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Insight of China's Banking Sector and the Capital Market

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ABSTRACT: *China is like a roaring dragon in the present times. It has become a creditor nation lending abundantly to countries of Africa, Asia, and the Caribbean in the name of infrastructure developments. Its enormously high exports make it a trade surplus nation until recently when it realized its first current account deficit because of the ongoing trade spat with the USA. This paper attempts to study the basics of the two important pillars of the financial system of any economy that are the banking sector and the capital market. It studies the building blocks of the banking sector of China and establishes how it is the largest banking system in the world. It also establishes the problem of shadow banking. It brings out that the banks are highly government controlled because of which there are close links in the business of banks and state-owned enterprises and local government. Capital markets of China recently faced a market crash in 2015 because of the inherent weakness of the market like being dominated by individual investors and the lack of government to manage the downside the market went through. Its banking assets are highest in the world but its capital market ranks third according to market capitalization. Recent stock connect program attempts to strengthen the capital markets. The economy is more bank-led.*
KEYWORDS::*banking, shadow banking, banking assets, state-owned enterprises, Shanghai, Shenzen, the stock market, market crash, stock connect.*

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I. INTRODUCTION

China is the country of one of the oldest civilization which has truly covered the journey from being an isolated nation to be the factory of the world. It now seems to be the strongest nation with well planned economic policies, financial plans, trade size, defense, arms etc. China is traditionally called 'Zhongguo' which means the Middle Kingdom or central kingdom. It was initially used to represent the actual middle areas of China located along the valley of the yellow river which was a culturally significant region. But as time passed, this term was used to describe the entire country. Chinese people feel proud to refer their country as the middle kingdom to imply their significance in the world. Historically China believed that it had nothing to gain by opening up its economy but slowly it opened up. Since the 17th century many treaties have been signed and in stages, China opened up to the entire world for trade, capital, and finances. If China has really opened up to the world or not remains a debate. It is still restrictive in many forms. A careful analysis of Chinese economy shows that it might have put forward policies to declare that it is becoming market-oriented but in the interior, there may be clear intentions of protecting the country from any vulnerabilities of the outside world. This study attempts to put forward a careful insight into the world's largest banking sector and the not so old capital market of China.

1.1 Significance of research

China is the second largest economy of the world and the most populous one. According to an IMF report, China accounts for one-third of global growth. According to World Bank data, it is going to contribute around 35.2% of the global economic growth to occur from 2017 to 2019. That's almost double the contribution expected from the USA. Such is the importance of China. This study attempts to provide a closer look at the two most important financial sectors of an economy that are the banking sector and the capital market. There is little information available about these sectors of China in the common masses. This study is meant to fill that void by providing a descriptive as well as an analytical overview of these two sectors of the Chinese financial system. It will help us to know China better in a time when China is expanding its presence worldwide.

1.2 Objectives

- To know and analytically understand the broad economic indicators of China's economy.
- To understand the basics of the banking sector of China.
- To understand the inherent causes and impact of shadow banking in China.
- To study the recent reforms introduced in the banking sector of China.
- To understand the basics of capital markets of Shanghai and Shenzen.

- To analyze the motives and success of 'Stock Connect' program.
- To find out if China is a bank-led or market-led economy.

1.3 Organization of paper

This paper is structured in the following sections: section 1 introduces the background of China's economic outlook followed by significance and objectives of the study; section 2 provides a review of past and recent literature on various sections of China's economy; section 3 describes the methodology of the study; section 4 presents the description as well as analysis of our subject matter. Finally, it has been concluded by summarizing the study and discussing the outlook for further studies.

II. REVIEW OF LITERATURE

- **Yao Yao (2004)** attempts to describe the then past, present, and future of the Chinese stock market. The study describes what changes were already made and what future changes needed to develop the stock market. It brings out that the Chinese stock market is slowly opening up to foreign investors but still many reforms are needed.
- **SwetaChhaochharia (2008)** contrasts the initial development stages of Indian and Chinese stock market. It also at times compares Chinese stock market to that of US as it brings that Chinese market is dominated by individual investors as opposed to institutional investors in the US. The study also establishes that Indian capital market has got some advantages over the Chinese market as it could be seen by the fact that the value of BSE tripled from 2001 to 2008 but China's mainland equity markets had lost half of their value.
- **Tong Li (2008)** attempts to explore the problem of non-performing loans in Chinese public sector banks and the role of asset management companies to deal with such problems. The study attempts to describe the causes of the high size of such loans such as poor management, lack of risk management and inadequate governmental regulation.
- **Xiaoqing (Maggie) Fu (2009)** describes how various reforms in the commercial banking before and after joining of WTO in 2001 has made the industry more competitive. 'H-statistic' developed by Rosse and Panzar (1977) is used to describe the intensity of competition by studying 76 commercial banks from 1997 to 2006. The study states that the nature of commercial banking is monopolistic in nature. The study later states that more reforms are needed to make the industry more competitive.
- **Shen Wei (2013)** brings out the causes, uniqueness and governmental responses to shadow banking in China. The study brings out that the policy of state-owned banks to favor public firms lead to a credit crunch for private firms and SMEs. This has led to the emergence of underground shadow banking. It also highlights that Chinese shadow banking is unique and that its complete crackdown is not needed but reforms are required to reduce the systemic risk blooming.
- **Muhammad Saqib Irshad, et al. (2015)** explores various aspects of China Pakistan Economic Corridor (CPEC) for Pakistan, China and other nations related to One Belt One Road. A thorough review of past studies done in this area has been presented. The paper brings out that CPEC shall lead to the long-term development of Pakistan.
- **Wang, et al. (2017)** attempt to study the relationships that exist between the stock markets of Shanghai, Shenzen and Hong Kong after the historic stock connect program was rolled out. Results show that the stock connect program has impacts on both market returns and volatility. In the end, the study concludes that any market policy affects these markets differently because of their varied characteristics like type of investor base, entry thresholds, and regulatory requirements.
- **Allen Franklin, et al. (2018)** presents a comprehensive study of entrusted loans which is a result of shadow banking in China. The study of these loans have been conducted on transaction level basis and throws light on four important areas of this underground industry that are the reasons behind such tremendous growth of this sector; risks prevalent in it; pricing efficiency of such loans and also the ways of regulating shadow banking. Also, it clearly brings out the differences between two types of entrusted loans that are affiliated and non-affiliated loans. In the end, the study concludes that this mode of credit intermediation brings stability to the system, reduces the number of loans in the bank's balance sheets and thus reduces systemic risks.
- **Cong, Lin William, et al. (2018)** studies the pattern of allocation of funds during the economic stimulus plan of 2009-10 of 19 largest Chinese commercial banks. The study brings out that new credit was allocated relatively more towards state-owned or state-controlled firms which were firms with a lower initial marginal productivity of capital. This also signals to the cause of the high ratio of inefficient loan allocation.
- **Wang, Hao, et al. (2018)** bring out that it is excessive government interventions in the banking sector that led to shadow banking in China. It says that the mechanism of shadow banking has led to benefits for all households, state-owned enterprises, private firms, and banks. It is like dual track interest rate liberalization

that can lead to Pareto improvement. It puts forward that full interest rate liberalization in China would need many adjacent reforms if bank credit misallocation and low SOE productivity remain unchanged because full interest rate liberalization would lead to higher finance cost for both SOEs and private firms.

III. RESEARCH METHODOLOGY

The present study is descriptive in nature. It is based on secondary data. Data has been sought from various IMF reports, World Bank forum, WEF articles, Forbes articles etc. Some statistics have been picked up from the official websites of People's Bank of China, Shanghai stock exchange and Shenzen stock exchange. Analysis has also been provided from previous research done in these areas of China's economy.

IV. ANALYSIS OF THE STUDY

It was after World War II that China officially called ‘People's Republic of China' committed to restore its economy. The Communist Party of China under its chairman Mao Zedong led an economic and social campaign for the Great Leap Forward in which the aim was to rapidly transform the economy into a socialist society through rapid industrialization. It soon led to strict controls and cost the lives of millions of people in the cultural revolution. After 1976, Mao's successors focused on market-oriented economic development. Major economic reforms were introduced in the 1990s. Since then there was no turning back and now we have the China that is more market-oriented and that plays a major global role. China is now five times bigger than India. It focused on growth and attracted FDI. It consistently undervalued currency which made it an export-oriented economy. Its liberal norms for environment and labor helped it to grow at a very fast rate. Its world-class infrastructure and financial strength have surely made it stand as the strongest economy. Its currency is the Chinese Yuan Renminbi (RMB) that literally means ‘People's currency'. There is an onshore and offshore currency market for RMB. Its currency was included in Special Drawing Rights basket (SDR) by IMF in 2016. It has now emerged with many financial centers of the world. As of March 2018, eight Chinese cities find themselves ranked in the top 100 global financial centers of the world according to the Global Financial Centers Index. China also stands at 110th place out of a total of 180 countries in the Index of Economic Freedom. According to world development indicators database 2017, China is the second largest economy of the world with 14.84 % share in world GDP whereas India stands at 7th rank with a share of just 2.83 %. Its GDP per capita as of 2017 is $8,582.94 that is 4.75 times that of India.

4.1 Banking system of China

It is surprising to know that the banking sector is the backbone of the Chinese economy. According to the China Banking Regulatory Commission (CBRC), the total assets of China's banking industry reached around USD 39.9 trillion by the end of 2017 which is about 300% of its own GDP. It is indicative of the importance of banks in China. It is to note that Chinese banks surpassed the size of total assets of the US banking system that is the largest economy of the world way back in 2010. Currently, it is the largest banking system in the world. These claims of Chinese banks can be divided into domestic claims and cross-border claims. Most of the bank's assets are domestic which are looming because of the lending boom in the country to boost GDP growth, increase employment and make the economy more consumption-oriented under the economic stimulus plans. A major section of these domestic claims is towards State-Owned Enterprises (SOEs) and local government because of their predominance in the economy. The private sector is considered very risky and thus they generally starve for funds from the commercial banks. Foreign claims, when compared to domestic claims, are relatively small but are growing at a much faster rate. According to the Bank for International Settlement report, Chinese bank's cross-border claims amounted to $970 billion as of second quarter of 2017. It ranks eighth globally in order of its cross-border claims. It is more in tangency with its outward FDI worldwide especially in countries of Africa, Asia, and the Caribbean. Shockingly in case of some countries, China's claims on them exceed 25% of their country GDP like that for Laos, Congo, and Djibouti. This size of loans extended by Chinese banks to different countries is indicative of something larger than just financial intermediation. It is being criticized for increasing its political and strategic influence. Such lending may come for transfer of some diplomatic recognition or some veto power in important council meetings. China has become a lender nation lending funds for construction of large-scale infrastructure projects and if the borrower nations find themselves unable to repay the loans or make interest payments then China may take over some important national assets. This was seen when Sri Lanka was lent enormously for construction of its port facility but when it could not repay, the same port was leased to China for 99 years. This practice of leases and annexations may also be evident in countries like Venezuela where Beijing has lent more than $60 billion; in Argentina; in Kenya; in Laos and Pakistan which has borrowed billions. These debts will eventually become political according to many studies. Such situations also prove the strength of the banking sector of the People's Republic of China. According to S&P global market intelligence's latest global bank rankings; 18 of the top 100 banks of the world are headquartered in China with around $23.761 trillion in assets as of Dec 31, 2017. The top 4 banks of the world are 'Big Four' state-owned banks of China with combined asset size of $13.637 trillion. There were 11 US banks and 8 Japanese banks ranked in the top 100 banks.

4.1.1 Types of banks in China

It is to observe that the banking sector of China is dominated by state-owned banks only. Its banking system used to be monolithic with the People's Bank of China (PBC) that is now the central bank as the only institution authorized to conduct banking operations in the country. For three decades PBC and its branches served as the only bank. All other banks were either division of PBC or non-deposit taking agencies. It was established in 1948 and in the 1980s it was split into 4 state-owned commercial banks also called the 'Big Four' which are industrial & Commercial bank of China (ICBC) predominately for the industrial sector; China Construction Bank (CCB) for medium and long-term infrastructure and housing projects; Bank of China (BOC) or foreign trade and trade finances and Agricultural Bank of China (ABC) for the agriculture sector. But now these main functions are dissolved and they provide all the banking services. Despite IPOs around 60% stake in these banks is of the government only. These 4 banks are also the top 4 banks of the world on the basis of asset size. The next category of banks in China is the Joint-stock banks. 12 large joint stock banks at the end of 2015 constituted around 18% of the total banking assets. These are such banks where around 20% stake is allowed to foreign banks to reduce risk burden on state-owned banks and bring the risk appetite of the foreign banks to the system. Then there are foreign banks which are allowed to operate as both foreign branches and foreign subsidiaries. There are sophisticated requirements and regulatory approvals needed for establishing a foreign bank in Mainland China. There is high uncertainty for these banks in China because of the limitations on holding assets and acquisition of shares, expansion, and branching. Earlier only maximum 49% stake was allowed to foreigners but now that cap has been increased to 51%. As of 2016, only 0.4% branches of the total network of 2,28,000 branches in mainland China were those of foreign banks with only 1.2% share in total assets according to CBRC. There are also country banks dedicated to the objective of financial inclusion in the countryside. Next important type is of the city commercial banks which are on the lines of urban credit cooperatives. These are established by local government, enterprises, and residents of a city so these are highly influenced by the local government. Their main goal is to boost local economic development and grant loans to Small and Medium Enterprises (SMEs) that operate in the cities. These banks lend heavily to the local governments because of fiscal weakness which arises due to low tax revenues and no property taxes for the local government but still under pressure to develop their cities. The last type of banks to be discussed here is the policy banks. Three policy banks were established in 1994 to provide policy lending functions on behalf of central government. These banks have taken over the government directed spending function of the big 4 banks and not commercial banking. These three are Agricultural Development Bank of China to provide funds for agricultural development projects in rural areas; China Development Bank for infrastructure financing and Export-Import Bank of China for trade financing. These policy banks are involved in the major funding of the One Belt One road initiatives. Officials say that only around 12% Chinese banking industry's total capital belongs to the private sector. However, now there is an encouragement for the establishment of banks owned by private companies like Alibaba and Tencent.

4.1.2 Shadow banking in China

Alongside the legitimate banking sector operates one more form of banking in China that is called shadow banking. According to the Financial Stability Board (FSB), shadow banking is defined as 'credit intermediation involving entities and activities outside the regular banking system'. According to some reports, global assets of shadow banking were of the value of $45 trillion at the end of 2016 that is also 13% of global assets. Out of this China's share is of around 15.5%. It is like a substitute of the traditional banking system but well outside the purview of any banking regulations. This system is a little different in the case of China because it involves legitimate banks acting either as a key mediator or even as the guarantor of the unregulated activity. Banks try to bypass the strict regulations relating to deposit rate ceilings, loan quotas, high reserve requirements etc. by raising money through new and structured trust products and wealth management products and then lending via trust loans to various parties at higher rates. Banks also serve as intermediaries for large enterprises which get easy credit in helping them to make entrusted loans to credit-starved industry. Even nonbank financial institutions participate in this process of credit intermediation. This system emerged out of the strict regulations on the Chinese banking sector and also the requirement of providing easy credit to SOEs at very low rates that restrict their profits and thus low efficiencies. This system does come with many risks because such credit may be heating up the real estate sector or lending money to some inefficient private entities. This may lead to large-scale capital misallocation. Chinese regulators are monitoring the shadow banking activities to prevent such misallocation. But one school of thought also believes that shadow banking can provide more stability to the economy. Generally, these are SOEs which gain access to cheap credit easily which they also use to provide credit to the private sector which doesn't get easy access to legitimate credit from the banks. This process increases gains of such SOEs and provides funds to private enterprises which may be more efficient than the SOEs. It is observed that 90% of shadow lenders are large SOEs like PetroChina, Yangzijiang shipbuilding holdings, China mobile etc. The closeness between State-Owned Banks and State-owned enterprises was also evident during the economic stimulus plan of 2009-10 where 19 of the largest commercial banks allocated credit more towards state-owned and state-controlled firms (Cong, Lin William, et al. (2018).

4.1.3 Supervisory responsibilities

Supervisory responsibilities of Chinese banking sector lie on two bodies that are the People's Bank of China (PBC) and China Banking Regulatory Commission (CBRC). PBC got the status of the central bank in 1995. It is responsible for the macroeconomic management and has 18 functional departments dealing with monetary policy, issue and administration of Yuan Renminbi, regulation of financial markets, maintenance of foreign exchange rate, management of foreign exchange reserves etc. It has the largest foreign exchange reserves of $3.143 trillion as in March 2018. China has been consistently the world's currency hoarding nation due to ever BOP surplus. It is in the first half of 2018 that China had its first current account deficit in 20 years due to the ongoing trade spat with the USA. The high quantum of reserves enhances its credibility to maintain its currency commitments. But because the Chinese government is highly indebted to its banks so its official reserves are needed to hedge nearly the entire financial system and not just its currency (SalvatorBabones). China Banking Regulatory Commission (CBRC) was established in 2003 and is responsible for supervision and regulation of the banking sector. To make the financial system more modern, many banking reforms have been introduced in China. Two major reforms have been regarding interest rate liberalization and deposit insurance.From Dec 2015, interest rate liberalization has been introduced in China. There are two benchmark rates i.e., one-year lending rate and the one-year deposit rate. Lending rate is not yet liberalized. Then there is deposit rate which now depends on market forces. Banks can set it up to 1.3 times of the official rate. It is analyzed that big state banks would not raise it much because their lending rates to SOEs and local government are still restricted. Whereas smaller banks can raise the interest rates because they have risky lending and thus can provide their depositors with higher rates. Next big reform is that of deposit insurance which was introduced from 1st May 2015. This program covers all deposit-taking institutions excluding foreign bank branches and Chinese bank branches abroad. It covers deposits in both RMB and foreign currency. The amount covered under deposit insurance is RMB 5,00,000 per account. It covers 99.6% of all Chinese depositors but only 46% of all money deposits. This is indicative of high inequality in deposit sizes.

4.2 Capital market of China

Besides banks, the other most important financial sector of an economy is the capital market. China's capital market is dominated by two stock exchanges i.e., Shanghai stock exchange and Shenzen stock exchange. Shanghai stock exchange came into existence on November 26, 1990. It is the largest stock exchange in Mainland China and fourth in the world in terms of market capitalization as in March 2018 with around $4.48 trillion as market cap. Its major index is SSE Composite index which is also the representative of the direction of movement of the Chinese capital market. It lists more of old- economy companies from traditional industries. 34% share in the sectoral breakdown is of financial companies. The second stock exchange in China is Shenzen stock exchange. Shenzen is the manufacturing hub of China. It was established on 1st December 1990. It is the world’s eighth largest stock exchange with a market cap of $2.94 trillion as in March 2018. It lists more of unique, niche companies and stocks of companies in technology, pharmaceuticals, consumer services, capital goods, startups, and young entrepreneurs. Its sectoral breakdown shows 22% listing of IT companies. It shows more trading turnover than Shanghai exchange indicative of the increased interest of investors in new and emerging companies. Its major index is SZSE component. There are two main classes of stocks in China. A-shares are quoted in yuan and are available to domestic investors and to foreign investors only through qualified programs such as Qualified Foreign Institutional Investors. B-shares are quoted in USD and are generally open to foreign investors. China Securities Regulatory Commission (CSRC) is the public body which performs regulatory function over the capital market directly under the authority of state council. According to the official website of CSRC, it is responsible for regulating the securities and future market and to ensure legal operation. It also supervises the issuance, listing, trading, custody, and settlement of stocks, bonds, futures etc. Unlike the banking sector, China's capital market is not the largest in the world. Until August 2018 it was ranked second as per market cap with around 11.17% share in total world market capitalization just behind the USA. But since August 2018 China lost its rank to Japan. The USA is still the world's largest stock market with $31 trillion as market cap. Japan stands second with a market cap of $6.17 trillion as market cap and China ranks third with a market cap of $6.09 trillion. According to Bloomberg, Shanghai composite index is the world's worst performer by losing 17% of its value by August 2018. The industrial and tech stocks have been worst performing.

4.2.1 Stock market crash in China

Chinese capital market has some inherent weaknesses as evident in the stock market crash of 2015. It started from 12th June 2015 and saw a 30% drop over 3 weeks in A-shares. Such a fall is attributed to the lack of experience that China had in dealing with a stock market. SSE composite first shot up to 150% from Nov 2014 to June 2015 on account of the government campaign to promote stock market investments. Such campaign encouraged inexperienced individual investors to buy securities. This also meant a lack of big players or institutional buyers who have high-risk tolerance and who can play a major role in maintaining market liquidity. Circuit breakers are most obvious means to prevent fear and panic selling from collapsing prices by halting trade for few minutes or even for a whole day. China could not use this tool effectively when it was needed the most. One major concern that makes the Chinese stock market less attractive to international investors is its high regulations to fit the government needs. Some of the reforms that were introduced after the market crash were putting a limit on short selling, restricting IPOs for some time, increased participation of large mutual and pension funds. Cash was provided to brokers to buy shares to bring buoyancy to the market. There was a six month ban on selling stocks on such stockholders who owned more than 5% of a company's stock.

4.2.2 Stock connect program

One major program that has attracted international attention is the "Stock Connect program". Shanghai Connect launched on November 17, 2014, and Shenzen Connect launched on December 5, 2016, are collectively referred to as the "stock connect" scheme. It is like a milestone step in opening up of the capital account of Mainland China under the Mutual Market Access Pilot program between Mainland China and Hong Kong. It promotes 2-way opening up and healthy development of the capital market. Under northbound trading, Hong Kong and overseas eligible investors can trade certain eligible shares listed on Shanghai and Shenzen exchanges. Under southbound trading mainland eligible investors can trade certain eligible stocks listed on the Hong Kong stock exchange. It creates a single "China" stock market to rank as the world's second-largest market with $10.6 trillion as the market cap as of September 2016. This program brings with it the advantages of allowing international investors to capitalize on the performance of Chinese companies which were otherwise not accessible. It might also increase efficiencies for trading in Chinese companies and also make it more likely that Chinese shares be included in global benchmark stock indices. Such trading experience may nurture the maturity of mainland investors. But it is still a closed system with trades executed only in Yuan Renminbi so no capital outflow problem in long run and also no connectivity in the primary market is available for now. There is also monitoring of the usage of daily quota to avoid any sudden adverse movements. Currently neither there are Hong Kong indices, stock futures or options available for hedging nor the A-share hedging tools. This may not be so in future as the eligible instruments under the "mutual market" are expandable so there can be many other instruments like ETFs, bonds, commodities, risk management tools like equity derivatives, RMB interest rate, and currency derivatives. At the end comparing the strength, weakness, size, and importance in the economy, it is evident that the Chinese banking sector is much more developed than its capital market. Banking assets are around 300%of its GDP and also the largest in the world. China is thus a bank-led economy where banks play the major role in fueling up the second largest economy of the world. Savers of the economy prefer to pool their money in banks and corporate and government also prefer banks for raising money.

V. CONCLUSION

China has traveled a journey from being a completely closed economy to one which now plays a major global role. It is essentially the factory of the world but its exports are now suffering because of a trade war with the USA. It has still got the largest foreign exchange reserves in the world. It has got the largest banking sector of the world with its 18 banks listed in the top 100 banks of the world. But the banking sector is now plagued with excessive funds lent to domestic SOEs, local government and international governments. Shadow banking is also a growing concern because of the intimacy between state-owned banks and state-owned enterprises. The banking sector is dominated by state-owned banks only. The stock market as another pillar of the economy is still in its infancy and very inexperienced. Its stock market is ranked third in the world in terms of market capitalization. The capital market is still not very open however the "stock connect" program provides more opportunities for opening up of the capital account and also to bring maturity to the market. Comparing the two financial systems, it is evident that China is a bank-led economy with the major reliance on its strong and largest banking system. Future studies can be conducted to analyze the possible impacts of a looming slowdown on the economic system of China. The dangers and hidden benefits of shadow banking can be analyzed further. An analytical study comparing its stock market with other developed nations can help the policy makers of China to take initiatives in the positive direction for the growth of a still infant capital market.

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