The Chinese Banking System and the Impacts of the 2008 Global Financial Crisis on It

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Abstract: This article aims to analyze the Chinese banking system, with a special emphasis on the impacts of the 2008 Global financial crisis on it. Firstly, the general structure of the banking system is briefly described, pointing the major banks and general ownership structure, as well as some of the problems associated to the system's features. Secondly, the article describes the reforms the Chinese banking system has been going through since the early 1980's until the outbreak of the Global Financial Crisis. Finally, the article sheds a light on the impacts of the Crisis on China's banking system. On this last section, China's response to the Crisis, embodied on its stimulus package, is highlighted. Moreover, features of the banking system such as the local governments – and banks under local government's influence – role during the unfolding of the Crisis are given particular attention. In addition, the impacts on the banking reforms' agenda are studied, with focus on the interest rates control.

Key words: Banking System, Financial Crisis, China

Resumo: Esse artigo tem como objetivo analisar o Sistema bancário chinês, com uma ênfase especial nos impactos gerados pela Crise Financeira Global de 2008. Primeiramente, é feita uma descrição sucinta da estrutura do sistema bancário, indicando os principais bancos e a estrutura de propriedade do sistema, assim como alguns dos problemas associados com as características do sistema. Em segundo lugar, o artigo descreve rapidamente as reformas que o Sistema bancário passou desde o início da década de 1980 até 2008. Finalmente, o artigo se debruça sobre a questão dos impactos da Crise Financeira Global de 2008 no sistema bancário chinês. Nesta última seção, a resposta do governo chinês à Crise, consubstanciada em seu plano de estímulos, é sublinhada. Ainda, características do sistema bancário, como o papel dos governos locais – e dos bancos sob sua influência - durante os desdobramentos da Crise, e as reformas nas taxas de juros, mereceram atenção especial.

Palavras Chave: Sistema Bancário, Crise Financeira, China

Área 5: Dinheiro, Finanças Internacionais e Crescimento

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Sessão Ordinária

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Introduction

As part of the wide-ranging post-1978 economic reform program, the Chinese banking system has been undergoing through a comprehensive and gradual process of reorganization and transformation. The overall trend of the banking reforms is to improve the soundness of the system and to serve an increasingly complex and diversified national economy. Therefore, since the 1980's market forces are gaining importance *vis a vis* the state in terms of credit allocation. Banking reform in China has been relentless and the liberalization progression is an ongoing process ever since.

Nonetheless, even after decades of reforms, legacies of the central-planned era are still present within the Chinese banking system. The dominance of state-owned banks, government intervention and controls in key variables, such as interest rates, are noteworthy. In spite of the liberalization and market-oriented reforms, government control and/or management is a hallmark of the system.

Moreover, as China becomes more engaged with the world economy, the country has to progressively consider the impacts of the latter on its overall reforms program. When relatively isolated from the rest of the global economy, this was not an important variable to be taken into account. After the 1980's, the benefits of the opening-up strategy and market reforms were becoming increasingly clear. However, the risks and problems triggered by such integration can also pose threats to the Chinese national economy.

The more engaged and open to the world economy China is, the more susceptible its economy becomes to the nuances and fluctuations of the international markets. More specifically, key national variables, such as the level of economic activity and employment, become harder to be managed by the central government. The ability of the Chinese leadership to find a balance between the benefits and threats stemmed from this integration process is vital to its legitimacy. The banking system, as a fundamental economic sector of every national economy, is found in the midst of this tension.

Indeed, this article sets out to discuss the Chinese banking system and the impacts of the most recent financial global crisis on it. The paper is organized into four sections, excluding this introduction. On the first section the structure and problems of the

Chinese banking system will be discussed. The second section draws a brief description of the reforms from the early 1980's up to 2008. The third section scrutinizes the impacts of the 2008 Global Financial Crisis on the Chinese banking system. Lastly, the conclusions will be presented.

1) The Chinese Banking System

1.1) Structure

In order to study the impacts of the 2008 Global Financial Crisis on the Chinese banking system, it is important to firstly shed a light over its structure. The Chinese banking system is composed by different sorts of institutions, a reality that differs a lot from the Maoist Era, when the national banking system was basically its Central Bank – the People's Bank of China (PBOC).

Gradually, the system has been reformed and overhauled, and currently one can state that the Chinese Banking system is a complex web of banks, featuring different ownership structures and serving different functions. It consists of its Central Bank (the PBOC), five stated owned "equitized" commercial banks, three wholly state owned policy lending banks, more than a hundred of commercial banks (most of them city commercial banks and owned by local governments), the Chinese joint-stock commercial banks (featuring lower levels of government ownership and/or even private ownership[2]) and others urban and rural credit cooperatives, and about 37 foreign owned banks combining around 270 branches or representative offices in China[3].

The five state-owned "equitized" commercial banks, commonly known as "the big five", are: The Agricultural Bank of China (ABC), The Bank of China (BOC), the China Construction Bank (CCB), the Industrial and Commercial Bank of China (ICBC) and the Bank of Communications (BoCom). They dominate the banking sector both in terms

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[2] The most well-known example is the Minsheng Bank, a private bank established in 1996

[3] For a complete list of all banks and banking associations operating in China, see the CBRC (China Banking Regulatory Commission) website: http://www.cbrc.gov.cn/showindexlinks.do?s=dbi

of number of branches, employment, but especially due to its overarching presence on the national deposits and loans rates (Martin, 2012). In terms of market share, their chunk is of around 50% of the sector. In the past, the figures were even higher[4], but as a result of decades of reforms, now the “big five” lost some ground, yet still are by far the major category of the Chinese banking system. Some analysts sometimes work with only the four first banks of the list, relabeling this category as the “Big four”.

Historically, the striking feature of the so called “big five” is its connection with the Chinese state owned enterprises (SOE’s). According to Wong & Wong (2001), the “big five” mostly extend their funds to SOE’s, even if those companies do not present the best profit figures in many cases. According to Shirai (2002), by 2001 40% of those SOE’s were loss-making companies. In other words, “direct policy lending”, a major characteristic from the planned economy era, was a major feature of the banking system by the beginning of the 21st century, and the state owned commercial banks were the chief tool used by the central government.

Most of the economic reforms regarding the banking system focus on transforming the commercial banks, making them more profit-oriented and less subject to the government interference. In this sense, many improvements were achieved eventually, and currently the Chinese banking system differs in a great extent from what it was two decades ago. The reformist’s efforts took time and faced considerable barriers to show clear results, though, as many reports (see Podpiera (2006), for instance) attest.

The state plays a major role on the banking system, not only due to its overarching ownership of the banks, but also due to the establishment of national policies and specific regulation, close management and control of system as whole. By 2010, foreign capital corresponded to roughly only 2% of the total assets of the system.

The persistence of some of the central planned era’s features in the banking system, at the same time that perpetuates problems that harm the overall efficiency of the banking system, can be useful to the Chinese leadership as it enables them to closely watch and manage it.

[4] At the outbreak of the Asian Financial Crisis, this figure was of 90% of the banking system

1.2) Problems Associated with Its Structure

The reminiscences of the central planned era are clear when one realizes that the Chinese private sector, composed by all sorts of entrepreneurs, has been somehow starved from funds, since they cannot rely on the official banking system. As a response to this unbalanced situation, the booming Chinese private sector has to find its own way to be financed. The response is to recourse at a mix of rural and urban credit cooperatives, alongside with what is known as the "shadow" or "underground" banking/credit in China (Tsai, 2002).

Moreover, the persistence of the credit plan until the end of the 1990's created issues concerning the capital allocation of the Chinese banking system: At the end of 1990's, the non-performing loans (NPL's) were a major problem, and the monetary authorities had to tackle this issue.

The NPL's problem on the banking system was stemmed primarily because of many SOE's were excessively borrowing from the "big five", and many of those SOE's became insolvent during the end of the 1990's. Due to the fact that the SOE's still were in charge of providing its workers the welfare benefits inherited from the Maoist era, and to the restructuring of Chinese enterprises promoted by the government, especially during the Zhu Rongji Era (1997-2002), SOE's were in bad financial shape. Back on this time, creditworthiness was not a major criterion for providing loans, so state-owned banks could keep pumping funds into unprofitable SOE's. The lack of banking regulation and supervision also contributed for the rise of the NPL's across the banking system.

Another problem triggered by this structure of the Chinese banking system is the local's debt problem. Local politicians have some degree of autonomy on loan decisions by making use of local branches of banks and others local investment vehicles, potentially leveraging the local indebtedness (Alloway, 2011). When calculating the indebtedness level of the country, it is necessary to take into account the liabilities of both central and local entities. Figures that only consider the central government's debt might be, therefore, misleading. There are many publications warning about this risk, stressing the so-called "China's hidden domestic public debt". For example, the authors of the book "Red Capitalism", Carl Walter and Fraser Howie , state that although state debt appears to be low by international standards (around 20% of GDP), when all government obligations are lumped together, the number jumps to 76%.

Furthermore, another issue stemmed from the nature of the Chinese banking system is the concern of a credit bubble, outside of the official Chinese banks. As pointed out earlier, the Chinese private entrepreneurs have to finance their investments with cooperatives or through the “shadow banking” sector. Victor Shih (2011a) seems to be particularly concerned over this topic, pointing out the danger that might arise due to high interest rates charged by the underground banks.

With so many problems stemmed from the nature and structure of the Chinese banking system, the government has been trying to reform it. As part of the Post-1978 reform program, the Chinese banking system has been undergoing through substantial shifts and changes.

2) Reforms until the Outbreak of the 2008 Global Financial Crisis

The banking reform in China has been relentless since the early 1980’s. Therefore, it is mandatory to cover the most important steps and measures undertaken by the government until the outbreak and spread of the 2008 Global Financial Crisis and following years. From a market-oriented perspective, the banking system is being guided towards a commercial-oriented bias, with the liberalization of the main prices (interest rates on loans and deposits, mainly in this case) and flexibilization of the ownership structure.

According to Shirai (2002), after the initial momentum of economic reforms in the 1980’s, one can state that China initiated a “two-tier” banking system, involving the Central Bank (PBOC) and four specialized banks fully owned by the central government.

Trust and Investment companies were also established, by both local governments and the specialized banks. The underlying reason was that the specialized banks could not meet the demand for credit, given the rapid economic growth of the 1980’s. Therefore, they were encouraged to set up trust departments - able to conduct forms of business prohibited to formal banks. Local governments, conversely, started to set up trust and investment companies in order to raise funds to directly finance local priorities (Dobson & Kashyap, 2006). It reveals the search for financial autonomy by local governments and the tools it used to meet GDP growth targets, given its economic restrictions.

Later, the next step was the commercialization of the specialized banks and the separation between policy and commercial activities, followed by the transformation of urban credit cooperatives into city banks.

During the 1990's China underwent through more institutional reforms on its banking system. The 1995' Bank Law created a *de facto* 'two-tier banking system': commercial banks (subject to prudential regulations, supervised by the PBOC) and the three policy-lending banks.

The three established policy-lending banks are: the Agricultural Development Bank of China, the China Development Bank, and the Export-Import Bank of China. The objective of those banks is to take over long-term development finance and policy-lending business, previously performed by the specialized banks.

Accordingly, in 1995 the specialized banks were transformed into commercial banks, becoming what is commonly called as "the big four", and ever since they domain the Chinese banking sector.

By the end of the 1990's, Beijing took advantage of the lessons of the Asian Financial Crisis to fix some problems regarding Chinese banks. Since poor management, moral hazard issues and inadequate supervision were regarded as some of the major problems that led to, or potentialized the Crisis, the concern of the Chinese government was channeled to the deterioration of the asset quality of the 'big four' (Shirai, 2002).

Long (2009) stated that the NPL's proportion of the "big four" increased quickly after 1995, fact that led many analysts to regard some of them as technically bankrupt at the time. The system could remain stable, nevertheless, due to the support of the Chinese government and the deposits from Chinese household's savings.

Therefore, the government undertook many measures, in 1998, to tackle the NPL's problem. The period 1998-2002 is regarded as a period of financial restructuring, reorganization and management improving, in order to enhance the risk awareness, asset quality and capital adequacy of the Chinese banks. Not only was necessary to 'clean' the "big four" from the NPL's and improve its balance sheet[5], but also was fundamental to implement measures that would in prevent the same problems to take place again in the near future.

The government fostered the overhaul of the old credit approval systems. Finally, and most importantly, the formal abolishment of the credit plan system was witnessed. It meant that, at least formally, the government would not be able to directly drive the credit allocation from state-owned banks anymore.

Moreover, the fear of an overly liberalized banking system – exceedingly deregulated – was reinforced and translated into actions aiming a strong oversight and supervision of the banking system. Hence, the CBRC (Chinese Banking Regulatory Commission) was created in 2002. This newly created regulatory agency was shaped in order to monitor China's banks and to "impose a hard NPL reduction target on the Big four banks, in addition to liquidity and capital adequacy targets on all banks"(Shih, 2005).

Furthermore, with the accession to the World Trade Organization (WTO), in 2001, China was required to foster more market friendly reforms and open up its banking industry to foreign competitors. Many of the efforts undertaken just prior to 2001 and just afterwards this date are understood as the means to make the Chinese banks stronger and more prepared to a tougher competition (Okazaki, 2007). With the Chinese opening-up policy, the financial sector would become increasingly complex, and expectedly enlarged by the influx of foreign financial institutions (Shih, 2005).

The unfolding of the 2000's witnessed apparently the most drastic policies towards marketization of the banking system. A major step was the introduction of "foreign strategic investors': Foreign investors were allowed, for the first time, to have shares of the Chinese banks. There was a limit on shares held by one single foreign investor in any Chinese financial institution of 20% of the total. Also, the combined limit of the foreign investors' shares in any bank is understood to be 25%. More than this limit, the institution would be regarded as a foreign institution. Totaling US$ 13, 3 billion were invested in the "big four" during 2004-05 (Dobson & Kashyap, 2006).

[5] Indeed, a capital injection worth of RMB 270 billion to replenish capital for the "big four" was undertaken.

Finally, the ownership issue would be tackled, with the listing of the “Big five” banks in stock exchanges, via Initial Public Offers (IPO’s). This measure was not only an end in itself, but also the means to achieve a better management and pursue corporate governance principles. From June 2005 to May 2007, BoCom, CCB, BOC, and ICBC went to public by making Initial Public Offers (IPOs) and now are listed in stock exchanges[6].

This overall strategy, from the cleaning-up to the public offers, was sensible and well-thought, according to Anderson (2005). “The government’s main priority was to protect the stability of the big state-owned commercial banks”, states the author. Initially, those banks could be regarded as technically insolvent, and “simply could not withstand the shock of being forced to compete on an equal basis with experienced foreign institutions”

Furthermore, another important endeavor undertaken during this period was the lift of the separation of banking from fund management activities in 2005. It allowed banks to search different areas of business, apart from the traditional lending activities. This policy change opened new sources of revenue for the “Big five”. Moreover, over time they were able to initiate business activities covering securities, asset management, leasing and insurance areas. As a result, a rapid expansion of Chinese banks into non-interest income sectors was witnessed since the policy change in 2005; Chinese banks started to raise more revenues via bank custody fees and many sort of trading activities as well. (Loechel & Xiang Li, 2011).

In spite of bold reformist efforts, the Chinese state still controls its banking system in different ways: directly, it is still the main shareholder of all of the listed “big five”, not to mention the direct ownership of other smaller commercial banks across the country. Indirectly, the control the PBOC wields on interest rates and other policy options (such as lending quotas) enables the government to manage closely the lending activities in the country. Far from being a “bug” or a state of incompleteness of the reform process, it is actually a feature of the overall gradualist and controlled opening-up and liberalization processes.

[6] The IPO of the ABC was concluded only in 2010. The main reason of its relative delay in relation with the other “big five” banks is the fact that the ABC financial restructuring took longer than the others.

3) The 2008 Global Financial Crisis

The 2008 global financial crisis impacted, in different degrees, virtually all market economies in the world. It started in the USA but rapidly spread to other developed and developing countries. It not only triggered financial panic over the world, but also initiated other secondary crisis, such as the European sovereign-debt crisis.

The causes of the crisis are many and debatable, according to different theoretical affiliations. However, the role played by a deregulated and extremely liberalized financial market, both in the USA and in other advanced economies, is undoubtedly central.

Crotty (2009) highlights the accelerated deregulation accompanied by rapid financial innovation prior to the burst of the international financial system. The American and in large extend the international economy was characterized by a structure of incentives that created excessive risky operations and exacerbated booms. Many of the new created financial products were so complex and opaque they could not be priced correctly. Moreover, the regulation and supervision were weak, allowing giant banks to measure their own risk and set their own capital requirements.

The result of such a level of deregulation and financial innovation was an overinflated and overleveraged financial market relative to the real economy. The heavy reliance on complex financial products in a closely integrated global financial system created channels of contagion that raised systemic risk.

Even the countries which did not complied with the financial policies abovementioned were struck somehow by the Crisis. Developing countries, in particular, seems to have gone through this turmoil in a better shape than developed countries. Nevertheless, the recession in the developed world provoked negative impacts in developing countries as well.

Prior to the eruption of the 2008 global financial crisis, China was pursuing austere economic policies, justified by its overheated economy, inflationary pressures and the fear of a bubble in the real estate sector[7]. As a result, the Chinese economic growth started to slowdown in the end of 2007, as wished by the authorities. What the leadership could not expect was the outbreak and spread of the largest financial crisis in the world since the 1930's, arguably.

Since China was not at the core of the 2008 Global Crisis, and its financial and banking system were relatively insulated from the world economy, the impacts on its economy has not been so grave. Prior to the crisis, Chinese banks were clean, because as part of the domestic financial regulation, Chinese banks had a limited exposure to toxic financial assets and derivatives that were at the center of the crisis in the USA and later in Europe. As a result, the government did not have to take additional debt to inject funds and bail out any financial institution.

Moreover, the lessons from the Asian Crisis were still present, and the country enjoyed high levels of international reserves, working as a buffer against international turbulence, ensuring financial stability and thus making China less susceptible to external shocks. Capital controls, though more porous than before, were also important to block the transmission of international financial turbulence (Yang, 2011).

Furthermore, although the banking system had relatively quickly been liberalized during the 2000's, allowing banks a wider scope for trading (on areas such securities, asset management, leasing and insurance), the supervision and oversight had also developed accordingly. As those developments turned the Chinese banking system more complex and diversified, the CBRC became more alert to the instabilities and risks involved.

If on the banking and financial sphere China appeared to be relatively safe from the international meltdown, given its strict regulation and oversight, nobody could safely predict the size and consequences of the crisis on the real economy. Much more integrated into the world economy than before, China could be affected by the 2008 Global Crisis through its effect on trade, both because of the sharp decline in world trade volumes and commodity prices. China's largest export markets – the USA and

[7] According to Lardy (2012), the Chinese central bank repeatedly raised the required reserve ratio (the share of deposits that banks must place with the central bank safe), reducing, thus, the availability of funds to be lent to costumers; raised the benchmark interest rates on lending rates, making new loans more expensive; and finally introduced quantitative limits on bank's lending.

Europe – were facing a sharp economic slowdown, fact that made the Chinese leadership predict that the country would also suffer the consequences of the crisis.

Indeed, China suffered a great slump in its current of trade – both export and import levels fell dramatically. Even though at the beginning the import fell even faster than the exports – leaving a space for a continuous surplus on the trade balance – the export growth collapse meant negative impacts in countless factories across the country. Schmidt (2009) reminds that, in November of 2008, Chinese exports fell for the first time since 2001.

As expected, the foreign trade slowdown "has had a major impact on the Chinese labor market. Many jobs have been shed in export-oriented manufacturing sectors, and official industrial employment declined", states Wang & Hussain (2010). Schmidt (2009) goes through the same line of argumentation, pointing out that by January of 2009 "the most visible damage so far has been inflicted on China's export-oriented light industry in southern China. Thousands of companies have gone burst; tens of thousands of workers have been laid-off…"

Perhaps the most striking data was a government survey released in 2009 by the China Daily pointing out that 20 million migrant workers had lost their jobs, and that "some 15.3 percent of China's 130 million migrant workers became jobless" (China Daily, 2010). The report still affirms that "the increasing number of jobless migrant workers has posed a fresh threat to the social stability" and also "the rising unemployment rate could cause more social unrest and the government should be on the lookout for more mass incidents this year."

Furthermore, the Chinese social safety net is still not well developed and comprehensive, letting many unemployed with no other source of income, especially the migrant workers. Wang & Hussain (2010) warns that "another important concern is the proportion of personal disposable income that is falling". The unconcluded social welfare system in China, plus a fearful scenario of higher unemployment, made the same authors warn "that rising unemployment will cause social instability".

Those concerns, summed to the austere economic policy being undertaken prior to the crisis - a policy that was precisely aiming at cooling down the level of economic activity – let the Chinese leadership wary on the possible negative political and socioeconomic effects of the crisis on the country. And as the global meltdown was getting more severe, the need to act in order to combat negative effects of the crisis was getting clearer within the Chinese decision-makers. Schmidt (2009) went even as far as stating that "the financial crisis of today thus might confront the Chinese leadership and its bureaucracy with challenges they have never faced in their political life".

3.1) The Chinese Response

Consequently, the Chinese government decided to act in order to prevent more negative effects on its economy and social fabric. The first measure undertaken was a monetary easing, still in September of 2008. Firstly, the Chinese central bank cancelled the lending quotas that had previously restricted the ability of banks to lend to final costumers. Later, it reduced the required reserve ratio, enhancing the supply of funds to be lent. As a result, it became more profitable for the banks to increase loans, via market mechanisms. The goal of the monetary easing, as stated by Lardy (2012), was exactly to increase the availability of funds. On the demand side, the interest rate over loans was repeatedly lowered.

Lardy (2012) sustains that the result of this initial monetary loosing was a massive increase in credit lending, especially in the first semester of 2009. Keidel (2009) points out that in the first quarter of 2009 new bank credit was equivalent to 15 percent of the GDP - an enormous sum, according to the author. Yang (2011) complements stating that "the increase in monetary base in China led to an immediate increase in lending and credits with a multiplier effect". Putting it in simpler manner, the government made more funds available to be used in economic activities, fostering, indeed, the domestic demand.

Just afterwards the monetary easing program started, in November China responded with the largest (as a share of GDP) officially announced fiscal stimulus package in the world, summing up to RMB 4 trillion (USD 586 billion). It followed up with extensions and adjustments to the stimulus. "China was the first to initiate and implement a comprehensive fiscal stimulus package", stresses Yang (2011).

The package was focused on infrastructure projects – public transportation infrastructure (railways, highways, airports, and ports), affordable housing, rural infrastructure (irrigation, drinking water, electricity and transportation), environmental projects, technological innovations, natural disaster areas rebuilding. Also, it was designed to be relatively concentrated in time: 2009 and 2010[8].

Lardy (2012) reminds that the package was closely linked to the monetary easing, since the vast majority of funding for the stimulus package was financed by increased banking lending, made possible only by the previous monetary policy shift. The author states that the "increased banking lending would be the major source of funding for the stimulus program".

It is clear the coordinated endeavor of the Chinese State to implement counter-cyclical policies, in order to stimulate the domestic demand, either via monetary or fiscal actions. From a theoretical point of view, the influence of the Post-Keynesian reasoning is noticeable. Post-Keynesian economists are well-known for advocating a more active fiscal policy, led by the government, in contrast with the traditional orthodox economics. As Arestis and Sawyer (2003) puts, "the task of government policy specifically is to secure high levels of aggregate demand, when private demand is deficient". Tcherneva (2008), when summarizing the rationale of the post-Keynesian reasoning at the present days concludes: "a core proposition is to boost aggregate demand, investment and growth to underpin full employment".

The policy shift proved to be efficient in preventing a deep economic recession; China was the first to resume relatively high economic growth. The target, at 8%, "believed to be a safety target for unemployment and social stability" (Yang, 2011), was even surpassed. Wang & Hussain (2010) still complements stating that "nation-wide, employment and wage growth slowed substantially in 2009, but remained positive. Both official wage growth and rural per capita wage income growth picked up again somewhat in the third quarter of 2009", proving the power of the Chinese stimulus measures.

3.2) The Impacts on the Chinese Banking System

The Crisis, nevertheless, had an impact on Chinese banks. Moreover, as suggested above, in order to overcome the social and economic concerns triggered by the Crisis,

[8] The American package, as a matter of comparison, was designed to be spent over the next 10 years following its enactment, even though the bulk was budgeted for the first 3 fiscal years

the leadership had to make use of the traditional banking activity. The question, therefore, is in which degree and how the Chinese endeavors during the financial crisis impacted its banking system.

One of the immediate effects of the crisis over Chinese banks was on its capital base. Just as the crises erupted, the Chinese banks have witnessed the sudden pull out of many of their western partners (Bank of America, UBS, RBS) as these had to partly sell their minority stakes in order to retrieve capital and recompose the capital base of the headquarters (Schmidt, 2009).

In relation to the stimulus package, it triggered some concerns. Generally, there was the fear of excessive growth of banking lending, given the great increase in credit. It could entail higher levels of leverage and indebtedness across the country. More specifically, such massive amount of credit could lead to investments in projects which would generate weak future cash flows ("white elephants") and also excess of industrial capacity, leading to lower profit margins in the near future, thus impacting negatively the capacity of repayment of loans by the borrowers. This scenario could lead to a situation in which the banks would not receive the repayment of its loans, turning it into new NPL's, degrading the balance sheet of the banks.

Lardy (2012) dismisses much of those concerns. Chinese financial institutions, at the kick-start of the stimulus package and monetary easing, were in a strong position to increase credit supply, characterized with low leverage and indebtedness levels. The same applies for Chinese households and the central government: they had conditions to assume additional debt (a situation completely opposite to the American scenario at the outbreak of the crisis, for example)[9].

However, when we frame this concern through the local government's lenses the situation might be different. Since the central government did not bear even half of the financial costs of the stimulus package, much of this burden came to the shoulders of the local governments. Of the total 4 trillion RMB, the central government in fact contributed solely with 1,2 trillion RMB. Local governments and banks had to complement it.

[9] Moreover, the excess of capacity must be large and widespread in order to impair the ability of repayment of the loans and thus lead to large-scale losses across the banking system.

It is always important to remind that the Chinese banking system is fragmented, and many quasi-independent local branches and decision makers have autonomy to pursue its own policies. Provincial branches of a “Big Five” bank are vertically accountable to the bank's central offices, and ultimately to the Central Government. But at the same time, they are also accountable to the provincial finance bureau and the provincial government level (Breslin, 2000). Tackling this issue from a politics science stand, Victor Shih (2008) perceives it through the idea of “factional politics” within the Chinese Communist Party (CCP). Generally speaking, local governments are composed by a “loose collection” of local officials, which have the power to allocate goods, services and personnel to the banks.

Furthermore, according to the Chinese law, local governments cannot currently issue bonds or borrow from banks to finance infrastructure projects. Therefore, during the stimulus package implementation, local government created Local Investment Companies (LIC’s) or Local Investment Platforms, which are, in turn, allowed to borrow and issue bonds.

Indeed, this line of argument highlights the fact that much of the medium and long term loans for infrastructure projects went to LIC’s, which were given land use rights or development rights by the local governments. The LICs would then use these rights to obtain loans from banks or to issue bonds (often purchased by the local banks) to raise the necessary capital to develop the land or build the infrastructure projects (Azuma & Kurihara, 2011).

In the case they cannot repay the loans contracted, banks might suffer the consequences in the form of a new flow of NPL’s. Martin (2012) quotes a survey from the China’s National Audit Office, reporting that 6,576 LIC’s had been created by June 2011 with a total debt of 4.97 trillion Yuan ($782 billion).

The problem, therefore, is whether the local projects will generate economic returns sufficient to fund the repayment to the state banks. Lardy (2012) argues that some definitely will, especially the national-wide investments, because were based on long and detailed studies, made prior to the crisis[10].

[10] That’s the case of the railway expansion and China’s electrical grid (network of the ultra-high voltage (UHV) transmission lines) expansion.

However, on the other hand, the same author sustains that “eventually, municipalities and other local governments will probably have to assume responsibility of repaying some of the borrowing that their local investment companies are unable to repay”. Victor Shih (2009) is also concerned with the same issue, reminding that “banks are eager to finance government-sponsored projects because they come with implicit government guarantees (land as collateral)”. The Economist (2011) also fears that investments are becoming increasingly inefficient and that China is heading towards a “brick wall” of government debt, problem exacerbated by the recklessness of local governments during China's stimulus-spending momentum. Since local governments are legally limited in the ways by which they can raise revenues, the final bill might go to the banks involved in the process, entailing concerns about a sharp rise in NPLs and its financial health.

In case of those pessimist predictions come true, the central government might have to act again as a lender of last resort and ultimately end up injecting capital on state-owned banks[11], either controlled by the central or local governments. That would be technically a bail out. If this hypothesis materializes, it would mean a return to immediate post-Asian crisis period, when the State had to rescue the “big five”.

In spite of the concerns mentioned above, the “big five” apparently were quite successful in their operations as of 2010, featuring strong financial indicators, such as low NPL’s ratios and fair profits. The problems arisen from the financial crisis and the stimulus package might appear only few years later, since, according to Martin (2012), “as much as 1.84 trillion Yuan of the outstanding local debt will become due in 2012”, and many infrastructure loans will be due between 2013 and 2015.

An indicator of future problems might be that partial data from 2011 shows that among the “big four”, only the Agricultural Bank of China did not report a rise in overdue loans, and the other banks saw the value of their overdue loans rise by over 10% compared to 2010 (Martin, 2012). Finally, one cannot overlook the fact that most of the banks involved with the local government projects and LIC’s were not the traditional “Big Five”, but especially city commercial banks (Azuma & Kurihara, 2011).

[11] Just as after the Asian Crisis, the Chinese central government had to carry on a capital injection on its State-owned Banks, and lately proceed with another round of measures aiming a NPL’s cleaning up. To more details, see Fernald (1999).

3.2.1) Impacts on the Reformist Agenda

Maybe most importantly, the reform agenda seems to have been affected by the Crisis and the stimulus package.

A set of important reforms that seems to be stalled during the financial crisis period is the government control on the interest rates regarding the loans and deposits. Few steps were taken from 2008 to 2012. The government still seizes control over the interest rates on the banking system, which is in fact the main price for both loans (credit offered to companies and consumers) and deposits (the remuneration of household's savings). The PBOC sets both a ceiling for the deposits rates and a floor for the loans rate, managing, therefore, the interest spread (difference of the interest rates paid and received by the banks) of the banking system. This mechanism creates a guaranteed profit margin for the bank's lending activity, a tool to directly influence the profitability of the lending activity of the banks (Lardy, 2008)

This current system of government control on interest rates is positive for the real economy, to the extent that it provides banks a guaranteed and predictable profit on lending activities, and assures entrepreneurs alike enough funds at modest price to be invested. In terms of macroeconomic aggregates, the investment, thus, is spurred.

On the other hand, as the ceiling of deposit rates often is lower than the inflation rate (a negative real interest rates scenario), it reduces the growth of household *real* income, what leads to a lower aggregate consumption rate (as share of the GDP). The brakes to a higher level of household income, in turn, undermine the government's long-term goal to better develop a commercial banking system, since lower households income ultimately means a narrower scope of profitable activities for banks.

The contradiction arisen from the government's response to the Crisis is that the key variable sought on the stimulus package was precisely the investment, currently the main driver of the Chinese economic growth. However, by betting on the traditional lending activity of focusing more investments on infrastructure, the government automatically was setting up barriers on the way towards a more diversified and consumer oriented banking system. The stimulus package and the monetary easing policy attached to it represented, ultimately, more incentives for investment – lower lending rates and infrastructure projects – and less incentive to consumption. It is essential to emphasize that both the households' deposits and the lending rates are directly managed by the Central Bank, and not fully by market mechanisms (Jingu, 2012).

Reforms aiming the liberalization of the interest rates regimes would probably lead to a final structure of relative prices in which investment would not be as attractive as it is in the current configuration (Lardy, 2008). Therefore, it comes with no surprise that during the period 2008 – 2012 no progresses were made in terms of reforming the interest rates system. As a consequence, the banking system in China continuously works biased towards investment, leaving the consumption of households in a secondary place.

In terms of revenue, accordingly, Chinese banks are traditionally highly dependable on the lending business (interest income) as the main source of it. Loechel & Xiang Li (2011) shows that, as for 2008, the average portion of non-interest income in gross revenue of Chinese banks is only 14.8%, whereas in Europe is 51.8%, in the UK 46.5% and 41.0 % in the USA. While the control over interest rates continues, and while this pattern of guaranteed profit margin in lending operations prevails, we are likely to see a low level of non-interest revenue and a narrow scope of business activities within Chinese banks. Ultimately, a less diversified banking system.

This pattern could be attested by the financial reports of the "big five" up to 2010. According to Martin (2012), the largest assets for all five banks were loans, with the value of corporate loans three or more times the value of personal loans. The dependence on interest –revenues, as predicted (given the characteristics of the Chinese response to the Crisis) was not modified. In other words, the diversification of banking activities, towards non-interest business and consumer-driven activities still has not taken off.

The challenge to Chinese authorities, thus, is to tackle this pattern of overreliance on investment as source of economic growth, which overshadows the consumption (as percentage of the GDP). In order to do it, the reforms on the interest rates system must resume.

4) Conclusions

Summarizing, the hit of the 2008 global financial crisis created a pressure on the Chinese leadership, translated into a large and comprehensive stimulus package, approved in order to offset negative effects on employment and economic activity levels. As a result, investment-oriented lending activities were incentivized and fostered, reinforcing the Chinese bank's dependency on lending revenues.

As part of this scenario, the control the government wields over interest rates has played a vital role in this process, and thus the growth of the consumption aggregate (as share of the GDP) still is heavily constrained by both the banking system and China's macro policies.

Moreover, the stimulus package raised the fear of financial problems across the banking system. Actually, local governments and local (branch) banks are of particular concern. Financial innovations such as the LIC's allowed local governments to meet the demands posed by the Central government's ambitious stimulus package, but on the other hand, gave rise to the fear of a local debt problem.

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