Copyright

By

Rachel Marie Vought

2010

The Thesis committee for Rachel Marie Vought

Certifies that this is the approved version of the following thesis:

Weathering the Storm: Reforming China's State-Owned Banks

APPROVED BY

SUPERVISING COMMITTEE:

Supervisor: ______________________________

Huayin Li

____

Mark Metzler

Weathering the Storm:
Reforming China's State-Owned Banks

by

Rachel Marie Vought, B.A.

Thesis

Presented to the Faculty of the Graduate School
of the University of Texas at Austin
in Partial Fulfillment
of the Requirements
for the Degree of

Master of Arts

The University of Texas at Austin
August 2010

Weathering the Storm:
Reforming China's State-Owned Banks

by

Rachel Marie Vought, M.A.

The University of Texas at Austin, 2010

SUPERVISOR: Huaiyin Li

State-owned banks in China have been among the last institutions to undergo reform. Over the last ten years, new institutions and regulations have been created and the banks have undergone a process of divesting themselves of bad policy loans in preparation for public listing. Three of the "Big Four" are now exchanged on Chinese stock markets, though majority ownership remains with the state. The recent reforms of China's financial system have been tested by a financial crisis that has toppled banks around the world; yet China's banks remain profitable. They have been able to weather the storm because of the unique institutional relationships they have with various state vehicles. In particular, state ownership as manifested through asset-management companies have given the Chinese banks an edge over the international competition. However, this relationship is not without its risks. There still remains a great deal of dependence within China's financial system on the state and its favorable policies, subjecting the banks to continued interference.

TABLE OF CONTENTS

Introduction………………………………………………………………………… 1

Banking Reform in China……………………………………………………2

Literature Review……………………………………………………………7

Overview……………………………………………………………………13

I. Chinese Banking History……………………………………………………18

1948-2003…………………………………………………………………...19

2003-Present…………………………………………………………………27

AMCs and NPLs……………………………………………………………42

II. International Comparisons……………………………………………………46

The Eastern Europe and Russia Case………………………………………48

The Indonesia Case………………………………………………………....51

The India Case……………………………………………………………...56

Conclusion…………………………………………………………………59

III. Impact and Analysis…………………………………………………………..62

Web of Ownership and Investment……………………………………..63

Three Risk Factors……………………………………………………....67

Protective Measures……………………………………………………..74

Institutional Dependence………………………………………………..78

Agricultural Bank of China……………………………………………..80

Conclusion……………………………………………………………………82

Bibliography…………………………………………………………………..86

Vita……………………………………………………………………………89

LIST OF TABLES

Tables

Table 1: State-owned Banks 2007-2009 Figures……………………………………37

Table 2: Lending by State-owned Banks in 2009 ………………………………..41

Table 3: State Ownership of Banks in 2009………………………………………43

Table 4: Provisions and Loan Losses in 2009……………………………………75

LIST OF FIGURES

Figures

Figure 1: Investment/Ownership Structure of State-owned Commercial Banks….65

Figure 2: The Dollar Path……………………………………………………….66

Figure 2: Inflation Wheel ……………………………………………………….68

ABBREVIATIONS

ABOC	Agricultural Bank of China (*Zhongguo nongye yinhang*)
AMC	Asset Management Company (*Zichan guanli gongsi*)
BOA	Bank of America
BOC	Bank of China (*Zhongguo yinhang*)
CAR	Capital Adequacy Ratio
CBRC	China Banking Regulatory Commission (*Zhongguo yinhang ye jiandu guanli weiyuan hui*)
CCB	China Construction Bank (*Zhongguo jianshe yinhang*)
CCP	Chinese Communist Party
CPPCC	Chinese People's Political Consultative Conference (*Zhongguo renmin zhengzhe xieshang huiyi*)
CIC	China Investment Corporation (*Zhongguo touzi youxian zeren gongsi*)
FDIC	Federal Deposit Insurance Corporation
GDP	Gross Domestic Product
ICBC	Industrial and Commercial Bank of China (*Zhongguo gongsheng yinhang*)
MOF	Ministry of Finance (*Cai zheng bu*)
NPL	Non-performing Loan
PBOC	People's Bank of China (*Zhongguo renmin yinhang*)
RMB	Renminbi
SOE	State-owned Enterprise
SWF	Sovereign Wealth Fund
TVE	Township and Village Enterprise
WTO	World Trade Organization

Introduction

The collapse of Lehman Brothers in September 2008 precipitated a banking crisis not seen since the Great Depression. At the time, I was working for the largest U.S. thrift institution, Washington Mutual, and witnessing its death throes. Ten days after Lehman Brothers declared bankruptcy, Washington Mutual was seized by government agencies and sold overnight. For years, the bank had been seeking out riskier and riskier customer bases, offering loans and bank accounts to those who could not or did not understand how to handle them. Short-term profitability preceded cautious growth, and the banks paid the price when everything unraveled. Even at the branch level was this behavior evident; managers encouraged to push products into saturated markets, their own salaries dependent on how many new accounts they were able to open, how many loans approved. Ironically, when Lehman Brothers collapsed, I had already given my manager notice that I would be returning to the academic world to continue studies on China, and could only watch as my former company disappeared a week after my resignation.

This banking crisis and the experience I had, seeing the largest financial institution ever to fail in the U.S. fall to the wayside, led me to question the fundamental structure of the system itself. During this crisis, the U.S. has relied on institutions set up seventy to a hundred years earlier, namely the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve System, respectively. Washington Mutual's collapse called into question the strength of these institutions, which were not equipped to handle such a large collapse, and instead relied on selling what remained of WaMu to its competitor, J.P. Morgan Chase. The U.S. government has shored up banks by giving

them short-term credit, and expecting that the banks will pay them back. This combination of institutional reliance and government bailouts struck me as an interesting way to use a system that had been in place for so many years already.

China, by contrast, has reformed its banking system drastically in the last ten years, creating new institutions and relationships between government and banks. Ten years ago, the system was generally perceived as being "at-risk," and overburdened with bad loans. Recently, however, Chinese banks have grown phenomenally and continued to profit even in the midst of the U.S. banking crisis. How could the U.S. system, with its decades-old structure, appear to struggle when the new Chinese system appears to prosper? This paper aims to explore what the Chinese system looks like, in light of reforms over the last ten years, and what challenges it still faces.

Banking Reform in China

China has changed from an isolated country convulsed with political chaos to one of the world's most dynamic and robust nations. Many scholars on China have focused on the political and economic underpinnings in order to understand how these great changes have not resulted in a dramatic overturn of the ruling elite, and how China is now poised to surpass the United States as the world's largest economy. Much scholarly energy has been spent attempting to peer into the "black box" that is China. The ruling Communist Party has displayed great resilience over the last sixty years, and a great adaptability that is not always appreciated. Many of the reforms undertaken in the last few decades have been appropriate, well timed and thoroughly planned. When we

examine the sequence of reforms we can see new insights into how the Communist Party remains in power despite economic reforms. Less understood is how China's financial system has been altered by the events of the last thirty years. Relatively speaking, change has come very late for China's banks, but has come quickly.

The latest worldwide economic crisis has revealed the complexity of financial systems, as well as their fragility. Banks, like WaMu, that had been considered "too big to fail" were overnight seized by regulators and sold off to competitors. Governments have scrambled to protect their economies by spending trillions of dollars, creating new regulations and seeking out those most responsible for the crisis. China, by contrast, has seen its banking system flourish over the last few years, driven by strong economic growth. These same banks posting record profits now were considered extremely at risk only ten years ago. Riddled with bad debts and completely subject to the state, these banks have restructured and partially privatized and are now among the largest financial institutions in the world. The purpose of this paper is to explore the institutional changes to China's financial system and the banks over recent years.

This paper begins by looking at the most recent changes and what issues they are meant to address in China's economy. I will first move quickly through the formation of the current system from its Maoist legacy to the creation and proliferation of new banking institutions, and delve into systemic risks and threats as well as their possible solutions. What I will find is a system that started deceptively simple, was weakened, then reformed, and now faces difficult challenges in light of the globalized financial crisis. Have these

late reforms strengthened China’s state-owned banks enough to weather the storm? China has learned the lessons of its neighbors during the Asian Financial Crisis and has made, on the surface, the changes necessary for a modern banking system. However, the reforms are not complete, nor thorough enough for us to declare the system sound.

Of all of China's economic reforms since 1978, the banking system has been one of the last to undergo change. It played a key role in driving the reform of state-owned industries by providing stable capital flows that ensured a less cataclysmic transformation to a market economy. After these other economic and social reforms, Chinese banks were saddled with debt in the form of loans made to pay for reform, but those loans were not typically paid back by the recipient industries. In essence, the government used its state-monopolized banking system to fund rapid economic development and ensure social stability. By restructuring banks last, their resources could be mobilized for specific projects. This form of development is not unique to China. Former authoritarian countries such as Russia and even democratic nations like India use state-owned banks to direct economic growth. Each of these nations has selected a slightly different path to banking reform, with varying results.

The Chinese government chose to create new institutions, including asset management companies, *zichan guanli gongsi,* to carry the debt and free the banks to be listed on international stock exchanges. These banks have had to conform to different accounting models, specifically those prescribed by the World Trade Organization, requiring that debt be removed from the books. Over the last seven years, other

institutions have been created to provide support to the fledgling banking industry. However, private banks and foreign banks continue to play a downsized role compared to their state-owned counterparts. Part of this is because of the implicit guarantee afforded to the state-owned banks. Individuals, families and firms in many cases choose the perceived safe haven of state-owned banks over possible higher returns from private and foreign banks.

They have had to navigate treacherous waters these last few years, however, as the American banking system buckled under the weight of mortgage-backed securities, and a much larger volume of derivatives of all kinds gone bad. Despite the challenges, Chinese banks appear to be weathering well. They have taken advantage of government stimulus plans, pet projects, and an (over)heated economy to bolster their growth. These banks have posted large profits year after year when American banks have posted losses or failed outright. The appearance of strength, though, is not an indicator of actual strength. There are still serious problems contained within the system as the banks deal with a worldwide slowdown. Among these problems are non-performing loans, an unstable housing market, and exposure to unpredictable foreign capital flows, or "hot money."

The former state-owned banks have acknowledged these issues and taken steps to protect their positions. However, there is a narrow range of resources and capital markets for them to draw upon. On the one hand, this is an advantage because the banks do not face all the same risks as their American counterparts in raising capital. On the other hand,

it forces them to be extremely dependent on two factors. The first is continued strong, steady deposit growth from customers combined with increases in loans. The second is government support in the form of monetary policy, wherein interest rates and deposit reserve rates are set to deliberately advantage the state-owned banks in the market. Interest rate policy determines the profitability of lending. If the banks borrow money from the central government at a low rate and then lend out to customers at a high rate, they increase their profit potential. The reserve requirement is the amount of capital the banks have to keep in reserve in case of emergencies, though it's really a method of controlling the amount of money in the public market. Lowering this requirement gives the banks more capital to create new loans, and again, increase profit potential.

The government also uses regulations, or outright capital injections. Capital injections have come from the central treasury as controlled by the Ministry of Finance, (*Cai zheng bu*) but can also flow through government-owned asset management companies. Government-owned asset management companies in China are an important tool for state-directed economic investment. They act on the government's behalf as a major shareholder in dominant companies in key industries. They occupy the same positions as investment firms such as Goldman Sachs and Morgan Stanley in the American financial system. One key difference, of course, is that they are owned by the Chinese government and staffed by CCP bureaucrats. Another difference is where the money they invest in certain companies comes from. Aside from dividends they receive from their investments, they are tied to China's sovereign wealth fund. Sovereign wealth funds (SWF) should not be confused with foreign exchange reserves. SWF are separate

investment vehicles using foreign currencies. Not all countries have one (The U.S. does not, though some individual states do). Foreign exchange reserves come from trade surpluses with other nations and government debt (mostly U.S. Treasury bills). Asset-management companies can mobilize these reserves for domestic investments. Before we go further into the structure of China's banking system, however, first we need to see what other scholars have observed about the reforms.

Literature Review

Various scholars have been interested in analyzing the Chinese banking system, particularly since the Asian Financial Crisis of 1997, with the disastrous affect it had on banks in Korea, Indonesia and Thailand. They ask if China – the 800 pound economic gorilla of the region – could face the same disruption. With China's acceptance into the World Trade Organization (WTO) in 2001, many analysts expected a great change in China's financial system, more specifically turned toward liberalization and away from state control.

The socialist model of banking, which China followed explicitly from 1948 until recently, was described in great detail by János Kornai. He noted that the command-style socialist economy was dependent on a centralized banking system, or mono-bank system, wherein all financial transactions and credit flows were observed or controlled by the central government.[1] Under this system, banks are not obligated to make profits; rather, they monitor the accounts of the largest firms and allocate funds depending on

[1] Kornai, János, The Socialist System: the Political Economy of Communism. Oxford University Press. Oxford, England. 1992. Pg 132.

development goals set forth by the central government. In essence, the banks become arms of the bureaucracy.[2] This model was used in the Soviet Union as well as other socialist nations using command economies. As China began to reform its economic system, scholars began to debate what form the banking system would take to support a liberalized economy.

A basic assumption behind the expectations is a general acceptance of a neoliberal strategy for economic development. Neoliberalism is a concept shaped by American laissez-faire economic values, emphasizing fewer government controls in favor of market freedoms. It assumes that the market is a much better "hand" at creating growth than the state. Literature on East Asian economics from as early as thirty years ago, however, dismissed this concept in favor of what Chalmers Johnson called "the developmental state."[3] The developmental state, in contrast to neoliberalism, is a concept shaped by a government's deliberate manipulation of the economy in order to create growth, especially in industries where the market might not have gone on its own. The concept was originally applied to wartime and post-war Japan. The Japanese government created institutions and bureaucracies empowered with incentives and penalties to spur industrial growth. China, while it does not perfectly fit the developmental state model, employs many of the features of one, as well as more market-based features. When looking at banks, scholars have strived to explain the recent changes in light of both of these

---

[2] *Ibid.,* pp 132.
[3] Johnson, Chalmers. MITI and the Japanese Miracle. Kodansha Europe. 1986.

concepts. Three major methods for studying the Chinese banking system have been state-centered, elite-centered, and institution-centered.

The scholars that have chosen to take a state-centered view put all decisions squarely into the hands of the bureaucrats. One such study aimed specifically at the implications of China's WTO entry was done by Chien-Hsu Chen and Hui-Tzu Shih, who traced reforms up through 2003 and made several accurate predictions and recommendations for the state-owned banks. Among these, was that the Chinese state-owned banks were being privatized partially because of "the threat posed by foreign banks"[4] At the same time, however, state-owned banks have been partnering with foreign banks such as Citibank and Bank of America to increase their knowledge base for corporate governance and developing other products and services that they can provide, therefore increasing their competitiveness. An example that we will study in further detail in this paper is the ongoing relationship between the Chinese Construction Bank (CCB) and Bank of America (BOA). Contrary to expectations, the Asian Financial crisis of 1997 initially strengthened the fiscal position of the Chinese state-owned banks relative to private banks. They drew in more customer deposits, allowing for an increase in the traditional deposit and loan business that was not fraught with as much risk as many of the other banking businesses. For our purposes, this study has provided a valuable snapshot of the banking system just after a critical moment in its development – the entry into the WTO, but it has not been updated as the system becomes more liberalized.

[4] Chen, Chien-Hsu and Shih, Hui-Tzu. Banking and Insurance in the New China. Edward Elgar Publishing Limited. UK. 2004. Pg 135.

Increased exposure within the system to international capital has now put these early reforms at risk, and those risks need to be evaluated further. The institutions created in the wake of the 1997 crisis and 2001 WTO entry reflect the ways in which China has attempted to shield itself from future financial crises while also bringing its banking system up to date.

Another study by Connie Chung and Jose Tangzon emphasizes the risks created by not having an independent central banking system. China has long been accused of creating ways in which to keep the financial system under strict control, and one of the primary mechanisms for doing so has been through the People's Bank of China (PBOC), the central bank. This study points out that

> the pervasive stranglehold that the party has over the PBOC negates many efforts made in changing the rules of operation for effective central bank management, which, the authors believe, are only cosmetic in nature.[5]

The government interferes by controlling personnel appointments at the highest level of bank governance, restricting the prime positions to those with the most political awareness. Chung and Tangzon also argue that the central bank is subject to the ongoing push and pull between more conservative and more liberal elements in government, particularly when it comes to funding pet projects through the central bank. A similar study comparing the Chinese and Indian banking systems by Lawrence Saéz also criticized a lack of independence by the Chinese central bank, but more from the

[5] Chung, Connie Wee-we. Tongzon, Jose L. "A Paradigm Shift for China's Central Banking System." *Journal of Post-Keynesian Economics*. Vol 27. No. 1. Autumn, 2004. Pg 87-103. Published by M.E. Sharpe.

approach that it would continue to be plagued by policy lending prerogatives, therefore leading to more bad loans.[6] These claims limit the scope of our understanding of the banking system to simple politics. It also lumps the central bank and local banks together without distinguishing their separate functions, as would be done in an institution-based study such as this one. It could easily be improved by discussing the various different roles of different institutions within the system, rather than looking for cronyism and politics in every corner.

Another strategy, brought forward most effectively by Victor Shih, concerns the near-invisible power play in elite politics. Shih argues, in essence, that all financial reform, or even economic activity since the early 1980’s is the direct result of a power struggle between two different kinds of factions at the highest level of the Chinese polity.[7] These factions, which he labels as “generalist” and “technocrat,” favor expansive and centrally-controlled economic growth and behavior, respectively. The generalist faction, typified by Deng Xiaoping, Jiang Zemin and now Hu Jintao, prefer looser lending practices and explosive economic growth at the risk of creating hyperinflation. The balancing technocrat faction, typified by Chen Yun, Zhu Rongji, and lately Wen Jiabao, prefers to centralize financial policies and reign in extravagant growth. Both factions, Shih argues, still view the banking system in general as an open spigot for their own short-term policy goals. This factor, however, which seems to have been prevalent more in the 1980’s and 1990’s, doesn’t account for the growing complexity within the

[6] Saéz, Lawrence. Banking Reform in India and China. Palgrave Macmillan Press. New York, New York. 2004. Pp 99.
[7] Shih, Victor C. Factions and Finance in China: Elite Conflict and Inflation. Cambridge University Press. Cambridge, New York. 2008.

Chinese banking system today. This complexity stems from the public listing of three of the four state-owned banks, making them subject to shareholders (although majority share still belongs to the state in all cases). If this framework fit in the recent context, we would expect that the crackdowns, regulations, and macro-level fiscal controls derive directly from Wen Jiabao, and have the explicit purpose of expanding his personal power base within the party. However, we see two trends over the last five years: tighter regulations and more common use of macro level controls versus an expansion of the products and devices the banks can use to make a profit above the state-controlled spread. These products and devices include the stock market, trading in gold, and interbank lending. One side would seem to want to control the banks, and the other makes them more financially independent. It is doubtless, though, that the state-owned banks are enjoying much calmer economic waters than other world banks. Shih also says very little of China's WTO entry and the goals the banking sector had to accomplish in recent years, such as meeting capital adequacy standards and allowing foreign banks into the domestic market. China also adopted world accounting standards, which require certain levels of NPLs and capital adequacy ratios that the banks could not have achieved without strong government intervention.

Finally, a more recent study by Violaine Cousin provides the most in-depth and complex overview of the entire system, focusing almost exclusively on the institutions. Her study is recent enough to include the privatization of three of the state-owned banks, and examines the key players among foreign banks, joint-stock banks, and city

commercial banks.[8] Within her framework, however, she does not touch upon the debated independence of the central bank or the state-owned banks, nor does she track the institutional relationship between the banks and the government. In particular, the role of foreign exchange reserves and asset-management companies in maintaining the overall health of the system goes largely unexplored. These are key factors that must be included in any study on recent Chinese banking reform, because the reforms are a both a creator of and product of these factors.

Overview

I examine banking reform using the lens of historical institutionalism. The steps the Chinese government has taken in reforming their financial system over the last ten years are strongly influenced by the circumstances in which they were taken. The fall of the Soviet Union, the Asian Financial Crisis and current financial volatility engender the creation of certain kinds of institutions within China. Institutionalism explains how these institutions have changed over time as circumstances change, while still retaining some of the influences that prompted their creation. Past studies have looked at institutions as unchanging and powerless actors within a web of politics. My studies show that not only do institutions have the capacity to adapt, but they are doing so in order to achieve the strongest position relative to conditions around them. They are not powerless.

My argument focuses on the "Big Four" state-owned banks in China. They have received the most government aid and intervention during the reform process, and three

[8] Cousin, Violaine. Banking in China. Palgrave MacMillan. New York, NY. 2007. Pp 53, 128, 135.

of the four are now publically listed and thus are required to submit annual reports. The fourth bank is not yet listed at the time this paper was written, but was completing the process. In the comparative section, I look at Eastern Europe (along with Russia), Indonesia and India banking reforms. By holding China's reforms up to them, we can see how China has chosen to create different institutions as a consequence of its unique conditions. For sources I have chosen to rely heavily on the banks' annual reports, announcements from Chinese regulatory agencies and Chinese news sources. Annual reports, which undergo a rigorous process of auditing, provide detailed accounts of the health of the bank and what businesses it is engaged in. Banks must report on specific measures, such as their capital adequacy ratio as well as their non-performing loan amounts in addition to how much profit they made. They are also required to divulge who holds ownership of the bank.

I argue that within the complex relationship between the Chinese government and state-owned banks, the strength of the bank depends on asset-management companies being used as vehicles for investing foreign exchange at key times to ensure financial stability. As these banks become more exposed to foreign sources of capital, an implicit government guarantee provides a lifeline in times of crisis. Government influence over the banks remains pervasive despite all of the recent liberalizing reforms. This influence has a downside. It exposes the Chinese banks to the risk of policy-based loans and poor investment strategies they might not have undertaken in a pure market-based setting. These banks are both protected and threatened by continued government control. Within this world, Chinese banks have appeared to weather the recent financial storm with

greater success and temerity than internationally renowned banks. The tools to their success have been the same as those that bind them to the state: the asset-management companies.

The first section outlines the history of banking in China beginning in 1948, taking time to examine the reforms since 2003. Asset-management companies, the major regulatory agency and the sovereign wealth corporation were all created within this short time frame. The banks underwent restructuring and listed on public stock exchanges. They unloaded bad loans onto government-owned asset-management companies in order to meet international accounting standards. Financial meltdown over the last three years has tested the mettle of the reformed system and spurred the government to use the institutions it put in place in order to protect the state-owned banks. These same stimulating measures have opened the door for a new round of bad loans and potential recapitalization of the banks despite their current profitability.

The second section discusses the cases of Eastern Europe (including Russia), Indonesia and India's banking reforms. Eastern Europe and Russia's banking systems before reform shared many features with China's, including being an integral part to the command-style economy. Subsequent reforms have forced the state-owned banks to privatize. Some privatized completely while others remain under the influence of the state. Indonesia's banking system was hit hard by the Asian Financial Crisis but had already been weakened severely by reforms prior to the Crisis. It liberalized its capital markets before setting up strong regulatory agencies and invited rampant speculation and

bad loans to be created. Reforms since 1997 have aimed to recapitalize the system and work toward privatization of the state-owned banks. India's rapidly-growing economy shares features with China's current economic situation, though it chose to reform its state-owned banks years before. Instead of opting for privatization, India allowed new players into the system and forced the state-owned banks to restructure and compete in order to survive. The government allowed interest rates to go unregulated and the banks relied on an already matured security market to find sources of capital. China's banks have partially privatized, but do not have all the same opportunities to raise capital. Instead, they must rely on capital they receive from the asset-management companies and lending quotas from the central bank in order to gain profits. They also have fewer competitors that can challenge their dominance over the financial system, as well as an implicit guarantee from the state.

The last section examines current factors within the Chinese system in detail. Three factors in particular are relevant to the continued health of the state-owned banks. Inflation, non-performing loans and foreign investment and crises have pushed the banks to adopt certain protective measures. These factors threaten the stability of the banks because not all of them can be controlled within the current institutional structure. Inflation is created by many things, including increased lending from a loose monetary policy by the central bank and foreign investment. It prompts the bank to tighten monetary policy by controlling interest rates, which affect the profit potential of the banks as well as their lending portfolios. Non-performing loans are particularly worrisome for the banks because of their history of lending to state projects and state-

owned enterprises. They act as dead weight within the bank and the financial system as a whole, draining capital resources. Foreign investment through stock sales to foreign banks and foreign crises also affect the ability of the banks to raise capital. Foreign banks sell their shares of the Chinese banks to ensure their own health and force the Chinese government to pick up the loose ends. The state-owned banks have undertaken a series of measures to protect themselves from these factors, including provisions and relying on the asset-management companies to bail them out in the event of a downturn. Relying on asset-management companies and the government undermines the independence of the banks. The banks have profited from government-directed stimulus packages but have also continued to finance government-directed projects. Increased lending quotas have led to a lending spree over the last year and a half, increasing the possibility of a new round of bad loans. The relationship between the banks and the government grows increasingly complex and often invasive.

State-owned banks in China are caught between the interests of the state and the need to survive. Asset-management companies are they key institutions between the two, acting as mediator, guardian and shareholder. In order to understand how institutions have been created, and what roles they play within the system, we begin by looking at where the banks originate.

I. **Chinese Banking History**

Before modern banking in China, banking practices were dominated by the "three kingdoms" of *piaohao*, *qianzhuang*, and foreign banks.[1] *Piaohao*, or literally "ticket houses," acted as holding houses between different regions. A farmer would deposit his money in one, receive a note, and when he presented that note in another place, he would receive his money again.[2] *Qianzhuang* issued loans in foreign currency to local merchants wishing to buy from European traders.[3] These three institutions dominated the financial scene until the first modern bank opened in Shanghai in 1897, spun off from imperatives during the self-strengthening movement.[4] Nationalism and a need for reliable capital for industrial growth prompted its creation.

The end of the Qing dynasty saw the eliminations of the *piaohao* and the terminal decline of the *qianzhuang*.[5] The first government in the new Republic of China promoted modern banks as the lifeblood of industry; industry being the foundation of wealth for a nation.[6] From 1912 to 1927 a total of 266 new banks were established.[7] Most were organized by private owners.[8] The government created a central bank out of the remnants of the Qing central bank and renamed it Bank of China, *Zhongguo yinhang*.[9] Elite power

---

[1] Cheng, Linsun. Banking In Modern China. The Cambridge Press. Cambridge, U.K. 2003.
[2] *Ibid.,* pp 13.
[3] *Ibid.,* pp 14.
[4] *Ibid.,* pp 20.
[5] *Ibid.,* pp 37.
[6] Chen Jintao. "Chen Jintao wei niding shumin yinhang zheli qingcijiao canyiyaun yijue shixing chenggao" (Chen Jintao's report to the Senate for implementing the temporary regulations of common people's banks), from CSHA, *Jinneng fagui*. Pp 38.
[7] Cheng, Linsun. Banking In Modern China. The Cambridge Press. Cambridge, U.K. 2003. Pp 41.
[8] *Ibid.,* pp 46.
[9] *Ibid.,* pp 53

politics threatened the survival of both public and private banks, eventually forcing the privatization of government-run banks within a few years of their formation.[10] Over time, banks began to consolidate and merge with each other. After the Nationalists undertook their Northern Expedition in 1926, the country stabilized to the point that banks could flourish.[11] The Great Depression and a currency crisis prompted the Nationalist government to take over the largest banks outright.[12] War with the Japanese broke out after 1937, and banking development would be put on hold until peace was restored by the Communists in 1948.

1948-2003

The history of modern banking in China started with the formation of the People's Bank of China, *Zhongguo renmin yinhang* (PBOC) in 1948 out of the remaining private institutions that had survived the civil war.[13] The Chinese government followed the same route as other socialist nations when setting up a central-oriented, state-owned banking system. At the heart of the system was the PBOC. Having the entire system centralized around the PBOC enabled the government to monopolize capital resources and control investment in key industries during a command-style economy.[14] The concept of a mono-bank system with these features originated under Leninist doctrine, who theorized that only by putting the banks under national control could the government monitor the

---

[10] *Ibid.,* pp 59.
[11] *Ibid.,* pp 67.
[12] *Ibid.,* pp 100.
[13] www.pbc.gov.cn
[14] Healey, Nigel M. and Ilieva, Janet. "The Background to Reform: Central Banking in a Command Economy." Central Banking in Eastern Europe. Ed. Healey, Nigel and Harrison, Barry. Routledge, Taylor & Francis Group. London and New York. 2004. Pg 45.

progress of the economy without giving it over to capitalist elements.[15] However, while this type of banking system gave great control to the government, it could not provide all of the financial services required by a modernizing economy. Therefore, several socialist countries chose to create state-owned commercial banks to carry on more of the day-to-day financial needs of state-owned enterprises and individuals.[16]

The PBOC spun off the Bank of China, Zhongguo *yinhang* (BOC), which was a specialized foreign exchange bank tasked with administering exchange rates and foreign investment.[17] The People's Construction Bank of China, later renamed China Construction Bank, *Zhongguo jianshe yinhang* (CCB), was formed in 1954 to act as the cashier for the Capital Construction Finance Department of the Ministry of Finance.[18] These three banks made up China's mono-bank system, wherein all financial transactions and all credit were routed through the PBOC network. This type of system is not unique to China, but can also be found in the Eastern bloc including former Czechoslovakia. Business loans could only be obtained if they were related to projects approved by the Ministry of Finance and the State Planning Commission. They were not available to ordinary companies or individuals, because the entire market system was centralized around a state-directed planned economy. This system was built around two major principles: steady and increased deposits by customers into the state-owned banks, and government-directed loan allocation. Citizens were encouraged to save their money in

---

[15] *Ibid.,* pp 46.
[16] Kornai, Janos. Highways and Byways: Studies on Reform and Post-Communist Transition. The MIT Press. Cambridge, Massachusetts. 1995. Pg 92.
[17] www.boc.cn
[18] www.ccb.com

these banks, in return for a small amount of interest and a guarantee that their money would be safe. The banks would then use those deposits to fund state-owned enterprises, which dominated the pre-reform economy.

These state-owned enterprises (SOEs) were large, inefficient, and central to the Communist Party's desire for rapid industrial development and social stability. The enterprises were not just massive companies, but were closely involved in the *danwei*, or urban work unit system. Every city-dwelling individual belonged to a *danwei*, which provided housing, food, and education for his children. It was a self-contained environment built around the state-owned enterprise, with a guarantee of lifetime employment (also known as the "iron rice bowl"). When Deng Xiaoping enacted economic reforms beginning in 1978, many of these *danwei* and state-owned enterprises began the process of dismantling and restructuring. Huge amounts of public funds (in the form of unrestricted loans from the state-owned banks) poured into the enterprises as they were reformed. These "policy loans" created an enormous amount of unsustainable debt owed by the enterprises to the banks, and a legacy that remained within the banking system for decades. During the reforms, however, large enterprises were not the only companies undergoing dramatic changes. Small and medium-sized enterprises formed and needed capital of their own. For this, they needed commercial banks with the capacity to loan to all kinds of businesses.

The first commercial bank, Agricultural Bank of China, *Zhongguo nongye yinhang,* (ABOC) was founded in 1978. It was created in order to provide working

capital to state agriculture plans, and provide loans to newly forming township and village enterprises (TVEs) as part of the fledgling market economy growing out of the state-planned economy.[19] China Construction Bank, became independent from the Ministry of Finance in 1983, and that same year, the PBOC was formally designated as China's central bank. In 1984, Industrial and Commercial Bank of China, *Zhongguo gongsheng yinhang*, (ICBC) took over PBOC's commercial banking operations. By 1985, the "Big Four" state-owned commercial banks, Bank of China, China Construction Bank, Agricultural Bank of China, and Industrial Commercial Bank of China, were operating separately, but were still subject to the authority of the PBOC and the Ministry of Finance.

Within the People's Republic of China, the PBOC controls monetary policy while the Ministry of Finance controls fiscal policy. The central bank sets exchange rates, interest rates, and until 2003 it acted as the regulator for banks and their lending policies. The Ministry of Finance works with the national budget, collecting taxes and monitoring government spending and the national debt. Both share a ministry-level position in the central government and acted as owners of the state-owned banks. The Ministry of Finance retains partial ownership of one of the largest commercial banks to this day.

While the government was gradually moving toward an open market economy, it sought to reduce its budget burden by tapping the banks to assume their fiscal responsibilities. Instead of spending money directly from the state budget, the state-owned banks lent money to major industrial firms to cover transition costs. Banks continued to be the primary source of funding for state-owned enterprises (SOEs), which

[19] Naughton, Barry. Growing Out of the Plan. Cambridge University Press. Cambridge, UK. 1995.

received funds for daily operations. This function, as well as their historical lack of independence, has led to widespread criticism that the state-owned banks were merely cashiers for the Chinese government's development projects. These banks did not, in most cases, lend to the small and medium-sized industries as much as they did to the state-owned enterprises. The government maintained a strict credit quota system, which limited the number of loans these banks could create. By requiring them to loan to SOEs, there wasn't room leftover to loan to the Township and Village Enterprises (TVE's). Small and medium-sized enterprises would have to look to other sources for their capital.[*] Inflation concerns in the late 1980's prompted senior leader Chen Yun to impose strict, centrally-directed economic policies aimed at stabilizing and slowing the reform process.[20]

Despite this, the deposits in these state-owned banks continued to grow. One of the reasons behind this growth is that these banks had the implicit support of the state, despite no formal deposit insurance or effective interbank lending system outside of the PBOC lending operations at that time. An interbank lending system is a feature of an advanced capital market, wherein consumer banks will lend to each other for a short time, perhaps as short as 24 hours, to cover operating expenses and meet liquidity requirements.[21] The lending bank is able to charge interest to the receiving bank and

---

[*] Kellee Tsai's research on informal finance in China reveals how small and medium-sized enterprises raise their capital. They rely on social networks, unofficial and often illegal forms of finance to fund operations. The state has not actively policed these operations because they are both too widespread and provide a service that the large state banks do not.

[20] Shih, Victor. Factions and Finance in China: Elite Conflict and Inflation. Cambridge University Press. Cambridge, Massachusetts. 2008. Pg 141.

[21] http://stats.oecd.org

make a profit, without having to deal with the stipulations of the central bank. This option was not available to the state-owned banks, which were dependent on steadily growing consumer deposits and loans from the PBOC. For customers depositing their money into the banks, the common wisdom is that the central State would never allow one of its big commercial banks to fail. Even as the Big Four accumulated more and more bad loans, depositors continued to put their money into them. The banks turned around and lent money out to industries, creating money within the system. At that time, there were few other places to invest. There was, (and still is) no formal deposit insurance in China, so citizens would have to rely on the unspoken word of the state to protect their money. The "big four" banks helped keep the economy stable through much of China's explosive growth in the 1980's and 1990's. They also helped ensure social stability during this dynamic period of history. SOE reform produced turmoil in the urban working class as tens of millions of workers suddenly found their *danwei* dismantled and the iron rice bowl vanished.[22] The state kept many socially and nationally sensitive SOEs afloat, however, largely through continuations of policy loans from state-owned banks. These SOEs, some of which still lumber along today, are responsible for the lion's share of bad loans within the banking system.

Recently the Chinese state has gone through the process of first centralizing, then decentralizing the banking system. From 1993 to 1998, the People's Bank of China went through a restructuring, ultimately giving it a role similar to the United States Federal

[22] Woetzel, Jonathan R. "Reassessing China's State-Owned Enterprises." McKinsey Quarterly. *Forbes Magazine*. July 8, 2008.

Reserve. It set interest rates for loans, determined money supply and continued to act as a tool to control inflation. The purpose of the restructuring was to bring more macro-level economic control to the political center.[23] This was in response to many other commercial banks being allowed to open in China 1986 to 1992, offering competition to the state banks for the first time. These shareholder-owned banks did not have the implicit guarantee that the Chinese government gave the state-owned banks, but did they did not have the mandate to lend to unprofitable SOEs. By 1994, the excessive lending by the state-owned banks to SOEs comprised more than 80 percent of all lending in the banking system.[24] The inability of the SOEs to pay most of these loans back – their burden of providing secure jobs and payroll while improving efficiency even as their market share dwindled – created a growing number of non-performing loans (NPLs) on the banks' balance sheets. At the same time, the PBOC reduced its overall lending to the state-owned banks in order to force them to be more efficient and assume responsibility for their loans to SOEs. The state also created several policy banks: the Agricultural Development Bank, the State Development Bank, and the Import-Export Bank, in order to take over the day-to-day lending to SOEs and other projects the central government wanted to fund. Despite these institutional changes, the overall situation for the state-owned banks did not change immediately. They needed a dramatic series of reforms to save them from insolvency.

---

[23] Shih, Victor. Factions and Finance in China. Cambridge University Press. Cambridge, Massachusetts. 2008. Pg 141.
[24] Allen, Qian. "China's Financial System: Past, Present and Future." Reforming China's State-Owned Enterprises and Banks. Ed. Chiu, Becky and Lewis, Mervyn K. Edward Elgar Publishing Limited. Cheltenham, UK. Northhampton, MA. USA. 2006.

In 1998, in the wake of the Asian Financial Crisis, the government temporarily abandoned the credit quota system, where the state imposed a strict ceiling on lending by the state-owned banks. Removing the ceiling was intended to stimulate more lending from the banks to help grow the economy. A bank's new credit portfolio was, in theory, to be based on its capital adequacy ratio (CAR) and deposit-to-loan ratio, and with the understanding that they would only make loans that had the most likelihood of being paid back. The capital adequacy ratio refers to the cushion of capital that banks keep in order to meet their daily obligations while balancing their outstanding loan balance and deposit balance. According to the Basel I international standards Chinese banks adopted in 1998, the banks had to obtain an eight percent capital adequacy ratio by 2000. By and large, this goal would not be met, even with much government intervention, until several years after the target date. The deposit-to-loan ratio is the comparison between the total deposits a bank has to the total dollar amount of loans outstanding. It indicates whether the bank has enough funds within itself to finance these loans, or if it has to rely on outside lending of its own, such as interbank lending, which is much more costly. In 1998, banks also adopted a new five-tier loan assessment in order to single out which existing loans posed the most risk to the bank's solvency.

These new rules revealed a dangerous situation within Chinese banks. The non-performing loans had grown enough to knock all of the banks out of the international standards for capital adequacy ratios and loan-to-deposit ratios. Without the continued support of the PBOC and an implicit guarantee from the central government, the banks would not likely have survived on their own. Therefore, in 1999, the central government

transferred a total of 1.4 trillion renminbi (RMB) ($169 billion) worth of NPLs to newly established government-owned asset-management companies (AMCs), removing a substantial portion of the bad loan burden from the banks overnight. The asset management companies purchased bad loans and the role of administering those loans from the commercial banks. This resulted in the banks losing a significant portion of their bad loan burden in exchange for fresh capital.

The purpose of the asset-management companies was to resolve these bad loans through auction to other banks and foreign investors. The four asset management companies, Cinda, Orient, Huarong and Great Wall, received 10 billion RMB in initial funding. However, their success, even more than ten years later, has been limited. After passing these loans on to the asset management companies, the government injected 270 billion RMB ($32.6 billion) into the four state-owned banks in order to recapitalize them. These measures were the beginning of a transformation of the state-owned banks from mere "cashiers" of the government to, as the goal was, independently operating, internationally competitive financial institutions.

2003 to Present

In 2003, the banking reform process shifted from a series of centralization and capital injection measures to decentralization and preparation for shareholding status. New support institutions were created and three of the big four banks went up for public offerings. Since 2003, several major reforms took place and the world went from a period of steady growth to the specter of worldwide recession after 2007. New and vital

institutions were established to fulfill key roles within the banking sector. Many of these institutions have been active in non-socialist financial systems for some time. In China, their responsibilities had belonged to larger institutions such as the PBOC before, and only now were they spun off into separate bureaucracies with their own set of governors. Ostensibly this separation has appeared to grant some measure of independence from the older institutions, but only as far as they are still under the aegis of the State Council. Even the newest institutions such as the China Banking Regulatory Commission, *Zhongguo yinhang ye jiandu guanli weiyuan hui*, (CBRC) is ultimately governed by the State Council, just as the PBOC and the MOF are.

Equally important to the creation and empowerment of new institutions, three of the Big Four banks underwent a process of partial privatization and stock sales. The privatization is considered partial because the state retains majority shareholder status in all four banks. They engaged in many of the activities private banks do, but were still subject to influence by the central government because the majority shareholder of all three is a government-owned AMC. The AMCs act as the central government's voice in all corporate matters; their representatives sit on the company boards and direct the overall direction the bank takes. As a financial crisis crashed down on the world in 2007, these reforms and institutions faced their first major test. By 2010, the strengths and weaknesses of the system have begun to show. First, however, we continue with our journey through recent Chinese banking history by taking stock of the situation that banks faced coming into 2003.

It was estimated that at the end of 2001, the four big banks had lent a total of seven trillion RMB ($846 billion), a quarter of which were considered NPLs.[25] The PBOC indicated that it wanted all of the banks to have their NPLs below 15% before 2005. NPLs from banking sector amounted to an estimated 35% of GDP in 2001.[26] The asset management companies, created in 1999, had only disposed of about 16 percent of the 1.4 trillion RMB given to them by 2002. However, these loans were not seen as an immediate threat to the Chinese economy, because they were understood to be a kind of internal national debt, or a debt the government owed to itself, offset by China's rapid economic growth. China had weathered the Asian Financial Crisis because, it was thought, only huge external debts, convertible currency and "hot money" flows could create a financial crisis such as the Asian one in 1997. Furthermore, the government could fall back on its ballooning foreign exchange reserves, amounting to $230 billion beginning 2003. That amount would double in one year, and increase tenfold in seven. This revealed, however, another feature of the Chinese financial system with another potential weakness: the dependence on foreign trade. China's explosive growth in many ways was tied to the huge amount it was exporting to foreign nations. Any disruption in this demand could slow down the economy. This growth, though, was sustained not just through exports, but also through heavy lending from the state-owned banks, upwards of 15 percent more new loans to total loans each year above the year before. These loans, in turn, would inevitably create more NPLs.

---

[25] Zhu Jiadi. "Will a Financial Crisis Break Out?" *Beijing Review*. Vol. 46 No. 1 Jan 16, 2003. Pg 33.
[26] Cousin, Violaine. Banking in China. Palgrave MacMillan, NY. 2007. pg 82.

These inherent risks resulted in the formation of a brand new regulatory agency in 2003. The Chinese Banking Regulatory Commission, or CBRC, was created in order to take banking regulation away from the PBOC. This would free up the PBOC to concentrate solely on monetary policy and fighting inflation while maintaining domestic economic growth.[27] The CBRC would be directly under the control of the State Council, the highest non-party government body in China. It would play a role not unlike the FDIC and Office of Thrift Supervision in the United States, but without acting as a deposit insurance institution. The CBRC's primary mandate was to reduce the number of NPLs, but it quickly expanded its jurisdiction to anti-corruption and diversification of the risks within the banking industry.[28] The PBOC at this time would issue national currency as well as enforce monetary policy through a series of mechanisms, including reserve requirement ratios and interest rate setting, in addition to direct lending to banks. The CBRC also reserved the right to take over troubled institutions in crisis, or resell or restructure the institution. However, without any formal deposit insurance, this perpetuated the sense that the Chinese government would not allow financial institutions to fail in order to preserve social stability.

In 2003, there was also a growing concern in China about the booming real estate market. Over 3 trillion RMB ($363 billion) had been invested in rural real estate from 1998-2002, mostly from bank loans.[29] Prices went up, but many high-end properties went unsold because there was not enough demand, or too much speculation. In June, 2003,

[27] www.cbrc.gov/cn
[28] See Cousin, Violaine. Banking in China. Palgrave MacMillan, NY. 2007. pp 23.
[29] Huang Zhen. "Building on a Bubble." *Beijing Review*. Vol 46 No 18. May 1, 2003. Pg 24.

the PBOC, frustrated with several speculation scandals, recommended that banks limit their lending to the real estate business.[30] The Commercial Bank of China (CCB) imposed an increase on interest rates to any commercial housing and stopped lending to high-end properties altogether. During this time, the CBRC launched a huge investigation into the Big Four banks, including demanding to see "off-the-sheet" items at Agricultural Bank of China (ABOC) and CCB. Off the sheet items had rapidly developed in order for these banks to increase their competitiveness (or hide their losses), when they were struggling with a large number of NPLs and lack of profitability. At that time, the primary way for the state-owned banks to make money was to live off the spread between deposit and loan interest rates, both of which were controlled by the PBOC. They had few other effective ways to gain revenue.[31]

The CBRC audits had another goal, though, to get an understanding of just how much lending was going on in order to estimate how much money there was in the market. When banks issue loans, they are creating new money in the market. Excess money could impact stability by driving prices up and creating inflation. There was also a concern that no centralized credit rating system was impacting the loan making decisions of banks. These banks had no real, definitive idea of which loans would go bad, and which presented a reasonable risk. Therefore, they lent out to sectors such as the real estate and automotive industries, and these loans often presented problems.

[30] Li Rongxia and Lan Xinzhen. "Shanghai Property Market Facing Credit Crunch." *Beijing Review*. Vol 46 No. 26. Jun 26, 2003. Pg 20.
[31] Tan Wei. "Gold Fever?" *Beijing Review*. Vol 50. No. 2. January 11, 2007.

In December 2003, the state created a fifth government-owned AMC, Central Huijin Investment Ltd. (Central Huijin). It is mandated to exercise the rights and responsibilities of a major investor in state-owned banks and other financial firms.[32] It does nothing else, nor is it supposed to interfere in any day-to-day operations of the banks. It is subject to the State Council and all members of its Board of Directors and Board of Supervisors are appointed by the State Council as well. It is the majority shareholder in all Big Four banks as well as several other large financial enterprises. In 2007, Central Huijin was "acquired" by the Ministry of Finance and handed over to China Investment Corporation, *Zhongguo touzi youxian zeren gongsi*, (CIC), which manages China's foreign exchange reserves. We will discuss the implications of this complex institutional relationship in the second section.

By early 2004 it was clear that not only did the Big Four banks have a large number of NPLs on their books, but also they were creating more. In order to give the banks more options for making money, the PBOC discussed whether or not to allow banks to operate in separate businesses, such as securities and insurance.[33] Bank capital could be used in a myriad of ways, including investment and financing in stocks and bonds, but the banks themselves could only issue loans based on the deposits they receive from customers. Banks were allowed to enter these businesses later in 2004. The Big Four went through a downsizing process from 2003 to 2004, laying off a quarter million employees and closing tens of thousands of branches in order to become less cost heavy.

[32] www.huijin-inv.cn
[33] Li Zi. "Possible Mixed Banks." *Beijing Review*. Vol 47 No. 2. Jan 8, 2004. Pg 31.

In February 2004, the Bank of China and China Construction Bank received a total of $45 billion of capital injection from China's foreign exchange reserves.[34] The injection works when the central investment agency, in control of the reserves, purchases stock in the banks with dollars. The banks then convert the dollars into renminbi. This $45 billion, about 10 percent of all reserves at the time, was to be managed by Central Huijin. The injection itself was not intended to write off the bad loans held by the banks, but to help prepare them for public listing on the stock exchanges and to help bring their capital adequacy ratio above the 8 percent mark. It was successful on both counts.

The PBOC also began a process of differentiating the reserve rate requirement for different kinds of banks. The reserve rate requirement refers to the money a financial institution must deposit into the central bank as a kind of guarantee. It takes balances away from the banks so that they have less money to loan, therefore reducing the number of loans and the money supply in the open market. However, the state-owned commercial banks were not subject to the same reserve requirements because of their special relationships to the PBOC and Ministry of Finance. In August of 2004, Bank of China and China Construction Bank sold almost 280 billion RMB ($134 billion) worth of NPLs to the Cinda Asset Management Company to further improve their balance sheets prior to listing on the stock exchanges. CCB itself reformed its corporate government structure to split into a company group and a joint stock company. The group would remain the

[34] Tan Wei. "Banks get IPO Windfall." *Beijing Review.* Vol 47 No. 8. Feb 26, 2004. Pg 34.

property of the state and take on remaining assets and debts, while the joint stock company would operate the banking business.[35]

By early 2005, the PBOC formalized its role in helping the banking sector modernize and reform. The CBRC was realizing that one of the best ways to rid the banking sector of its NPLs was to sell them to foreign investors. These international investment banks, such as Merrill Lynch, Citigroup, and Goldman Sachs, were the only ones considered financially strong enough to take on these liabilities. Morgan Stanley bought 10.8 billion RMB ($1.3 billion) worth of bad assets from Huarong.[36] The risk seen, however, in selling these assets to foreign investors is that they would often sell the assets immediately after, giving rise to speculation without really removing the loans from China's banking system, or getting the loans repaid. In March 2005, China Construction Bank's chairman and director resigned after the media reported that he had received kickbacks in deals related to information technology, and he was replaced by a vice governor of the PBOC, Guo Shuqing. In October 2005, China Construction Bank listed on the Hong Kong Exchange and raised almost $8 billion. It was the first of the Big Four to list, but it would not be the largest in terms of raising capital. Industrial and Commercial Bank of China, ICBC, received a $30 billion capital infusion from both foreign exchange reserves and the Ministry of Finance prior to its listing. It would list on both the Hong Kong Stock Exchange and the Shanghai Stock Exchange in October 2006,

[35] Mo Ran. "State Bank Reform." *Beijing Review.* Vol 47 No. 31. Aug 5, 2004. Pg 30.
[36] Tan Wei. "The Value of Worthless Assets." *Beijing Review.* Vol 48 No. 5. February 3, 2005. Pg 38.

raising nearly $20 billion and becoming the world's largest IPO at that time. Bank of China listed in June 2006 and raised over $11 billion.

During this time, China's foreign exchange reserves surpassed $1 trillion and the economy continued to grow at an enormous rate (10.7% growth in 2006 alone according to the government statistics bureau).[37] China had only in 2005 allowed its currency to float a bit on the international exchange – though it was still tightly controlled in order to prevent precipitous valuation. The exploding foreign exchange reserves forced the government to issue more renminbi, which contributed to a growth in the money supply. The gold markets were opened, where banks and individuals were, for the first time, allowed to trade.[38] Growing interest in the stock market kept pushing prices higher, resulting in ICBC becoming the second biggest bank in the world by market value, second to Citigroup and passing Bank of America. Before, domestic banks were only allowed to lend and borrow money from each other at a rate controlled by the government, but in 2007 the rate began to fluctuate with the market. All of these factors resulted in the PBOC raising interest rates and raising the reserve deposit requirements six times and ten times, respectively, to their highest levels since the PBOC took on the role of the central bank. Inflation accelerated from 2007-2008 to a decade-high 8.7% as the PBOC attempted to reign in the excessive liquidity in the market.[39] The CBRC cracked down on eight different banks, including ICBC and BOC, for using bank loans

[37] http://www.stats.gov.cn
[38] Tan Wei. "Gold Fever?" *Beijing Review*. Vol 50. No. 2. January 11, 2007.
[39] Bradsher, Keith. "China's Inflation rose to 7.1% in January." *The New York Times.* February 19, 2008.

and bank funds in order to speculate illegally in the stock markets.[40] Most of these funds had gone to several large, state-owned companies who subsequently used them in the stock market, with the banks' knowledge. The real risk was not so much that the banks were breaking rules, but that if the funds were lost on the stock market, then the banks themselves would be saddled with the losses on their own balance sheets. The losses could then be transferred to the government, who implicitly guarantee each of the banks, and require the government to pay for the losses.

In the following table, assets refer to financial resources controlled by the bank, including deposits and loans. Total loans are all outstanding loans monitored by the bank, including pre-existing loans from the year before. Non-performing loans (NPLs) are loans that are at risk to not be paid back or are confirmed to be lost. The capital adequacy ratio (CAR) refers to the ratio between risk and capital. Generally, the higher the CAR, the easier it is for the bank to absorb losses.

---

[40] Lan Xinzhen. "Drowning in Illegal Capital." *Beijing Review.* Vol 50 No.27. July 5, 2007.

Table 1: State-owned Banks 2007-2009 Figures: (totals in RMB billions)

Industrial and Commercial Bank of China			
	2007	2008	2009
Total Assets*	8,683.71	9,717.15	11,785.05
Total Loans	4,073.22	4,571.99	5,728.62
Non-Performing Loan (NPL) Ratio	2.74	2.29	1.54
NPL Amount	111.61	104.7	181.49
Capital Adequacy Ratio	10.99	10.75	9.9
China Construction Bank			
	2007	2008	2009
Total Assets	6,598.10	7,555.40	9,623.30
Total Loans	3,183.20	3,683.50	4,692.90
Non-Performing Loan (NPL) Ratio	2.6	2.21	1.5
NPL Amount	82.76	81.4	70.39
Capital Adequacy Ratio	12.58	12.16	11.7
Bank of China			
	2007	2008	2009
Total Assets	5,991,2	6,951,6	8,748,1
Total Loans	2,754.40	3,189.60	4,797.40
Non-Performing Loan (NPL) Ratio	3.12	2.65	1.52
NPL Amount	85.94	84.52	72.92
Capital Adequacy Ratio	13.34	13.43	11.14
Agricultural Bank of China			
	2007	2008	2009
Total Assets	5,305,5	7,014,3	NA
Total Loans)	2,709.10	3,014.90	4,052.34+
Non-Performing Loan (NPL) Ratio	23.57	4.32	2.91
NPL Amount	638.53	130.24	117.92
Capital Adequacy Ratio	NA	9.41	10.07

.

+ABOC had not published its 2009 annual report by the time this paper was written. Figures on the chart are those reported by the Chinese media before an audit was completed.

Sources: http://www.boc.cn ,Bank of China Ltd. 2007 Annual Report, Bank of China Ltd. 2008 Annual Report, Bank of China Ltd. 2009 Annual Report, http://www.icbc-ltd.com/icbcltd/, Industrial and Commercial Bank of China Limited 2007 Annual Report. Industrial and Commercial Bank of China Limited 2008 Annual Report. Industrial and Commercial Bank of China Limited 2009 Annual Report, http://www.ccb.com/en/investor/annals , China Construction Bank Corporation Annual Report 2007, China Construction Bank Corporation Annual Report 2008, China Construction Bank Annual Report 2009, http://www.abchina.com/, Agricultural Bank of China 2007 Annual Report, Agricultural Bank of China 2008 Annual Report, Zhang Jiawei. Wang Bo. Jiao Xiaoyang. “Agricultural Bank plows ahead.” *China Daily.* March 11, 2010.

The Agricultural Bank of China also stepped up its own reform processes in order to prepare itself for listing. It did not split itself into separate companies as other ones had, but planned to be listed as an entire company. It closed 24,000 branches and cut 170,000 jobs from 2000 on[41], but still had 818 billion RMB ($112 billion) worth of bad loans at the end of 2007. ABOC's position was unique in that its mandate conflicted fundamentally with any sort of profit-making procedures. Its purpose is to provide loans to farmers and other agricultural industries, but without proper collateral (as farmers do not own their own land outright in China), and without a suitable credit registry, there was no guarantee that these loans would be paid back. In 2007 alone, ABOC's newly-added NPLs totaled 84 billion RMB ($11.75 billion). Some of these NPLs were created by the tightening credit policy of the PBOC, cutting off the capital flow to companies taking out these loans. Therefore, ABOC must somehow strike a balance between its mandate and making profits as an independent company. It received a 284 billion RMB ($40 billion) capital injection in early 2008, and there was some hope that foreign investors might come to the rescue. Beginning June 30, 2010, ABOC's stocks began to be sold to foreign investors.[42]

Throughout 2007, the Chinese economy showed signs of inflation, despite the central bank's efforts to control it. The Consumer Price index rose above 6%, then even higher at the beginning of 2008. New loans actually declined in the first quarter of 2008, bringing down the earnings of some major corporations and the stock market. Housing

---

[41] "Finance Ministry to take Stake in Agriculture Bank."*Beijing Review.* Vol. 50. March 12, 2007.
[42] Tang, Edmond. "ABC to Launch $11.4 billion HK IPO." *The China Daily.* June 30, 2010.

prices also began to drop. This created a concern that developers would default on their loans from banks, which comprised 70% of lending to real estate developers, possibly resulting in a massive mortgage fallout similar to what the United States was seeing.[43] However, even as Chinese banks quickly worked to disclose their slight exposure to the U.S. subprime crisis, they posted huge profits. ICBC officially became the world's largest bank by market value, surpassing the beleaguered Citigroup. By August 2008, the increase in the Consumer Price Index, or CPI, dropped back down to 4%, and the central bank began to consider looser credit restrictions in order to help China weather the looming global financial crisis. PBOC cut interest rates for the first time in several years, including a special cut for mortgages for first time home-buyers in order to stimulate the real estate market. By the end of October, the PBOC stated that controlling inflation was no longer its top priority, but rather maintaining growth. ABOC received another $19 billion capital infusion from Central Huijin, and split its ownership between Huijin and the Ministry of Finance. It declared that it would finally reach the 8% capital adequacy threshold (after years of promising), and spin off its NPLs to a government-managed fund. In October 2008, over 800 billion RMB of bad loans were written off.[44]

The PBOC's sudden turn from inflation control to stimulating growth was a result of the deepening of the worldwide financial crisis. The Chinese government's strategy quickly focused on boosting domestic demand when foreign consumption, particularly from the United States, began to drop off. In November 2008, it announced a 4 trillion

[43] Lan Xinzhen. "Impending Crisis for Mortgage Lenders?" *Beijing Review*. Vol 51. No.32. August 7, 2008.
[44] Yuan Yuan. "ABC Reform Gets Green Light." *China Daily.* October 22, 2008.

yuan ($586 billion) economic stimulus package.[45] This stimulus package, roughly equal to 15% of China's GDP, was extolled as a "government spending spree... certain to help hold up domestic demand in several key sectors, while the tepid consumer market seems less likely to pick up the slack."[46] The biggest beneficiaries of this package are construction-related, agriculture and hi-tech industries. Infrastructure projects in particular loomed large in this equation. Railways received 600 billion yuan ($87.8 billion), new housing projects 900 billion ($131.8 billion), airports 400 billion ($58.6 billion) and transport infrastructure received the largest portion, 1 trillion yuan ($146.4 billion). Not surprisingly, the reduction in the capital adequacy ratio, increased lending quotas, and finally the stimulus package brought great advantages to the big banks.

Three of the Big Four banks recorded profits in 2008, despite the worldwide crisis. CCB reported a 34% increase in profitability, ICBC reported 35%, and BOC, with its increased exposure to international financial operations, reported just a 14% increase in profit. By contrast, Bank of America Corporation reported a $12 billion loss in 2008.[47] Much of this profitability came from issuing new loans, which accelerated through 2009.

---

[45] Yue, Hu. "Spending Our Way Out." *Beijing Review*. Vol. 51. No. 48. November 27, 2008.
[46] *Ibid.,* pp 1.
[47] Bank of America Annual Report 2008. pp 178.

Table 2: Lending by State-owned banks in 2009

	Industrial and Commercial Bank of China	China Construction Bank	Bank of China	Agricultural Bank of China
Total Loans (In RMB billions)	5,728.62	4,692.90	4,797.40	4,052.34*
Percentage Loan Increase over 2008	25.30	27.40	50.40	34.4
Provisions for Bad Loans	145	175.77	151.17	124.25
Percentage Provision Increase over 2008	6.96	44.19	24.19	41.84

*ABOC had not published its 2009 annual report at the time of writing, figure is author's estimate based on Chinese media sources.

Source: Bank of China Ltd. 2009 Annual Report, Industrial and Commercial Bank of China Limited 2009 Annual Report, China Construction Bank Corporation 2009 Annual Report, Wang Bo. Jiao Xiaoyang. "Agricultural Bank plows ahead." *China Daily.* March 11, 2010.

All four banks increased their lending by wide margins. Even ABOC, which has not yet published its audited 2009 results, was reported by the Chinese media as having dispersed 1 trillion RMB ($152 billion) worth of new loans.[48] It also increased its provisions for bad loans by over forty percent, though this was done primarily to bring itself in line with international accounting standards for loan provisions. In 2009, these banks continued to lend at an extraordinary pace, leading to more concern about the possibility of an overheated real estate sector. This lending spree was precipitated by the economic stimulus package and increased lending quotas from the central government, with the intent of stimulating the economy. While we cannot with absolute certainly claim that these policies directly resulted in economic gains, China still reported an

[48] Wang Bo. Jiao Xiaoyang. "Agricultural Bank plows ahead." *China Daily.* March 11, 2010.

impressive 8.7% GDP growth in 2009.[49] In addition, ABOC announced in April 2010 that it was completing its internal reforms and would be going through the process of an IPO as early as July 2010.[50] The proceeds from this stock sale are expected to surpass even ICBC's record $21.9 billion IPO, despite ABOC's troubled past.

AMCs and NPLs

Two major items have been introduced in this historical section that require further explanation. Government-owned asset management companies, *Zichan guanli gongsi* (AMCs) make up a key part of the Chinese banking system. They act as both owner and government voice within the bank's corporate leadership in China. In the American system, companies such as Merrill Lynch act as asset managers. They pool the resources of thousands of individual and corporate clients and invest those resources with the goal of bringing the highest returns to both the manager and the client. In China, AMCs manage the government's assets. This includes the government's foreign exchange holdings. In 2009, one AMC owned major parts of all four big state-owned banks.

---

[49] "China GDP Grows by 8.7 Percent in 2009." CNN. January 20, 2010

[50] Mao Lijun. Wang Bo. "Agricultural Bank May Float IPO in July." *China Daily.* April 8, 2010.

Table 3: State Ownership of Banks in 2009

	Central Huijin	Ministry of Finance	Total State Ownership
Industrial and Commercial Bank of China	35.35%	35.35%	70.70%
Bank of China	67.53%	0%	67.53%
China Construction Bank	57.09%	0%	57.09%
Agricultural Bank of China	50.00%*	50.00%	100.00%

*Agricultural Bank of China underwent an Initial Public Offering (IPO) beginning in July 2010, the stock sale was not yet complete at the time this paper was being written.

Sources: Industrial and Commercial Bank of China 2009 Annual Results Announcement, Bank of China Limited 2009 Annual Report, China Construction Bank 2009 Annual Report, Agricultural Bank of China 2008 Annual Report.

Despite the corporate restructuring and stock sales of three of the "Big Four" banks, the government retains at least 50% ownership of all banks through its asset-management company, Central Huijin Investment Limited. Central Huijin has the power to buy and sell bank stock, increasing and decreasing its ownership and bringing in capital to the bank. Other AMCs have been used to offload old loans from the banks' books with the intent of selling the bad assets and bringing the banks within reach of international accounting standards.

Non-performing loans, or NPLs, also remain at the front of the reform discussion. The large number of NPLs in China's financial system put a damper on the amount of capital free for the banks and other investments. Loans are created when a depositor places a certain amount of money into the bank, and the bank creates additional money off of that deposit to issue as a loan. In addition, new bank balances are created when the bank issues a loan. The loan recipient turns and deposits the loan proceeds into their bank.

This process essentially makes money “out of thin air” and boosts the assets of the bank without creating real currency. When the loan is paid back to the bank, with interest, the new credit is extinguished and the bank collects its profit. This margin of profit between what the bank pays the depositor and what the lender pays the bank is called “the spread.” Traditionally, this is where banks make the most consistent profit other than service fees. The only risk the bank incurs is when the borrower becomes a credit hazard and is unable to repay the loan, or when the depositor removes their money and the bank no longer has the spare funds to lend. When loans are not paid back, or become non-performing, they transform into an asset that is not making money for the bank, but will not affect the bank negatively until the deposits are withdrawn out from under it.

Non-performing loans are extensions of credit from a bank to another entity which the other entity has either defaulted on, or lacks the ability to pay back. It is a drain on the resources of a bank, because the deposits tied up as a reserve to cover the loan are not resulting in any returns to the bank, usually in the form of interest payments. The reason that the Chinese banks have been able to weather the huge numbers of NPLs is their strong, steady growth in deposits as well as repeated recapitalization and support from the state. Banks are able to create new loans from these deposits without having to worry as much about the previous loans that have become non-performing. However, international capital adequacy standards such as Basel I require that the banks have a certain amount of working capital above their typical deposit growth, and thus the Chinese government has repeatedly injected them with fresh capital. In addition, banks can also lend to each other at daily rates via the interbank lending market. This market

allows the banks to draw on each others' resources without tapping the central bank, and can be a source of revenue. China's interbank lending market has been undeveloped for a long time, but has become much more robust in recent years.

Chinese banks have undertaken an accelerated process of reforms over the last seven years. Since 2003, new institutions and regulatory agencies have been created, modified, and adapted to meet international accounting and WTO standards. One after another, the state-owned banks spun off their bad loans to government-owned asset management companies and proceeded to raise capital by selling shares. Year after year their lending and profits remain high. The global financial crisis triggered by the collapse of Lehman Brothers in 2007 has had little to no effect on the growth of these former state-owned banks. Why did Chinese banks remain profitable while American banks went bust? However, we should not assume that bank profitability equates to overall health. China's banks are creating new loans while many of their old loans are beginning to show signs of distress. We will examine this in further detail in the next section, and compare China's banking reforms to those of other nations.

II. International Comparisons

In this section, we will look at three other countries in which state-owned banks have played a large part in the financial system. China's banking sector reforms share certain similarities with reforms of other nations. Over the last half of the 20th century, many countries experimented with different styles of economic development. We will look at Russia and Eastern Europe, Indonesia and India's banking reforms over the last twenty years. Russia and Eastern Europe, like China, used a command-style economic model build around freewheeling loans from a government-controlled banking system. They also shared features such as the mono-bank system and credit quotas. Despite this shared legacy, Russia and Eastern Europe chose different tracks for reforming their systems, with varying success. Indonesia, once a Dutch colony, secured independence after World War II and looked to economic growth for security and stability for its diverse population, particularly after the accession of President Suharto in the 1960's. It was hit hardest by the Asian Financial Crisis in 1997. India, like China, shares a semi-colonial experience until after the Second World War. Both were keen on building national security and independence through economic growth, despite differences in their political systems. Both India and China extended government control over the banking system and monopolized financial resources for the benefit of state projects. However, India's approach to banking reform was aided by the fact that its capital systems had developed already. Liberalization forced each region and country to face the debts within their banking systems, and to take steps to protect themselves from future fiscal crises within the scope of international regulations.

In all of these cases, as in the Chinese one, the state-owned banks carry a legacy of government direction, and are facing modernizing reforms. Each region and country has chosen a slightly different method in which to reform their state-owned banks. The first, the former Soviet bloc countries of Eastern Europe and Russia struggled through a process involving capital injections and privatization, though the results are decidedly mixed. In Eastern Europe, the problem of bad loans was often resolved, ironically, by hyperinflation. In Russia, bad loans continue to be created, even when the banks are privatized, because they are still in large part owned by the state. The second case, Indonesia, chose to deregulate and liberalize the capital market system years before the banking sector. This created a situation in which the banks had weak governance and poor oversight and many options for raising capital. This lack of oversight led to bad loan choices and financial crises even before the 1997 East Asian Financial crisis. The Indonesian government has subsequently tried to correct these issues by merging the unhealthiest banks together and pursuing privatization in the 2000's. The third country, India, allowed foreign and private banks to play a larger and larger role within the financial system, prompting state-owned banks to modernize themselves, or face losing to the competition. China's financial reforms, following in the wake of each of the others, appear to have taken their issues into consideration. We begin with reforms in the Soviet bloc.

The Eastern Europe and Russia Case

The Eastern European and Russian model for banking reform provides our first comparison. In these cases, there was a centralized system with several state-run commercial banks for the purpose of distributing funds according to government policy. The Soviet Union created specialized commercial banks in order to handle specific sectors of the economy, such as light or heavy industry.[1] These banks inherited a large number of bad loans, estimated at 50% of all loans, from their state-run predecessors. In Eastern Europe, banks opted for nominal privatization and offloaded their bad loans onto the government. In Russia, privatization occurred in name only, while banks maintained close ties to the state in order to ensure a steady supply of capital. China has also opted for privatization, though a significant portion of shares remain in the hands of Central Huijin or the Ministry of Finance. In the meantime, Czech banks have become somewhat profitable, even if their independence remains questionable, and Russian banks have embraced illicit government control for their own survival.

In the case of one specific Czech bank, Komerční banka, which inherited the bad loans from almost all of the state-owned enterprises, the bank was able to transfer about a third of the loan portfolio back to the government, and saddle a newly-formed "hospital bank" with the rest. In the Czech Republic, Komerční banka is the largest financial institution. Even after privatization had been declared complete, the state maintained 48% ownership in 1996 under the guise of the National Property Fund. In addition, Komerční

[1] Meyendorff, Anna. Snyder, Edward A. "Transactional Structures of Bank Privatizations in Central Europe and Russia." *Journal of Comparative Economics.* No. 25. Revised April 30, 1997. Pg 5-30.

banka owns shares of and is owned by other large financial institutions. It was speculated that this dense network of cross-ownership was simply a mask for the extent to which the government still controlled the industry despite privatization.[2] In 2001, the government's share was entirely bought by an international investment firm, Société Générale .[3] Banks in Hungary and Poland used similar methods, although in Poland much of the issue was resolved by hyperinflation. Hyperinflation solves debt crises when the real amount of a loan decreases as the currency becomes more and more devalued. In almost every case, the banks required a capital injection from the government.

Russia engaged in political reform before meaningful economic and financial reform, disrupting any attempt at coherent restructuring of the banking system. While splintering the state-owned bank assets among over 800 independent banks in 1990, none of these banks attempted to free themselves from government cronyism.[4] These new "old" banks discovered that they could be profitable without being productive by engaging in a multitude of financial transactions, including foreign exchange and developing the interbank credit market. They were ensured of a steady stream of credit support from the Russian central bank because of their maintained ties.[5] Russia also experienced hyperinflation, resulting in the bankruptcy of most of its bank-dependent business enterprises. Its primary method of dealing with the bad loans was to basically allow capital to flow freely from the government coffers to the preferred banks in order to keep

---

[2] *Ibid.,* pp 799.
[3] http://www.kb.cz/en/com/profile/index.shtml
[4] Lane, David. Ed. Russian Banking: Evolution, Problems and Prospects. Edward Elgar. Cheltenham, UK. 2002.
[5] Johnson, Juliet. A Fistful of Rubles: The Rise and Fall of the Russian Banking System. Cornell University Press. Ithaca and London. 2000.

them afloat. These banks also went through corporate restructuring, IPOs, and general sales to shareholders in order to reduce the amount of government interference in their operations. However, these actions did not necessarily translate into total independence for the banks. As late as 1998, the Russian government was still using former state-owned banks in order to channel money into key industries. The purpose of these reforms and capitalizations in Russia and Eastern Europe were to allow the banks more stable financial footing in order to compete in the open market. However, in the Russian case in particular, the reforms did not necessarily correct all of the issues within the banking system.

The reforms of these Eastern European and Russian banks are remarkably similar to those undertaken by China. The commercial banks began their process of restructuring and recapitalizing in the 1990's, but have not followed the "shock therapy" method espoused in the former Soviet Union and Eastern Europe. The Chinese state-owned banks have also dumped their loans onto asset management companies, and delegated policy lending to state-run policy banks. They have also received a large amount of capital injections from the government. However, the last key part of reform, total privatization, has not happened. The state, first in the form of the Ministry of Finance and currently Central Huijin Investment Company (or both), continues to own a majority stake in all of the banks. For the Chinese banks, as with Komerční banka , the state remained the primary shareholder of the largest financial firms through an investment intermediary, the AMCs. The Czech National Property Fund (NPF) appears on the surface to fulfill the same purpose: represent the government's interest as a major shareholder in the bank.

However, the NPF actually serves the role of guarantor and investor in the Czech case. It paid for each of the one-time therapeutic measures such as transferring bad loans from the state-owned banks to the hospital bank.[6] It was seen as an intermediary between the state and the banks as they underwent privatization in order to lessen the budget burden of the state. The NPF also sold the entirety of its stake in Komerční banka in 2001, which Central Huijin is unlikely to do.

The state is likely in the Chinese case to continue to hold the dominant shareholder position in each of the Big Four banks. The maximum that a foreign investor can hold in a Chinese bank is a 19.9% share. By the end of 2009, Central Huijin, the government's shareholding representative, owned 67.55% of Bank of China[7], 57.07% of China Construction Bank[8]and 35.4% of Industrial and Commercial Bank of China (the Ministry of Finance owns another 35.3% of ICBC).[9] Also, while three of the Big Four have now listed on stock exchanges, it is more likely that these listings were enabled mostly to allow fresh capital to flow into the banks rather than expose them to any true accountability. Without any true shareholding or private ownership, the banks are still subject to heavy influence by the government, not unlike the Russian banks.

The Indonesia Case

State-owned banks in Indonesia, as in China, started out as key institutions in economic development, until political motives gradually co-opted their economic

[6] Horčicová, Milena. Payson, Liana. "The Old Bad Debts Problem: The Czech Experience." *Eastern European Economics.* Vol. 35, No. 2. M.E. Sharpe. March-April 1997. Pp 29-40.
[7] Bank of China Limited 2009 Annual Report. Pp 403.
[8] China Construction Bank 2009 Annual Report. Pp 70.
[9] Industrial and Commercial Bank of China 2009 Annual Report. Pp 38.

mandates. These banks required repeated recapitalization throughout their existence, and compounded with the 1997 crisis, which exposed the bad loans and losses created by a history of political interference.[10] These problems were created by a combination of weak government supervision and liberalized capital markets, giving banks in Indonesia a great deal of freedom in creating massive, ill-advised loan portfolios. China has chosen to reform its banking sector before liberalizing capital markets, relying largely on its foreign exchange reserves, or sovereign wealth fund, rather than highly mobile capital. For Indonesia, the result was that after 1997, state-owned banks were merged together and put through a process of privatization not unlike China's state-owned banks.

Bank Indonesia served as the central bank, but until the 1999, it was governed by a board chaired by the Minister of Finance, with government representatives retaining more influence than the actual governor of Bank Indonesia. For a long time, the central bank was required to advance bank funds to the government Treasury whenever the Finance Minister deemed it necessary, this amount increasing as time went on despite laws designed to reduce it.[11] This created a system in which few, especially those with the most power, were held accountable for bad financial decisions. Therefore, institutions created to provide oversight and governance for loans and other financial products were weak.

---

[10] Srinivas, P.S. Sitorus, Djauhari. "State-Owned Banks in Indonesia." The Future of State-Owned Financial Institutions. Brookings Institution Press. Washington, D.C. 2004. Pg 127.
[11] *Ibid.,* pp 135.

As early as 1972 there were almost no controls over the capital market.[12] In the 1980's, the government further liberalized the financial sector by removing the credit ceilings for banks and allowing them to engage in other activities they had previously not been allowed in, such as borrowing large amounts of short-term capital from overseas and foreign investors. A series of dramatic reforms in 1983 were aimed at protecting Indonesia capital from fluctuating oil prices, which the country had been long dependent on as a steady revenue source. As a major oil exporter, Indonesian officials realized that they needed to break themselves of this one-product dependency and allow the banks to experiment with domestic and foreign investment to create capital. Therefore, state-owned banks were prompted to mobilize customer deposits rather than depend on financing from Bank Indonesia, which they had been dependent on.[13] An interbank lending system developed, usually in the form of private banks borrowing from state-owned banks with their larger deposit base in order to create consumer loans. Ironically, consumers themselves tended to take out loans from private banks, but preferred to deposit their savings into the perceived safe haven of the state-owned banks.[14]

Combining this liberalization with weak government oversight proved to be disastrous. The total number of banks in Indonesia skyrocketed, including both foreign and domestic banks.[15] These new banks quickly outpaced the large, state-owned banks

---

[12] Montes, Manuel F. The Currency Crisis in Southeast Asia. Institute of South Asian Studies. 1998.
[13] Srinivas, P.S. Sitorus, Djauhari. "State-Owned Banks in Indonesia." The Future of State-Owned Financial Institutions. (Brookings Institution Press. Washington, D.C. 2004.) Pg 144, 148.
[14] *Ibid.,* pp 155.
[15] Pangestu, Mari. "The Indonesian Bank Crisis and Restructuring: Lessons and Implications for Other Developing Countries." G-24 Discussion Paper Series. No. 23. United Nations. Center for International Development, Harvard University. November, 2003.

for market share and deposits, while ignoring, for the most part, any attempt at regulation by Bank Indonesia in the early 1990's. Competition between banks pushed the weaker banks into riskier and riskier projects. Even before 1997, banks were beginning to fail. When investors suddenly began to flee the region in 1997, it precipitated a devaluation of the currencies in the area and resulted in a large number of defaulted loans. Non-performing loans in Indonesia were estimated to have peaked at 65-75% of all loans, and the total cost of the disaster was 55% of GDP in 2002.[16] However, despite the massive departure of foreign capital, only one state-owned bank's insolvency was caused by foreign exchange.[17] The rest were caused by non-performing loans. As the Indonesian economy picked back up in the 2000's, the government injected a huge amount of capital into the state-owned banks. This was the most expensive financial reform it undertook during the entire recovery process, amounting to Rp 283 trillion (approximately $37 billion in 1999).[18] Recently, Indonesia has also begun a process of privatization of state-owned banks, and has encouraged more lending to small and medium-sized enterprises (SMEs) rather than to large or tiny corporations, which had created the largest number of NPLs during the 1990's.

China is not entirely subject to the same risks, despite its own weaknesses. First of all, the Chinese government has been one of the last in the area to begin to liberalize its financial sector. Reform of the banking sector came much later than reform of the

---

[16] Caprio, Gerard. Klingebiel, Daniela. "Episodes of Systemic and Borderline Financial Crisis." The World Bank. January 2003.
[17] Srinivas, P.S. Sitorus, Djauhari. "State-Owned Banks in Indonesia." The Future of State-Owned Financial Institutions. (Brookings Institution Press. Washington, D.C. 2004.) Pg 155.
[18] *Ibid.,* pp 156.

planned economy, and it didn't attempt some reforms until long after even domestic stock markets were established. The capital markets were not allowed to operate freely until 2007. Although credit ceilings had been temporarily abolished in 1998, the PBOC was able to loosely regulate the amount of money being loaned by adjusting interest rates and reserve ratios. Finally, a severe devaluation of Chinese currency is unlikely because of China's vast foreign exchange reserves. As the worldwide financial crisis broke out in 2007, the state again began to rely on solid credit quotas in order to control just how many new loans were being created. This is not just to put a cap on loans, however. It is a tool designed to stimulate growth. The PBOC raised the quota in 2008[19] for just this purpose, and then lowered it in 2010 to keep things from "bubbling over."[20]

Finally, a severe devaluation of the Chinese currency is unlikely. Even while allowing the currency to gain value in recent years, China has not allowed it to rise precipitously, building up on its reserves to control it. These were features not present in the Indonesian system in the 1990's. At the same time, however, there are some shared weaknesses. First of all, total banking assets tend to be concentrated in fewer hands, including the government, in China's case. There is also a tendency to overinvest using bank loans. Loans in Indonesia went into real estate ventures (based on inflated collateral prices) and the stock market, while China displayed similar behavior in the 2000's. The most important similarity, though, is that China's regulatory agencies are still relatively weak due to their subordination to the State Council. China's state banks have shown

[19] "Central Bank raises lenders credit quota." *The China Daily*. August 5, 2008.
[20] Zhou Xin, Wheatley, Alan."China Bank Lending Slows as Beijing's Curbs Bite." Reuters. April 12, 2010.

themselves to be capable of meeting international standards for NPLs and capital adequacy ratios, unlike Indonesian banks in the 1990's, but they are still subject to weak internal regulations and few incentives to operate efficiently. China's NPL value in the banks, not including the asset-management companies, at the end of 2007 was over half of its GDP. The state-owned banks made up over 90 percent of those loans.[21]

The India Case

Aspects of China and India's economies have often been compared in recent years. Both nations are considered to be the rising economic powerhouses of Asia, with starkly different political systems and history. China has grown out of a semi-colonial and socialist system, while India has transformed itself from a British colony to the world's largest democracy. For our discussion we will compare how they have dealt with their respective state-owned-bank "problems." China has chosen to rehabilitate its banking sector by strengthening the large state-owned banks with government and foreign capital, while India has chosen to allow new, competitive entrants in the system in order to force banks to reform.[22]

As with China, India's state-owned banks carried a crippling amount of non-performing loans. Unlike China, however, India's banking sector is much more diverse, and has been for some time. There are public (state-owned), private, and foreign banks in India. The public banks are dominated by the State Bank of India and are closely

---

[21] "NPLs of Commercial Banks as of end-2007." http://www.cbrc.gov.cn/
[22] Saéz, Lawrence. Banking Reform in India and China. Palgrave Macmmillan Press. New York, New York. 2004. pp 7.

associated with economic development plans initiated by the Indian government.[23] Private banks, some of which were founded before India's independence from Britain in 1947, have had a long presence as well. However, new private banks were not established until 1993. These new private banks are characterized as having better technology, more access to equity capital, and a penchant for aggressive growth.[24]

In 1991, the Indian government set up the Narasimham Committee to examine the overall health of India's financial system and to make recommendations for improving the efficiency and effectiveness of the system. It found that the system needed several fundamental changes in order to deal with the blossoming non-performing loan and asset quality problems of the dominant state-owned banks.[25] The report recommended, among several options, that the Reserve Bank of India (RBI), which serves as the central bank, be divested of its role as a direct supervisor of the banking system, and that it should no longer set all interest rates. Rather, each bank will set its own interest rates individually.[26] The goal was that banks could become more responsive to the changing credit needs of the economy, and thus begin to reduce their bad debts by bringing in new and better quality loans. It also recommended that the internal operation of banks should be left to the internal initiative of the management, not the government.[27] New entrants such as private and foreign banks flourished in India in subsequent years, reducing the market

---

[23] *Ibid.,* pp 68.
[24] *Ibid.,* pp 41.
[25] *Ibid.,* pp 46-47.
[26] Varma, Jayanth R. V. Raghunathan, A.Korwar and M.C. Bhatt. *Narasimham Committee Report - Some Further Ramifications and Suggestions*. Working Paper No. 1009. Indian Institute of Management, Ahmedabad. February, 1992. pp 2.
[27] See Saéz, Lawrence. Banking Reform in India and China. (Palgrave Macmmillan Press. New York, New York. 2004.) Pp 47.

share of public banks and forcing them to become internationally competitive in order to survive. The government chose to "level the playing field" through deregulation, except for holding to a few key fiscal indicators such as a standardized Cash Reserve Ratio (basically the same as the reserve deposit ratio in China that is dictated by the PBOC). Public banks, however, benefited the most from deregulation because they were able to bring down their operating costs to market level.[28] Private and foreign banks, as they played catch up to the public banks in terms of market share and deposit base, were forced to invest heavily in new technology and high employee salaries in order to compete. This strategy contrasts with how China has decided to reform its banking system.

The PBOC has controlled interest rates in China since its designation as central bank in 1983. It has not pursued a policy of interest rate deregulation in order to retain tight control over economic growth and inflation. It has many other tools at its disposal as well in order to ensure that inflation and interest rates do not get out of hand. In addition, the Indian supervisory body created out of the Narisamham Committee, The Securities and Exchange Board of India (SEBI), does not regulate the public banks. It only regulates banks listed publicly on stock exchanges.[29] The CBRC, the closest approximation in China, regulates both the state-owned banks and the private banks. Chinese banks also offloaded most of their non-performing loan portfolio onto the government-owned asset management companies such as Central Huijin. Indian public banks benefited from a

---

[28] Sensarma, Rudra. "Are Foreign Banks Always the Best? Comparison of State-Owned, Private and Foreign Banks in India." Economic Modelling. Volume 23, Issue 4. Indian Institute of Management. July 2006. Pp 717-735.
[29] *Ibid.,* pp 68.

"one-time settlement scheme" that allowed a bank with a large amount of non-performing assets to be granted a no dues certificate, which dictates that the firm that owed them the money wouldn't have to pay interest on the loan.[30] This facilitated the repayment of old, oppressive loans to the public banks and helped to clean up their portfolios. Both the Chinese and Indian systems still face serious challenges, but for the most part, both appear to have managed to fend off the worst of a financial crisis through a series of deliberate and sweeping reforms.

<u>Conclusion</u>

In each country, state-owned banks faced a crisis. Years upon years of policy or government-directed loans left a large percentage of the nation's GDP locked up into non-performing loans. This creates a drain on any economy, and needed to be corrected through a series of reforms. All of the reforms were intended to make state-owned banks competitive, if not totally independent. To do this, governments used international standards such as Basel and WTO regulations, mandating that banks carry a certain set of capital adequacy ratios and other guidelines. The Eastern European and former Soviet bloc countries chose the way of privatization, using massive capital flows from government coffers or from hyperinflation in order to correct the problem. Indonesia relied on a liberalized capital market long before reforming its banks, and was lacking the institutions to properly regulate banking practices. The result, again was a massive capital injection from the government. India chose to give its public banks a great deal of free rein with interest rates and securities, the same tool that private and foreign banks had.

[30] *Ibid.,* pp 82.

This forced public banks to compete internationally, but they carried with them the competitive edge of market share and could afford to reform. However, once again, the government needed to step in with no dues certificates in order to clean up bad loans from the books, in a one-time settlement scheme.

In each case, as in China, the government had to spend money in order to recapitalize its state-owned banking system. The largest difference was the use of foreign exchange via a sovereign wealth fund and the preferred role of government-owned asset management companies with Chinese banks. When Indonesia recapitalized its banks in 1999, it did so by issuing government bonds in its own currency.[31] It also sold off assets from seized private banks in order to finance the restructuring of state-owned banks.[32] India recapitalized its state-owned banks by making it easier for delinquent corporations to pay back their loans, and opening up new equity sources for state-owned banks through its developed securities and stock exchanges. The Czech Republic used the National Property Fund to finance privatization, easing banks toward total private ownership. The former Soviet Union relied on government funds and hyperinflation.

China recapitalized its banks through two sources: government-owned investment companies such as Central Huijin and direct use of foreign exchange reserves through a complex set of institutional networks. This process allowed the banks to clean up their books enough to be desirable to shareholders. Three, and soon to be all of the Big Four have gone through initial public offerings, raising a record amount of new capital for

---

[31] "Government of Indonesia Announces Sweeping Reforms of the Bank System." Press Release. Jakarta. March 13, 1999.

[32] "Subsidies and Bank Restructuring." *Indonesia's State Budget for Fiscal Year 1999/2000.*

themselves. By delaying banking reform until all the proper support institutions were in place (except for a deposit insurance system), Chinese banks have avoided some of the most unfettered and chaotic capital flows such as those that plagued Indonesia. However, its domestic capital markets are not as developed as India's, and thus the banks still rely a great deal on investments from state-run vehicles. In addition, the protection provided by government ownership does not shield the banks entirely from all risk. In the final section, we will examine how the process of recapitalization works in China and begin to unravel the intricate web of its institutions. It is in this web that we will see where the risks to China's state-owned banks still lurk.

III. **Impact and Analysis**

Chinese banks face many threats, just as beleaguered American banks do, but they have certain institutional arrangements that make some factors more threatening than others. Within the institutional matrix are not only the keys to reform but also the barriers to its progress. When looking at banking reform in China, it is clear that decisions are made from the highest levels of the Chinese financial regime – the People's Bank of China, the Ministry of Finance, and ultimately the State Council. This follows in the same line as the developmental state model, when the government guides economic growth through a set of tools focused on key industries that might not survive a free market system. Without the government's aid in disposing of bad loans, Chinese banks would have been faced with a crushing non-performing asset burden. These last few years of reform, though, have displayed that the managers of the state-owned banks are not so much interested in their survival (it's taken for granted) as in making a quick profit. They know that the government will not allow them to fail or be marginally set back by the economic climate. There is too much at stake in terms of social stability. Therefore, the banks even in recent years have continued to issue new loans at a rapid pace and dabble with using bank money in the stock market. They are taking advantage of free-market mechanisms to turn the highest profit quickly, running greater risks in the process.

Within this context Chinese banks find themselves. They are caught between the interests of the government in creating economic growth, financial stability, and their own interest in profitability. Rather than rely completely on market forces or pure government aid, the banks have taken advantage of the institutional environment they

have grown into. Specifically, the unique relationship between the banks, the government-owned AMCs and China's sovereign wealth fund enable the financial system to maintain its stability despite critical risks. In this section, we will highlight the various factors affecting the system. These factors include inflationary pressures, non-performing loans (NPLs), foreign investment and crises. Then, we will examine the details of the institutional relationships introduced in this paper and discuss what tools and relationships the banks utilize in order to address these factors. Inflation puts pressure on the central bank to curb lending, NPLs prompt the government-owned asset management companies to step in with fresh capital, and foreign crises expose the entire financial system to risk. The key part of this system is the institutional relationship between the government and the banks through a web of asset management companies.

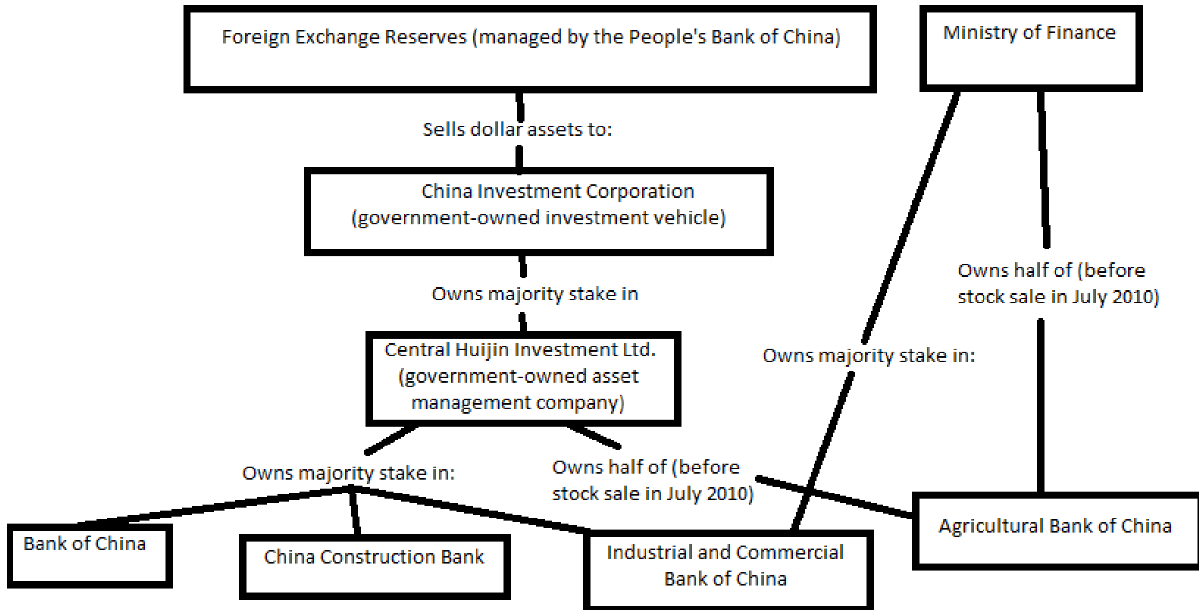
Web of Ownership and Investment

One of the core components of a financial system is the creation of money. Not just in the sense that the government prints paper money, and that can be exchanged for items, but the extension and creation of credit without the printing of physical currency. Money is created when banks issue loans. That loan may be from the central bank to a commercial bank for its day-to-day operations, or it may be from a bank to a company, or from a bank to a customer. The bank is required to keep a certain amount of deposits on hand for withdrawals and for covering unexpected emergencies, but above that, loans can be issued. Those loans then go into bank accounts, and when the loan is paid back, the money created in the process disappears, leaving the bank with the profit it made in

interest in fees. This process repeats on a minute and massive scale in all financial systems. Money can also be created when the central bank buys securities and raises loan quotas when interest rates are already low or near zero. The securities cover the basic deposit reserve requirement, and the loans flow out into the system. In China, an additional point of money creation comes from the trade imbalance with other nations, particularly the United States. China holds a surplus of dollars in its coffers, and has invested those dollars in several ways, including buying U.S. debt and investing in domestic financial institutions.

China's reform process has followed in some of the same lines as other socialist countries in the creation of asset management companies to act as partial or total owners of financial institutions. However, what is unique to the Chinese system is the direct line of investment between the state-managed foreign exchange reserves and the state-owned banks. This direct line advantages the banks by giving them a source of capital that their foreign competitors do not have. As the Chinese banks face risks, that advantage can be utilized to protect them from those risks. The following figure shows one layer of the complex relationship between the government (particularly the government's dollar assets and the Ministry of Finance) and the banks.

Figure 1: Investment/Ownership Structure of State-owned Commercial Banks:



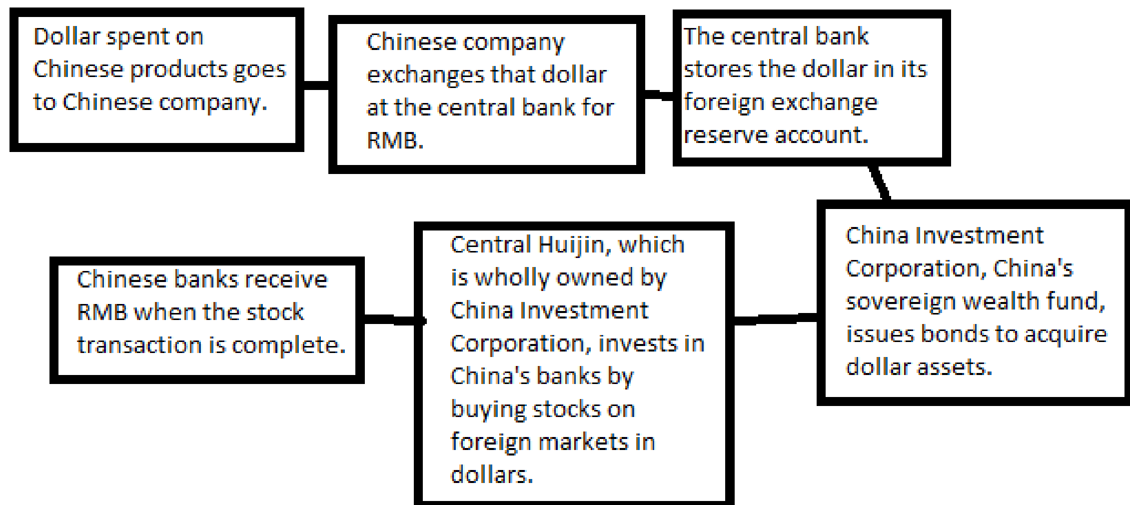
Sources: Central Huijin Investments Ltd. 2009 Annual Report, China Investment Corporation 2009 Annual Report, Agricultural Bank of China 2008 Annual Report.

Two agents share majority ownership of the banks: Central Huijin Investment Limited, and the Ministry of Finance. The Ministry of Finance remains a part of this system because of China's command-style socialist legacy. It directed government expenditures in industries through banks such as China Construction Bank up until the banks were restructured and put under the ownership of Central Huijin in the early 2000's.[1] Bank of China and China Construction Bank, which listed publically in 2005, no longer have a direct tie to the Ministry of Finance. Industrial and Commercial Bank of

[1] *2006 Niandu Qiye Shehui Zeren Baogao*. (Corporate Social Responsibility Report 2006). China Construction Bank. 2006.

China and Agricultural Bank of China in particular still maintain partial MOF ownership. In theory, this would allow the Ministry of Finance to directly contribute funds to the banks despite their public listing. BOC and CCB, on the other hand, must rely on an indirect method of investment through Central Huijin. The following figure shows the path that a dollar brought into China by trade can end up in the state-owned banks' capital coffers.

Figure 2: The Dollar Path



The key part of this figure is when the dollar exits China's foreign exchange reserves and enters the sovereign wealth fund, which can be used at China Investment Corporation's (CIC) discretion to invest in any company listed on a stock exchange. By issuing special bonds, CIC raised capital for itself. It exchanges those proceeds into dollars from the central bank. Those dollars may then be used by Central Huijin to purchase stock in any company, which it has done recently by buying more stock in

China's banks in 2008.[2] However, in recent months, Central Huijin has been facing a credit crunch of its own and has been forced to issue its own bonds to raise capital.[3] While the efficacy of this system of moving dollars from the central reserves into bank coffers remains to be proven, it would appear that the continued strain on the financial system may be more than this particular route can manage. Various risk factors remain, as we shall examine next.

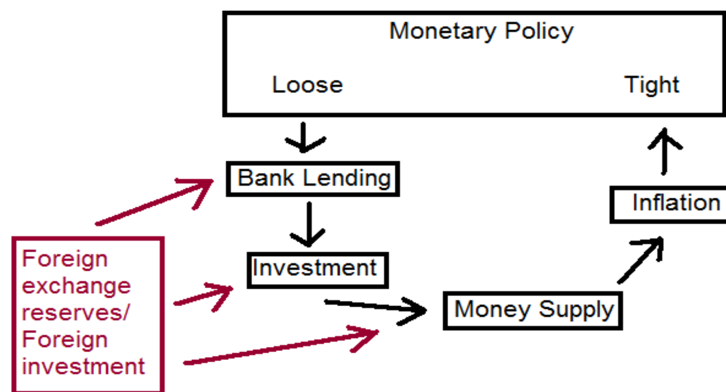
Three Risk Factors

Inflation. Chinese banks are somewhat justified when they go on lending sprees. Banks are the primary lending institutions and much of the country's economic stability over the last thirty years is attributable to their lending practices. The loose lending practices combined with foreign investment and ballooning foreign exchange reserves, leads to an excess of money, or liquidity, in the system. The excessive liquidity helps spur the growth of investment in real estate and other large government-sponsored projects, but it also leads to an increase in overall prices. An undue increase in price equates with inflation. High inflation prompts the financial powers-that-be to institute a stricter, or tighter, monetary policy in order to ensure stability. Their tools have changed over time, from the austerity policies of Chen Yun from 1988-1991, to tentative introduction of interest rate adjustments and reserve requirements ratios set by the PBOC over the last seven years. The two latter policies help ensure that fewer loans are taken out, and that banks cannot loan as much overall. Therefore, there is less money loose in

[2] "China Huijin Increases Stake in Three Top Commercial Banks." *Xinhuanet.com.* September 23, 2008.
[3] "Huijin Bonds to Finance Banks." www.china.org.cn. July 8, 2010.

the system, and inflation will start to come under control, as it did in 2008. This was when the PBOC shifted its focus back to spurring economic growth, raising credit quotas and encouraging the banks to make more and more loans. These activities restart the cycle and runs the risk of creating new NPLs and a fresh round of inflationary pressures. First, we will look at inflationary pressure within China's financial system. The following chart is a demonstration of the forces at work within the last inflation cycle.

Figure 3: Inflation Wheel



A loose monetary policy, started when China lifted the credit ceilings in 1998, combined with few interest rate adjustments, lead to an increase in bank lending. Those loans were used in investments, such as real estate, infrastructure, or agriculture. Increased investment lead to an increase in the overall money supply, due to the increased amount of loans created from bank deposits. In turn, an increase in these loans resulted in greater inflationary pressures, which finally prompted the central bank to enact tighter monetary practices in order to control it. However, the external factor of

foreign exchange reserves and foreign investment exerted further pressure at different points in the cycle. Foreign exchange reserves were used through a series of conversion maneuvers to recapitalize the state-owned banks. Typically, dollar assets were first transferred to asset management companies, who used the dollars to buy shares in the state-owned banks where they are listed in overseas markets.[4] The banks then convert the proceeds from the stock sale into renminbi and their capital levels increased. This allows them to create more loans. Finally, foreign investment flows into domestic industries increase inflationary pressures because domestic producers convert foreign currency into renminbi to use it, increasing the total amount of currency in the system. The resulting issue for China's central bank and economic planners is that no matter how they control their own monetary policy, because there are foreign capital influxes, there will continue to be inflationary pressures.

Non-Performing Loans. China's state-owned banks up to the early 2000's were known for having a large number of NPLs because of their legacy as primary financers for state-run projects. In particular, the banks were responsible for providing policy loans to specific SOEs or investment projects based on government dictate. The irony is that in the 1980's, in order to make SOEs more independent of state financing, the government partially exposed them to the open market, but required state-owned commercial banks to loan indiscriminately to them. In this way, the government might have cleared their own budgets of the multitude of inefficient SOEs, but saddled the already fragile banking sector with severe capital quality issues. When lending money to the SOEs, the Chinese

[4] McMahon, Dinny. "Victor Shih Sees Bank Bailout Redux." *The Wall Street Journal.* March 17, 2010.

banks were creating money off of their consumer deposits, without any guarantee that the loans would be paid back. In fact, it was normally expected that the loans issued to SOEs would, in fact, go bad. This created a drain on the bank's capital, because they still had to honor the requests for withdrawals from their customers for their deposits, but still loan money to the SOEs.

Periodically, the PBOC would be forced to recapitalize each of the state banks, often from converting foreign reserves rather than straight from the Ministry of Finance (which acts similar to the U.S. Treasury). The PBOC sells dollar assets from the foreign exchange reserves to China's government-owned investment vehicles, namely the asset management companies (AMCs) under the supervision of China Investment Corporation. The AMCs buy stock in the banks and the banks raise more capital to issue more loans. The majority of these bad loans were offloaded from the state-owned banks' books to other AMCs or to foreign investors. However, most of these loans have not been repaid. Furthermore, the credit tightening policies from 2007-2008 resulted in a new round of NPLs from the booming real estate sector. Therefore, while the state-owned banks look much better on paper now than they did just five years ago, there is still a latent drag on the entire financial system if the new and old NPLs are not handled properly.

Foreign Investment and Crises. Another factor affecting the banks is foreign investment. As mentioned earlier, foreign investment creates inflationary pressures by increasing the foreign exchange reserves and the overall money supply. Chinese banks have also created financial relationships with American banks in the form of mutual stock

purchases. Bank of America and CCB in particular have had a relatively close relationship. When CCB first listed itself in 2007, Bank of America bought a stake in it, increasing its holdings to a maximum of 19.13% total ownership in late 2008.[5] This made it the largest shareholder of CCB aside from the Ministry of Finance and Central Huijin (also government-owned). However, the strain of the financial crisis on Bank of America quickly prompted it to sell what shares it could in order to raise capital for itself. It sold almost 10% of its owned shares over 2009, the maximum it was allowed to under the contract it has with CCB. By December 2009, Bank of America's stake had been reduced to 10.95% with no more shares available for sale until August 2011.[6] Bank of America raised $10.1 billion in capital for itself by selling shares in CCB.[7] Meanwhile, CCB has purchased Bank of America's Asian (Hong Kong) unit for a total of $1.25 billion.[8] In 2010, CCB announced that it would sell at least 75 billion yuan worth of shares over 2010 in order to raise more capital for itself.[9] The largest shareholder of all the big banks, Central Huijin, increased its stake in the three big banks in 2008 in order to replenish capital and assure investors that the big banks were healthy.[10] The foreign investment bulks up foreign exchange reserves, adding to liquidity in the market, because the government must issue more renminbi in order to keep the exchange rate as stable as possible.

---

[5] "CCB Says Partnership with BoA Unaffected." *China Daily.* January 9, 2009.
[6] *CCB Annual Performance Announcement 2009.* Page 69.
[7] "Construction Bank Confirms BoA Stock Sale." *China Daily.* May 14, 2009.
[8] Wang Bo. "CCB Expanding Global Footprint." *China Daily.* April 7, 2010.
[9] "China's Big Banks need $70 billion Capital in 5 years." *China Daily*. April 13, 2010.
[10] "China Huijin Increases Stake in Top Three Commerical Lenders." *China View.* September 23, 2008.

Financial crises, whether international or domestic, influence consumer confidence and the stock markets. China's stock markets have demonstrated themselves to be extremely sensitive to exuberance and panic. One might argue, though, that the current worldwide credit crisis has not directly impacted Chinese banks. Thanks to China's insulated reform policies, the banks were not authorized to deal in the multitude of financial products, such as mortgage-backed securities, available to foreign institutions. Their revenue consistently derived from strong growth in consumer and business deposits, and a fixed spread between paid deposit rates and lending rates. In addition, growth in deposits also came from the issuing of new loans. Thus, there was always, at least on paper, a steady source of income. In addition, the implicit government backing of the state-owned banks, the functional equivalent to of deposit insurance, strengthened their positions and allowed them to receive multiple capital infusions and restructurings. The first foreign factor mentioned, foreign direct investment, may have had a greater impact. First, the IPOs of three of the banks raised a great deal of outside capital. Second, the ballooning foreign exchange reserves provided a convenient well in which the government could dip into for those multiple capital infusions. Foreign reserves could be sold to government-owned investment companies, who turn and use those dollars to purchase stock in Chinese banks. However, the investment was also blamed for the rise of "hot money" that prompted the central bank to tighten the credit market.

"Hot money" refers to funds that investors constantly shift around toward for the highest short-term gain. For example, a bank can attract hot money by increasing interest rates on short-term deposits. As soon as those rates are lowered, the money flows away

again. For China, hot money has created a great deal of concern, because it can also have a large impact on the strength of a country's currency. When money comes into a country, its currency strengthens, and when it flows out, it weakens. Financial institutions that had benefited in the short term from "hot money" suddenly find themselves short on capital when it suddenly leaves. When central banks around the world lowered their interest rates at the same time, investors sought the best place to put their investments. Many came to China, putting pressure on the total money supply and driving up inflation in 2007-2008. The PBOC tightened its credit market over those years, bringing down inflation but creating new bad loans for Chinese banks in the process.

There is also the risk of "runs on the bank." Banks runs became famous during the Great Depression in the 1930's, and are still possible. In China, an investigation into the lending practices of several small, private financial institutions in Zhengzhou unraveled a Ponzi-style pyramid scheme in 1998.[11] The guilty shadow company fled the country, triggering a city-wide run on the banks. Contributing to the panic no doubt was the knowledge that there is still no formal deposit insurance system. The government was forced to place limits on the amount individual depositors could withdraw to prevent the private banks from shutting down completely.[12] Even in the United States, as recently as July 2008, banks face the same risk. After Senator Charles Schumer made several public accusations against Indymac, the bank and lending institution lost $1.3 billion in deposits

[11] Tsai, Kellee. Back-Alley Banking: Private Entrepreneurs in China. Cornell University Press. Ithaca, New York. 2002.
[12] *Ibid.,* pp 210.

to bank runs in just a few days.[13] It was eventually seized by the FDIC. However, bank runs and decreased deposits are not as likely to threaten China's Big Four banks as much as they threaten private institutions. The greater threat is from non-performing loans.

Protective Measures

Subsequent loosening of credit policies have increased loans and thus banks have begun to take steps to protect themselves in the event of capital flight or financial crises. One of these steps is to use provisions. The other is to take advantage of the backing of government-owned AMCs and China's foreign exchange reserves. We begin with provisions.

Provisions. These are expenses a bank creates to account for future losses or defaults on loans. In essence, provisions are money set aside by the bank to cover bad loans before they ever go bad. This ensures that a bank remains solvent and has enough capital to cover their deposits and other obligations. Typically, when provisions increase year-on-year, it means that the bank is taking on riskier loans. A bank with small provisions has taken on safer loans. When we look at China's banks compared to the behemoth Bank of America, several trends are apparent.

[13] "WaMu's Final Days: A 2008 Timeline." *Puget Sound Business Journal (Seattle).* April 12, 2010.

Table 4: Provisions and Losses in 2009 (in RMB billions)

	Industrial and Commercial Bank of China	China Construction Bank	Bank of China	Bank of America
Total Loans	5,276.57	4,322.58	4,418.79	5,966.4
Provisions for Bad Loans	133.5	161.92	139.22	145.07
Percentage Provision Increase over 2008	6.96	44.19	24.19	99.10
Net Charge-offs/Loan Losses	10.94	22.32	14.21	223.1
Percentage Increase in Charge-offs over 2008	-4.1	-33.08	-9.55	100.10

Source: Industrial and Commercial Bank of China Ltd. 2009 Annual Report, China Construction Bank Corporation 2009 Annual Report, Bank of China Limited 2009 Annual Report, Bank of America Corporation 2009 Annual Report, and author's own calculations. Conversion of dollar to rmb based on exchange rate on 12/31/2009 (1 dollar = 6.2883 rmb), the date the reports are filed.

First, as mentioned in the first section of this paper, the Chinese banks are increasing their provisions for loan losses. This indicates that they are anticipating a new round of bad loans in the near future, most likely as a result of their increased lending in 2009. ICBC's announcement that Chinese banks would need as much as $70 billion in fresh capital over the next five years is also a sign of trouble ahead.[14] Equally provocative is the disparity between Bank of America's losses and the Chinese banks' losses. Bank of America charged off more than $35 billion in bad loans in 2009, twice the amount it had lost in 2008. A charged off loan is a loan that the banks have given up hope of recovering

[14] "China's Big Banks need $70 billion Capital in 5 years." *China Daily*. April 13, 2010.

and have accepted as a loss. These are the loans that they create provisions for. However, while Bank of America's provisions are increasing equally with their losses, China's banks provisions are not. The provisions are growing faster than the losses. Again, this indicates that the banks are anticipating more losses in the future.

AMCs and Foreign Reserves. Another safeguard for Chinese banks is their continued government ownership via asset-management companies (AMCs). The state does not have to raise funds for the bank directly from its own budget. AMCs such as Central Huijin earn income off of their investments in the form of dividends. As Chinese banks have posted year after year of profit, it would seem that Central Huijin has the money to invest. It poured these funds right back into three of the Big Four to boost their capital base and reassure the public that the banks had government support.[15] In 2010, however, Central Huijin has started to show signs of strain itself. It made a request for and was granted approval by the State Council to raise $11.7 billion in new capital through the sale of bonds.[16] It had wanted as much as $50 billion. The reason behind this capital raising, it is speculated, is a keen interest in retaining majority control over the financial institutions it invests in, including the Big Four. The recent lending spree and prospect of a new round of NPLs is also a possible motivation.

It should also be noted that Central Huijin is the domestic arm of China Investment Corporation (CIC), which manages China's sovereign wealth fund. China has used foreign exchange before to recapitalize its banks, but it is not as simple as writing a

---

[15] "China Huijin Increases Stake in Top Three Commerical Lenders." *China View.* September 23, 2008.
[16] Rabinovitch, Simon. "China Huijin gets nod for $12 billion bond issue-paper." Reuters (Beijing). April 21,2010.

check. The banks issue more overseas shares, as they did in October 2009.[17] Then these shares are bought by CIC using dollars from the reserves. This strategy results in a direct increase in capital for the banks. Bank of America, facing a capital shortfall in 2009, raised money in two ways. First, it issued and sold more of its own stock, including shares that had previously been privately owned.[18] Then, it sells part of all of its shares held in other banks. For example, Bank of America sold all the shares it was contractually allowed to sell of its ownership in China Construction Bank, raising $7.3 billion.[19] Chinese banks have tended to buy more ownership in other banks over recent years, not sell their shares as Bank of America has. Industrial and Commercial Bank of China (ICBC) has bought shares of banks in Thailand, South Africa, Macau, and Indonesia.[20] Therefore, Chinese banks have had to rely on selling their own stock.

The PBOC cannot simply give the banks dollars straight from the foreign exchange reserves because they would have to be converted back into renminbi, resulting in a rise in net indebtedness.[21] Net indebtedness indicates long-term debt minus the assets held by the state in this case. In other words, simply handing dollars to the banks takes those dollars out of the PBOC's balance sheet, and those dollars were already borrowed money. The banks, then, must rely on their complex relationship with the AMCs and CIC in order to be recapitalized through use of foreign exchange reserves. Banks can also rely

[17] "Huijin Continues to Increase Shares of ICBC, CCB and BOC." *Global Times*. October 12, 2009.
[18] Barr, Alistair. "Banks Try to Raise New Capital Without Government Support." Marketwatch.com *The Wall Street Journal.* May 9, 2009.
[19] Flaherty, Michael. "Bank of America Sells $7.3 billion CCB Stake." www.reuters.com. Hong Kong. May 12, 2009.
[20] Yu, Rose. Ng, Michelle. Phromchanya, Phisanu. "ICBC to buy Thailand's ACL Bank." *The Wall Street Journal.* October 1, 2009.
[21] Pettis, Michael. "What the PBOC Cannot Do With Its Reserves." China Financial Markets Blog. February 22,2010. http://mpettis.com

on the favorable interest rates the PBOC gives them and lend at higher rates to customers.[22] In the event that NPLs do increase dramatically, China has already created the other four AMCs specifically to be saddled with bad debt. These AMCs still hold as much as 1.5 trillion yuan in bad loans from previous clean ups.[23]

The web of ownership and investment displayed in the figure above results from China's reform process combined with rapid economic growth. Rapid growth, with a trade surplus has given China a reservoir of foreign exchange reserves to invest. Those reserves not only protect the value of the renminbi, but also can be used to invest in overseas companies denominated in dollars, or, to re-invest in Chinese banks that have issued shares overseas.

Institutional Dependence

One common critique of recent Chinese banking reforms has been that all of these changes have been "cosmetic," without substantially changing the way the banking system works. It is true that the primary players in the system, such as the PBOC, as an extension of the state, and the Ministry of Finance still hold the greatest powers. There have also been recent examples of interference in the banks. For example, the Agricultural Bank of China agreed in March 2005 to provide an 80 billion RMB ($11.3 billion) credit line to a new economic zone founded in Fujian on the west coast of the Taiwan Strait, at the direction of the CPPCC.[24] The CPPCC, *Zhongguo renmin zhengzhe*

[22] McMahon, Dinny. "Victor Shih Sees Bank Bailout Redux." *The Wall Street Journal*. March 17, 2010.
[23] *Ibid.,* pp 2.
[24] Li Li. "Arena for Change." *Beijing Review*. Vol 51. No. 13. March 27, 2008.

xieshang huiyi, is the China's People's Political Consultative Conference, and is known for containing senior leaders of the Chinese Communist Party and their pet projects. It could be that the ABOC was chosen for this project because of its extensive branch network, as it claims to be the only Chinese bank with a branch in every township. It could also be that the other state-owned banks were completing their restructuring and preparing to list on the stock exchanges, and the possibility of creating a new 80 billion RMB non-performing loan would have severely impacted their initial appearance. However, a few years later, in 2008, ABOC was finally allowed to purge the NPLs from its books by handing them over government-managed fund, similar to what the other banks had done before. In 2007, CCB entered into an agreement with the Ministry of Railways to be the primary financier of the construction of a new express rail line between Beijing and Shanghai.[25] It was prepared to invest as much as 10 billion renminbi in the project. If the banks could be used in a manner such as this even in the last few years, then government interference remains.

Evidence for this interference is also found within the institutional relationship between the banks and the government. All four of the Big Four's largest shareholder is Central Huijin, a wholly government-run asset management company. In 2007, Central Huijin's largest shareholder became newly-formed China Investment Corporation (CIC). CIC was created by issuing 1.55 trillion RMB special bonds, which were immediately exchanged with $200 billion from China's foreign exchange reserve.[26] This was CIC's

[25] "Construction Bank to Invest in Beijing-Shanghai Express Railway." China Transportation Watch. SinoCast, LLC. October 30, 2007.
[26] http://www.china-inv.cn/cicen/about_cic/aboutcic_overview.html

starting capital. It invests in all sectors of China's economy, using the foreign exchange reserves to do so. Subsequent recapitalizations of the banks have come directly through this relationship between CIC, Central Huijin and the banks themselves. In this manner, the banks are dependent on not only Central Huijin as their primary investor, but also China's sovereign wealth fund as a source of capital.

Agricultural Bank of China

Perhaps the brightest demonstration of the continued dance between state control and privatization has been the ongoing story of the Agricultural Bank of China. The first three of the "Big Four" listed on stock markets several years ago, but the ABOC has lagged behind. It holds perhaps the largest socialist legacy of all the banks: the mandate to provide rural and agricultural credit. It began its corporate restructuring process in 2008 by offloading bad debts onto asset management companies and receiving a capital infusion.[27] It became a joint-stock company in 2009, and began to search for investors. In July, 2010, it underwent a long-awaited initial public offering, projecting to raise 149 billion RMB ($22.1 billion), which would surpass the previous largest IPO of Industrial and Commercial Bank of China.[28]

However, despite these impressive numbers, the ABOC faces an identity crisis. Should it continue to extend credit to poor farmers, who are not likely to bring in profits for the bank, or should it tap into the lucrative real estate and construction market, as it has been beginning to? As the bank looks for profits, it is more likely that the poorer

[27] www.abchina.com
[28] Chu, Kathy. "Agricultural Bank of China IPO Could Set Record Next Week." *USA Today.* July 8, 2010.

farmers will be left outside of the system, but the impressive reach that the ABOC has into all parts of China will make it an attractive investment for others. The culmination of ten years of banking reform ends with the bank with the most social burden taking the step forward.

Conclusion

The worldwide financial crisis has revealed both the complexity and fragility of banking systems in both the U.S. and China. China chose to reform its banking system only recently, beginning by partially opening the economy to a dual-track partially planned, partially free market system, and placed the burden of supporting the planned economy squarely on the Big Four banks. While Deng Xiaoping created the Special Economic Zones (SEZs) on the southeastern coast, he placed the burden of funding the inefficient, welfare-burdened state-owned enterprises (SOEs) squarely onto the banking system. After the economy began to grow, and new capital was generated by foreign investment, did the Chinese government turn to their next pressing issue: reforming the SOEs. Not until they had found a solution to the potential political explosion that was tens of millions of laid-off SOE workers could they begin looking at the banking sector. However, they could not wait indefinitely. The Asian Financial Crisis in 1997 demonstrated to the Chinese government that a weak banking system could bring down the entire economy of a nation, even those growing as quickly as those in Southeast Asia. Even former Soviet Russia could not escape the capital loss from the crisis. China weathered the Asian Financial Crisis much better than its neighbors, in no small part because its own banking system was not open to the world yet, and it controlled most of the capital flow within its borders. As the economy continued to flourish in China in the 1990's and early 2000's, it became clear that the government would have to exert some sort of macro-level control over inflation. Thus the PBOC and CBRC were given their current roles as monetary policymaker and banking watchdog, respectively, to safeguard

the financial system. The large state-owned banks, starting with China Construction Bank, then Industrial Commercial Bank of China, then Bank of China, underwent corporate restructuring and recapitalization. Government-owned asset management companies were created, one set with the purpose of disposing of prior bad loans, the other for retaining government ownership in the banks. The Agricultural Bank of China, bank with the greatest legacy burden, is joining their ranks.

What might be the result of China's banking reforms, and what shape would a banking crisis take? Massive government intervention has enabled them to post enormous profits even as American banks plead for bailouts or succumb to market pressures. Individually, these banks appear capable enough. However, systemic issues remain in China, echoed through the weaknesses found in Indonesia and elsewhere during the Asian Financial Crisis. Widespread lending could result in an "overstretching" of financial resources and lead to the creation of more bad loans. The banks, may require future bailouts that pull even more financial resources out the system. If the dollar weakens, as it did in 2008, China will suddenly be sitting with assets that are worth less, and the dollars brought in from abroad will not go quite as far as they did before. The Chinese regulatory agencies, not only the CBRC but also the China Securities Regulation Commission, which oversees equity and stock market transactions, remain relatively untested. The Chinese economy, which has grown at an unprecedented rate for the last thirty years, faces the risk of inflation or deflation and asset bubbles.

Knowledge about China's banks and the reform process over the last ten years still needs to be explored in further detail. The complex interactions between the government, the central bank, the asset-management companies and the banks have been introduced in this paper. The creation of regulatory agencies and asset-management companies are just the beginning. China's explosive growth has given rise to this particular institutional structure because of the potential of the foreign exchange reserves, managed by the central bank and invested by the sovereign wealth fund. The banks may continue to see benefits from these arrangements.

Future research on this topic must examine certain issues in more detail. First, a close account of China's current NPLs, particularly the new ones, and how they have been disposed of, must be undertaken. Have they been confined to the new infrastructure projects mandated in the stimulus of 2008? Or real estate and the stock markets? In addition, we must look at the NPLs effect on China's GDP, instead of just a gross percentage, but rather as actual production lost each year because of this bad debt. Furthermore, here we have only examined the state-owned banks, but there are many other financial institutions within China playing an equally important role. Joint-venture, foreign-owned, urban and rural cooperative banks make up the rest of the market share, and are not subject to all the same rules and burdens as the state-owned banks. While research on any particular topic is never fully completed, we must also observe how the current world financial crisis is truly affecting China's banks, because there is inevitably some delay between annual reports, when news is reported, and when actual corporate decisions are made. These research topics and sources would greatly strengthen this

preliminary look at China’s state-owned banks. We must understand how these recent changes to the banks will impact the strength of China’s financial system as a whole, and whether it will be able to weather the storm.

BIBLIOGRAPHY

Allen, Qian. "China's Financial System: Past, Present and Future." Reforming China's State-Owned Enterprises and Banks. Ed. Chiu, Becky and Lewis, Mervyn K. Edward Elgar Publishing Limited. Cheltenham, UK. Northhampton, MA. USA. 2006.

Barr, Alistair. "Banks Try to Raise New Capital Without Government Support." Marketwatch.com *The Wall Street Journal.* May 9, 2009.

Bradsher, Keith. "China's Inflation rose to 7.1% in January." *The New York Times.* February 19, 2008.

Caprio, Gerard. Klingebiel, Daniela. "Episodes of Systemic and Borderline Financial Crisis." The World Bank. January 2003.

Chen, Chien-Hsu and Shih, Hui-Tzu. Banking and Insurance in the New China. Edward Elgar Publishing Limited. UK. 2004.

Chen Jintao. "Chen Jintao wei niding shumin yinhang zheli qingcijiao canyiyaun yijue shixing chenggao" (Chen Jintao's report to the Senate for implementing the temporary regulations of common people's banks), from CSHA, *Jinneng fagui*.

Cheng, Linsun. Banking In Modern China. The Cambridge Press. Cambridge, U.K. 2003

Chung, Connie Wee-we. Tongzon, Jose L. "A Paradigm Shift for China's Central Banking System." *Journal of Post-Keynesian Economics*. Vol 27. No. 1. Autumn, 2004. Pg 87-103. Published by M.E. Sharpe.

Cousin, Violaine. Banking in China. Palgrave MacMillan. New York, NY. 2007.

Flaherty, Michael. "Bank of America Sells $7.3 billion CCB Stake." www.reuters.com. Hong Kong. May 12, 2009.

Healey, Nigel M. and Ilieva, Janet. "The Background to Reform: Central Banking in a Command Economy." Central Banking in Eastern Europe. Ed. Healey, Nigel and Harrison, Barry. Routledge, Taylor & Francis Group. London and New York. 2004.

Horčicová, Milena. Payson, Liana. "The Old Bad Debts Problem: The Czech Experience." *Eastern European Economics.* Vol. 35, No. 2. M.E. Sharpe. March-April 1997.

Huang Zhen. "Building on a Bubble." *Beijing Review*. Vol 46 No 18. May 1, 2003.

Kornai, Janos. Highways and Byways: Studies on Reform and Post-Communist Transition. The MIT Press. Cambridge, Massachusetts. 1995.

Johnson, Chalmers. MITI and the Japanese Miracle. Kodansha Europe. 1986.

Johnson, Juliet. A Fistful of Rubles: The Rise and Fall of the Russian Banking System. Cornell University Press. Ithaca and London. 2000.

Lan Xinzhen. "Drowning in Illegal Capital." *Beijing Review.* Vol 50 No.27. July 5, 2007.

Lan Xinzhen. "Impending Crisis for Mortgage Lenders?" *Beijing Review*. Vol 51. No.32. August 7, 2008.

Lane, David. Ed. Russian Banking: Evolution, Problems and Prospects. Edward Elgar. Cheltenham, UK. 2002.

Li Li. "Arena for Change." *Beijing Review*. Vol 51. No. 13. March 27, 2008.

Li Rongxia and Lan Xinzhen. "Shanghai Property Market Facing Credit Crunch." *Beijing Review*. Vol 46 No. 26. Jun 26, 2003.

Li Zi. "Possible Mixed Banks." *Beijing Review*. Vol 47 No. 2. Jan 8, 2004.

McMahon, Dinny. "Victor Shih Sees Bank Bailout Redux." *The Wall Street Journal.* March 17, 2010.

Meyendorff, Anna. Snyder, Edward A. "Transactional Structures of Bank Privatizations in Central Europe and Russia." *Journal of Comparative Economics.* No. 25. Revised April 30, 1997.

Mo Ran. "State Bank Reform." *Beijing Review.* Vol 47 No. 31. Aug 5, 2004.

Montes, Manuel F. The Currency Crisis in Southeast Asia. Institute of South Asian Studies. 1998.

Naughton, Barry. Growing Out of the Plan. Cambridge University Press. Cambridge, UK. 1995.

Pangestu, Mari. "The Indonesian Bank Crisis and Restructuring: Lessons and Implications for Other Developing Countries." G-24 Discussion Paper Series. No. 23. United Nations. Center for International Development, Harvard University. November, 2003.

Pettis, Michael. "What the PBOC Cannot Do With Its Reserves." China Financial Markets Blog. February 22,2010. http://mpettis.com

Rabinovitch, Simon. "China Huijin gets nod for $12 billion bond issue-paper." Reuters (Beijing). April 21,2010

Saéz, Lawrence. Banking Reform in India and China. Palgrave Macmillan Press. New York, New York. 2004.

Shih, Victor C. Factions and Finance in China: Elite Conflict and Inflation. Cambridge University Press. Cambridge, New York. 2008.

Srinivas, P.S. Sitorus, Djauhari. "State-Owned Banks in Indonesia." The Future of State-Owned Financial Institutions. Brookings Institution Press. Washington, D.C. 2004.

Tan Wei. "Banks get IPO Windfall." *Beijing Review.* Vol 47 No. 8. Feb 26, 2004.

Tan Wei. "Gold Fever?" *Beijing Review*. Vol 50. No. 2. January 11, 2007.

Tan Wei. "The Value of Worthless Assets." *Beijing Review.* Vol 48 No. 5. February 3, 2005.

Tang, Edmond. "ABC to Launch $11.4 billion HK IPO." *The China Daily.* June 30, 2010.

Tsai, Kellee. Back-Alley Banking: Private Entrepreneurs in China. Cornell University Press. Ithaca, New York. 2002.

Wang Bo. Jiao Xiaoyang. "Agricultural Bank plows ahead." *China Daily.* March 11, 2010.

Wang Bo. "CCB Expanding Global Footprint." *China Daily.* April 7, 2010.

Woetzel, Jonathan R. "Reassessing China's State-Owned Enterprises." McKinsey Quarterly. *Forbes Magazine*. July 8, 2008.

Yu, Rose. Ng, Michelle. Phromchanya, Phisanu. "ICBC to buy Thailand's ACL Bank." *The Wall Street Journal.* October 1, 2009.

Yuan Yuan. "ABC Reform Gets Green Light." *China Daily.* October 22, 2008.

Yue, Hu. "Spending Our Way Out." *Beijing Review*. Vol. 51. No. 48. November 27, 2008.

Zhou Xin, Wheatley, Alan."China Bank Lending Slows as Beijing's Curbs Bite." Reuters. April 12, 2010

Zhu Jiadi. "Will a Financial Crisis Break Out?" *Beijing Review*. Vol. 46 No. 1 Jan 16, 2003.

VITA

Rachel Marie Vought was born in Houston, Texas. Upon graduation from Memorial High School in 2002, she entered the University of Texas at Austin, graduating with a bachelor's in Asian Studies and Liberal Arts Honors in 2006. She was employed for two years with Washington Mutual Bank. In 2008, she entered the Graduate School at the University of Texas at Austin for the Asian Cultures and Languages Master's Program. She is married to Jeremiah Vought.

Email address: Rachel.vought@yahoo.com

This thesis was typed by the author.