

## **Analysis of the Chinese Bank System and AIIB from an East-Central-European View**

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### **ABSTRACT**

The development of the Chinese banking system at the beginning was very similar to the Hungarian ones, as only consisted of one bank based on the Soviet model. Although, they have the same starting-point they described an entirely different developmental path. Currently, China is one of the leading countries with one of the World's largest economy and strongest geopolitical position. Since the millennium an outstanding expansion observable, which became slightly more open after joining the WTO however, still quite sheltered from the external impacts. This is why China is considered the "Winner" of the 2008 financial crisis. Investment is an extremely high proportion of China's GDP. We are analysing how the investments are doing their share in regards to the growth in the different provinces. Several researches of Chinese economists are going to be revealed. These works introduce us to the banking system of the country in detail, give us some data and describe their effects on the economy.

Keywords: bank systems, banking and finance, Central and Eastern Europe, China.

### **1. INTRODUCTION**

Amongst all countries of the world China is prominent in many respects. Its territory is more than 9 and a half thousand km<sup>2</sup>, the population is almost 1,5 milliard people – and this number is continuously increasing, presumably till 2030 will culminate. No small wonder that China is leading the world-wide level economic growth – and the engine of the expansion is given by the bank financing. The analysts proclaimed China as the „Winner” of the - in 2008 outbroken - financial crisis, its developmental model could compete even with the capitalist models. After all China is considered as the largest importer of the EU. One of the catalysts of the quick improvement was the expansion of the foreign currency reserves. However the banking system is underdeveloped because they are not able to handle the foreign capitals properly and the savings are immobilized mostly in low interest American government securities.

The foreign trade of China has been expanded rapidly since the joining to the WTO (World Trade Organization). In 2010 within one year the trade between the EU and China increased with 37%, the deals with the US extended with more than 30%. Japan is considered as the third greatest foreign-trade partner of China. The study gives an inside view of the development of the Chinese banking reforms and banking system demonstrating how the reasons resulted in what kind of consequences in the Chinese banking system. Through the reveal of technical literature the works of Chang, Zhang, Lin and Berger have been elaborated and were highlighted the

features of the bank sphere. Furthermore, the study mentions the impacts and opportunities of the foreign banks and investors in China and in its economy.

## **2. RESEARCH WORKS OF CHINESE ECONOMISTS IN THIS TOPIC**

### **2.1. The work of Chang**

The redistribution of bank funds and the market concentration also affects the growth of the gross domestic product. The study prepared in 2010 by Philip C. Chang, Chunxin Jia and Zhicheng Wang examined 31 provinces in the territory of China between 1991 and 2005, and the analysis focused on four state-owned commercial banks. At regional level, no correlation was found between the allocation of bank funds and the bank credits; however, the bank deposits show a correlation with the local economic development. A possible explanation of the relationship between the asymmetric credit growth and deposit growth is the low efficiency of state-owned banks. They give higher priority to state-owned companies, thus the bank credits have no effect on the development of the local economy. Despite this, the local economies still prosper, and the bank deposits show an increase (Chang, 2010).

The credit-to-deposit ratio of the state-owned commercial banks ranged from 0.38 to 2.12. The high value means that money arrives from other provinces through the internal capital market of the state-owned commercial banks. The state-owned banks have a market share in the deposit market, in each province. However, none of these has an impact on the GDP growth, but the deposits increase the GDP. The national commercial banks are inefficient in allocation of funds.

### **2.2. The work of Zhang**

Jin Zhang, Lanfang Wang and Susheng Wang (2012) studied 286 Chinese cities between 2001 and 2006. The goal was to learn about the relationship between the financial development of China and its economic growth at city level. The financial development promotes growth. Most of the traditional economic indicators indicate a clearly positive relationship. However, this statement contradicts the claim that the state-controlled banking system - just like the Chinese one - hinders the growth of the economy because of the governments of distorted nature. In 2001, China was already a member of the WTO, therefore the study assumes that the financial reforms taking place in China are made in the right direction.

Indicators for the development of financial impacts Researchers, who observe the relationship between finance and growth in China, have introduced a number of new indicators in relation to the theme, which are calculated per city. As a result of the examination, the following average values were determined: Credit – the proportion of total credits to the GDP: 0.809; Deposit – the proportion of total deposits to the GDP: 1.131; Savings – the savings of the population in the financial system compared to the GDP: 0.713; LOA – financing of fixed asset investments from in-house credits and the proportion of state loans for the same purpose: 5.032; Corporation – the proportion of corporate deposits to the total deposits in the financial system: 0.337

Thus, for instance, if a city increased its credit from 0.059 to the average value of 0.809, it would result in a growth of 0.9% (Zhang et al., 2012).

### **2.3. The work of Lin**

According to the theory of Justin Y. Lin, Xifang Sun and Harry X. Wu (2012), the dominance of state-owned commercial banks is typical. As the time goes by, the market share decreases, however, currently they still have about 50%.

Two points of view are distinguished:

According to ownership structure: It focuses on the state-owned four major banks. The state-owned corporations are less effective than private firms. The state-owned banks are biased for the state-owned companies, which results in a misallocation of funds. This, in turn, decreases economic growth.

According to size: This puts the size of the four major banks to the fore. The labour force-intensive companies tend to be smaller, by which the information is vaguer about them, too. However, to obtain loans, the banks need information. The big banks have much less access to information than small banks. Thus, due to the current banking system, the companies that require more labour force, receive less money.

Despite the fact that the four major banks dominate the Chinese banking system, there are also other state-owned banks present in the country. It is hard to separate the two views. Lin and his partners, however, examined also this.

The research was about 28 manufacturer corporations. The examination lasted for 8 years - from 1999 to 2007 - in 30 provinces. Their primary goal was to learn the various effects of the banking structure in the specific sectors. The banking structure can be measured based on the credit market share of the banks not belonging to the four major banks. To identify which structure affects the growth, it is necessary to introduce two variables: the relationship between the labour force-intensive industry branches and the bank structure, furthermore, the relationship between the non-state-owned corporations and the banking structure. They found that the state-owned commercial banks hinder the growth of those corporations which have higher shares of non-state-owned companies (Lin et. al., 2012).

### **2.4. The work of Berger**

Allen N. Berger, Iftekhhar Hasan and Mingming Zhou studied 38 Chinese commercial banks between 1994 and 2003. The study focused on the estimated profit and cost data. The 38 banks were examined in the same position. The four major banks' return on assets was 23.4% of that of the bank with the largest value. The smallest cost/asset ratio between the banks was 89.2% of that of the four major banks. The four major banks proved to be more cost-efficient than the privately owned domestic banks, but in profit gaining and the quality of credits they lag behind. The foreign banks are the most profitable, the most cost-efficient and have the best quality assets. The cost-benefit efficiency measures the expected performance of a bank in the same environment and under the same conditions. This shows how the bank is close to the minimum cost or the maximum profit, which values are calculated on the basis of the best performing banks (Berger et. al. 2007).

### **2.5. Foreign banks in China**

The flow of foreign direct investment in China is at about 11.3% each year in the period between 1990 and 2014. Since the late 1980's, this process can be linked to the cross-border mergers and acquisitions. This means that the foreign companies acquire shares in domestic firms. The so called "greenfield investments" fell into the background. Those investments can be called greenfield investments during which

the foreign company established its offices or plants in the host country. In 2014, the proportion of mergers and acquisitions and of greenfield investments was 60%.

The inflow of the foreign direct investment becomes increasingly important in the banking and financial sector. 15% of the global foreign direct investment is made up of financial services. Between 1995 and 2009, the presence of foreign banks in the countries increased from 21% to 35%. Most of the foreign banks migrate to another country from OECD (Organisation for Economic Cooperation and Development) countries. The significance of foreign banks is large, especially in emerging markets and developing countries.

In a given country, the foreign banks can appear in two ways. They can purchase shares within the framework of cross-border merger or acquisition, or deploy new sectors as a greenfield investment.

### **2.6. The effect of foreign banks on the domestic ones**

The foreign banks act as shareholders. In fact, the foreign shareholders bring - amongst others - technological innovation and know-how to the new market. This works in the same way also in case of banks. Each new settler bank means something new for the recipient country. The foreign shareholders decrease the expenses of domestic banks by optimizing their operation. Nevertheless, due to restructuration, they may mean also additional costs to the domestic banks.

The foreign banks mean competitors, as their appearance may result in a sharp price competition. The foreign banks select the entities to which they provide credit more carefully. They are more cautious and lend only to the most reliable debtors. Thus the less reliable customers get to the domestic banks, and cause more problems to them. In order to keep up with the foreign banks, the domestic banks can increase their costs.

### **2.7. Targeted foreign investments**

They began in 1996, but until China's WTO accession - i.e. until 2001 - the targeted foreign investments were limited. The China Banking Regulatory Commission stipulated that foreign investors must meet four criteria. These are the following: long-term equity portfolio, optimization of corporate governance, business cooperation, avoidance of competition.

In 2005, the China Banking Regulatory Commission explained these four points also in more detail. Then it had the following version: a minimum of 3-year portfolio of shares, personal discussion of the board members, technological and network support, up to two Chinese bank investments.

### **2.8. China Construction Bank and the Bank of America**

The Bank of America purchased 9% of the China Construction Bank in June 2005, at a price of 3 billion – by which America has become the largest foreign investor in China. China had already taken precautions at that time to strengthen the banking system, before the unlimited appearance of the foreign competitors in the country. Under the WTO rules, it had the possibility until the end of 2006.

It was a part of the agreement that the China Construction Bank provided a seat for the representative of the Bank of America in the board of directors. 50 people arrived from America to help the operation of the Chinese bank, in several areas. Such an involved sector was corporate governance, risk management and the assistance in public affairs. The chairman of the Bank of America declared that the investment

aimed to establish a mutually beneficial relationship in the long run between his company and China's largest bank. Otherwise, the Chinese bank counted as the fastest-growing economy, with nearly 1.3 billion consumers (Bei, 2005).

### **2.9. Intesa Sanpaolo**

Two years after the purchase of the Americans, the Italian Intesa Sanpaolo purchased 20% of the Qingdao City Bank. By this, also the Italians put down roots in the rapidly growing Chinese financial market. At that time, the local banks introduced targeted foreign investors more and more frequently in connection with mergers and acquisitions, furthermore, more and more people were considering an entry to the stock market, as well. The local governments are pleased to support these transactions, as the foreign investment promotes also the development of the local economy (Jialu, 2007).

From Italy, three senior executives arrived to China: a vice-chairman and executive consultants to the IT department and the area of lending. However, labour force flowed also to Italy from China after the investment.

### **2.10. The advantages of domestic banks**

For the foreign investors, it is obviously profitable to invest in China, but also the domestic banks can gain several advantages. The foreign banks supplement the equity capital of banks with their investments, which promotes the restructuring of the bank. They comment on the management of the Chinese banks, which is used to improve the corporate culture and management of the domestic banks; they cooperate in business life. Through the seconded employees, the knowledge is exchanged, it improves the public opinion on the Chinese banks and makes the information published more credible. They encourage the domestic banks to make their shares public and appear in the stock market.

### **2.11. The disadvantages of foreign investors**

However, the investors also have to face a number of disadvantages. Joint management - There are few independent directors, furthermore, the risk and audit committees must be taken into account, as well. Control and management influence - The maximum value applicable for every foreign company is 20%. Legal and regulatory frameworks. Risk management - Credit evaluation can still be influenced. Its basis is the guarantee and the liquidity of the applicant. The quality of assets - The non-performing credits mean a big problem.

## **3. THE BANK REFORM**

Before 1979, the bank of issue of the People's Republic of China was in a monopoly situation and constituted a part of the Ministry of Finance. It collected retail deposits through its nationwide branch network. It is true that it has facilitated the financing of economic plans, but it was unable to contribute to successful projects. Another of its tasks was to redistribute income on the basis of the budget plans.

### **3.1. The first phase**

The first phase of the reform of the Chinese banking system lasted from 1979 to 1993. The bank of issue became the central bank of the country at that time. In this period, four state-owned commercial banks were established: China Industrial and Development Bank: this was the institution that took over the banking activities that

are related to industry and trade. The investments of the large Chinese enterprises were financed through this; Agricultural Bank of China: it took over the agro-industrial banking activities; China Construction Bank: it dealt with the financing of projects; Bank of China: it was in charge of foreign exchange-related transactions and the international business-related banking activities.

With the establishment of the four banks, the two-tier banking system was created in China. The financial sector was supplied by the central bank, the People's Bank of China, and today it also fulfils the function of the bank of issue.

### **3.2. The second phase**

The second phase began in 1994. The act was brought that regulated the operation of commercial banks, and in addition to this, a new act on the bank of issue came into force, as well. The bank of issue divided 31 provincial sectors to 9 regional centres, thus the political influence of provincial leaders decreased – this compares to the US banking system.

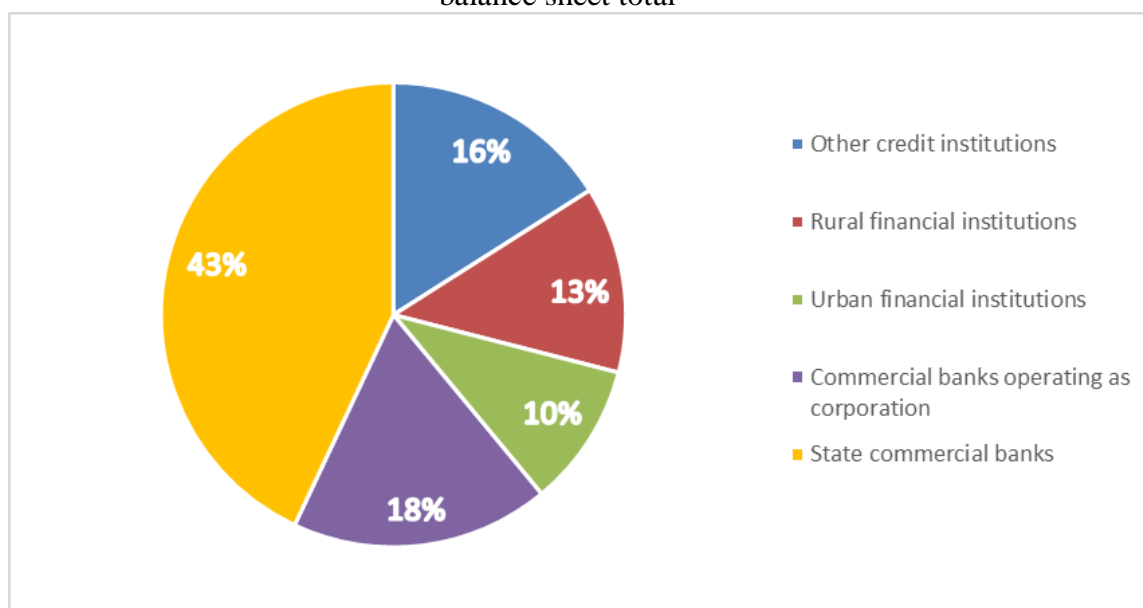
The task of the bank of issue is to increase economic development and stabilize prices, furthermore, it also supervises the financial system. However, since 2003 this task has been taken over by the newly established China Banking Regulatory Commission.

In the second phase, three new banks were established in China: China Development Bank, Export and Import Bank, Agricultural Development Bank.

Thereafter, the credits related to the economic policies were arranged by these three banks instead of the previously introduced four ones, and the other four were oriented towards commerce. In connection with this, an act was brought in 1995 which regulated the operation of commercial banks. At the same time, the act on the central bank was introduced, too. Thereafter, the commercial banks had the possibility to judge the loan applications independently. The position of the national bank was strengthened due to the fact that the personal power was concentrated in Beijing. This was necessary to reduce the political intervention of the political leaders in the province. The new rules ensured a greater autonomy to banking institutions; however, they still had to provide loans also to those large state-owned corporations which operated at a loss. (Komlóssy et al. 2015)

Thereafter, another banks appeared in China. An example of this is the Minsheng Bank, which began its operations in 1996. It was set up primarily from the investments of non-state-owned corporations. This bank separated itself from the other state-owned and commercial banks. Its operation is realized with the involvement of the economic branches of the financial sector and the combination of modern corporate systems.

Figure 1: Distribution of institution types based on the March 2015 data of the balance sheet total



Source: own edition, the source of data: Komlóssy et. al. 2015.

In the figure above, it can be clearly seen that the role of state-owned banks is the most significant in China's economy even today. The urban and rural banks operate in a given region and are in close contact with the local authorities. Despite the fact that they do not operate nationally, they may play a crucial role in the economic life of the region, where appropriate. Examples of other credit institutions are: leasing companies or insurance companies.

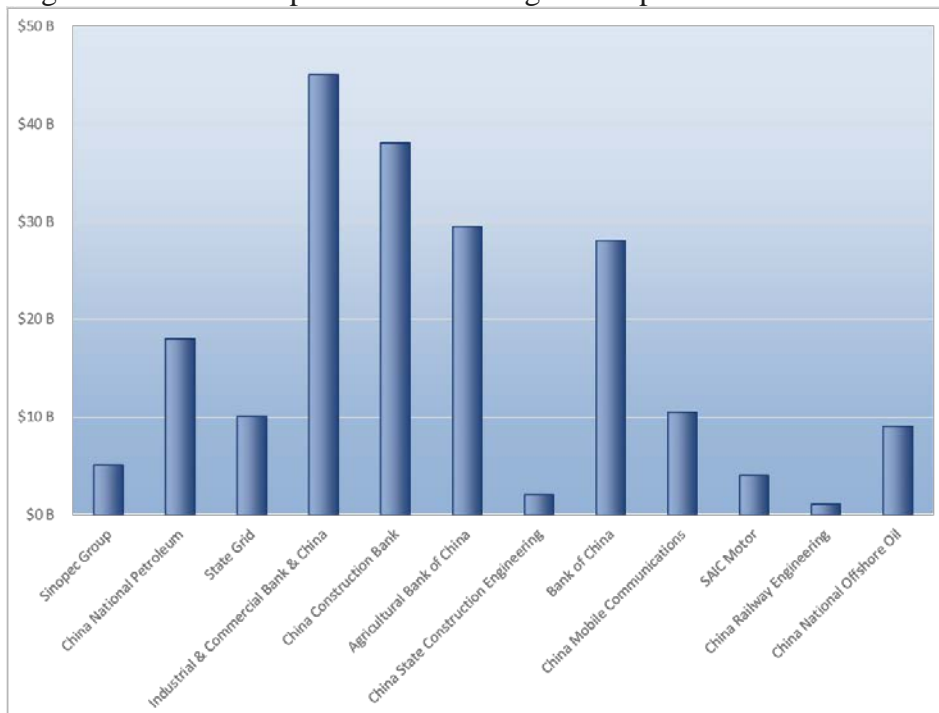
### 3.3. The reform of state-owned commercial banks

The reform started with the liquidation of non-performing credits. The large state-owned banks do not structurally belong to the ministry, but in the field of lending, they did not have the opportunity to become completely independent. They financed the state-owned companies according to a central plan, without considering the risks. They did not question the decision makers at the bank and the corporations did not particularly suffer due to the unpaid loans either. This led to the decline of the banking system. The operation of banks became similar to that of the state agencies. The non-performing portfolio of credits was increasingly growing. The credit rating system applied a five-point evaluation scale. This considered also the past behaviour of the debtor and it was not examined only in relation to the loan received in the given case. The introduction of this international standard eased the problem, as the banks received a greater leeway, so they did not solve the problems occurring in the same way. This made comparability more difficult. However, the new system also highlighted the huge size of the loan portfolio.

In 1998, the Ministry of Finance issued special bonds, and from the income it raised the capital of state-owned commercial banks. A year later, in 1999 an asset manager was assigned to the four major banks to deal with the problematic credits. The major banks needed the help of the central government, and the smaller ones were supported by the local authorities. The transfer of the non-performing credit portfolio was a major step before the restructuring of the state-owned commercial banks. The distribution of credits and the interest rate was changed, too.

Capital arrived from foreign investors, to ensure the improvement of governance, management and efficiency. At this point, the issue of entering the stock market was raised also in connection with three commercial banks.

Figure 2: The annual profit of the 12 largest companies of China in 2014



Source: own edition, data: <http://fortune.com/2015/07/22/china-global-500-government-owned/>

In the chart above, we can see the annual profit of the 12 largest state-owned companies of China in 2014. The ICBC (Industrial and Commercial Bank of China) highly tops the list, with an annual profit of more than 40 billion dollars. However, it is surprising that in the rank order there are also three other banks with outstanding results.

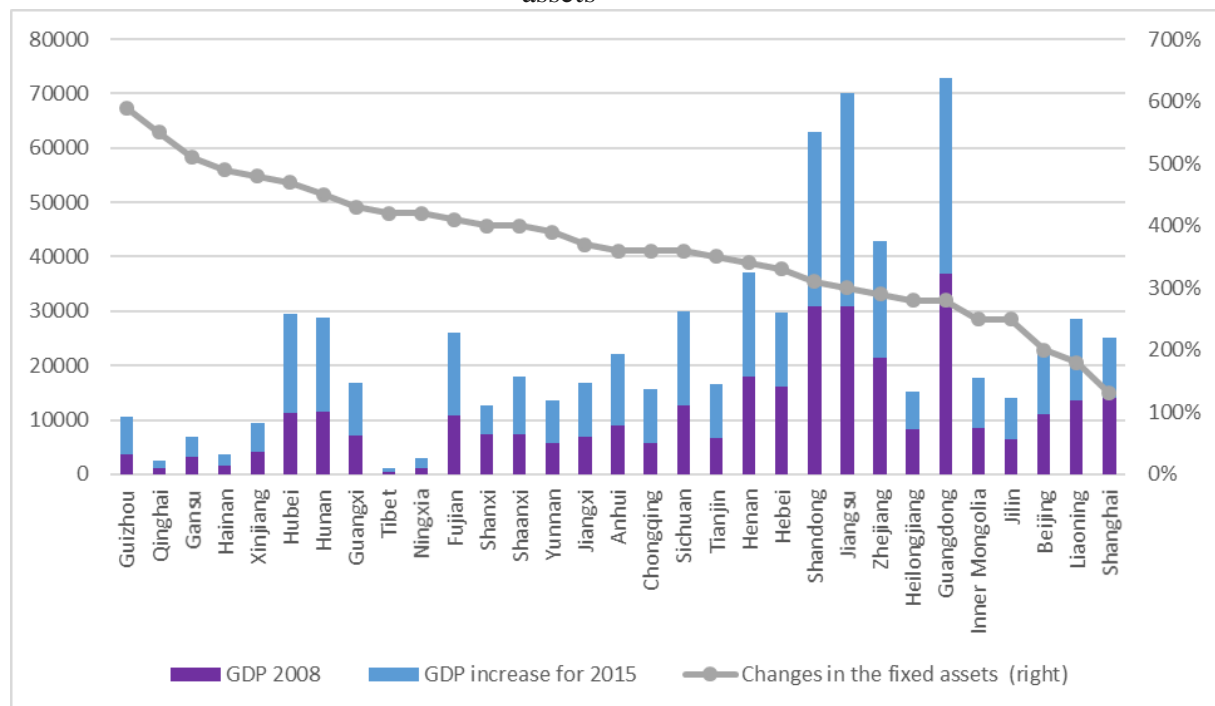
### 3.4. Findings related to the relationship between the change in GDP and the changes in the fixed assets

Figure 3 clearly shows that the increase in fixed assets between 2006 and 2015 shows a negative relationship with the magnitude of GDP of the provinces. The degree of negative medium correlation is -0.65.

It is astonishing that the change in fixed assets in the 7-year period of time examined exceeded 350% in two-thirds of China, in 21 provinces out of the 31 ones. Two-thirds of the 21 provinces which received outstanding investment assets belonged to the provinces producing a lower, less than 20,000 GDP.



Figure 3: The relationship between the GDP growth and the changes in the fixed assets



Source: own edition, data:

<http://data.stats.gov.cn/english/easyquery.htm?cn=E0103>

The 4 provinces producing an outstanding GDP (Guangdong, Jiangsu, Shandong és Zhejiang) have managed to keep their leading character despite the change in the relatively “smaller” change (under 350%) in the fixed assets. (These four provinces produced the highest GDP also in 2008.) Due to the location (eastern, coastal location) of the above-mentioned provinces, the established historical traditions, the volume of industrial capacities located here for the above reasons, the number of skilled workers, i.e. the economic development and economic potential of these areas this performance is not surprising.

Even in case of medium correlation, the convergence of the less developed areas is clear from the graph. This can only rarely be the sole result of activities performed by the commercial banks, it suggests rather the intervention of the government. Of course, by way of regulation as a part of the state financial policy, the commercial banks can be involved into a more active participation in the development policy of a country, too; however, examining the financing sources of fixed assets, we get a reply to the actual and determining reason.

Looking at the sources devoted to fixed assets, it can be stated that a significant part of these came from state aid. Therefore it can be stated that the convergence of the less developed regions is clearly the result of the Chinese economic policy, for which, however, the modernization of the Chinese financial sector and the effective contribution of the new banks was necessary.

It can be stated that the new banking system is not only the result of the “Chinese economic miracle”, but is also an active contributor to it. Without the established Chinese banking system, the things currently admired by half of the world could not have been realized.

### 3.5. The Asian Infrastructure Investment Bank

China's reaction to its changing dynamics of increase has two parts, an internal and an external one. On the external side it was the capacity surplus of the given period when China launched new and expensive initiatives like the Asian Infrastructure Investment Bank (AIIB), the BRICS Bank and the "One Belt One Road". The aim was to strengthen the infrastructure towards the West and from China through Central Asia and through the South eastern Asian, South Asian, African and European seaways.

The AIIB as one of the biggest multilateral development bank was established with a 100 billion dollars initial capital and in July 2016 opened its doors to the joining of the interested parties. In May 2017 Hungary's National Assembly (Parliament) accepted the joining agreement.

The AIIB initiated by China was established with the aim to ease the finance needs of the Asia Pacific region with 1000 billion dollars by offering competitive instruments. The bank has verified the correctness of the original aims as the value of the projects financed by the bank has been exceeding the 2 billion dollars from the beginning.

## 4. CONCLUSION

In the study, the features of the Chinese banking system and the conclusions drawn by the research carried out on these were introduced. It is also due to the particularities why the Chinese economy works so well, solving its own challenges and becoming currently one of those countries with the largest foreign exchange reserves. However, problems can be observed, as well; such as the stiffness of the nominal exchange rate and the inflation, which can be harmful later on.

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