The sustainable growth of China's economy and its banking sector

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‘Beijing, not Washington, increasingly takes the decisions that affect workers, companies, financial markets and economies everywhere’ (Economist, 2005). Obviously not every economist would agree with this sensationalist statement, especially when it is to be interpreted literally. However there exists broad acknowledgement that in the last twenty five years China has emerged as one of the key players in the world economy. According to Chinese government official data, the economic reform over the past two decades has resulted in lifting out of poverty approximately 230 million Chinese. Taking into account the rate of growth we can not but agree that the recent development of the Chinese economy has demonstrated the greatest creation of wealth in the history of humankind.

Given China’s expanding role in global economy, continued growth has become a central concern both within and outside China. The purpose of this paper is to analyse the factors that cause the stunning economic achievements of China. Special attention is given to its banking sector which is crucial to sustain the economic growth of the nation. Though many tough challenges and risks need to be urgently addressed, a sustainable growth is very much likely if China continues to leverage its growth drivers and give relatively free reign to the invisible hand of the financial market mechanism.

1 The driving forces

When the new China under Mao’s Communist Party was established in 1949, it was determined to follow the former Soviet Union model, i.e. centralized command system. In the countryside, farms were collectivised into large communes. Nationalised industries were concentrated in large cities. All the productions of goods and services, as well as prices were fixed by the central government in a 5-year-cycle. By the end of Mao’s era in the late 1970s, China was fully impoverished and isolated. For the ruling party the choice was clear - either to take a reform course or to lose power. In 1978 the Chinese government led by Deng Xiaoping started to liberalise market with abandoning collectivized agriculture, and expanded to include fiscal decentralization, encourage foreign trade and investment through joint ventures. China’s implemented transition to market-oriented economy has resulted in a
phenomenal increase in GDP since 1978, see Fig. 1. Measured on purchasing power parity (PPP) basis, China became the second largest economy in the world after the US in 2006. Fig. 2 shows the GDP growth in the past ten years. Though in the recent published revisions to PPP rates by IMF (IMF Research, 2008) China's PPP-based GDP for 2005 resulted in a downward by around 40 percent, it remains unignorable that China has been one of the main driver of global growth in PPP terms, which alone contributed nearly 27 percent to global growth in 2007, see Fig. 3. According to the estimates from IMF for 2007, China still ranks as the world's second largest economy, with an almost 11 percent share of world output.

There are a number of common determinants that lead to high growth. The resources of global economy, i.e. international demand, transfer of advanced technology and investment that stand out as driving forces in sustaining high growth (Spence, 2007). In the case of China, the three elements, i.e. FDI, mobilised resources and Confucian culture, alongside other factors, have played particularly vital roles in driving fast development of China’s economy.

![Fig. 1 China’s GDP in selected years since 1978 (Original data source: National Bureau of Statistics of China).](image1)

![Fig. 2 China’s GDP growth in the period between 1996 and 2006 (Original data source: National Bureau of Statistics of China).](image2)
International trade in goods and services and FDI are two important interaction mechanisms between China and the rest of the world. After opening up, China in contrast to some Central and Eastern European countries has adopted a gradual approach to economic reforms. This is also reflected in the policies toward FDI. From the introduction of FDI until 2006, the development of FDI can be divided into three distinct phases. The first phase is characterized by gradual and limited opening to FDI. In 1979 FDI obtained the official legal status. Four special economic zones in Southern China were established in 1980. The main purpose was to attract FDI and encourage the formation of joint ventures with Chinese local firms. Wholly foreign owned firms were not permitted. Most of the FDI was vertical and therefore foreign invested enterprises (FIEs) engaged in export processing. In the second phase from 1986 to 1995, more favourable regulations were entailed to promote export-oriented and high tech joint ventures. Wholly foreign owned firms were allowed. Joint ventures with preferential tax treatment, freedom to import raw materials and capital equipment, and the right to retain and swap foreign exchange. The largest proportion of FDI went to the manufacturing sector and consisted of greenfield investment (Das 2007). The third and final phase was more comprehensive and included alignment of FDI promotion with domestic priorities such as energy, agriculture, transportation and high tech industries. Fig. 4 illustrates the increasing annual inflow of FDI to China at current exchange rate. Among developing countries, China has been the largest recipient of FDI in recent years.

The contribution of FDI to China’s economy is threefold. Firstly, knowledge transfer which includes not only technology transfer but, equally important, the acquisition of modern management and marketing know-how. This provides Chinese firms access to global markets. Secondly, it enables Chinese firms to raise foreign capitals. Due to the shortcomings of Chinese capital market in financing private firms, the gain derived from FDI can hardly be overestimated. Following on from the second point, China benefits from FDI implied productivity gains and improved management efficiency through increased competition in the domestic market. In short, FDI plays a crucial role in structural adjustment. A sustainable development of China will still depend very much on domestic investment and FDI.
1.2 Mobilised resources

As China is still in its early stage of development, the mobilization of resources is very important to growth. The liberalisation of the labour market has enabled manpower moving to where investment is taking place. The migration of millions of labour forces each year from the underemployed agriculture sector to cities has resulted in an accelerated process of urbanization in China. The immediate effects are, on the one hand, the intensified demand for infrastructure, services and education; on the other hand, the enlarged fraction of employment in industry and higher productivity sectors.

Another remarkable resource comes from highly qualified human capitals outside. By the end of 2005, more than 150,000 overseas employees had registered to work in China. Shanghai alone has lured about 500 multinational companies with more than 40,000 foreign talents engaged (CHINA daily, 2006). According to the statistics of the Ministry of Education of China, during the period between 1978 and 2003, the State had funded a total number of 700,200 Chinese students and scholars studying in foreign countries and regions all over the world, covering almost all disciplines. In the same period, 172,800 returned to China. Currently there are more than 300,000 students and visiting scholars studying or doing research in Western countries. As working conditions and living standard have been improved dramatically, there is an increasing quota of return. No doubt this part is the leading engine to drive modernization of the society.

1.3 Culture

Culture in the form of certain dominant values is an important resource for economic development. However, culture alone cannot create wealth of nations. There are at least two other necessary conditions – the existence of the market and a functioning market system that safeguards growth. The first condition is there if nothing else but in sheer numbers of Chinese consumers. Since 1987, China has started to adapt a long-term approach relying on the market-based system and opening up the economy to international trade and investment. This strategy of making use of the invisible hand but guided by the central government to generate income has been extremely successful.
An important fact in this context is that though China is among developing countries one of the most open economies in the world (the share of exports and imports of goods and services in GDP in 2006 is approximately 60%), politically it remains a strictly controlled system under one ruling party! To understand this paradox, one has to go back to the principles that are deeply rooted in the Chinese culture and investigate to what extent the teachings of their philosophers are still applicable today.

Chinese culture has no clearly defined division between religion, philosophy and business (Chu, 1991). Philosophically there are several major influences affecting Chinese thinking, including Confucianism, Taoism and Buddhism. Of those, Confucianism is the most popular and viable. Confucius’s teachings have been established among Chinese as a set of ethical rules for daily life. For about 2500 years, these rules have formed the core values of Confucian culture:

- deference to authority and stability
- preference for order over freedom
- belief in the virtues of education and hard work
- emphasis on frugality and thriftiness
- pursuit of harmony while avoiding confrontation

The influence of culture on business and management has been intensively studied worldwide. Differences in organizational behaviour and leadership style can be traced back to the cultural background (Hofstede 1997). There are counter-arguments about to what extent the Confucian culture underpins economic development. Confucianism regards learning and
knowledge as of paramount importance in life. In many Asian countries, it is widely spread that achievements can be gained through repeated learning. In global economy, learning from the best practice is possible. Obviously, learning is also the quickest way to catch up. The economic miracles of the Asian four ‘tigers’ can probably be attributed to one of the most enduring, if not the only, explanatory factor - Confucian culture. It is how Japan – another Confucian neighbour - becomes one of the leading nations. In mainland China between 1949 and 1978, especially during the Cultural Revolution in 1960s, traditional culture was constrained, suppressed and destroyed. Since China’s economic reform, gradually but steadily Confucian values have been reliving as the dominant societal ideology. This is not an ancillary effect of economic prosperity, rather the essence of it.

2 China’s banking sector

In the early 1980s the corporate bond and stock markets in China were nearly non-existent. Hence, banks played a major role in intermediating savings that comprised about 40% of GDP and channelling funds for investment. In 2003, bank assets have boomed over 3 trillion US$, or over 200% of GDP. The biggest problem in the banking sector was and still remains the issue of non-performing loans (NPL). It is difficult to figure out the true size of the NPL, if possible at all. According to the People’s Bank of China, bad loans at the state-owned Big 4 banks stood at 26% of total loans by the end of 2002. Some foreign financial institutions estimated the level much higher. But the origin of the NPL was certain – a legacy from the state-directed lending to non-profitable state-owned enterprises (SOEs). Another crucial point was the lack of commercial credit culture in all Chinese financial institutions. Since 1998, the Chinese government has carried out a series of measures to shrink the NPL. The main actions include directly injecting capital (33 billions of US$) into the Big 4, moving out large portions of NPL to newly established Asset Management Cooperation, and pushing state-owned banks to go public. At the same time, opening up banks for foreign investors with the aim to modernize governance and management.

China’s banking sector today has improved remarkably though it is still under the burden of NPL, see Fig. 6, Fig. 7 and Table 1. The major players in China’s financial system includes 4 large state-owned commercial banks, 3 policy banks, 12 joint stock banks, and numerous commercial banks, credit cooperatives and financial institutions. The Big 4 banks dominate the domestic banking sector, collectively accounting for over 50% of total assets and liabilities.

![Fig.6 Total assets and liabilities of China’s banking institutions (Source: China Banking Regulatory Commission Annual Report 2006)](image_url)
Table 1: The NPLs of Major Commercial Banks 2006

<table>
<thead>
<tr>
<th>Items/ Institutions</th>
<th>Commercial Banks (in total)</th>
<th>Major Commercial Banks (Big 4)</th>
<th>City Commercial Banks</th>
<th>Rural Commercial Banks</th>
<th>Foreign Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding Balance of NPLs (RMB 100 million)</td>
<td>12,549.2</td>
<td>11,703.0</td>
<td>654.7</td>
<td>153.6</td>
<td>37.9</td>
</tr>
<tr>
<td>Substandard</td>
<td>2,674.6</td>
<td>2,270.7</td>
<td>315.3</td>
<td>66.9</td>
<td>21.6</td>
</tr>
<tr>
<td>Doubtful</td>
<td>5,189.3</td>
<td>4,850.3</td>
<td>247.0</td>
<td>82.7</td>
<td>9.3</td>
</tr>
<tr>
<td>Loss</td>
<td>4,685.3</td>
<td>4,581.9</td>
<td>92.4</td>
<td>4.0</td>
<td>7.0</td>
</tr>
<tr>
<td>Share in Total Loans (%)</td>
<td>7.1</td>
<td>7.5</td>
<td>4.8</td>
<td>5.9</td>
<td>0.8</td>
</tr>
</tbody>
</table>

(Data source: China Banking Regulatory Commission)

To fulfill a long-standing commitment to WTO, China opened its retail banking sector to foreign participations. According to the official statistics of China Banking Regulatory Commission, by the end of December 2006, 74 foreign banks from 22 countries and regions had opened 200 branches and 14 locally incorporated institutions in 25 cities in China; 186 foreign banks from 41 countries and regions had opened 242 representative offices in 24 cities in China. Though the share of total banking sector assets of foreign banks is not yet big, only about 2%, the landscape of China’s financial market has undergone significant change. The role model of foreign banks and the competition in the domestic market shall give a strong push to the restructuring of the banking sector. Another aspect is the capital markets which are underdeveloped and should play more and more important role in corporate lending. All in all, it still remains critical for China’s banking sector to further consolidate the operational system, improve governance and promote transparency, and finally to let the market mechanism take effect.
3 Is the growth sustainable?

The impressive achievement of China’s growth notwithstanding, when the size effect is taken into account, China is still far below the per capita income in developed economies. In the annual report 2006 of the National Bureau of Statistics of China, there are 35.5 million people living below the official poverty line of 958 RMB per year (about 150 CHF). If China keeps an average growth of 10%, the income will double roughly every 7 years. This means for about 20 years or so the Chinese income level will reach that of today’s Japanese. See Fig. 8. There is no other way but China must maintain high growth because this is the real cause of the reduction of poverty. No government can escape the choice between creating more income through promoting efficiency and redistributing the income to the poor who are left behind. The key point, though obvious, often overlooked, is that the creation of a social safety net has to be financed. Given the huge population of China this is an overwhelming task. China is actually aware of the challenges it is facing. Deepening reform in the banking sector and state-owned enterprises, efficient use of energy and environmental protection, narrowing the income gap between rich and poor, as well as development of rural regions have been taken as top priorities in the government’s agenda. However, it should also be noted that no rigid political system can survive for a long-term while the economic transition is taking place actively. In conclusion, with its long history, rich culture, and pragmatic approach, China will succeed to continue growth and development. We should keep in mind that the further development of China depends on the rest of the world but, equally, the rest of the world now also depends on China.

Fig.8 GDP per capita (PPP) in selected countries (Original data Source: CIA 2006)

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