

## Chapter 13

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# THE PUBLIC BANKS AND PEOPLE'S BANK OF CHINA: CONFRONTING COVID-19 (IF NOT WITHOUT CONTROVERSY)

**T**he outbreak of Covid-19 in Wuhan and its subsequent domino effects due to the lock-down in major cities have had a devastating effect on the Chinese economy. China is an interesting case to illustrate what policy instruments the central bank can deploy through state-owned commercial banks (a form of 'hybrid' public banks) to buffer the economic shock during times of crisis.

In addition to the standardized practice of liquidity injection into the banking system to maintain its financial viability, the Chinese central bank issued two top-down and explicit administrative directives to state-owned commercial banks: the minimum quota on lending to small- and medium-sized enterprises (MSEs) and non-profitable lending. Notwithstanding its controversy on loopholes related to such lending practices, these pro-active policy directives provide counter-cyclical lending and appear able to provide short-term relief for SMEs from the Covid-19 shock in a timely manner. This has helped to mitigate the devastating impacts of the pandemic on the Chinese economy.

## INTRODUCTION

The outbreak of Covid-19 leading to the lock-down in Wuhan on January 23, 2020 and the subsequent pandemic had significant impacts on the Chinese economy. China's policy response regarding the banking system has helped to mitigate the devastating impacts of pandemic on the Chinese economy.

Before we review the measures implemented by the Chinese government, it is important for us to give a brief overview of the roles of two major group of actors (institutions) in the banking system. In China, the People's Bank of China (PBoC) is the central bank. It is responsible for formulating and implementing monetary policy (including setting minimum reserve requirements and interest rates, and money supply and exchange rate targets) to ensure the stability of the financial system (Yeung et al. 2017).

There are numerous financial institutions but the key banks in terms of equity and market share are five state-owned commercial banks (SOCBs): the Industrial and Commercial Bank of China (ICBC); Bank of China (BOC); China Construction Bank (CCB); Agricultural Bank of China (ABC); and the Bank of Communications (BOCOM). The state is the largest equity owner, although all SOCBs have been listed in the Stock Exchange of Hong Kong between 2005 and 2010 and function like private commercial banks elsewhere, especially in their daily operations at the local/branch level.

What makes the SOCBs different is that the PBoC can issue administrative directives on SOCB lending due to the nature of its hybrid ownership structure (Yeung forthcoming). Importantly, the most senior executives at the SOCBs are appointed by the central government: they could be former senior executives from another SOCB or seasoned officials transferred from the PBoC and other government development banks (Agricultural Development Bank of China, China Development Bank and Exim Bank of China). One could therefore argue that the senior management at the SOCBs'

headquarters could prioritize the status of the national economy over profit-maximization in their decision-making processes, including the conception of ‘corporate strategies’, i.e. SOCBs could be functioning more like ministries in the central government than private commercial banks. There is also an impression that SOCBs have a lending bias favour for the state-owned enterprises as both are ultimately owned by the Chinese government. This impression could, however, be partially reconciled by the lack of credible financial credit records among private entrepreneurs in China (see Yeung 2009).

The PBoC has issued a number of administrative directives since January 2020 and we will focus on two of the most important ones: liquidity supports and quotas on low-cost lending, and non-profitable lending. A brief and very preliminary review of the effects of such lending directives will be presented.

## **COUNTER-CYCLICAL LENDING MEASURES: SUPPORTS AND QUOTAS ON LOW-COST LENDING**

After the first Covid-19 case in Wuhan was reported in December 2019 and the subsequent outbreak of the coronavirus spread across the country, the PBoC implemented a series of measures to stabilize the economy in China through two related policies: to maintain the liquidity in the banking system and to provide low-cost lending.

Liquidity is crucial for the financial viability of the banking system during times of crisis. Commercial banks tend to be much more conservative to preserve their scarce capital with the expectation of a (much) higher non-performing loan ratio. Potential borrowers, especially the small- and medium-sized enterprises (SMEs), could find their credit lines cut or even their existing loans recalled by banks due to their deteriorating balance sheets and diminishing market value of their collateral. Capital injection by the central bank is a common policy instrument to maintain the liquidity in the

banking system, with the expectation that commercial banks are more willing to grant loans to credible companies.

Instead of increasing the money supply by purchasing government and corporate bonds, as per the US Federal Reserve, the PBoC improves liquidity through adjusting its regulatory requirements, specifically the reduction of reserve requirement ratio (RRR). The RRR is the minimum percentage of a commercial bank's deposits that are held in cash or cash-like assets in order to reduce the chance of bank run or failure due to mass customer withdrawals. A lower RRR allows banks to provide more credits and this in turn improves liquidity in the banking system. The PBoC reduced the RRR by 0.5% during the beginning of the outbreak in January 2020 (see Table 13.1). To maintain ample market liquidity, the PBoC has since cut the RRR twice, in March and again in April 2020, and subsequently pumped a total of CNY 1.75 trillion (US\$245 billion) into the banking system. Moreover, the PBoC reduced the reverse bond repurchase agreement rate in February and March and the loan prime rate (LPR, the benchmark interest rates charged by commercial banks for their most creditworthy customers) in February and April 2020.

To further improve liquidity in the banking system, the Chinese government issued two explicit instructions to SOCBs to provide credits to privately-owned SMEs. A number of SMEs have already been under tremendous financial pressure due to the ongoing trade friction between the US and China. In spite of the above-mentioned policies, however, new lending fell significantly: from CNY 3.34 trillion (US\$468 billion) in January to CNY 906 billion (US\$127 billion) in February 2020. Importantly, short-term business lending, normally used by SMEs, contracted by CNY 396 billion in February 2020 (SCMPa 2020).

About one month after the lock-down of Wuhan started on January 23, 2020, the State Council and PBoC instructed the SOCBs to grant at least 30% of their loans to SMEs in the first half of 2020 (see Table 13.1). As part of this important initiative, the PBoC provided a

preferential LPR at 0.25% lower to SOCBs for their lending to farms, agriculture firms and small businesses in February 2020. Moreover, SOCBs were eligible for additional government funding for loans, if they should charge a lower interest rate to borrowers at no more than 0.5% mark-up from the LPR.

**Table 13.1: Major capital injection measures implemented by the PBoC in the first half of 2020**

Date	Institutes	Measures
Jan 6	PBoC	<ul style="list-style-type: none"> <li>Reduced RRR by 0.5%: 12.5% for SOCBs &amp; 10.5% for small- and medium-sized banks</li> </ul>
Feb 1	PBoC & CBIRC	<ul style="list-style-type: none"> <li>Allow banks to sell coronavirus relief bonds</li> </ul>
Feb 3	PBoC	<ul style="list-style-type: none"> <li>Reduced the seven-day reverse bond repurchase agreement rate from 2.50% to 2.40% &amp; the 14-day tenor from 2.65% to 2.55%</li> <li>Resulted in an injection of CHY 1.2 trillion (US\$168 billion)</li> </ul>
Feb 20	PBoC	<ul style="list-style-type: none"> <li>Reduced the one-year LPR from 4.15% to 4.05% &amp; five-year LPR from 4.8% to 4.75%</li> </ul>
Feb 25	State Council & PBoC	<ul style="list-style-type: none"> <li>Provided CHY 800 billion (US\$112 billion) for small business lending</li> <li>SOCBs have to grant at least 30% of their loans to small businesses in the first half of 2020</li> <li>Three government-run policy banks to lend CHY 350 billion (US\$49 billion) to small businesses at preferential rates</li> <li>LPR for farms and agriculture firms &amp; small businesses reduced from 2.75% to 2.5%</li> <li>Banks are eligible for additional government funding for loans no more than 0.5% higher than the LPR</li> </ul>
Mar 16	PBoC	<ul style="list-style-type: none"> <li>Reduced RRR by another 0.5-1%, results in an injection of CHY 550 billion (US\$77 billion) into the banking system</li> </ul>

Mar 30	PBoC	<ul style="list-style-type: none"> <li>Reduced the seven-day reverse repurchase agreement rate to 2.2%, resulted in an injection of CHY 50 billion (US\$7 billion) into the banking system</li> </ul>
Mar 31	State Council	<ul style="list-style-type: none"> <li>PBoC provided a credit line of CHY 1 trillion (US\$140 billion) to small lenders</li> </ul>
Apr 3	PBoC	<ul style="list-style-type: none"> <li>Reduced RRR of small- and medium-sized banks to 6%, resulted in an injection of CHY 400 billion (US\$56 billion) into the banking system</li> </ul>
Apr 15	PBoC	<ul style="list-style-type: none"> <li>Reduced the one-year MLF loans to financial institutions from 3.15% to 2.95%, resulted in an injection of CHY 56.1 billion (US\$7.9 billion) into the banking system</li> </ul>
Apr 20	PBoC	<ul style="list-style-type: none"> <li>Reduced the one-year LPR to 3.85% &amp; five-year LPR to 4.65%</li> </ul>
June 1	PBoC	<ul style="list-style-type: none"> <li>CHY 400 billion (US\$56 billion) to acquire 40% of unsecured loans made to SMEs with maturities of at least six months made between March 1 &amp; December 31 2020</li> </ul>
June 17	State Council & PBoC	<ul style="list-style-type: none"> <li>Instructed banks to sacrifice CHY 1.5 trillion (US\$210 billion) in profits in 2020 to provide low-cost loans to small businesses</li> </ul>

Sources: Compiled from State Council February 27, 2020; CBIRC June 3, 2020, SCMPc and SCMPe, 2020.

Notes: CBIRC (China Banking and Insurance Regulatory Commission): the regulatory authority of banking and insurance institutions; RRR (reserve requirement ratio): cash or cash-like assets that banks are required to hold in reserve to maintain the liquidity; LPR (loan prime rate): a lending reference rate set monthly by 18 banks for their most creditworthy customers. Banks have to link their LPR quotations to the rate of MLF (hence, the lower costs loans) since August 2019; MLF (medium-term lending facility): a funding facility that the PBoC extends to commercial banks.

## COUNTER-CYCLICAL LENDING MEASURES: PROVISION OF NON-PROFIT MAKING LOANS

The lock-down of Wuhan and its domino effects have had devastating effects on the Chinese economy. The economy shrank by 6.8% in the first quarter of 2020 in spite of all the pro-active policies to improve the liquidity and the provision of low-cost loans to businesses. The possibility of a collapse of more than 18 million private enterprises (most of them SMEs and single proprietor businesses that employ some 200 million people) could result in massive unemployment, since SMEs account for 60% of industrial output and employ 80% of employees in China. As only one fifth of privately-owned SMEs were ever granted a bank loan before the pandemic (Yeung forthcoming), the reduction of the RRR and LPR appears to be unable to provide sufficient lending to private enterprises.

In June 2020, the State Council and PBoC issued another set of strong policy measures to the SOCBs to ensure the provision of low-cost lending to SMEs. Under the ‘Document 6’, the PBoC acquired 40% of unsecured loans made to SMEs with maturities of at least six months made between March 1 and December 31, 2020 (see Table 13.1). By effectively taking over almost half of such loans to SMEs, the PBoC freed up CHY 400 billion (US\$56 billion) of liquidity in the banking system.

Another more important and unprecedented policy directive involves the most explicit instruction given to the SOCBs since partial privatization in the 2005-2010 Stock Exchange of Hong Kong listing. Following on from the May 2020 open call from Premier Keqiang Li on the duties of SOCBs, PBoC Governor Gang Yi openly said: “Financial institutions are urged to sacrifice profits to benefit corporate borrowers, helping reduce their borrowing costs” (SCMPe 2020). Specifically, the PBoC instructed the SOCBs to sacrifice up to CHY 1.5 trillion (US\$210 billion) in profits in 2020, equivalent to 75% of their profits in 2019, to provide low-cost loans to SMEs. Moreover,

the SOCBs have had to reduce their various fees to customers, defer loan repayments and grant unsecured loans to SMEs to help them survive the economic downturn.

This measure is not administratively feasible or even financially viable for conventional private commercial banks in developed or developing countries. This unusual instruction on lending issued by the PBoC could be reconciled by the hybrid nature of the SOCBs, for which the Chinese state still holds the majority of the equity. Ownership here translates into effective control, should state authorities choose to exercise it. Due to the hybrid nature of its property rights, the state can deploy the SOCBs to provide counter-cyclical lending to contain economic shocks from the Covid-19 pandemic in a timely manner (see Yeung 2009 and forthcoming).

The aggressive policy lending in China appears to have created a (short-term) stimulus effect on the economy: Gross Domestic Product (GDP) grew by 3.2% in the second quarter of 2020 and the urban unemployment rate fell from 6.2% in February to 5.7% in June 2020 (NBS July 17, 2020). Such aggressive lending by the SOCBs, however, has its drawbacks.

## **EXPLOITATION OF LENDING LOOPHOLES**

The SOCBs have been lending aggressively to fulfill their lending quotas and this unavoidably has led to cases of abuse. Under the policy directives of the PBoC, SOCBs have been granting loans at unusually high levels of leverage, which increased from the usual 50 to 90% of the collaterals, and at below the benchmark interest rate of 4.35% (SCMPb 2020).

An unknown proportion of loans intended for improving the liquidity for SMEs were granted to shell corporations and diverted for speculation on real estate illegally (SCMPb 2020). Such exploitation of the lending policy from the SOCBs appears to have contributed to the rising property prices in major cities, especially the Shenzhen



special economic zone in southern China. The property prices in Shenzhen increased at the fastest rate among Chinese cities at 1.6% between February and March 2020, during the peak of the Covid-19 outbreak in China (SCMPb 2020). It is also estimated that the prices of new properties in 100 major cities in China increased by 15% year on year during the first quarter of 2020 while GDP fell by 6.8% simultaneously (SCMPd 2020).

There is no reliable way to estimate the extent of such exploitation of the lending policy in Shenzhen or China. According to official figures, bank lending in Shenzhen reached CHY 315.8 billion (US\$44 billion) in the first quarter of 2020 (an increase of CHY 71.8 billion from the same period in 2019, while there was a reduction of lending nationwide), and around 80% were to corporate entities. The PBoC has since instructed SOCBs to control such lending, including the close inspection of using property as the collateral for new loans (SCMPb 2020).

## CONCLUSION

The top-down administrative directives adopted by the PBoC has had an impact on stimulating economic growth during the Covid-19 pandemic in China (although this has not been without controversy). Liquidity in the banking system is one of the keys for the provision of low-cost lending. What makes the Chinese case interesting is that the PBoC issued two very explicit directives to the SOCBs: the minimum quota on lending to SMEs and the non-profitable lending. These pro-active policy directives provide counter-cyclical lending and appear able to provide short-term relief for SMEs from the Covid-19 shock in a timely manner.

Nonetheless, the potential cost inefficiency of such capital injection in the long-term cannot be ignored. Another pertinent issue revealed by the recent counter-cyclical lending is the ‘publicness’ of the SOCBs: to what extent could such lending be classified as policy

lending by public banks? The hybrid ownership structure of SOCBs illustrates the limitations of conventional typology of public and private banks in the financial system. Perhaps it is the time for us to re-examine the meanings of public banks.

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