *NCNA*, 22 March 2010.

¹²⁹ 'News Analysis: China looks to central SOEs to back low-income housing projects', *NCNA*, 5 May 2011.

¹³⁰ Views on funding were summarised in 'Affordable housing highlighted in curbing China's soaring home prices', *NCNA*, 9 March 2011.

¹³¹ 'China's cabinet urges more support for low-income housing projects', *NCNA*, 19 September 2011.

¹³² Wen Jiabao reported in 'China's overcapacity no relation to central government investment', *NCNA*, 27 December 2009.

¹³³ See Wen Jiabao's remarks quoted in 'Premier Wen stresses reform of government officials' evaluation criteria', *NCNA*, 14 March 2011.

been endorsed as proper means to eliminate over-capacity and obsolete and polluting plants in a very wide range of industries.¹³⁴

Governments everywhere feel free to interfere with investment and other business decisions in order to promote national and community wellbeing even at the expense of economic growth. Nevertheless, in China, this intervention is in conflict with financial officials' long-standing plea to follow the OECD model and reduce the role of the state. Business enterprises ought to be free to make their own decisions about what is in the best interests of their shareholders, the PBOC has insisted in the past.¹³⁵ These official advocates of banking autonomy have the support of the IMF which in 2011 voiced concern about the way that 'commercial banks often act as the channel of monetary policy and as facilitators of fiscal policy', which 'creates large distortions to incentives and places risk on the public balance sheet as contingent liabilities'.¹³⁶

In contrast to the 1997-98 Asian financial crisis, the global financial crisis did not lead to a better understanding among the leadership that greater autonomy for the banks (and their regulators) is essential to the construction of a thoroughly modern financial system. However, with globalisation of the RMB and, inevitably, of China's financial institutions, the banking industry will become more market driven and sensitive to fluctuations in share prices and credit ratings. Commercial considerations will clash increasingly with the current assumption that bankers can be forced to absorb NPLs even if assured that the state will eventually write them off.

¹³⁴ 'Steel, cement, plate glass, coal chemical, polycrystalline silicon and wind power equipment sectors' were listed in late 2009. 'China's overcapacity no relation to central government investment', *NCNA*, 27 December 2009. Shortly afterwards, it was announced that almost no sectors would be unaffected. Under study were 'specific targets to eliminate outdated capacity in fields such as 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.

¹³⁵ See, for example, Zhou Xiaochuan, PBOC Governor, 'Improve corporate governance and develop capital market', *Euro money* 'China Forum: Capital Market and Corporate Governance' (1 December 2004), pp. 1-6. URL: http://www.pbc.gov.cn/publish/english/956/1942/19421/19421_.htm. A strong case for this principle in banking was also made by Wu Xiaoling, PBOC Deputy Governor, 'Remarks', International Seminar on the 10th Anniversary of the Asian Financial Crisis (21 June 2007), p. 4. URL: http://www.pbc.gov.cn/publish/english/956/1946/19467/19467_.html

¹³⁶ IMF, 'People's Republic of China: Financial System Stability Assessment', p. 38.