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State Capitalism in China: The Case of the Banking Sector

Ing. Jan Bejkovský,
Department of World Economy, Faculty of International Relations,
University of Economics, Czech Republic.
E-mail: shibal88@centrum.cz

Abstract

This article aims to analyse how the banking sector in China helps domestic state-owned enterprises. Support for state-owned enterprises is certainly one of the fundamental elements of Chinese state capitalism and the banking sector is one of the key elements in this support. In order to perform this analysis, the article initially analyses state-capitalism as a system opposing the predominant paradigm of liberal free-market economies in today's world. The article briefly defines state capitalism as an economic system and introduces countries that adopted this system. Then, the paper proceeds to analyse banking sector in selected state-capitalist countries to indicate that state ownership of the banks is fundamental for such system. Having dealt with these issues, the article proceeds to analyse Chinese banking sector and the scope of state ownership. Consequently, the paper looks into ways how the state banks subsidy domestic state-owned enterprises based on government plans while evaluating the possible negative impacts on the efficiency of the whole Chinese economy simultaneously.

Key Words: *China, state-owned banks, state-owned enterprises, state capitalism, subsidies, market economy*
JEL Classification: *G21, H11, P21*

1. Introduction

Given the importance of the state-controlled economy in the whole economy, the case of China does not resemble full-fledged market economy. Often, by contrast, academics speak of state capitalism because government influence is more significant in China than in countries depending on the liberal principles of market economy. State capitalism therefore might constitute a system opposite of market economy. As every economic system, state capitalism has certain characteristics and fundamental features. This article focuses mainly on the banking sector, which plays vital role in any modern economy. Indeed, it is the banks that are responsible for efficient capital allocation, thus ensuring the country's economic development. This article aims to analyse how the banking sector in China helps domestic state-owned enterprises. Support for state-owned enterprises is certainly one of the fundamental elements of Chinese state capitalism and the banking sector is one of the key elements in this support. This, in many cases hidden support, however, goes against China's commitments, for example in the World Trade Organization (hereinafter WTO) and against attempts to implement efficiently functioning economy.

In order for the article to analyse the above-stipulated topic, the following structure is used. First, the article briefly defines what kind economic system is the state capitalism and how it is different from the capitalist market economy. After this definition, is appropriate for the article to present the most important and typical representatives of the state capitalism in the world economy. Furthermore, the article analyses the importance of the state-owned banking sector in countries implementing the principles of state capitalism. Thus, the article should gain a suitable framework and context for the analysis of the Chinese banking sector.

In the main part of the essay, we deal specifically with the Chinese banking sector. In the initial part of the chapter, the most important players in the Chinese banking market are analysed. Consequently, the chapter looks into the extent of state ownership in the entire sector. Further to defining the scope of state ownership, the article then analyses the specific ways that state-owned banks utilise to support and subsidy state-owned enterprises, including the impact of such behaviour on the efficiency of the entire economy.

2. State Capitalism

State capitalism is an old-new concept, which reappeared during the financial and economic crisis of 2008 in connection with the government assistance and bail-outs provided to affected businesses in many countries. (Crouch, 2011) It is obvious that state capitalism as an economic system is significantly different from the market economy system or systems common in developed market economies. State capitalism is like any economic system in the aspect that it has many definitions. Most researchers, however, agree that it is a system where the state significantly interferes with the functioning of the free market. No economy in today's world does work without some degree of state intervention. However, the Anglo-Saxon, European and Asian models, all agree that the role of government is only for the sake of coordination of the market and it failures. Thus in the US, Germany and Japan, we speak of the market economy. States in all these systems respect the role of the free market in allocating resources. Differently they perceive only a concrete scope of state influence and/or intervention. (Bremmer, 2010)

Economic researchers naturally focus on the economic aspects of state capitalism, which they define as a system of wide-spread influence of the state in the economy through state business ownership, granting preferential loans and other benefits to private companies. (Musacchio, 2014) Other researchers, notably political scientists, seem to emphasize the state intervention in the economy as means to gain political benefit. (Bremmer, 2010) For the purpose of this article, it is appropriate to work with the definition that combines both aspects: thus the state capitalism is a system where the state significantly influences the economy (market) in order to pursue the state objectives as defined by the government; market only plays in this system a subordinate role, preference is given to the state (government) target.[1] This definition includes various forms of state intervention from regulation, through the protection of the domestic market to the state-owned enterprises. At the same time it is not limited to political objectives, but to any targets that the state determines whether it is to maintain employment, acquire raw materials or expand into foreign markets. The definition is thus compatible with the definition according to the Economist (the effort to combine the power of the state with the forces of capitalism and the free market), and other definitions given in literature about the topic. (Jiránková and Žamberský, 2014)

Based on this definition, the main representatives of state capitalism in the world economy is a group of countries, where the following countries are moat typically included: China, Russia, Saudi Arabia, the United Arab Emirates and Kuwait, also sometimes Brazil or India. (Jiránková and Žamberský, 2014)

2.1 State Bank as a Pillar of State Capitalism

In the literature often neglected common feature of countries practicing state capitalism is the existence of banks under state control. The share of state-owned commercial banks in market economies is negligible, thus ensuring the most efficient allocation of capital based on

[1] In countries with established state capitalism a political regime different from the European or US democracy usually functions. Therefore, the governments do not alternate so often, so there is no danger that the state or government targets are changed. Therefore, it is also possible to unify state and government targets, there is no division. Singapore has many elements of state capitalism, while it is considered a democratic system. However, there has so far been only one ruling party despite the elections, which provides continuity of state policy. It is debatable whether state capitalism could work in countries with regular exchanges of governments because these new governments have a tendency to define themselves against the previous government and focus rather on short-term goals.

market criteria. In contrast, capital allocation by the state-owned banks is typically affected by the state (or government) objectives and interests. State-owned banks (hereinafter SOBs) often serve as a channels for financing the state-owned enterprises (hereinafter SOEs) or enterprises preferred by the government regardless of economic efficiency. Thus significantly affecting the market environment of the country, favouring companies with links to the state. SOBs can finance loss-making enterprises if their support is perceived as a national goal. Furthermore, these banks finance international expansion of national champions and provide capital for government-selected projects, once again often regardless of market criteria. Therefore, the SOBs are an important pillar of the state capitalism.

SOBs are the dominant part of the banking sector in China as well as they are by many parameters the largest banks in the world. (Schaefer and Murphy, 2016) Their lending decisions biases are analysed in the following part of the article, however, their tendency to lend to state enterprises is more or less evident. In Russia, the two largest state banks Sberbank and Vneshtorgbank (VTB) have more total assets than the next 20 largest banks combined together. A third bank in terms of assets, is the Gazprombank, a banking arm of state oil company. (Ross, 2015) SOBs of the Russian Federation are suspected of funding the Ukrainian pro-Russian separatists, which is quite obvious manifestation of preferring national targets over market criteria. (Business & human rights resource centre, 2014)

In Arab gulf countries, the banking sector is also dominated by SOBs. In Saudi Arabia, among the largest banks ranks the National Commercial Bank, Saudi British Bank and Alinma Bank, where the government is the decisive stakeholder. (Sillah, Khokhar, and Khan, 2014) In the UAE, the major banks are linked to the ruling families of individual emirates. This is an example of Abu Dhabi Commercial Bank, National Bank of Abu Dhabi and Abu Dhabi Islamic Bank all connected with the government of the emirate. The situation is similar in the emirate of Dubai, where the Dubai Commercial Bank, Dubai Islamic Bank and Dubai Bank are all via ownership structure all linked to the ruling families. Co-existing Islamic banks, although they work on different principles, also are connected with the ruling families. (Central Bank of the United Arab Emirates, 2014) The hard impact of the financial crisis in 2009 brought changes in the balance of power between the Emirates, when banks from Abu Dhabi had to provide a financial injection to the Dubai Emirate. Since then, we have seen more strengthening of the state-controlled economy ensuring lower efficiency but greater stability. (Reuters Editorial, 2014)

The system of state banks constitutes indispensable pillar of the state capitalism, because it provides the whole economic system with capital and thus keeps it going. The state also maintains significant influence in the domestic economy through the SOBs and is able to support certain projects, industries or businesses, regardless of economic return. (Musacchio,

2014) Therefore it is necessary to consider the system of SOBs as one of the pillars of the state capitalism, although it may be in the literature sometimes neglected.

3. Chinese State Banks

Having introduced the SOBs as a pillar of the state capitalism, we can now move to Chinese banking sector, which is the main focus of this article. First of all, it is necessary to deal with the actual size of the Chinese banking - according to Forbes magazine, which takes into account in its ranking of the largest companies of the world their sales, assets, profits and companies, the four largest Chinese banks ranked in the top four places of the world ranking of companies in 2015; leaving behind companies like Exxon Mobil or another state-owned company PetroChina. In the list of the world's top 20 largest banks, it is possible to find a total of seven Chinese banks, which is more than any other country has. (Schaefer and Murphy, 2016) This means that Chinese banks are according to various statistics the largest banks in the world.

However, analogous to other sectors, the banking sector is highly regulated. Single foreign entity/bank cannot hold more than 20 percent of Chinese banking institutions and foreign entities aggregate share on the ownership cannot exceed 25 percent. (China Banking Regulatory Commission, 2016) Foreign securities traders and funds are still not permitted to establish a full-fledged branch in China. If a foreign bank wishes to enter the Chinese banking market as a foreign entity, it is subjected to a number of additional regulatory requirements. Even after 15 years since China's entry into WTO, equal treatment of foreign and domestic banks does not exist in China. (Banking & Securities Position Paper, 2015) These measures have resulted in a very low share of foreign banks on the total assets of the whole sector. Indeed, in 2014 it was less than 2 percent, as we may see below. What is the overall situation in the rest of the banking sector is indicated in the following table, which lists the types of banking institutions and their assets.

Table 1: Assets of Individual Types of Banking Institutions in China in 2014; 100 Million Yuan RMB and Percent

Types of banks and institutions	Assets in 2014; Unit: RMB 100 million	Share on the total assets in the banking sector
Large State-owned (commercial) banks	710140	41.21%
State policy banks	156140	9.06%
Joint-stock commercial banks	313801	18.21%
Local banking institutions (rural and urban)	296115	17.18%
Local cooperative banking institutions	138435	8.03%
Postal Savings Bank and other local institutions of a new kind	70981	4.12%
Foreign banks	27921	1.62%
Other financial institutions (consumer loans, trusts, leasing companies and others)	50123	2.91%
Total	1723355	100.00%

Source: China Banking Regulatory Commission, 2016

The term large **state-owned (commercial) banks** indicates the following institutions:

- Industrial & Commercial Bank of China (ICBC);
- China Construction Bank (CCB);
- Agricultural Bank of China (ABC);
- Bank of China (BOC);
- Bank of Communications (BOCOM).

The first four of these are also the four largest companies in the world according to the Global 2000, as mentioned above. These banks are state-owned enterprises administered by the CBRC. The structure of management and organization being similar to SOEs under central administration - it is a parallel corporate and Communist Party hierarchy. (Haley and Haley, 2013) In this system, it is not a problem for the government to exercise influence in the banks.

Policy banks are three:

- Export Import Bank of China (ExIm Bank);
- Agricultural Development Bank of China (ADBC);
- China Development Bank (CDB).

These banks are also fully controlled by the state, and their goal is not profit, but the participation on assigned tasks. Each of them has specific scope, in which it helps to achieve the goals set by the government. It is therefore an institution similar to institutions in the developed countries, but on a much larger scale. ExIm Bank, for example, contributed to favourable loans, through which Chinese car manufacturer Geely acquired Swedish Volvo. (Reuters Editorial, 2009)

Joint-stock commercial banks were tied to a particular province and could not operate nationwide. That changed by the adoption of the Law on Commercial banking. Therefore, since 1995 they can fully compete with large national banks. These banks may look like private, but they are not. (Yin, Yang, and Mehran, 2013) In all of these banks government entities have a significant share, although it might not be the only share. Shares in these banks are owned by private entities, Chinese or foreign. But it is typically only complementary to state ownership.[2]

These are the following banks: (China Banking Regulatory Commission, 2016)

- China Bohai Bank;
- China Everbright Bank;
- China Merchants Bank;

[2] Foreign entities controlling their shares include institutions as Citibank and/or Morgan Stanley

- China Minsheng Bank;
- China Zheshang Bank;
- CITIC Bank;
- Evergrowing Bank;
- Guangdong Development Bank;
- Huaxia Bank;
- Industrial Bank;
- Shanghai Pudong Bank;
- Shenzhen Development Bank.

The rest consists of 'local' banks that operate in urban and/or rural areas, according to their geographic location. The common denominator of these banks is always the dominant ownership by the government. Ownership by other entities in not always prohibited, but the local government and its components retain the most significant part. The local cooperative banking institutions were especially important in the early stage of China's economic reforms and are now not so significant according to the total assets. (Huang, 2008)

We have thus showed that the vast majority of assets in China's banking sector is under state control. The banking sector provides capital and allows for the development of state capitalism. We can therefore expect that profit maximization is not the sole criterion for lending decisions by the banks. How does the government use this influence to support domestic economy is the focus of the next part.

4. Support for State Enterprises

Above all, this influence manifests itself in the form of preferential access to capital for the SOEs. Over the period of 10 years since China's entry into WTO, SOEs received around 60 percent of loans from big state banks. (Haley and Haley, 2013) In 2009, for example, when the Chinese government introduced a stimulus package of 10 trillion RMB, the SOEs received around 85 percent of this sum. (Borio et al., 2013) Chinese SOEs therefore have no problem in obtaining loans.

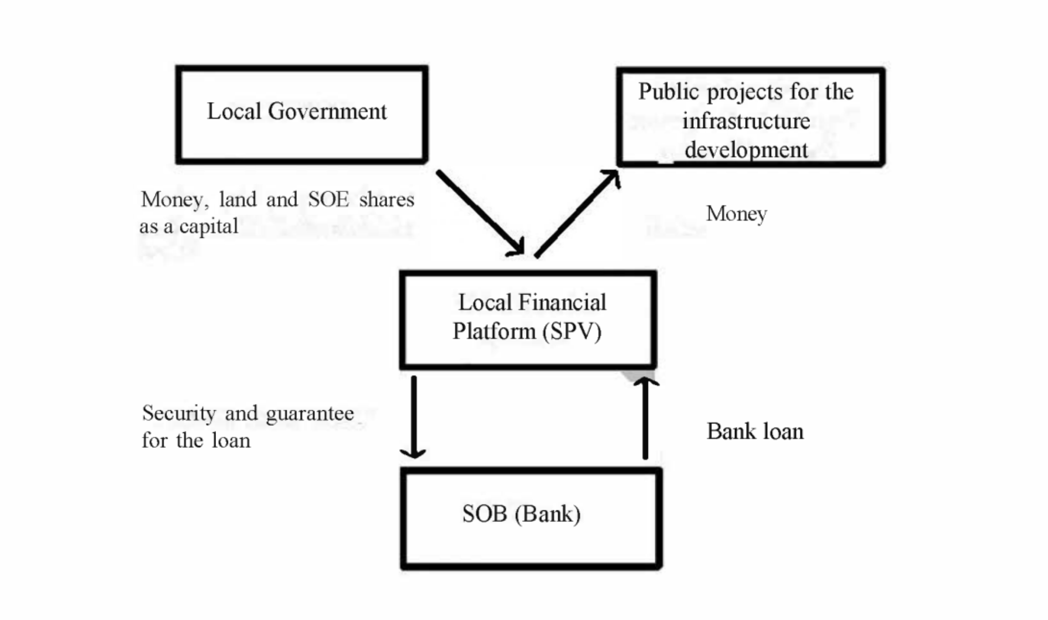
This in itself is not a problem for the efficiency of the economy and may not constitute any form of preferential support. However, SOEs get these loans at below-market interest rate. According to available data, SOEs had in an average interest rate of 1.6 percent in 2010, while the average interest rate for private firms was 4.7 percent. (Du, 2014) The favourable interest rate advantage is yet another form of support for domestic state-owned enterprises. From interviews with SOE managers and state officials, it is obvious that SOEs are also favoured in other loan parameters - for example, their loans have longer maturities or less thorough project profitability evaluation. Approval of loans may often only be a formality negotiated between the management of state enterprise, managers of the respective state banks and leader of the Communist Party in the area. It is in the interest of all those officials that given SOE in question continues development, which they may present as their own success, according to descriptions by Chinese academics.

This method of making lending decisions does not support efficient allocation of capital, which has significant costs for the whole economy because given limited supply of credit, more profitable projects are not financed. It is one of the key reasons why Non-performing loans (hereinafter NPLs; these are loans where the bank does no longer expect repayment) constitute such major problem of Chinese banking. In 2001 the share of these loans reached 31 percent of total banking assets. (OECD, 2016) The government had to establish institutions (special purpose companies), where those NPLs were transferred in order to relieve balance sheets of the SOBs. A significant majority of these claims were against state enterprises, which means that in addition to preferential tariffs, the Chinese state-owned enterprises enjoyed subsidies in the amount of those 31 percent of outstanding or only a marginally paid-up loans. This brings us to a sum of more than 2 trillion yuan RMB. (OECD, 2016) The inefficiency of the SOBs was paid by the Government, therefore it is possible to say that all citizens. These data are from 2001 and show how SOBs participated in subsidizing of SOEs during their transformation in the "national champions". This means that government provided time for the SOEs to transform. By doing this, China did not suffer from increased unemployment and decline in life standard that occurred in countries privatising their SOEs. This was in accord with the government targets that were focused on improving the life standard and creating wealthy middle class. (Bremmer, 2010) It is often the national and local SOEs that provide stable and relatively well paid jobs for the growing numbers of middle class workers. However, this system of abundant credit does not create enough stimulus for the SOEs to improve their efficiency.

Today, the share of NPLs on the balance sheets of the SOBs is only 1.2 percent, which is in line with international standards. (China Banking Regulatory Commission, 2016) However, today SOBs may use, and they do so in practice, different types of loans that are not included in the balance sheets according to international standards, such as guarantees for payment or entrusted loans. In these cases, the bank acts as guarantor of payment from client accounts or only as an intermediary, but in the end the credit is provided. For these products, the main clients are SOEs. This kind of loans grew parallel with the declining proportion of NPLs. In 2011 it was 3.8 trillion yuan RMB, while five years earlier it was only a tenth of that amount. (Haley and Haley, 2013)

At the local government level, the system functions encompassing the local branches of large state-owned banks, but the system itself is not different from the system at the central level. Furthermore, at the local government level, the Local government financing platforms are very active. These special purpose vehicles are often used to finance local infrastructure projects. (Lu and Sun, 2013) These platforms act as entities receiving money for local projects. It is often these platforms that are responsible for growing indebtedness of the local governments. Their typical structure is shown in the following diagram. It is useful to note that at every level of the system we find only state entity. Therefore, the risk of moral hazard and non-market decision making significantly increases.

Diagram 1: The Functioning of the Local Financial Platform



Source: Lu and Sun, 2013

We may assume that the participants in this system do not act on the basis of market criteria. All the participants in the system have their own decision-making processes as a complement to market criteria:

- SOBs provides the loan to local government backed up financial platform, because it is always going to receive compensation.
- The local government has no reason to keep project costs down because it knows that it can easily obtain financing from SOBs and also can support the local economy.
- SOEs involved in the projects are also not motivated by market and economic criteria, because their reward depends rather on relations with the local government than on other factors. They might take part in the government projects only for the support they can receive, not because of business development and profitability of the project. (Lu and Sun, 2013)

Needless to say that infrastructure project is an ambiguous term that can contain a lot of projects designed to promote a particular industry or local producer/ local SOE. It may for example be the construction of a technology park, where investors can be forgiven taxes or even given substantial grants for research and development. All these projects are in reality funded by the local financing platforms. (Haley and Haley, 2013) In 2014, indirect liabilities of local governments, that include the financial commitments of local financing platforms, totalled to 8.6 trillion yuan RMB. (Tejada, 2015) This is not an amount that could be overlooked easily.

Among other forms of support from SOBs towards the SOE, we can include higher interest rates on bank deposits in state banks. (Haley and Haley, 2013) Given the size of Chinese SOEs and their financial companies, this may in fact be a significant advantage bringing extra capital. These and other forms of support are very difficult to analyse exactly or to show they represent a subsidy, as it is almost impossible due to a general lack of market price formation to find relevant benchmark. (Du, 2014)

5. Conclusion

In this article we examined the Chinese banking sector as an important pillar of state capitalism in China. Firstly, the article introduced the economic system of state capitalism, which it defined as a system, where the state significantly influences the economy (market) in order to pursue the state objectives as defined by the government. Therefore market plays in this system only subordinate role, preference is given to the state (government) target. Based on this definition, we may find the main representatives of this system in the world economy, countries such as Russia, China and the oil states of the Persian Gulf.

Furthermore, the article focused on the banking sector in these countries. It has been clearly indicated that in all countries with state-capitalist tendencies, state-owned banks play a significant part of the banking sector. Significant state ownership of banks is in fact one of the manifestations of state capitalism. State ownership of the bank enables the government to use these banks as a means to influence the whole economy and provides capital to support the whole system.

China is also representative of state capitalism, and therefore we can expect that SOBs play an important role in meeting the national targets stipulated by the government. Article showed that a significant majority of banking institutions in China are state-owned, and that the state has the means to influence their lending decisions.

As the article has further indicated, the Chinese SOBs constitute fundamental pillars of Chinese state capitalism. Without them it would not be possible to subsidy the state sector on such scale. The banking sector is able to provide significant financial injections to Chinese SOEs or entire industries. The banks do so in accordance with government policy support of the domestic economy. If it is necessary to promote a certain segment and allow it to catch up with the technological gap and/or keep it safe before demand crisis abroad, SOBs are ready to provide financing. In reality, many Chinese SOEs were spared from bankruptcies thanks to the inflow of funds from the banking sector that also enabled them to transform into successful companies with global operations. Because of this, China was spared the decline in living standards and an increase in unemployment, which surely is an unparalleled success in comparison with other transitional economies. However, it is not possible to overlook the significant societal costs of selective support and of subsidizing SOEs whose profitability is not as high as profitability of private companies. Put simply, the capital allocation efficiency is lower than it could be if market criteria for market allocation were used. Chinese SOEs have preferential access to credit, receive preferential interest rate and many other advantages from the SOBs. A similar system of subsidies can also be found at the local government level due to the existence of local financing platforms.

In practice, however, it is precisely this system of government subsidies, which defines the Chinese state capitalism and supports non-market decision making. A Chinese SOE has the advantage over the competition in the barriers to entry for foreign or private competition, it can receive preferential loans, receives grants for research and development, gets free land, has tax rebates and cheap inputs of materials from other SOEs. The result of this system is naturally a product that is highly competitive on world markets, which is the goal of the Chinese government. Its price, however, does not reflect the market situation and is not made on the basis of market determinants. This fact can, in the long term perspective, cause significant problems for the whole Chinese economy.

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