

Modernization of Chinese banking market:

A concise history since 1911

How did China's political development influence the development of the China's Banking system?

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Table of content

Chapter 1	Introduction.....	2
Chapter 2	Closed economy versus open economy	4
Chapter 3	The rise of Chinese Banking.....	6
Chapter 4	The republic of China (1911 – 1928)	8
Chapter 5	Nationalistic China (1928 – 1949).....	11
Chapter 6	Communitic China (1949 – 1976).....	12
Chapter 7	The period after the Great Proletarian Cultural Revolution (1976 – today).....	15
Chapter 8	Conclusions.....	17
	References.....	18

Chapter 1 Introduction

The world is suffering a depression. Not since the Great Depression has the worldwide economy been more impacted. Despite (statistical) growth in 2010, the worldwide economy is at large risk. Mainly one country seems to benefit. Where other countries struggle, China shows rapid economic growth. With yearly GDP growth rates up to 10%, China is quickly catching up with the United States and Europe. The economic power is shifting and the world is changing. It is extremely interesting to investigate why this is happening.

Though there are many possible reasons, this article will search for causes in the development of the Chinese banking market. The ability to lend out money and the capability to influence interest and exchange rates are important economic drivers. The banking sector has big influence on these drivers.

During the crisis the Federal Reserve and several European governments had to bail out “local” banks, to prevent them from falling and to prevent a system crash. Though several banks stand-alone again, it will take at least the next decade to recover fully. During the period of recovery the influence of the United States and the European Union on worldwide economics will decrease. Chinese banks however seem unharmed and benefit from this crisis. While most European banks focus on their home markets, Chines banks are expanding their cross border activities rapidly.

Was the Chinese banking sector always this competitive? And why are Chinese Banks currently in this competitive situation. To understand this, this thesis will investigate 100 years of Chinese Banking in an historical and political perspective. Chronologic this article will describe 4 periods in Chinese history, the periods are:

1911 – 1928	Republic of China
1928 – 1949	Nationalistic China
1949 – 1976	People’s Republic of China
1976 – Today	The period after the Great Proletarian Cultural Revolution

Deng Xiaoping once said: “It doesn’t matter if a cat is black or white, as long as it catches mice”. He suggested that a countries political system is irrelevant as long as its results are good. Levine suggests that the development of an banking sector has a positive linear relationship with economic growth¹. Is it be that easy for China? What would the results be if politicians would continuously stimulate the growth of the banking sector? How did 100 years of political choices influence the development of the banking sector? Did for example these political choices allow the Chinese banking system to develop optimal? Or did the development of Chinese banking system start just recently, mainly due to political changes? A concise description of 100 years of Chinese history will attempt to create better understanding of these questions. The research question thereby is:

How did China’s political development influence the development of the China’s Banking system?

The following secondary questions will be answered:

- *How developed was China’s banking system during each political area?*
- *Which period and which development in the 100 year of Chinese history had the biggest impact on the current Chinese banking system?*

¹ Levine, R. (1997). Financial Development and economical Growth: views and agenda, Journal of economic Literature, Vol. 35, p. 689

- *What was the impact of that development on China's worldwide economical competitive position measured by Gross Domestic Product (GDP) as a percentage of worldwide GDP?*

In these 100 years of history, China has switched from an open economy to a closed economy and back. This political change has an big impact on the development of the banking sector and the economy. Therefore chapter 3 will theoretically describe what impact the is on a banking sector and on an economy. The theory will be used to better understand the effect of the political choices in the 100 years of history. To understand how the banking system is originated before 1911, chapter 4 describes the long history of Chinese banking until 1911. Chapter 5,6,7 and 8 describe the transition of the Chinese banking sector from 1911 until today. Also chapter 5,6,7 and 8 explain the influence of the political situation on this transition. Chapter 9 answers the research questions.

Chapter 2 Closed economy versus open economy

In contrast with an open economy, there is no international trade and finance in a closed economy. The impact of no international finance on a banking sector is significant and could theoretically impact the banking in different ways. First the central bank cannot increase the money aggregate by lending on foreign money markets. Second, due to the domestic restricted ownership of shares, foreign companies cannot jointly own local banks which could lead to less SME financing and a bigger financing gap ratio². Besides that an open economy stimulates competition and therefore drives money to more competitive and more financial healthy companies³.

A central bank that cannot lend from foreign markets is restricted to its own capability to supply its home market with money. In a closed economy a central bank normally has exclusive power to change the volume of the money aggregate. When a central bank increases the money aggregate and offers this additional money to local banks for low interest rates, then local banks wil lend out extra money to local companies. The availability of extra, low priced, money will stimulate investments and will have an short term positive affect on productivity and economy. A long period of low interest rates combined with sufficient money supply for investors, can make productivity and economy grow rapidly. This

² Tai-Leung Chong, T., Lu, L., Ongena, S. (2010) Does Banking competition alleviate or worsen credit constraints faced by small and medium enterprises? Evidence from China, EBC

³ Park, A., Sehart, K. (2001) Test of Financial Intermediation and Banking Reform in China, Journal of Comparative Economics, p. 608-644

effect can be bigger in an open economy. Then the central bank can lend additional money from foreign markets and the money aggregate can grow faster, which can lead to increased economic growth. With the available historical data it is difficult to investigate if these type of effects occurred in China. At least a country's Gross Domestic Product (GDP) is an indicator for a country's value expressed in money. Assuming that the total money aggregate and the GDP have a linear relationship, the available data on GDP will be used to analyze how the type of economy impacted the size of the money aggregate and the economy.

In a perfect economy the money aggregate grows stable, interest rates and inflation are stable. In a perfect economy the banking sector is stable too. The ability to provide companies with money is stable. The equilibrium of the amount of money the banks lend out and the amount of buffer capital to secure the lending's is stable as well.

When an economy changes from a closed to an open economy, foreign investors will enter the market. If those foreign investors buy shares from local banks, the equity of those banks, and with that the buffer capital, increases. This will change the equilibrium. According to the current Basel rules, a higher buffer capital provides a bank the opportunity to lend out more money. To meet foreign investors profit demands, the banks will use this opportunity.

Companies will have more access to money and with that increased investment opportunities. Because foreign investors normally are profit driven, money will flow to the most competitive companies. Recent investigation by Chong, Li and Ongena has shown in China that mainly underexposed companies with a low financing gap ratio will benefit⁴.

In a closed economy investment decisions are made less rational and money is not enough available for profitable companies. This view is supported by research done by Park⁵. In an open economy normally money should flow to the most competitive companies. This can only occur in a perfect market situation where all information about the lenders of money is available and where rational decisions are made. If for example domestic banks have an irrational preference for certain companies, then an economy could perform less than it would be capable of. Competitive companies might not get full access to the money they need for maximum growth. In an open economy this will occur less. Foreign investors will likely behave less irrational when they provide companies with money. Money therefore will naturally flow to the more competitive companies, which would give those companies growth opportunities and that would lead to increased economic growth.

Did the Chinese banks make rational money lending decisions in the periods when China was a closed economy? Was the banking sector only focused on specific sectors and did not all profitable companies get enough money supplied? This also will be further analyze in the following chapters.

⁴ Chong, L.

⁵ Park, A.

Chapter 3 The rise of Chinese Banking

This thesis is focused on the development of the Chinese banking sector in the last 100 years. The development of Chinese banking was initiated already far before this period. To have better understanding of the last 100 years of Chinese banking I briefly describe this history.

Research has learned the first banking activities in China already occurred more than 2000 years ago. During the Tang dynasty (618 – 907) the world's first banking transactions were done⁶. Traders in that period used “flying money”, which was a by the government issued paper, that could be traded for money. When the Song dynasty (960 – 1279) arrived Chinese banks were executing all relevant banking functions⁷.

In the Qing dynasty the Chinese banking sector grew fast. Three groups of banks were active. the Qian Zhuang, the Piao Hao and foreign banks dominated the market.

Table 1.1 Capital spread in the Chinese financial market (1894)

Organisation	Capital		Other Funds		Total	
	Amount	%	Amount	%	Amount	%
Qianzhuang	42	19%	238	37%	280	32%
Piaohoa	143	65%	160	25%	303	35%
Foreign Banks	35	16%	245	38%	280	32%
Total	220	100%	643	100%	863	100%

Source: Linsun Cheng, p. 19

In Shanxi the company Xiyuecheng Dye Company opened the Piao Hao. At first these banks were mainly focused on transferring money. To meet competition the firm was reorganized into a financial institution. Later the Piao Hao became responsible for transferring government money to the capital of China. Through this good relationship with the government, the Piao Hoa started executing more governmental tasks. Slowly the Piao Hoa grew to become government institutions.

In the same period that the Piao Hoa arise the Qian Zhuang entered the market. The Qian Zhuang banks were small local financial institutions that operated as commercial banks. Unlike the Piao Hao the Qian Zhuang was focused on small enterprises and citizens. These banks were merely active around the long river in cities like Ningbo, Shanghai and Shauxing.

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⁷ Cheng, L., Banking in modern China, Entrepreneurs, Professional Managers, and the development of Chinese Banks, 1897 – 1937, Cambridge University Press, 2003 p. 14

Already in that period the banking sector and the political power was split into the northern area (around Beijing) and the southern area (around Shanghai). Historically the Qian Zhuang increased their business through foreign trade. Beijing was the center for foreign trade. Around 1900, when the Qian Zhaung declined foreign services, the “Piao Hao” took over this position. Shanghai replaced Beijing as financial center.

The third big group of banks were foreign banks. In 1894 foreign banks had 32% of the capital market. Banks from Belgium, Britain, France , Germany, Japan, Portugal and Russia were active on the Chinese market. Below an overview of foreign countries which possessed bank note issuing privileges around 1911.

Table 1.2 Foreign Note Issuing Banks of Imperial China (1900 – 1912)

Issuing Authority and (Branches)	Parent Country	Dates	Denominations
Bank Belge Pour l'Etranger (Bank Sino-Belge) (Hankow, Peking, Shanghai, Tientsing)	Belgium	1912 1913	1, 5, 10, 50, 100 dollars/piastres 5 exican dollars
British and Belgium Industrial Bank of China	Britain Belgium	1912	5, 10 taels
Deutsche-Asiatische Bank (Hankow, Peking, Shanghai, Tientsin, Tsingtao)	Germany	1907 (2X) 1914 (2X)	1, 5, 10, 20, 50, 100, 500 taels 1, 5, 10, 25, 50, 100, 200 dollars
International Banking Corporation (Canton, Hankow, Harbin, Peking, Shanghai, Tientsin)	United States	1909 - 1919 1918	1, 5, 10, 50, 100 dollars 1, 5, 10, 50, 100 taels
Banque de l'Indochine (Canton, Shameen, Shanghai)	France	1901 - 1902	1, 5, 10, 100 dollars/piastres
Banco Nacional Ultramarino (Macao)	Portugal	1905 - 1942 1920 - 1942	1, 5, 10, 25, 50, 100 patacas 1, 5, 10, 20, 50 avos
Netherlands Trading Society (Shanghai)	Netherlands	1909 1922	1, 5, 10 dollars 50, 100 dollars
Russo-Asiatic Bank (Harbin, Kuld'sha, Changuchak, Kashgar, Newchwang, Peking, Shanghai, Tientsin)	Russia	1910 - 1917 1917 1913 - 1924 1914 1917	1, 5, 10, 50, 100, 500 dollars 50 kopeks, 1, 3, 10, 100 roubles 1, 2, 10, 50, 100 gold fen 1, 5, 10, 50, 100 Mexican dollars 500, 1000 roubles
Sino-Belgian Bank (Banque Sino-Belge) (Hankow, Shanghai, Tientsin)	Belgium	1902 - 1912 1908 - 1912	1, 5, 10, 50 dollars 5, 10 Mexican dollars
Bank of Taiwan, Ltd. (Amoy, Canton, Foochow, Hankow, Kiukiang, Shanghai, Swatow)	Japan	1905 - 1911 1906 - 1921 1911 - 1917	1, 5, 10, 50 silver yen 1, 5, 10, 50 gold yen 1, 5, 10, 50 dollars
Yokohama Specie Bank, Ltd. (Dairen, Hankow, Harbin, Newchang, Peking, Shanghai, Tientsin, Tsinan)	Japan	1902 1913 - 1917 1918 1902 - 1937	5, 10, 50, 100 taels 1, 5, 10, 100 gold yen 10, 50 sen 1, 5, 10, 50, 100 dollars

The Netherlands Trading Society was funded in 1903. It only had one office in Shanghai. The company offered a large variety of trading business. Compared to the other foreign banks it was not a large bank. Although small in size, the Netherlands Trading Society helped with educating many Chinese Bankers, which went on to form their own banks.

With the industrialization of China the need for large amounts of capital increased. The Piao Hoa and the Qian Zhuang did not have enough capital to meet these needs. Foreign banks were not interested in investing in the long term development of China. In 1897 the first “modern” bank was founded. The Imperial Bank of China was opened in Shanghai. This bank had the largest starting and working capital ever in China and was built on foreign examples. Also shareholders were limited liable for the banks activities. Investing in these kind of banks was less risky than it was before in other Chinese banks.

Though for several reasons IBC initially did not perform well, the Chinese government proceeded with reformations, which in 1905 lead to the creation of the “Da Qing Bank”. This bank had permission to issue money and also managed public treasury.

The Bank of Communications was opened in 1908. This also government owned bank was focused on industry.

In this period also the first private banks emerged the Chinese market. These banks had no governmental support and were owned by private entrepreneurs. The private banks were smaller than banks with government support. In 1906 the “Xingcheng Bank” opened in Shanghai, in 1907 the “National Commercial Bank” opened in Hangzhou and in 1908 the “Ningbo commercial and savings bank” opened. 17 other private banks were opened before 1911. Though relatively small in size, these banks would later have an big impact on the Chinese banking system.

The government owned banks were opened around Shanghai in the “southern area”. The banks in the “northern area” around Beijing. The owners of the banks in the northern area where former members of the Beijing government.

Chapter 4 The republic of China (1911 – 1928)

In 1911 the last Chinese Emperor was dethroned and the Qing Dynasty ended. At the first of January 1912 China became a republic and at first Sun Yat-Sen was chosen as president. The Kuomintang (KMT) also known as the Nationalist Party won the elections and was recognized as national government, which was stationed in Nanjing. Shortly after the KMT was forbidden and Yuan Shikai became president of the republic, which was no stationed in Beijing⁸. Yuan was a former military leader in the Qing Dynasty. The actual political power of the Nationalistic party was small and China was politically controlled by militarist and the financial circles around the cities Shanghai and Guangzhou⁹. In Guangzhou a counter government formed, which wanted to form China as a democracy according to western example.

⁸ Fairbank, J.F. (1983), Cambridge History of China, Republican China, 1912 – 1949, Cambridge University Press, vol. 12, p. 219

⁹ Theobald, U. (2000), Chinese History – The Republic of China (1911 – 1949)

In 1915 Yuan Shikai attempted to throne himself as emperor. He failed and shortly after he died due to illness. A period of political division and instability followed. Large parts of China were controlled by Warlords or governors of important regions .

In 1921 the Communist Party was founded¹⁰. The goal of this party was to unite China and to decrease the power of the warlords. At first the Communist Party and the Nationalistic party worked together to defeat the warlords. Later in 192 most of the Nationalistic party opposed to the communistic party and Jiang Jieshi lead a war against Communist. The Communist party was expelled to Yan'an and Beijing was conquered from the warlords.

China was continuously in war. Due to these wars, and the loss of some of them, China in had made financial losses. The Chinese government had in the previous period become custom to borrowing from foreign and Chinese banks. The losses had a negative impact on the development of the Chinese economy and the Chinese banking sector. The Chinese governments used the financial institutions for financing the wars. Despite of the wars, the development of the Chinese banking sector proceeded. In 1912 the in 1897 founded Imperial Bank of China changed its name into the Commercial Bank of China. This bank was China's first modern bank and organized as a joint-stock firm. Originally this bank was ruled by foreign professionals. One year before, in 1911, China's first central and government owned bank changed its name from Da Qing Bank into Bank of China. The other government owned bank in this period was the Bank of Communications¹¹. The government owned banks were large banks with a main focus on specific Chinese industries.

China was an open economy depending on foreign investments. Specifically in the Lower Yangzi area, which includes the city Shanghai, the relationships with foreign investors were well developed. Between 1910 and 1920 Shanghai was transformed from a colonial treaty port into a Western city under the rule of European property right, for both Chinese and European companies within its jurisdiction¹². Shanghai also provided effective public security. The GDP per capita in this area grew much faster than in the other areas in China.

Several private banks were opened. The "southern banks" were opened in the Shanghai area. Around Beijing the "northern banks" were opened. Though some of these northern banks were privately owned, they mainly were controlled by former members of the Beijing government. Slowly the Piao Hao disappeared due to their small scale. The number of private owned banks grew rapidly after the start of the republic. In 1912 24 new private banks were opened¹³. This number of open banks grew to 160 in 1927¹⁴. In the same period many banks went bankrupt. The Qian Zhuang also had difficulties to survive this competitive

¹⁰ Schurmann, F. (1967), *The Chinese Reader, Republican China*, Massachusetts, The colonial Press Inc, 1967, p. 88

¹¹ Cheng, L.

¹² Ma, D. *Economic Growth in the Lower Yangzi Region of China in 1911 – 1937: A Quantitative and Historical Analyses*, *The journal of Economic History*, pp. 355 – 392, p. 2

¹³ Cheng, L.

¹⁴ Cheng, L.

period, but do to their historical ground in commercial and industrial areas they survived. Their influence however decreased due to the expansion of the “modern” banks.

Table 1.3 China split into north and south



The Chinese banking market in this period was well-developed compared to many other countries at that time. Though the banking sector differed around the country due to different political leaders. In the Yangzi area, especially in Shanghai, the banking sector flourished due to its open character and different ownership structure. In the other parts of China, where banks were mainly lead by the government or former members of the Beijing government, and foreign banks were not that active, the development of the banking sector did not grow that fast. The assumption that competition in an open economy drives money to more competitive and more financial healthy companies, might apply in this period, but only for the Yangzi area. In that area the structure was right for foreign investors to invest in local banks, it was also in that area that the GDP growth exceeded the Chinese GDP growth by far. The distraction of money by the Beijing government to empower the several wars impacted banks and the economy in the other areas. The big difference in economic growth can therefore totally be explained by the difference in the approach of foreign investors by authorities. How however China would have developed if the Nanjing government would not have been replaced by Yuan Shikai is an interesting question. Possibly larger parts of China would have become more open to foreign investors, and the economy would have grown faster.

The total Chinese GDP grew almost equally with the Chinese Population. The total Chinese GDP grew from 241.431 dollar to 274.090 dollar. The GDP per capita grew from 552 dollars to 562 dollars¹⁵. Measuring by GDP, the Chinese economy hardly showed any growth in 17 years. The effect of an growing banking sector was not expressed in the GDP. The parts outside the Yangzi area showed negative growth.

¹⁵ Madison, A. (2007)

Chapter 5 Nationalistic China (1928 – 1949)

In 1928 Chiang Kai-shek defeated the last warlords and forced back the communists. With this defeat China turned from a republic into a nationalistic lead country. Still with the defeat of the warlords, China remained a divided country. In 1930 Japan attacked China and conquered Manchuria. The war with Japan forced the Nationalistic party to join forces with the Communist party¹⁶. In 1937 China the war officially started and Japan conquered large parts of eastern China. With help of allies in 1945 Japan was defeated and the war ended. China again was divided and a civil war soon followed. The communists have gained influence and the People's Liberation Army won this civil war. On 1 October 2010 the People's Republic of China was proclaimed by Mao Zedong.

Before the war banks could avoid the national government. When the Japanese armies surrounded Shanghai, the banks in that area were forced to move further inland. Many banks were weakened and the governmental influence increased. High inflation and an unstable Chinese currency in this period threatened the banking sector¹⁷. At the start this period foreign banks still were highly active on the Chinese banking market. The Chinese banking market was an open, and according to theory, well performing market, especially around Shanghai. Later foreign bank activity slowly decreased due to government policy and wars. The number of banks remained stable, but the amount of issued capital grew rapidly. Besides the increase of issued capital, the banking sector became more concentrated. Together, nine of the largest banks in China, issued more than 50% of total capital¹⁸.

The nationalistic government believed that it was in China's best interest to decrease private owned capital within banks. This would help the development of the Chinese economy. The government increased its grip on the Chinese banking sector. The government created Central Bank of China (CBC) in 1928. In the open economy at that time, the Bank of China was focused on foreign exchange. Another government owned, the Bank of Communications, was focused on industry development. To support the governmental ambitions, the Board for Financial Supervision was set up. The task of the board was to write laws and legislation and to do research for the Chinese banking sector. More focused banks have higher profit, lower costs, higher profit efficiency and higher cost efficiency¹⁹. Also foreign ownership of banks mitigates diseconomies of diversification. Which type of banks did perform better? The Yangzi area banks which were partly owned by foreign investors? Or the government owned banks which were more focused on specific tasks. At least the governmental owned and more focused owned banks did not make the economy perform as good as the local economy in the Yangzi area. It is very likely that the government owned

¹⁶ Fairbank, J.F. (1983)

¹⁷ Fairbank, J.F. (1983)

¹⁸ Cheng, L.

¹⁹ Berger, A., (2010) The effect of focus versus diversification on bank performance: Evidence from Chinese banks, *Journal of Banking & Finance* 34, 1417 – 1435

banks did not mainly invest in the most profitable companies. The governmental policy therefore had a negative impact on economic growth. The Yangzi area model probably would have made the Chinese economy perform better.

The GDP per capita decreased from 562 to 448 dollar. Also China's total GDP decreased by 11% from 274.090 million dollar to 244.985 million dollar GDP dropped to a twentieth of world total where previous China's GDP was one third of the worldwide GDP²⁰. With this drop of national GDP to 244.985 the national GDP of China almost returned to the level of 1911²¹. In the same period the worldwide GDP nearly doubled. Compared to worldwide development China heavily underperformed.

China's GDP decreased, China's banking sector decreased, China turned from an open economy into a closed economy, China's ruling political party changed, China was in war and for a long period internally divided. The difficult question is what caused what. It is sure that some of these changes would have been different, if China had not been in war. But would China not have become a communistic lead country if it had not been in war? And would the banking system then not have been nationalized? Would the strategy of sectorial focus then not have been implemented? Would foreign banks have remained active on the Chinese market?

For sure the Chinese banking sector and the economy were impacted heavily. In this period theory matches practice when GDP is taken as a measure. While competition decreased, and foreign capital decreased also the total GDP decreased while the worldwide GDP grew. Of course it is arguable to use this period as a representative time frame to test theory. It is, with the available information, already difficult to argue whether the political preferences caused this negative period for the Chinese economy. On the other hand, however, it is extremely interesting what China learned from this period. As Johan Cruijff, a Dutch Philosopher, once said: "each disadvantage has its advantage".

Chapter 6 Communistic China (1949 – 1976)

A large combat ended the Chinese Civil War with the control of China by the Communistic Party of China. On 1 October 2010 the People's Republic of China was proclaimed by Mao Zedong. In 1937 already, Mao Zedong had described a theoretical formulation concerning Marxism and the Chinese Revolution. After a period of creating alliances Mao Zedong restored China's sovereignty after a long period of division. China became communistic and with that a centrally planned economy. Private companies were forbidden and capitalism did not occur. With the Great Leap Forward Mao Zedong tried to change the agrarian Chinese economy to a modern economy by industrialization and collectivization. Though the

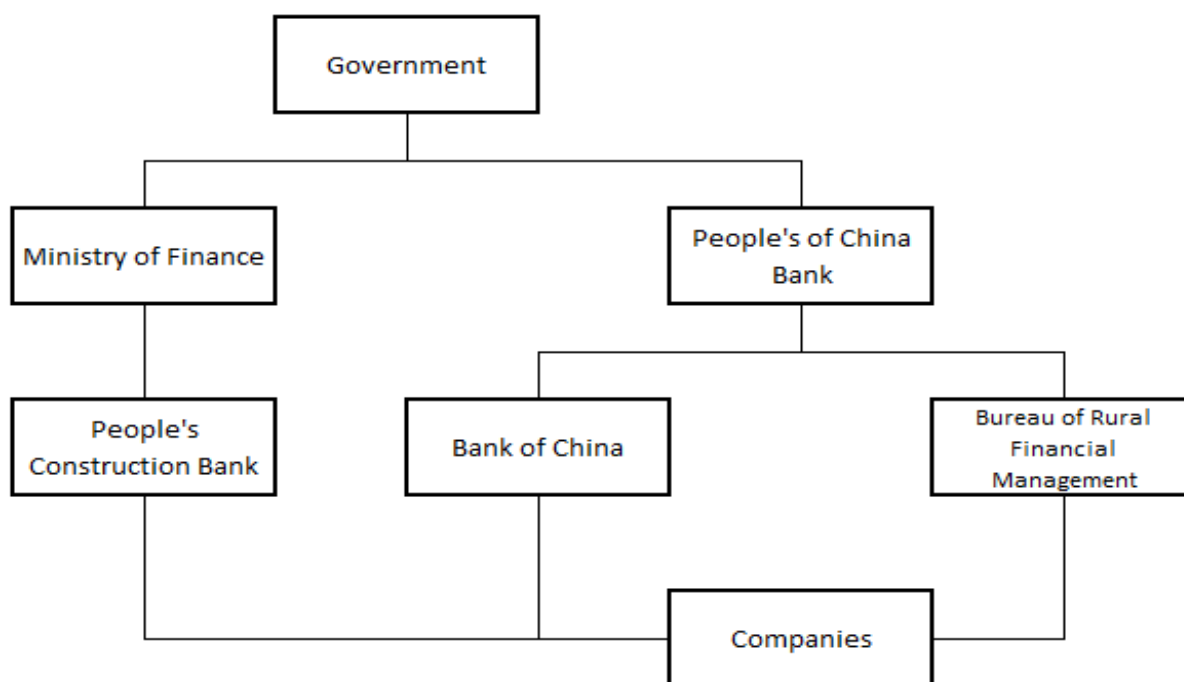
²⁰ Madison, A., (2007)

²¹ Madison, A., (2003)

economy grew, the Mao Zedong period was not considered a success. Especially the Great Leap Forward turned into a catastrophe with millions of death. After a period of critics in 1966 Mao Zedong initiated the Great Proletarian Cultural Revolution in 1966 to further socialize China. With the death of Mao Zedong in 1976, the Cultural Revolution ended and Deng Xiaoping became the political leader of China.

Despite some relationships with Russia, in Communistic period politics turned China from an open economy to a closed economy. The impact of the change in political system on the Chinese banking sector was huge. The new political system embedded a total change in the structure of the financial market. All financial institutions were nationalized²² and the remaining financial system anchored solely the People's Bank of China and the, through the ministry of Finance controlled, People's Construction Bank. The People's Bank of China was both central bank, the Bank of China, and commercial bank, the Bureau of Rural Financial Management. As in the previous period the money lending of the central bank was focused too. Most loans went to large government owned companies. The banking system operated like a government administrative agency, which performed governments monetary and economic policy. Banks were heavily government subsidized and had large debts²³.

Table 1.4 The Chinese financial sector (1949 – 1978)



²² Sau, L. (2009) Gradualism and the evolution of the financial structure in China, p. 9

²³ Cheng, L.

The Chinese government introduced the Credit Plan and the Cash Plan. All monetary institutions were split into 2 groups. Transactions between companies were mainly performed through bank transfers. Transactions between citizens were performed cash. The government strictly prescribed the rules for these transactions. The banks had no influence in the way capital was allocated²⁴.

Though China restricted itself to its own money market, this period showed significant recovery of total GDP and GDP per capita. From 1950 to 1976 the GDP per capita increased from 448 to 853 dollar. The total GDP even grew from 244.985 million to 793.568 million²⁵. However with 90% growth of the GDP per capita and 224% increase of total GDP, China did not grow as fast as the worldwide average. With 4,6% the average growth of GDP is almost equal to the current 4,5% growth target for of the European Union money market. The growth in China was weakened by wars with Korea, India an Vietnam²⁶.

Measured by GDP Communistic China performed significantly better than the People's Republic of China. The banking sector in contrary was more developed in the People's Republic of China. More banks were active, foreign banks were on the market and money was in principle available for all types of companies. China's seems to have benefited from the change from an open to a closed economy. It's not possible to argue that China would have performed better in an open economy after this period of war and division. Possible an overall strategy of focus was necessary for China to clean up. At least an focus strategy as introduced in this period could have an positive impact on the financial system. More focused banks have higher profit, lower costs, higher profit efficiency and higher cost efficiency²⁷. Besides these advantages of a focus strategy, maybe China needed this period of internal focus, to join internal forces and to come out stronger and more united. It was in previous periods not only war with other countries, which hindered the development of China, also the internal diversity made structural growth more complex.

Again the impact of the specific political area on the Chinese banking sector and the Chinese economy was huge. Though the banking sector did not flourish as described in theory, it did carefully support apparently governmental planned economic growth. The apparent carefully governmental growth planning imputes an positive impact by political choices. For that reason that reason this period can be seen as a more crucial period for Chinese banking and the Chinese economy. The impact of political decisions on the banking sector in this period has been bigger than in the previous periods. This is mainly due to the fact that the political choices this time influenced China as a whole. Unfortunately it was a negative impact. Though the previous economic growth in the Yangzi area has not been matched by far, the Chinese economy did grow overall again. Although Yangzi is only a smaller part of

²⁴ TONG, D. D. (2002), *The Heart of the Economic Reform, China's Banking Reform and State Enterprise Restructuring*, Ashgate

²⁵ Madison, A., (2007)

²⁶ Madison, A., (2007)

²⁷ Berger, A., (2010)

China, this does not mean that the previous set example of economic growth is not interesting to investigate for Communistic China. Especially since governmental decision making can be implemented for China as a whole.

Chapter 7 The period after the Great Proletarian Cultural Revolution (1976 – today)

After the death of Mao Zedong, Deng Xiaoping became political leader of China. Deng Xiaoping, who was purged twice before he became leader of China, rapidly started to reform China. Besides the new Open Door Policy China was steered in to a socialist market economy. With focus on economy, agriculture, scientific and technical development Deng Xiaoping aimed for the modernization of China. Rapidly political relationships with foreign countries were restored. More slowly the Chinese market was opened for foreign companies.

The banking system also needed reformation. Within the central planned economy the banks had not fulfilled their position as intermediary between investors and savers²⁸. Where most financial institutions find their resources in financial savings by citizens, these financial savings were underdeveloped in China. The only income came from companies, which flew directly to the state. On the other hand, the allocation of capital was not based on profitability measurement. The government decided which companies and which industries the bank would invest in.

In 1978 the reformation of the banking sector was put on the political agenda. Before 1978 China had a mono-bank model, in which all banks where part of one administrative hierarchy²⁹. Slowly governmental loans were replaced by bank loans, which were more profit oriented. Also tasks of the People's Bank of China were assigned to four specialized state-owned banks, also known as the "Big Four". These banks were the Bank of China (BOC), the Industrial and Commercial Bank of China (ICBC), the Construction Bank of China (CBC) and the Agriculture Bank of China (ABC).

The creation of the "Big Four" was the first step. In 1984 the China and South Sea Bank Ltd., the first Chinese-foreign-equity bank, was founded. In 1986 the Bank of Communications was established. This was the first domestic joint-equity bank³⁰. In 1991 the first joint-equity bank was listed on the Shenzhen stock exchange. Shortly after the first policy banks were established. These banks were created to increase the ability of commercial banks to lend out money to new profitable industries. The policy banks took over the financing of state directed trade and development projects. The first three policy banks were the Agricultural Bank of China (ADBC), the Export-Import Bank of China (Chexim) and the China Development Bank (CDB). With the creation of the policy banks China supported long term government strategy and also short profit opportunities for investors (because the commercial banks could focus on these markets).

²⁸ Xu, X. (1998), *China's Financial System under Transition*, Londen, Macmillan Press Ltd. p. 13

²⁹ Lin, X. (2009), *Bank ownership reform and bank performance in China*, *Journal of Banking & Finance* 33, p. 21

³⁰ Lin, X. (2009), p. 21

In 2009 China has 3 tiers of domestic banks. The first tier consists of the “Big Four” state-owned banks. The second tier consists of 12 national-level domestic joint-equity banks and the third tier consists of approximately 100 city-level commercial banks. Besides that policy banks, Chinese-foreign joint-equity banks, banks fully capitalized by foreign funds are active on the Chinese market³¹.

The reformation of the banking sector and the opening to the world economy steered China into enormous economic growth. The agricultural sector learned from foreign countries and became more efficient, foreign trade exploded, and foreign technologies were implemented rapidly with the support of foreign investments.

From 1976 to 2003 China’s total GDP has increase from 793.568 billion dollar to 6.187.983 billion dollar. The GDP per capita grew from 853 dollar to 4803 dollar³². China by far developed faster than worldwide GDP³³.

It seems as if China has learned from previous periods. Since the Communistic period the Chinese government actually had control of the largest part of China. With the knowledge about banking learned in the previous periods in different areas of China, and with the opportunity to build the Chinese banking sector from scratch, China had a huge opportunity. The 3 tier approach utilizes this opportunity very well. China, in opposite of many other countries, can use the banking system to support its long term economic strategy. The “Big Four”, the policy banks and the 12 national banks support national strategy. Additional to this advantage these focused banks have the advantage of higher profit, lower costs, higher profit efficiency and higher cost efficiency³⁴.

Besides the support for long term governmental strategy, the banking sector was also adapted to supply funding for local companies. Due to the different types joint stock ownership, the local banks allocate money more efficient to profitable companies and thereby stimulate competition. Companies with a low financing gap ratio benefit from the newly investment opportunities. On national level, China still has an big impact on decision making, and is still steered in the previous communistic way. Locally however the Chinese economy is an open economy similar to model in the Yangzi area in the periods between 1911 and 1949. After 30 years without commercial banking China again used foreign expertise (China imported text books, business schools and trained their staff by foreign experts) to rebuild the commercial banking in China. What color does this mixed Chinese political system have? It seems Deng Xiaoping is right, it doesn’t matter, because the system works.

Compared to the Republic of China and to Nationalistic China, the last political period had an bigger impact on the banking sector and on the Chinese economy. China is now less diversified and political decisions have an larger impact on the banking sector, also the structure of the banking sector is better than in those two periods. The growth in GDP supports this view. China has developed faster by far.

³¹ Lin, X. (2009), p. 22

³² Madison, A. (2007)

³³ Madison, A. (2003)

³⁴ Berger, A. (2010)

It is more difficult to explain why Communistic China did not have an bigger impact on the Chinese banking sector than the last period. The change from an open economy with an large banking sector into a closed economy with a mono-bank model was huge. However, since the banking sector currently is more developed than it was before Communistic China, it is arguable that the transition from Communistic China into the current China, has had the biggest impact on the Chinese banking sector. For sure the last period had the biggest impact on the Chinese economy.

Chapter 8 Conclusions

The last 100 years China's political development have made the banking sector shift from a regionally well-developed open sector into a mono-bank closed sector and afterwards into a nationally well-developed open sector. Political choices largely influenced the state of the banking sector.

In the Republic of China and in Nationalistic China, political influence was spread, and different types of banking sectors appeared. China was part of several wars, for which the government subtracted money from the banking sector. In the southern area, mainly in the Yangzi area, the banking sector and the economy flourished. In that area Shanghai was transformed from a colonial treaty port into a Western city under the rule of European property right, for both Chinese and European companies within its jurisdiction. The northern area banks were mainly steered by the government and supported government policy by focusing on specific sectors. Though the economy grew rapidly in the Yangzi area, the overall Chinese economy performed bad compared to the world's economy.

Communistic China turned the banking sector upside down. All banks were nationalized and the banking sector was turned into a mono-bank model. The political influence in this period was big. The focus strategy for the banking sector provided China the opportunity to invest in long term development. The Chinese economy grew steady and matched worldwide growth.

The last period of Chinese political choices changed the Chinese banking sector into a national open and well-developed sector. In contrary to the Republic of China and Nationalistic China, the banking sector in this period is well-developed throughout China. China benefited from the in 1949 created national political influence, and the offered opportunity to build a banking sector from scratch. China learned lessons from both worlds, the northern and the southern area, in previous development of the Chinese banking sector. In my opinion the last period of political choices has had the biggest impact on the Chinese banking sector and on Chinese economy for four reasons:

1. China has turned a mono-bank model back into a more developed banking sector than the period before the mono-bank model. Therefore this switch is bigger than the previous switch to this mono-bank model
2. China has combined the best of both worlds. The Communistic methodology is used for supporting China's long term strategy with the "Big Four", policy banks and 12 national banks. Lessons from the Yangzi area are implemented locally with different types of stock-owned commercial banks, which ensures that money is supplied to profitable companies.
3. The new banking model was implement throughout whole China. Only in the Communistic period was the political influence that large.
4. The Chinese economy outperforms the worldwide economy by far for the first time in these four periods.

For other countries it is important to understand how the Chinese economy and the Chinese banking sector have developed and why they currently in this strong position. Likely China will outperform western economies for a long period. Possibly in short term China will control worldwide politics. As this thesis shows, this is not a coincidence. Lessons can be learned by European countries. The Chinese set up is more future proof than that of example western countries because it better balances short term and long term investment decision making. It is extremely interesting to compare the political and financial structure in western countries and their economic development to that of China. Can for example the currently diversified European Union learn from the Chinese set up? Is the western mainly free market methodology not enough focused on long term development?

In the end Deng Xiaoping might be right when said: "It doesn't matter if a cat is black or white, as long as it catches mice". As we learned in the thesis, the political choices of an government do influence the banking sector and the economy. Maybe he intended to explain that it is not necessary to choose a specific political color, but that a combination of colors, the best of both worlds, could turn out even better. For sure the results of his political choices are good.

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