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Geopolitics of the Chinese Banking Sector

The Chinese economy has seen enormous growth in the last few decades. One of the components driving this growth has been the financial sector. While the growth of the Chinese technology sector has caused concerns and even political backlash in the West, the similar growth of the Chinese financial industry, especially the banking industry, has passed under the radar. This paper will explain the historical background of the Chinese banking industry, the present status of the sector, the regulatory environment faced by the industry, and how China is using its banks to achieve its broader geopolitical goals.

Historical Background

The Chinese banking system has had a turbulent past mirroring the unstable nature of China throughout the 19th and 20th centuries. While there were bank-like institutions throughout the 2000 year-long period of Imperial China, the first modern bank, the Imperial Bank of China, was established in 1897. However, banks played a minimal role until the late 20th century. One major reason was that China was a poor nation, depending on sustenance agriculture and plagued by internal instability. The numerous conflicts with Japan throughout the first half of the 20th century also prevented economic modernization. The second half saw the establishment of the communist regime, which was naturally hostile to the “capitalist” banks. However, the country was still primarily agrarian with state ownership over most resources, so access to credit was not a major concern for most people. The existing banks were nationalized, and the Communist Party of China established the “People’s Bank of China,” which was the sole bank allowed in the country until 1979. In that year, the People’s Bank of China spun off three commercial banks, and by the end of the 1990s, the current structure of commercial banks and policy banks was in place (Chen & Vinson, 2016).

Current Situation

On the surface, Chinese and American financial systems appear to be similar. China has the second-largest equity market in the world, with a total market capitalization of $8.5 trillion. China also has a well-developed banking system with many national, regional, and local banks. But a primary difference between American and Chinese banks is that while American banks are beholden to their private investors and driven by market concerns, Chinese banks remain under the direct or indirect control of the state. The state-controlled Chinese banking industry can be further split into two groups. The first is the state-owned commercial banks. They serve the general public and businesses and are comparable to American commercial banks in the scope of their activities. The second group is the three policy banks, consisting of the China Development Bank, the Export-Import Bank of China, and the Agricultural Development Bank of China (Bisio, 2020). These banks have stated political purposes, unlike the commercial banks. The China Development Bank is tasked with financing domestic and international development projects, particularly those related to infrastructure. Some of the projects financed by the China Development Bank include the Ansuo Power Plant in Ghana, Yamal LNG Project in Russia, and Karot Hydropower Project in Pakistan(Xu, 2020). The Export-Import Bank of China provides export credit and is comparable to the Exim Bank of the United States. However, having the three separate policy banks doesn’t mean that the Chinese government doesn’t maintain political control over the commercial banks. Direct control is exercised by state ownership of the major banks. All six major commercial banks are owned through various arms of the central government, such as the Ministry of Finance, China Investment Corporation, and National Social Security Fund. Indirect control over lending decisions is exercised by the central and local governments through various policy directives and informal meetings known as “window guidance” between government/party officials and bank executives. In effect, the commercial activities of the banks are subordinated to the political concerns, which distorts credit allocation and prevents the development of a fully professional financial system (Bisio, 2020).

The Chinese banking system is also quite concentrated as even though there are 4000 registered commercial banks in China, the six largest commercial banks held about 50% of all banking assets. The other 12 lesser commercial banks hold another 21% of the total commercial banking assets. In effect, this means that almost 70% of the banking assets in the country is controlled by 18 banks, which are all owned by the Government of China in some form or another. The banking industry also dominates the financial sector in China, providing about 2/3rds of the credit to the economy in the last fiscal year. The dominance of banks has stalled the growth of capital markets in the country. For example, stock holdings account for 52% of the outstanding corporate credit in the US while they only account 3% in China. The banks generally maintain a buy and hold strategy, and their risk averseness causes them to primarily lend to large enterprises. This underdevelopment of the financial markets forces small Chinese entrepreneurial firms to seek unofficial sources of funding, primarily from the burgeoning shadow banking sector. Though the current administration wants to increase access to direct financing, they remain fearful that any liberalization of the financial markets would result in instability (Bisio, 2020)

Regulatory Environment

The Chinese banking sector is regulated by the People’s Bank of China and China Banking and Insurance Regulatory Commission. The People’s Bank is the central bank of China, and though it has similar goals to the US Federal Reserve, such as implementing the monetary policy, it differs from the Fed in its lack of political independence. Under President Xi Jinping, the financial affairs of the nation have been subordinated to the Communist Party, outside of the constitutional state structure. Though the Premier, as the head of the State Councils, maintains nominal control over financial policymaking, the newly formed Financial Stability and Development Committee chaired by Vice Premier Liu He, a close lieutenant of President Xi has bypassed State Council’s authority and now maintains de facto control over financial policymaking in the country. This process follows the general trend of President Xi Jinping consolidating powers for himself and marks a sharp break from the past three decades when consensus-based governance between the party leaders was emphasized(Bisio, 2020).

Belt and Road Initiative

Chinese banks are playing a crucial role in the implementation of the Belt and Road Initiative (BRI). Two major groups play this role; the long-established state-owned commercial and policy banks and the newly formed Asian Infrastructure Investment Bank. To understand this new era of Chinese banking expansion abroad, some background knowledge is necessary. BRI is one of the most ambitious foreign policy projects undertaken in the 21st century. It consists of a large number of infrastructure and development projects with an overall aim of increasing Chinese economic influence across Eurasia and Africa(Council on Foreign Relations, 2020). The project began in 2013 and is aimed to be completed by 2049, which is also the 100th anniversary of the founding of the People's Republic of China. There are many competing viewpoints regarding the nature of this project. The first is that BRI is fundamentally a geopolitical project by which China aims to supplant American and Western influence. Under this analysis, the economic concerns are secondary, and all the financial institutions aim to promote the geopolitical objectives. The second viewpoint is that this project is driven by domestic economic needs. In this view, the Chinese government wants to use BRI as a platform to address the country's chronic excess capacity(Lowy Institute).

Chinese banks in the developing world

China has masterfully leveraged the combination of state-owned enterprises and banks to outcompete Western businesses in the developing world. Called the "golden triangle" by the Japanese External Trade Organization, this informal agreement allows private Chinese companies and state-owned enterprises access to cheap credit from Chinese banks. China, in dealing with the developing world and especially when dealing with African nations, has adopted the so-called "Angola model" (Institute of Developing Economies). The Angola model developed in the 2000s as China first began to enter the African market. During the Cold War, Africa faced an ideological battleground between the United States and the Soviet Union. But following the collapse of the Soviet

Union, Africa was firmly under the influence of Western countries, especially France, with its Franceafrique foreign policy. Development financing was primarily provided by Western non-government organizations, Western governments in the form of foreign aid, and multilateral institutions such as the World Bank and the International Monetary Fund. But this model began to change in the early part of the 20th century. Following the end of the 26 years long, Angolan Civil War, the Angolan government was in dire need of cash. The government needed at least $15 billion dollars in credit but could only raise about $4 billion from local banks. The remaining $11 billion would have to be raised abroad. The traditional source of credit was Western institutions, but the country already owed the Paris Club of Creditors(a group of Western creditor nations) about $11 billion. Angola was also having difficulty servicing the existing line of credit and so to obtain additional credit, the Western creditors mandated that Angola embrace structural reforms. These included governmental reforms and transparency with regards to Sonangol, the state-owned petroleum company. However, as Sonangol was an extremely powerful entity, the government was not willing(or afraid) to reform Sonangol. This resulted in a stalemate where Western institutions were not willing to lend because of the lack of reforms, and the government that could not reform because of the lack of credit. This is where China stepped in. As the US began the 21st century by waging war on terror and focusing on the Middle East, China began a series of ambitious programs to increase its influence in the African continent. In 2000, China started a series of China-Africa triannual summits, which was followed in 2007 by the establishment of the China-Africa Development Fund controlled by the China Development Bank, to provide funding for Chinese companies interested in investing in Africa. Following two decades of extraordinary economic growth, the Chinese treasury was brimming with cash, and it was ready to use this new-found wealth to advance its geopolitical influence. In the case of Angola, China, through the Exim Bank, used this surplus to offer Angola loans at cheap interest rates and favorable repayment schedule with the understanding that China would gain preferential access to the Angolan oil markets. These included joint projects with Chinese oil giants such as Sinopec instead of Western and Indian oil companies, which were also trying to expand their presence in Angola.

China also expanded its influence over the commercial banking sector in Africa during this period. In 2007, the Industrial and Commercial Bank of China bought a 20 percent stake in the South Africa-based Standard Bank Group, which is the largest bank in Africa, with over $140 billion in assets. But the biggest advantage China had over the West was that it attached no political or moral conditions with the loan. In return for economic aid, China only demanded access to the economic resources of Angola. China has tactfully adopted this model of “non-interference” in domestic affairs to lend to corrupt governments throughout the world(Institute of Developing Economies).

Asian Infrastructure Investment Bank

Another major financial institution that is playing a crucial role in advancing Chinese geopolitical interests is the Asian Infrastructure Investment Bank (AIIB). Following the Second World War, the Americans, Europeans, and the Japanese founded and controlled the big three multilateral financial institutions. Americans headed the World Bank, Europeans headed the International Monetary Fund, and the Japanese headed the Asian Development Bank. This situation was fine in the early years as the Western nations and Japan dominated the world economy. But as the other countries, particularly China, began to develop, frustration with the governing model of these institutions grew. These institutions demanded strict financial and ethical requirements for obtaining loans, which many developing nations found frustrating to deal with. The governing structure of these institutions dominated by Westerners and Japanese also came under criticism, particularly by China. But China found Western nations slow or even unwilling to change the model. A particularly egregious example of this was that the US Congress took five years to approve a change in the International Monetary Fund that gave more powers to developing nations. Another issue that the developing nations faced with the existing multilateral development banks were the slowness and inefficiency of the lending process. The 2009 Zedillo Report issued by representatives of major developing countries(China, India, Brazil, and Mexico) recognized the importance of environmental and social constraints but argued that this had caused the World Bank to become so risk-averse that implementing the socio-environmental safeguards posed an overwhelming burden to the borrowing nations. As disenchantment with Western-backed multilateral financial institutions grew, China stepped in, forming the Asian Infrastructure Investment Bank in 2016. The governing structure of the bank was more favorable to China as it has almost 27% of the voting share in comparison to the World Bank, where it has only about 5% of the voting share. Other traditionally sidelined countries such as India and Russia also got a boost in influence with 8% and 6% voting share, respectively. Thus it is not hard to see why this new bank was appealing to the developing world who wanted an avenue to increase their influence. Though the United States tried to prevent other countries from joining the institution, it has faced an enormous setback in its attempt as 102 countries have joined at present, including some of its closest allies such as the United Kingdom, Canada, Australia, and Israel. The only significant nation other than the United States that hasn't joined the Asian Infrastructure Investment Bank is Japan, which heads the Asian Development Bank and is a close ally. In its four years of history, the AIIB has financed over 135 major projects ranging from bus rapid transit in Pakistan, fiber optics in Cambodia, and sanitation services improvement in Egypt (AIIB, 2020). And thus, the AIIB has been a major soft power success for China, and the Chinese policymakers hope that these investments will create hard power dividends in the future (Dollar, 2017).

American Response

The American response to the rapid increase in the Chinese economic influence overseas has been haphazard and lacking in vision. American policymakers had long hoped that increasing trade with China, coupled with economic liberalization, would lead to political liberalization. And American attention throughout the 1990s and 2000s was focused on the Middle East. China also portrayed its economic rise as non-threatening with the "peaceful rise of China" as the official policy. But in recent years, the view has been on the decline as China increased its military assertiveness coming into border conflicts with Japan, India, and especially with its neighbors in the South China Sea region. The Obama Administration had his Pivot to Asia strategy, which called for increased economic, military, and political cooperation between Asian nations so as to contain China. The Trans-Pacific Partnership was supposed to a major step in this strategy; however, President Trump withdrew from the initiative in January 2017. However, the US has taken some other steps to counter Chinese influence, especially in Africa. It formed the United States International Development Finance Corporation in December 2019 with a total capacity of $60 billion to invest in the developing world. It has been authorized to provide loans up to $1 billion and direct equity financing of up to $1 billion (JD Supra, 2020). In just three months, the DFC had invested about $200 million in projects across the developing world, such as a solar photovoltaic plant in Kenya and a wireless broadband network in Myanmar (DFC, 2020). However, China has had a two-decade long head start, and it would take some time for the United States to catch up.

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