AUSTRALIAN ALMANAC
Vol. 9 No. 22

China's Glass-Steagall standard

The following article is based on a presentation delivered at the Western Australian and Northern Territory CEC state seminars on 30 June and 7 July 2018.

By Elisa Barwick

How has China been able to raise more than 700 million people out of poverty in the last few decades; build new housing for 80 million people in the last eight years; construct 20,000 km of high-speed rail (to reach 30,000 km by 2020); accomplish phenomenal canal development and water projects; massively grow its industry and agriculture; and at the same time invest trillions of dollars into the development of infrastructure overseas?

Here's a clue. Their banking system had something to do with it.

Today we are going to take a look at China's approach to see what made it work. After it was established on the eve of the founding of the People's Republic of China in 1948, China's banking system consisted solely of the People's Bank of China (PBC), for some time. Spin-offs were eventually created to specialise in certain areas, but for the most part the PBC acted as the central bank and the commercial bank for the entire country.

Following the Cultural Revolution (1966-76), which under Communist Party Chairman Mao Zedong and the so-called Gang of Four purged traditional Chinese and classical culture and sent the economy into a dire downward spiral, China underwent a moral and spiritual reawakening. After the death of Mao in 1976 and the arrests of the Gang of Four, Deng Xiaoping took the reins of leadership. He knew the destruction of the education system had to be reversed with a scientific revolution, and that by doing so China could re-emerge as a great nation within 30 years. Deng instigated China's "reform and opening up" in 1978.

As China opened up its markets to the world and reformed its banking system to conform to international standards, it soon ran into problems, particularly as banks increasingly engaged in speculation. Thus China was driven to discover a "third way"—an alternative to pure communism or capitalism. Such a system actually predated communism, having been developed in the period following the American Revolution, when it was known as the American System. It was created as an alternative to the British free trade system which was strangling the young American Republic, and was based on governments fostering the development of manufacturing and agriculture through tariffs and other protective mechanisms, along with infrastructure to support the population and the nation's industry, funded with a national credit system to make it all possible.

China had some knowledge of the American System as we will see; it also responded to an additional uniquely American measure, introduced by US President Franklin Delano Roosevelt in 1933—Glass-Steagall legislation, which prevents commercial banks from engaging in speculation, and investment banks from taking deposits. This understanding allowed China to create a hybrid system for itself. As Chinese President Xi Jinping often says, it is important every nation discover its own pathway rather than merely follow a model established by others.

The Shanghehang high-speed railway under construction in Huzhou in east China's Zhejiang Province, September 2017. Photo: AFP/Tan Jin/Xinhua

Xi expressed this third pathway at a Chinese Communist Party caucus meeting in May 2014: "We should make good use of both the market, the 'invisible hand', and the government, the 'visible hand', to promote sustained and sound social and economic development."

China adopted Glass-Steagall-style banking separation regulations in late 1993; following the 1997-98 Asian financial crisis, Chinese officials became acutely aware that the Glass-Steagall regulation had helped China immensely, compared with other nations without the same laws. In the years leading up to the 2007-08 global financial crisis, many Chinese leaders had been re-thinking Glass-Steagall. Fortunately, however, they were not quite ready to dispense with the banking rule, and the aftermath of the GFC convinced them of the necessity to stick with it. China was thus in a position to help bring the rest of the world through the crisis.

Following the GFC, Chinese officials conducted a study comparing the crisis with the Great Depression. They concluded that, along with neoliberal policies, the decoupling of the financial sector from the real economy was a major cause of both crises. ("To avoid a new financial crisis, look through China's eyes", *AAS* 14 Feb. 2018.) Extending Glass-Steagall internationally would play a vital role in reducing the sheer volume of global speculation and increasing the flow of credit to the productive economy, eradicating this decoupling.

Since the 2008 crisis China has pumped out more credit than the four central banks responsible for Quantitative Easing (QE), the US Federal Reserve, European Central Bank, Bank of England and Bank of Japan. China's state-owned banks channelled the equivalent of US$20 trillion into development projects and industry, producing some US$10 trillion worth of assets, growing at a rate of 40-50 per cent each year. By contrast, the US$15 trillion issued in QE has gone into speculation, producing bloated bank balance sheets and a myriad of new asset bubbles.

Historical context

There are a number of cultural tendencies in China that explain why it implemented Glass-Steagall banking regulation just as Western countries were dismantling it. International Schiller Institute founder and president Helga Zepp-LaRouche has often commented that China is more Confucian than Communist, due to the deep roots of Confucian philosophy within the population. Confucianism stresses unity, harmony, balance, and humanism, i.e., what is beneficial for the economic and social welfare of the people. As Chinese President Xi Jinping said at the Shanghai Cooperation Organisation summit in Qingdao, China, on 10 June, this mode of thinking transcends the "clash of civilisations, Cold War and zero-sum mentality".


Confucius
(551BC-479 BC)

Father of the Chinese republic Sun Yat-sen (1866-1925) was schooled in the American System of Economics in Hawaii in the 1870-80s, and brought the ideas of Alexander Hamilton (the first US Treasury Secretary under President George Washington) and Henry Carey (the leading economic advisor to President Abraham Lincoln) back to China. In opposition to the British free trade approach, Hamilton had defined a new pathway to economic wealth, based on a national credit bank to fund national infrastructure, and rapid industrial development. At the time of Lincoln, Carey revived this approach, which was picked up by America's Civil War ally, Russia; Germany under Chancellor Otto von Bismarck; and Japan following the 1868 Meiji Restoration which had set up a modern central government. Other Asian economies later adopted this approach.


Sun Yat-sen
(1866-1925)

In the last couple of years there have been quite a few references to the fact that China has adopted this unique American policy, in particular with its state credit creation. For example, an article from *Foreign Policy* magazine on 3 February 2018, under the headline, "How Trump can win with China", referenced this hybrid model: "Despite America's infatuation with the notion that free markets always win, the truth is that a combination of mercantilism, protectionism, industrial planning, and markets have built every successful national economy. … [O]ur first US Treasury Secretary Alexander Hamilton, in 1791 laid out some basic rules that foreshadow China's policies of the last couple of decades."

When Deng Xiaoping came to power in 1977 he immediately set to work revolutionising China's economy. Deng was a hero of the Revolutionary period; he was purged from power three times and suffered personal loss when his son was denied medical care, resulting in him being paralysed for life. Zhou Enlai, the first Premier of the People's Republic of China, from 1949 until his death in January 1976, had set the stage for this shift, outlining a policy of "four modernisations" to bring China's industry, agriculture, science and technology, and national defence out of the devastation of the Cultural Revolution.


Deng Xiaoping
(1904-1997)

At a Communist Party Central Committee meeting in 1978, Deng laid out the mission to transform China after the Cultural Revolution, launching a "new era of development". Current president Xi Jinping's father, who had held key posts earlier but was working in a factory during the Revolution, was called in to help with this. He ran the first "open economy" experiment, in the city of Guangzhou in the south of China. This was successful, allowing Deng to move towards reforms on a national scale.

Deng was the architect of China's modern banking laws. China looked to the West for models, accepting some and rejecting others. It decided, for instance, that "the stakes were too high for the government to relinquish its control and to have an independent banking system like the United States' Federal Reserve System".[1]

At a seminar in 1979 Deng told government officials: "Banks should focus on economics. Now they are only bookkeepers and accountants and fail to play the banking role". The same year, in a seminar for party officials he said: "Banks should become a lever for economic development and technological innovation. We should turn banks into real banks."[2]

China's banking system

China's banking system consists of a structure with the People's Bank of China at the top, acting as the central bank; the Big Four commercial banks, created from 1979 through the mid '80s, with the intention that they become fully commercial lending operations operating on a market model; the three policy banks, established in 1994, which provide government-directed credit into particular sectors; and in addition there are ten other commercial banks, and many non-banking financial institutions, including more than 5,000 urban credit co-ops and some 60,000 rural credit co-ops.

The first reform was the creation of the commercial banks. The function of commercial lending was split away from the central bank, and moved into four specialised banks, the Industrial and Commercial Bank of China, the China Construction Bank, Agricultural Bank of China, and the Bank of China.

But while these banks would conduct banking for commercial purposes, the government still needed to be able to support industries and enterprises, and ask banks to carry out policy tasks such as agricultural product purchase, infrastructure development, facilitating imports/exports, et cetera. So policy banks were created to direct development critical for the nation. A Communist Party meeting in 1993 had established the objective of economic reform as allowing the market to play the fundamental role in resource allocation. This was, however, qualified under a "socialist market economic system", or as it's often referred to, "socialism with Chinese characteristics".

The three policy banks are the Agricultural Development Bank of China (ADBC), the China Development Bank (CDB),

1. "Transforming China's Traditional Banking Systems under the New National Banking Laws", Andrew Xuefeng Qian, *Georgia Journal of International and Comparative Law*, Vol. 25. No. 3, 1996
2. "The Intrinsic Logic of China's Banking Industry Reform", Yi Gang, an essay in the book *Transforming the Chinese Economy*, edited by Fang Cai, 2010

and the Export-Import Bank of China (EXIM).

Glass-Steagall

After opening up to market forces, there were problems, particularly associated with banks beginning to engage in speculation. By the early 1990s some banks were treating the inter-bank lending market as an easy, low-cost place to raise funds and invest in real estate or speculate—something which is commonplace and unremarkable here.

Figure 1

Box 3.5 Some opinions regarding the current economic situation, June 1993

Due to the high inflation in 1993, the PBC has decided to increase interest rates. The PBC will focus on enforcing financial supervision; separating state-owned commercial banks from their affiliated trust and investment firms; requiring all specialized banks to call back loans made outside the credit plan immediately; restricting inter-regional lending; sending out working groups to the provinces to check the implementation of these measures. Four policy measures are being implemented: clearing up and withdrawing loans granted without authorization; raising interest rates on deposits and loans; restraining irregular capital-raising activities and restoring order among investments in real estate and development areas.

Source: People's Bank of China, *ACFB: Almanac of China's Finance and Banking*, 1994.

Figure 2

Box 3.6 Memorandum of the Chinese Communist Party Central Committee, 14 November 1993

- As the central bank, the People's Bank of China shall conduct monetary policy independently.
- The People's Bank of China shall be under the leadership of the State Council.
- The People's Bank of China shall manage the money supply and stabilize the currency value, by changing from relying mainly on control over the credit quota to the reserve ratio control.
- The People's Bank of China shall supervise all other financial institutions.
- The People's Bank of China will not conduct business with non-financial institutions.
- The banking business and the securities business shall be separated.
- A committee shall be formed to conduct monetary policy.
- The commercial banks shall engage in the management of assets, liabilities and risks.
- According to the situation of money supply and demand, the central bank shall make timely adjustments of the benchmark rates.
- The interest rates of the deposits and loans in the commercial banks can be freely floated within a certain range given by the PBC.

Source: People's Bank of China, ACFB: *Almanac of China's Finance and Banking*, 1994.

Chinese scholar Yong Guo wrote in 2002, that "In 1993 Chinese commercial banks speculated stocks by moving savings deposit funds into the stock markets. By the summer of 1993, deposits in commercial banks were insufficient to cover development needs. To solve these problems, Chinese central banks learned from the US in separating commercial banking from investment banking business that is related to the securities market. ... The *Glass-Steagall Act* of 1933 forced a separation between these industries."[3]

Figure 3

The Commercial Banking Law

Article 43 No commercial banks may, within the territory of the People's Republic of China, engage in trust investment or securities business, or invest in immovable property which is not for private use, in non-banking financial institutions or in enterprises, except where otherwise provided for in the regulations of the State.

Article 62 The banking regulatory authority under the State Council shall have the right at any time to carry out inspection of and exercise supervision over the deposits, loans, settlements, doubtful accounts, etc. of commercial banks, in accordance with the provisions of Chapters III, IV and V of this Law.

Chinese economist Yi Gang, who worked at the People's Bank of China from 1997, and today is the Bank's governor (appointed March 2018), wrote in a 2010 essay on China's banking reform: "At the initial stage of reform and opening, China adopted the mixed operation model under which a commercial bank was allowed to operate brokerage and insurance businesses. In the midst of economic overheating and financial chaos at the end of June 1993 the Chinese government enacted 16 rectification measures, 13 of which were related to the financial sector. When re-examining the causes of the financial chaos, policymakers held mixed operation partly to blame and decided to draw on the US experience of separating commercial banking from investment banking."

As a result of this financial chaos the PBC was given the power to regulate the commercial banking system and conduct the monetary policy of the nation. The policy banks (independent of the PBC and directly under control of the State Council) were created to set a standard for banking and ensure economic growth, and bank separation regulation was introduced.

In **June 1993** the PBC issued a document, "Some Opinions Regarding the Current Economic Situation", announcing it would "separate state-owned commercial banks from their affiliated trust and investment firms" (**Figure 1**).

A "Memorandum of the CPC Central Committee, **14 November 1993**" was then issued, stating that "The banking business and the securities business shall be separated" (**Figure 2**).

In **1994** the policy banks were established.

Supporting legislation was finalised on **10 May 1995** to reinforce the "firewall" provisions, stipulating that "commercial banks cannot engage in trust and investment activity inside the borders of the People's Republic of China, and that they must not invest in real estate that is not occupied by the commercial banks itself." (There were other provisions such as banks could not play the stock market.)

This was formalised as the Commercial Banking Law (**Figure 3**) and was designed to keep the banks which were open to market forces, in line. I have included in the graphic Article 62 by way of providing an indication of the strictness of China's regulatory authorities—they can carry out inspections at any time and I bet they take advantage of it—a far cry from our Australian Prudential Regulation Authority (APRA). This law also contains a charter addressing the protection of the interests of depositors.

Various experts compare this law to Glass-Steagall, by name. We will look at a couple of examples.

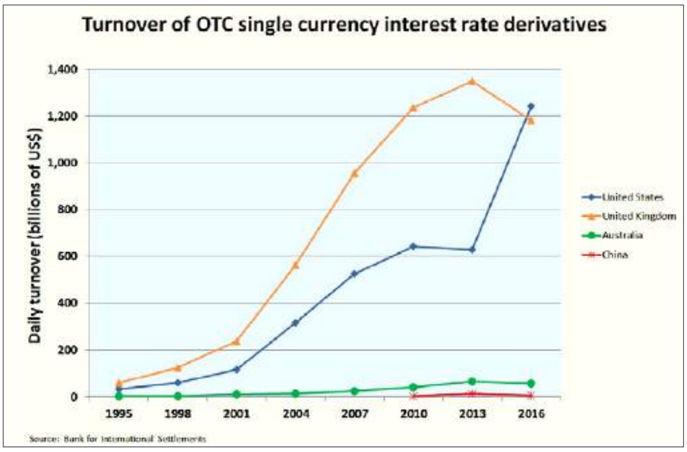
Yi Gang, now head of the PBC: "In the United States, the passage of the *Glass-Steagall Act* by Congress in 1933 separated commercial banking from investment banking. The principle of the *Glass-Steagall Act* was that mixed operations are exposed to excessive risks and therefore commercial banking and investment banking should be separated and regulated under different authorities. ... The *Glass-Steagall Act* drew upon the experiences and lessons from the 1929-33 Great Depression in the United States."

This author, Yi, did his graduate studies in the USA and researched Glass-Steagall in great depth, particularly because one of his professors spoke against the law vehemently: "I conducted increasingly focused research and comparison of this issue from an international perspective", said Yi.

But the USA and Europe had abandoned Glass-Steagall standards. "Before the US subprime crisis broke out, Chinese scholars had reached a consensus to gradually adopt the universal banking model", that is, a model without Glass-Steagall restrictions, recounted Yi. They drew back sharply though, once the GFC unfolded. The US crisis "cast doubt over the universal banking model". The impact of this realisation was "profound and forceful", said Yi.

3. *Banking Reforms & Monetary Policy in the People's Republic of China*, Yong Guo, 2002

Figure 4



Yong Guo, in his book on banking reforms, wrote that the policy protected China from the worst impact of the 1998 Asian crisis: "These reforms were patterned after the financial architecture of the United States and Europe, as codified in the *Glass-Steagall Act* of 1933 in the United States (US) ... These reforms may have placed the PRC on a sound financial footing in the post-reform era and may have helped to protect the Chinese economy from the effects of the recent financial crisis in Asia."

In his 1996 essay Andrew Qian referred to the Commercial Banking Law on bank separation, saying, "This provision is similar to the *Glass-Steagall Act*, which forbids American commercial banks from engaging in the securities underwriting business."

Anti-speculation

Because of its tight top-down regulation of commercial banks and Glass-Steagall separation, the volume of derivatives speculation (financial side bets) in China is very low. In 2012 a Bank for International Settlements report, "Development and Utilisation of Financial Derivatives in China", put China's share of the global derivatives market at only 0.33 per cent. If you compare their derivatives with Australia's the difference is stark. **Figure 4** compares interest rate swaps (the most common type of derivative): China's total is $4 billion; Australia's is $56 billion. Our derivatives turnover is 14 times that of China just in this category, with a much smaller economy. We have 1/60th the population of China, so the derivatives trade represents $2.80 per person in China; $2,300 per Aussie. This will make a big difference in a new financial crisis.

In 2016 China further tightened regulations on derivatives trading. The China Banking Regulatory Commission established more detailed guidelines on calculating financial exposure to counterparty risk on derivatives contracts. Banks' capital reserve requirements for derivatives positions have risen as a result. Restrictions and bans on overseas investment into speculation and non-productive investments were introduced; a new super agency for regulation was set up; and a crackdown on the shadow banking sector is under way.

Meanwhile...

The USA repealed Glass-Steagall in 1999, but JPMorgan had started the drive to repeal it in 1984, with the paper "Rethinking Glass-Steagall", put together by Alan Greenspan when he was a director of the bank, three years before he became chairman of the US Federal Reserve. From this position he hastened the process.

The UK's Big Bang financial reforms of 1986 ended a period of bank separation that existed by convention in the UK, rather than by a formal law. With the real economy growing, a natural divide had formed, where some banks did quite well lending into business and industry and others speculated, but the two functions didn't tend to mix. As the speculative marketplace grew, however, banks wanted to "get their hands on the deposits" to leverage them into big profits, as the Chancellor of the Exchequer at the time, Lord Nigel Lawson, later said.

Many European countries dismantled Glass-Steagall-styled laws following the fall of the Berlin Wall in 1989. British PM Margaret Thatcher and French President François Mitterrand acted to prevent the emergence of a strong, sovereign Germany and so moved towards a European Banking Union. Sovereign control over banking was abolished. A European Commission directive in December 1989 allowed any credit institution to engage in any kind of derivatives trading.

Japan also had Glass-Steagall laws since the US moved in after World War II. After the USA got rid of Glass-Steagall, Japan followed, largely dismantling their regulations by 2002.

Glass-Steagall for Australia!

Look at what Australia faces given the complete lack of regulation in our banking sector. Witness the housing bubble and the securitisation of mortgages (a form of derivatives); the laundry list of crimes of the banks as documented in our magazine, *Time for Glass-Steagall Banking Separation and a National Bank*; even concerns like too much foreign investment coming into Australia and foreign control of our national assets—not only from China—all stem from lack of regulation.

The fact that China has stuck with Glass-Steagall through a period in which the rest of the world was dismantling it—through the Asian crisis, through the global financial crisis, and since—and has demonstrated the superiority and efficiency of this regulatory model, gives us a platform today to rip up the economic model of neoliberalism, free-trade and deregulation—the proven lose-lose approach—and replace it with this win-win model.

Sources

- *The Next Financial Crash is Certain! End the BoE-BIS-APRA Bankers' Dictatorship: Time for Glass-Steagall Banking Separation and a National Bank!* CEC, 2018
- "The Truths Driving China's Banking System Today", by Brian Lantz, *Executive Intelligence Review*, 14 July 2017
- "The Secret to China's Rise—A Question of Leadership", by Jeffrey Steinberg and William Jones, *Executive Intelligence Review*, 4 Mar. 2016
- *Banking Reforms & Monetary Policy in the People's Republic of China*, Yong Guo, 2002
- "Transforming China's Traditional Banking Systems under the New National Banking Laws", Andrew Xuefeng Qian, *Georgia Journal of International and Comparative Law*, Vol. 25 No. 3, 1996
- "The Intrinsic Logic of China's Banking Industry Reform", Yi Gang, an essay from the book, *Transforming the Chinese Economy*, edited by Fang Cai, 2010