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Austerity and Moral Compromise: Lessons from the Development of China's Banking System

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Summary. — China's state-owned banks have demonstrated a tremendous capacity for change, but their implications for development policy are often unclear. The paper examines why the pre-reform banking system based on moral compromise almost seamlessly changed to one based on self-advancement. Focusing on a period when resources were desperately short, the paper argues that China's great advantage has been Hong Kong and the safe access to international markets it provided. Consequently China's leadership is more familiar with international markets than is often assumed, and although capitalism is no longer exceptional, access to formal institutions continues to be a core development priority in achieving modernization.

Key words — Asia, China, banking, institutions, economic systems, trade

1. INTRODUCTION

The importance of good institutions and policies has been highlighted in the literature as decisive for economic development (Olson, 1996). However the question of how and why they matter is often unclear. The puzzle is deepened by large economies such as China which have achieved remarkable growth by following policies that work rather than what is desirable (Qian, 2003). While this approach is useful in explaining policy success, it is less useful in identifying long term development priorities. By focusing on a period of China's development when resources were scarce and foreign exchange desperately short, this paper argues that important lessons from China's development, particularly in banking, are to be found in the pre-reform economy. Policies emphasizing integrity, stability, and predictability were key to supplying the PRC with a stable supply of foreign exchange at a time when international blockades meant that foreign exchange was scarce. Shortage meant that exceptional capitalist banking measures could be justified in the national interest, and their benefits were clearly quantifiable in hard currency. After three decades of reform, although capitalism is no longer viewed as exceptional and corruption the incidental albeit lamented price of growth, access to formal institutions continues to be a core priority. The conundrum presented by this paper concerns why the banking system originally followed a system based on idealism and integrity and almost seamlessly changed to one, which by its own admission was beset by corruption. This puzzle is related to broader questions surrounding China's participation in the global financial system and its measured reaction to one of the worst financial crises in history. The Chinese leadership virtually ignored attempts to lay the blame for the 2007–08 crisis on China's foreign exchange reserves. Instead their major concern has been the revival of protectionist sentiments in its export markets. The explanation advanced in this paper is that China is far more familiar with the global financial system than is often understood and measured engagement with market capitalism remains a consistent feature of China's development strategy.

China's banking transition provides a fascinating study of institutional reform. While China's state-owned banks have demonstrated a tremendous capacity for change, it is not clear whether this seemingly smooth transition was driven by deliberate government policy, changes in global banking or by the dynamics of development itself. Although foreign participation in China's banking sector remains low, China is now a major participant in global finance in a way that Japan and India have never been. China still needs foreign exchange, but blockades and scarcity have been replaced by extraordinary currency reserves and ample FDI. Maoism and Puritanism gave way to markets and self-advancement. Banking deregulation replaced zero tolerance for capitalism and corruption before the leadership realized the dangers that lay ahead from venality. Banking liberalization also coincided with major changes in global banking in the 1970s, which saw the emergence of large money centre banks, viewed as the optimal formula for sustained business growth and stability before the onset of the current financial crisis. At the same time many of the cadres who led the banking system during the Maoist era were due to retire and their replacements, although well versed in modern banking techniques, did not have the same reputation for probity.

Using an evidence-based approach, this paper argues that China's great advantage has been the location of a sophisticated and open financial center on its doorstep. This advantage could only have been utilized through a pragmatic co-existence between colonial officials and Mainland banks. It is remarkable that this cooperation occurred despite the "cold war" and British military involvement in Malaysia and Korea. It is also remarkable how little change China has made to Hong Kong's economic and legal institutions post-1997, thereby enabling it to remain an external and separate reforming force. The paper outlines the special set of circumstances that allowed China to accumulate a reservoir of knowledge and experience of pursuing China's interests in international markets. For pre-reform China, access to the market economy of Hong Kong provided predictability and control. Hong Kong's attraction was its membership of the sterling area

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and the access it afforded to convertible sterling. It was also largely free from US attempts to isolate China from international trade and finance. The interface for this relationship was the banking system, in particular the Bank of China and its so-called "sister banks" (also under Beijing's ownership and control), in Hong Kong. The relationship was coordinated with remarkable efficiency and sensitivity by the banks' management. It is significant that a majority of this management belonged to the pre-1949 financial elite. Their capitalist origins made them entirely comfortable with international finance and having witnessed how corruption destroyed the pre-1949 regime, they were also sympathetic toward communist ideals. Their expertise and idealism meant that they were ideally positioned to understand the opportunities presented by post-Mao liberalization. Economic reforms after 1978 eliminated many of the systematic differences between China and the outside world, but also blurred the value of good institutions. Although commercial banking is no longer regarded as a moral compromise, the pursuit of modernization through measured engagement with market capitalism remains a consistent feature of China's development strategy. What changed were the types of behavior permitted.

The analysis of a secretive organization such as the Bank of China presents numerous difficulties. To help overcome these, the paper draws on unpublished archival material and statistics. These records provide valuable insight into China's pre-1978 development and its efforts to overcome serious resource shortages. These records emphasize the importance placed on accessing foreign financial institutions and the willingness of China's banks to respect the rules imposed by these institutions. Section 2 outlines the unique set of circumstances that allowed China to access external financial institutions. Sections 3 and 4 examine the central role of the banking system, in particular the Bank of China, describing how its operations were based on rationality, integrity, and the informal tolerance of British colonial officials. Section 5 describes how despite the environment of seemingly irreconcilable tension between the Chinese Communist Party (CCP) and the colonial authorities, the Bank was not only comfortable with doing business according to the conventions and laws of colonial Hong Kong, but also using these to China's advantage. Section 6 discusses the paradoxes that have emerged from banking reforms.

2. ECONOMIC BACKWARDNESS, BORDERS, AND EFFICIENT INSTITUTIONS

It is well known that the period 1949–76 represented a chaotic period in China's development. The policies implemented by the CCP during this period represented nationalist aspirations, state controls, and planning modeled initially on the Soviet Union but transformed by Maoist mass movements and the desperate need to overcome scarcity. However, all agendas were played out against the background of severe shortages (Strauss, 2006). In such an environment, Hong Kong's position as a capitalist economy on China's doorstep offered the potential to resolve shortages through participating in world markets. From a theoretical perspective, this allowed China to overcome the high transaction costs associated with backwardness and isolation, but only because of a unique set of circumstances such as reluctance of British colonial officials in Hong Kong to publish even the most basic statistics, and the willingness of PRC state-owned banks to accept the alien rules of Hong Kong's institutions. This poses an interesting challenge to the prevailing thought on the conditions for overcoming economic backwardness and scarcity.

Despite the egalitarian predictions of standard neo-classical growth models, it is now accepted that capital does not generally flow from developed to developing economies (Lucas, 1990). For example, it has long been argued that in order to overcome severe economic backwardness and resource shortages, state intervention is required to mobilize finance (Gerschenkron, 1962). Although development theory on the whole suggests that institutions and policies matter, in order to determine how and why, a source of exogenous variation in institutional quality is needed (Acemoglu, Johnson, & Robinson, 2001). One of the richest sources of institutional and policy variation and their effects are national borders. Not only do borders often represent the boundaries of wealth and poverty, but they also delineate areas of different rules, cross county variations in economic pay-offs and ultimately the extent to which societies have attained their potential (Baumol, 1990; Olson, 1996).

For China, the border with Hong Kong not only represented the above, but it was also the border between capitalism and communism. Hong Kong's free market offered the only point of safe access to the outside world. It also offered the opportunity to access a different set of rules with an invariably different pay-off. The more that isolation threatened China's development, the greater became the payoff from accessing outside institutions. China's central planners were aware that socialist industrialization required the importation of machines and raw materials. They also understood that export earnings were essential for balancing foreign exchange income and expenditure. [1] The predictability and efficiency of these inflows was crucial (Goodstadt, 2007, p. 91). Had these failed, state policy could also fail. That they were also technically illegal from the perspective of the United States (and the United Kingdom and Hong Kong itself prior to 1967) did not matter. For China this was probably irrelevant as the illegality represented a contradiction in capitalism.

External engagement also carried risks. Access to foreign exchange introduced normal market risk since trades took place outside the central plan. It also created incentives for opportunism. Although the Maoist period is widely condemned for its radical excesses, it was also accompanied by mass campaigns to root out corruption and malpractice as well as emphasizing high ethical standards among officials. These standards were adhered to by Mainland staff in Hong Kong, even though they were safe from the political campaigns of the Cultural Revolution (1966–76). China's banks were probably well aware of the moral compromises and the illegality of the sterling trade, but just like Hong Kong's officials, they were also aware that if the rules were strictly applied, the banking system would not function. In fact the whole of Hong Kong's exchange structure would not have worked as it was, strictly speaking illegal from 1946 until late 1967. Consequently a lax approach was followed in Hong Kong's banking regulation. [2] Given the predictions of transaction cost theory, it is surprising that PRC banks did not on the whole behave with opportunism. Instead China's banks adopted a policy of conscientiously implementing state policy, which recognized that hard currency earnings were essential to balancing the central plan.

Although the post-1978 reforms led to a gradual erosion in systematic differences between Hong Kong and the Mainland, China's quest for a secure point of access to work markets, be it through international listings in Hong Kong or FDI inflows from off-shore locations, remains a consistent feature of China's development. China's decision to open its economy to international finance after 1978 was, therefore, a continuation of state policy to overcome economic backwardness.