China: Banking Reform and Economic Development Revisited

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In early August 2007, He Fan of the China Academy of Social Sciences warned the US to stop escalating demands that China allow the yuan to appreciate against the dollar. Speaking in the state-run *China Daily*, He Fan noted that China has stockpiled "a large sum of US dollars" and has up until now played a crucial role in "maintaining the position of the US dollar as an international currency."

Undaunted by China's possession of US$1.3 trillion in foreign reserves, including over US$400bn in US Treasury securities, US Treasury Secretary, Henry Paulson, repeatedly referred to the commentary as "absurd," and he rejected the idea that China had powerful leverage in an economic showdown with the US. His buoyancy and good cheer about the predicament contrasts with previous warnings from Clinton Administration Treasury Secretary, Lawrence Summers, who speaks of the Sino-US relationship as a "balance of financial terror" similar to the cold war's mutual assured destruction. Reagan-era Assistant Secretary of the Treasury, Paul Craig Roberts, brought the metaphors of military catastrophe more directly to the fronts in Afghanistan and Iraq:

"If China ceased to buy US Treasuries, Bush's wars would end. The savings rate of US consumers is essentially zero, and several million are afflicted with mortgages that they cannot afford. With Bush's budget in deficit and with no room in the US consumer's budget for a tax increase, Bush's wars can only be financed by foreigners."

In July 2007, US Department of Housing and Urban Development Secretary, Alphonso Jackson, actually had meetings with China's central bank Governor, Zhou Xiaochuan, and Minister of Construction, Wang Guangtao, with the aim of persuading the central bank to buy up a lot more mortgage-backed securities. In June 2006, China possessed US$107.5bn in US mortgage-backed securities. Jackson also hoped that the China Construction Bank might invest in US mortgage-backed securities. One moment the US turns to China for apparent economic relief; the next moment they are telling China to reform themselves pronto.

Though banking reform remains a backdrop to the latest drama, the US Treasury Department has long pressed China to carry out a renovation of the nation's financial system. China's ascension to the World Trade Organization is regarded as the vehicle that can open the economy to foreign bankers and a new era of market-driven efficiency. While there are now foreign banks open for business, China's financial sector is still under the domination of the 'Big Four' banks (Bank of China, China Construction Bank, Agricultural Bank of China, and the Industrial and Commercial Bank of China).

In recent years, foreign banks have invested several billion dollars for a minority stake in these gargantuan state-owned banks. "Since 2002," reports *Bloomberg Markets* (May 2007), "Chinese banks have sold US$52.4bn of shares in public offerings." This may seem odd given the reigning opinion about the Big Four's performance. China's banking system is regularly derided as wretched, with one academic account evoking the image of a lumbering "elephant mired in a swamp."

A grand paradox seems to linger then: how does torrid economic growth co-exist with banking judged swamp-like, elephantine, and awful? If not fully able to resolve the contradiction between China's weak financial sector and 30 years of blistering 9% economic growth, many analysts step up predictions that sub-par banking could eventually capsize the economy and bring the great wave of industrial development to a crashing halt. Back in 2002, Joshua Kurlantzick, the foreign editor of *The New Republic*, wrote an article called "Asia Minor: Is China's economic boom a myth?" which raised the spectre of "a useless banking system" that by 2008 "could lead to millions of Chinese trying to withdraw their life savings from banks, followed by panic when they realize the banks are insolvent, and potentially massive social turmoil."

In contrast, Indian political economists Jayati Ghosh and C.P. Chandrasekhar are rare analysts who find some redeeming features in China's financial system for superior coordination of national development objectives compared to India's banking order. The blogosphere promptly greeted them with hot-tempered vilification.

Let me explore why China's banking order may work slightly better than might be imagined by those listening to the non-stop chorus calling for financial liberalisation, expanded foreign ownership, and overall modernisation. Many Chinese leaders openly admit and are working to remedy the system's shortcomings: the petty corruption, the vast oceans of non-performing loans (NPLs), the least efficient firms often having better access to loans than the most efficient, and the limited services for small-fry customers and businesses. So long as ministers rather than markets determine interest rates, however, there will be those who will shout that China is not doing enough, with the predictions of a future development debacle.

Let's begin with a few propositions about the role of banking in economic development:

1. **Good banking does not always lead to stellar economic performance.**
   To take two examples from 19th century Europe, the Netherlands and Sweden had reputations for outstanding banking. Yet Catholic Belgium pulled way ahead of the Calvinist, 'Protestant ethic' Netherlands in industrialisation. Buried among the poorest nations of Europe until the growth spurt of 1870-1914, Sweden was an "impoverished sophisticate," according to economic historian Lars G. Sandberg. Sweden's economic takeoff and subsequent affluence owed less to banking and more to the UK's dismantling of tariff walls (1846) and timber duties (1866), which eventually allowed Swedish oats, iron, and timber to pour into the UK.

2. **Export-led growth may benefit from sub-optimal banking and interest regimes.**
   China's central bank has preferred to park several hundred billion dollars in safe but

low interest yielding Treasury bills, thus contributing to US economic stability and allowing the US consumer to keep on shopping. (The mortgage meltdown in the US may indeed threaten to rein in the overconsumptionist lifestyle that keeps China's factories churning.)

Meanwhile, the low, sub-optimal interest rates paid out by China's banks reduce upward pressure for the appreciation of the yuan. There are indeed analysts who cite this factor in arguing that the US may wildly overestimate how much a freely traded yuan would gain against the dollar.

There are, however, pressures for a more generous banking order. Recognising that the Chinese economy is too vulnerable to shocks and turbulence overseas, China's leadership wonders if improved interest rates for the high-saving Chinese worker might be one avenue to get more yuan into the hands of domestic consumers. While sustained wage gains would be a faster way to promote domestic consumption, China has fears that more expensive labour could provoke transnational corporations to shift production to lower-wage alternatives in Indonesia, India, Vietnam and Cambodia.

China's financial institutions could embrace better techniques of risk management that would channel more assets to higher-yield investments and reduce the amount in the safe but low-yielding US Treasury vehicles. Perhaps worshipping a false god in hopes of generating Chinese-style growth rates, several other developing nations are emulating China's example of loading up on US Treasuries.

3. **Reformed, responsive banking systems may boost microfinance and neglect macrofinance.**

Microfinance has won near universal appeal, with foundation largesse lavished upon those spreading the gospel and a Nobel Peace Prize granted to the Grameen Bank and Bangladesh's pioneering Muhammad Yunus. The political right admires microfinance for getting plucky peasants and street vendors on the road to entrepreneurial glory, while the left has grown to fear the macrofinance of grandiose infrastructure projects and World Bank development schemes that reward what the anti-Stalinist peace activist E.P. Thompson once called "the Marxism of the heavy industrial base."

Though it has undoubtedly delivered many genuine and heartwarming stories of individual triumph, microfinance in its most celebrated heartlands such as Bangladesh remains part of a decidedly impoverished landscape. China's leadership has given priority to macrofinance and infrastructure, which in some cases has trampled on the rights of communities but in others has given regions the means to escape a world of scarcity and squalor.

Still, China's banking institutions are not seen as particularly accomplished in infrastructure development, as China has relied on government funding and major loans from the World Bank to carry out many of these projects. Private firms dominate small-scale housing construction especially in the south, while urban infrastructure remains the domain of state-owned enterprises (SOEs), which can count on better access to China's banking behemoths.

4. **Banking reform drains financial support for SOEs and can threaten social stability.**
The overwhelming thrust of criticism against China's banking industry has been directed against the system's favoritism of SOEs. In 1995, 83% of outstanding loans from China's banks went to SOEs, according to a Brookings Institution study by Nicholas R. Lardy. With more diverse sources of revenue and skyrocketing foreign investment, the government decided to crack down on loss-making SOEs, and manufacturing employment in the SOEs tumbled by two-thirds in the late 1990s. By the early 2000s, an estimated 30-40 million SOE workers underwent job displacement.

Those armies of unemployed have been a feared source of social unrest, with China worrying that more ambitious austerity measures against SOEs could bring the sort of volcanic upheaval that might put the modernisation project on the road to implosion.

Meanwhile, western media almost never report any positive aspects of SOEs. In 2004, I visited the state-owned mining firm, the Kailuan Group, which took pride in a superior safety record. In that year, 6,027 miners perished across China, and many private firms had execrable records in safety. In December 2005, when the privately operated Liuguantun mine in Tangshan had one of the year's worst mine disasters, initially leaving 54 dead and 22 missing, the state-owned Kailuan Group sent in two rescue teams and was counted on by the State Administration of Work Safety to stabilise a traumatised mining community. (A century ago, the future US president Herbert Hoover worked as a mine manager in China for the firm that merged with Kailuan, long before the company would be expropriated by the Chinese communists and turned into an SOE.) Some SOEs treat workers better than private production firms, and there are Communist cadres who regret that private operators are not held to higher standards. In May 2005, villagers dwelling near the Chaoshui River of central China destroyed over 200 mining sites when they recognised that private molybdenum miners had fouled rice paddies, killed off the fish, and caused flesh-eating rashes in children who bathed in the once sparkling waters. Officially, three of China's Big Four banks now claim vastly improved performance in reducing NPLs to single-digit percentages of their outstanding loans. The exception is the Agricultural Bank of China (ABC), which has an NPL rate exceeding 25%. In most advanced industrial nations, the agricultural sector is marinated with billions of dollars of government subsidies. China has left some of this dirty work to the banks. With a growing income gap between wealthy urban zones and the vast countryside, China may have reasons for relying on less stringent rural banking policies as one means of averting the feared scenario of Taiping-style social explosion. Employing over 100 million workers in the early 1990s, TVEs (township and village enterprises) served as subcontractors for the SOEs, and many TVEs went belly up when the Communist Party abandoned inefficient SOEs. TVEs were part of the collateral damage, sending NPL rates spiraling.

Financial Reform Today

Critics of China's banking system acknowledge major progress on several fronts:

1. The share of new loans going to households climbed to 20.2% in 2002, up from a miniscule 1.1% as recently as 1998. Home and automobile ownership rates are rising due in part to this development.

2. There has been a dramatic decrease in NPLs. Nevertheless, loans are increasingly backed by real estate, which could be vulnerable if overheated urban property markets go into collapse, or what some see as a future Sino variation on the Japan banking syndrome.

3. A crackdown on corruption has given pause to various banking malefactors. Auditor-general Li Jinhua, popularly called 'Iron Face', has taken down some of the nation's most powerful bankers. Liu Jinbao, who headed the Hong Kong division of the Bank of China, received a suspended death sentence in 2005 for his failure to explain the source of US$2m in personal assets and for embezzlement of US$1.8m. Zhang Enzhao, formerly head of the China Construction Bank, received 15 years in prison in November 2006 and, since 2003, Wang Xuebing, past president of the Bank of China and China Construction Bank, has been serving a 12 year sentence. The Communist Party announced that, in 2006, 100,000 party members underwent discipline for taking bribes.

4. The greater transparency from Li Jinhua's crackdown has improved investor confidence in those state-owned enterprises that have shares on public markets. Interviewed by *Bloomberg Markets* (May 2007), Mark Mobius of Templeton Asset Management declares, "We feel a little more comfortable with the Chinese state-owned companies since not only do you have independent auditors looking at the books, but you also have the government investigative and monitoring agencies looking at them. It's wonderful what they are doing."

Building an effective financial architecture took centuries in many nations of the West. Botched financial reform in post-communist Russia might be a cautionary tale for those so eager for China to quicken the pace of market-oriented transformation. China has broken with orthodox approaches calling for 'shock therapy' and has instead kept on a course of gradualism. "Over the space of a quarter century, China has managed to build financial markets that, for all of their flaws, have still managed to function effectively enough to power one of economic history's great development successes," writes economist Lee Branstetter in the edited volume *China's Financial Transition at a Crossroads* (2007). "Only when one compares the speed and nature of reform of financial markets in China to the reform of other sectors of the economy does progress appear to be slow." With the capitalist world in great turmoil during the summer of 2007, the US Federal Reserve and European Central Bank delivered financial injections exceeding US$200bn for the purpose of soothing panicky investors. Urging China's central bank to surrender to market imperatives, US policymakers may have chosen a less than ideal historical moment for sermons on the Washington Consensus.

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