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## Article

# People's Republic of China: an introduction to the party and its socialist base

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*Reference:* Watson, Christopher Daniel People's Republic of China: an introduction to the party and its socialist base.

This Version is available at:

<http://hdl.handle.net/11159/472>

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# People's Republic of China, An Introduction to the Party and Its Socialist Base:

## Is the Banking and Financial Industry a 'Natural Monopoly'?

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**Abstract** *The market ideology of the People's Republic of China (PRC) has undergone substantial reformation over the past three decades in regards to their engagement in international trade and investment. There is no doubt that China has embraced aspects of capitalism, however admitting this is a more difficult task for them. The inclination of Socialism with Chinese Characteristics has been apparent and the official economic and market position of the Communist Party of China (CPC) since its architect Deng Xiaoping instituted these reforms. Moreover, this market platform can be identified as Market Socialism with Chinese Characteristics or simply Market Socialism. According to the State Council, the banking and financial industry does not constitute a strategic and/or pillar industry, in which the CPC maintains an absolute or strong influence in. However, regardless of this determination, this paper argues that the CPC maintains a decisive and strategic role in the operations and practices of its financial champions. With respect to strategic trade theory, the idea that governments introduce mechanisms, which attempt to capture increased market share and profits for domestic enterprises. Traditionally, creating national champions through industrial policy has been a mode of augmenting the competitiveness of domestic enterprises engaged in commercial affairs. This approach can also be applied in creating national champions in the banking and financial industry, which can equally prove to be instrumental in aiding in the national economic agenda. This paper attempts to analyze certain aspects of the PRC banking structure to preliminary determine how inter-connected their operations are to China's Market Socialism.*

**Key words** State-owned Banks (SOBs), State-owned Enterprises (SOEs), Financial SOEs, Equitization, Market Socialism

**JEL Codes:** F50, P16

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### 1. Introduction

The market ideology of the People's Republic of China (PRC) has undergone substantial reformation over the past three decades in regards to their ideology and engagement in international trade and investment. Even as the Chinese began to undergo market reforms and a process of economic liberalization began to unfold in regards to foreign direct investment and advanced technique transfer, the foundation for economic and national growth would not change. It would establish a powerful and vast socialist base. There is no doubt that China has embraced aspects of capitalism. This even appears to be a strategic move portrayed in Deng Xiaoping's reform efforts, which allowed for a certain degree of economic liberalization. Ultimately Deng Xiaoping's reforms attempt to serve as a supplemental force in augmenting the growth and expansion of the socialist base (Xiaoping, 1984). Moreover, throughout the last two decades the CPC has further solidified the power and influence of their industrial base<sup>1</sup>. The influence and reach of the CPC is vast and one aspect of this is through its ability of controlling the career advancement of all senior Party personnel. The appointment process encompasses all financial state-owned enterprises (SOEs), all state-owned banks (SOBs), all SOEs, all regulatory agencies, and a majority of large non-SOEs. By controlling the career advancement of senior Party personnel, the CPC maintains great leverage on the facilitation and management of capital, the direction of production and output, and the fostering of Party personnel to adhere to the position and needs of the Party. The Party's role in appointing a majority of Party personnel is an important component of Building Socialism with Chinese Characteristics, in which the socialist base of the country remains the prime facilitator in directing overall national growth. This paper will identify and analyze certain aspects of the PRC banking structure to preliminary determine how inter-connected the structure and its financial institutions are to the Chinese socialist base.

### 2. The Executive Organ and Its Reach

The State Council under the National People's Congress of the People's Republic of China serves as the executive organ of the Communist Party of China. It is the overseer of the Chinese government machine, which implements Party policy throughout all levels of the country. The State Council serves as a paramount component of the command and control apparatus as interpreted in Deng Xiaoping's and the CPC's market platform of Market Socialism with Chinese

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<sup>1</sup> In 2006, the State Council identified seven strategic industries where the state will keep *absolute control*: (defense, electricity, petroleum, telecommunications, coal, aviation, and shipping), as well as pillar industries where the state will maintain *strong influence*: (machinery, electronics, information technology, automobiles, steel, nonferrous metals, chemicals, and construction).

Characteristics. Essentially, through a strong centralized executive power the public sector maintains a vital function in the direction and implementation of Party policy. The reach of the State Council is deep, ranging from drafting and managing the national economic plan of the country to more technical functions of providing governance and regulation of non-financial SOEs, Central State-owned enterprises (C-SOEs) and the banking and financial industry, including financial SOEs and SOBs<sup>2</sup>. Even though the banking and financial industry were not included in the 2006 directive of the State Council in being deemed a strategic and/or pillar industry, there are inclinations that the CPC maintains a firm grasp on the operations and practices of its financial champions.

In 2003, the CPC established the State-Owned Assets Supervision and Administration Commission (SASAC) of the State Council to direct reform and management efforts of China's SOEs. SASAC serves as the administrative body of all SOEs, excluding SOE banks (Leutert, 2016). In theory, SASACs primary responsibility is aimed at providing continued reform efforts of ailing SOEs. It also directs and supervises the management and operations of C-SOEs. However, SASACs role is often extended into the formation of local SASACs, which provide the same function(s) for local SOEs (L-SOEs). The principle responsibilities of SASAC include: (1) the appointment of executive and management officials for SOEs; (2) approving and authorizing any acquisitions and mergers of SOEs; (3) approving the listings of assets; and (4) drafting policy, rules, and regulations for C-SOEs. With the implementation of SASAC as the administrative body of C-SOEs and L-SOEs, through consolidation and equitization of these firms, this approach has led the CPC to claim that it is creating a "Modern Enterprise System" (Feng, 2016) with a fusion of public and private ownership. According to the National Bureau of Statistics a state-owned enterprise constitutes a non-corporate economic unit in which the entire assets are owned by the state<sup>3</sup>. The state in this case refers to the Party, more specifically SASAC of the State Council. While this definition is applied to enterprises that are wholly state-owned, China's adoption of certain capitalist characteristics and continually implementing consolidation and equitization of its SOEs has complicated this understanding. Building upon this, the importance of the State Council and SASAC play a crucial role in the institutional and regulatory framework of the Chinese economy.

### 3. The Chinese Banking Structure (Public Sector)

Parallel to SASACs guidance and management of SOEs, in 2003, the China Banking Regulatory Commission (CBRC) was established to direct and supervise the operations of the banking industry. Unlike SASAC, the CBRC does not retain any ownership over the banking institutions it directs and supervises. Rather that role has been given to the Ministry of Finance and a wholly-owned financial SOE – the Central Huijin Investment Ltd. In theory, banking institutions report to the CBRC, while the ownership structure is ensured through the Central Huijin Investment Ltd. and the Ministry of Finance.

Leading up to 2003, many financial SOEs had become insolvent and accumulated increasing non-performing loans (NPLs). In response, the State Council established the Central Huijin Investment Ltd., a financial SOE with the purpose of purchasing equity in financial SOEs, thereby injecting capital to help compensate for their accumulating NPL problems (Deng *et al.*, 2011). In 2007, the Central Huijin Investment Ltd. became a subsidiary of the China Investment Corporation (CIC), a Sovereign Wealth Fund under the guidance and supervision of the State Council. While the CIC does not possess governance nor ownership powers, these powers are laid out through Central Huijin's corporate charter, which specifies that its management and supervisory boards are to be appointed by the State Council (Pistor, 2010). Moreover, in practice the Organization Department of the CPC (CPC-OD) is the appointment body that approves and shifts executive and management officials throughout the CIC and Central Huijin. Technically, CIC is classified as a C-SOE under the administrative authority of SASAC, making the CICs investment portfolio a de facto extension of the CPC Committee.

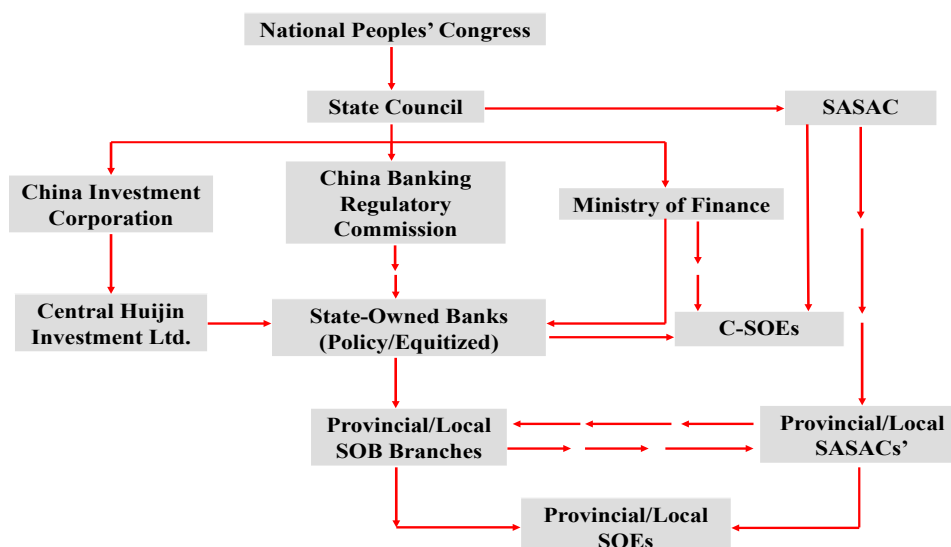
Within this regulatory framework, similar to SASACs directives of SOEs, the CBRC and the Ministry of Finance issue documents that direct the governance of SOBs. For instance, in 2009, the Ministry of Finance issued the "Interim Provisions on Performance Evaluation of State-Owned and State-Controlled Financial Enterprises" mandating the periodic evaluation of each SOE bank's profitability, asset appreciation, asset quality, and solvency for purposes of determining the salary, reappointment, and promotion of each top executive (Deng *et al.*, 2011). In the same instance as CIC and Central Huijin, SOB executives and management are appointed, re-appointed, re-assigned, and/or removed by the CPC-OD.

Moving on to specific banks within China's banking structure, there are multiple classifications of its banks and what their functions include. The People's Bank of China (PBOC) serves as the country's central bank and formulates monetary policy. The China Development Bank (CDB), the Export-Import Bank of China, and the Agricultural Development Bank of China (ADBC) are considered policy banks of the State Council. These banks are wholly state-owned and are used as tools for state intervention, as well as internal and external industrial policy objectives (Kyle and Szamosszegi, 2011). The Industrial and Commercial Bank of China (ICBC), the China Construction Bank (CCB), the Agricultural Bank of China

<sup>2</sup> How China is ruled. BBC News.com. 2010.

<sup>3</sup> China Statistical Yearbook (2014). General Survey, Explanatory Notes on Main Statistical Indicators.

(ABC), and the Bank of China (BOC) are considered state-owned commercial banks (SOCBs) and are commonly referred to as the “Big Four”. Traditionally, these banks have been controlled by the state; however have recently undergone a process of equitization, in which they have become listed on the Hong Kong and Shanghai stock exchanges. The intent of equitizing the SOCBs was to create increased policy space and incentives for the management of each bank to operate as a for-profit commercial bank attempting to minimize interference from the central government (Martin, 2012). Even though the Big Four have undergone equitization, state-ownership is ensured through the Ministry of Finance and the Central Huijin Investment Ltd. by obtaining blocks, enough equity to ensure CPC guidance in regards to its internal and external industrial policy goals. Moreover, as part of the CPCs directive to improve market forces throughout the Chinese economy, many banking institutions have undergone a process of substantial equitization and have become listed, thus establishing joint-stock commercial banks. Of these thirteen banks having undergone this process, eleven of the joint-stock commercial banks remain under state-ownership through a C-SOE, L-SOE, or a local/provincial government agency (Deng *et al.*, 2011). In 2011, the CBRC implemented a new policy regulation that provided increased incentives for commercial banks to lend on a “commercial basis”, specifically to small and medium-sized enterprises<sup>4</sup>. This is an example of a market reform effort aimed at reallocating credit away from SOEs and to diversify the operations of the Big Four and other smaller commercial banks. Following this is a chart illustrating the regulatory framework of the banking industry under the State Council. Additionally, it portrays an informal relationship between SOBs and local SASACs, which have been known to influence the lending decisions of SOBs (Kyle and Szamosszegi, 2011).



**Source:** USCC Report (2011); Deng *et al.* (2011).

Figure 1. Regulatory and Institutional Framework of China's Banking Structure

As identified previously, the CPC-OD is the appointment body of the CPC committee, in which it appoints, re-appoints, shifts, and removes management and party officials throughout different government agencies and institutions. Thus it is crucial for bank management to be responsive to the position and needs of the CPC, which values loyalty and obedience in advancing the policies of the state, as well as to the CBRC and the Ministry of Finance which value institutional performance.

China's banking structure has undergone episodic financial reformation since 1979, when the PBOC was divided up and the Big Four were created and began serving as the commercial arm of the banking industry. Leading up to 1998, even though reform efforts had been implemented, credit and capital allocation continued to occur on a non-commercial basis, resulting in both financial SOEs and the Big Four accumulating NPLs and running the risk of insolvency (Kyle and Szamosszegi, 2011). In response, the government provided relief through the purchasing of equity and injecting capital through state-owned asset management companies (AMCs). Hence, part of reasoning on the creation of the Central Huijin Investment Ltd. was to help consolidate and reverse the accumulating NPLs of certain financial SOEs and SOBs.

<sup>4</sup> "The Supplementary Circular on Supporting Commercial Banks to Further Improve Their Financial Services to Micro and Small-sized Enterprises" Banks Obtain More Incentives for Loan Offers to Small Businesses. *China Briefing*, 2011.

Presently, there are five main laws that govern the country's banking operations: (1) The Law of the PRC on Commercial Banks of 1995; (2) the 1995 Law on the PBOC; (3) the 2002 Foreign-Funded Financial Institutions Regulations (FFIs); (4) the 2002 Procedures for the Administration of Representative Offices of FFIs; and (5) the 1996 General Rules on Lending. According to the PRC Commercial Banking Law of 1995, the operations of commercial banks serve to maintain financial order and stability of the country, as well as adhere to the development of the socialist market economy. Article 4 of the Law states: *Commercial banks shall make their own decisions regarding their business operations, take responsibility for their own risks, assume sole responsibility for their profits and losses and exercise self-restriction. Commercial banks shall, pursuant to law, conduct business operations without interference from any unit or individual.*<sup>5</sup>

The language does not refer to a government entity, but there is to be an assumption that the operations of commercial banks are to be separate from any level of CPC intervention. However, in Article 34, the law paradoxically states that commercial banks are to adhere to the needs of national economic and social development and lending shall be in accordance to the industrial policies of the state<sup>6</sup>. This implies that in specific instances, commercial banks shall act as tools of state intervention, similar to that of the state's policy banks. This further crystalizes the existence of a powerful public sector base to mold long-term national economic growth.

Clearly, as outlined above, there is a well-established institutional and regulatory framework that directs and closely supervises the banking and financial operations of the country. This is important in correlating Market Socialism with the socialist base of the CPC, in which the public sector is vital for directing national development and economic growth.

#### 4. Capital Allocation as Strategic

The Party maintains a decisive presence in how the accumulation and allocation of capital is facilitated. Following this are two figures illustrating total financial assets of the country and the banking institutions that hold them for 2009 and 2014, respectively.

Total Financial Assets Yearend 2009	Assets: Trillion RMB	Percent Share
Policy Banks	6.95	8.63%
State-Owned Commercial Banks	39.04	48.47%
Joint Stock Commercial Banks with State as Largest Shareholder	12.59	15.63%
Postal Savings Bank	2.7	3.35%
Non-Bank Institutions	1.55	1.92%
Foreign Banks	1.35	1.68%
Others	16.36	20.31%
Total	80.54	100.00%
State-Owned or Controlled Banks	58.58	72.73%

**Source:** Deng *et al.* 2011; Reaffirmed from CBRC Annual Report 2009 and CSY 2009 Data

Figure 2. Assets Held by State-Controlled and Other Banks in China, 2009

Total Financial Assets Yearend 2014	Assets: Trillion RMB	Percent Share
Policy Banks	15.61	9.06%
State-Owned Commercial Banks	71.01	41.23%
Joint Stock Commercial Banks with State as Largest Shareholder	31.38	18.22%
Postal Savings Bank	7.10	4.12%
Non-Bank Institutions	5.01	2.91%
Foreign Banks	2.73	1.58%
Others	39.40	22.87%
Total	172.25	100.00%
State-Owned or Controlled Banks	118.01	68.51%

**Source:** Data compiled from CBRC Annual Report 2014 and CSY 2014 Data.

Figure 3. Assets Held by State-Controlled and Other Banks in China, 2014

<sup>5</sup> Article 4: General Provisions. Law of the People's Republic of China on Commercial Banks, 1995.

<sup>6</sup> Ibid, Article 34.

In both instances, a large majority of assets are held by state-owned or state-controlled banks. Particularly, the SOCBs appear to be the prominent players in providing financial intermediation, whether the credit is extended to public or private parties. In 2009, even though state-controlled banks held roughly 73% of all financial assets, it is important to note that in 2008, the State Council and the PBOC implemented a stimulus policy that mandated all banks to amplify lending to help (1) insulate the economy and (2) promote liquidity flow (Deng *et al.*, 2011). Basically, when the CPC imposes a mandate with respect to growth and liquidity injection, it is directed towards its financial SOEs and SOBs to lend and its non-financial SOEs to invest (Deng *et al.*, 2014). Essentially, through strict mandate, the Party reaffirms a strategic presence throughout its C-SOEs, its financial SOEs, and its SOBs.

Even though the banking and financial industry were not included in the State Council's 2006 directive of maintaining absolute control or a strong influence of its strategic and pillar industries, the CPC's presence is more than visible. One understanding of the CPC's presence results from a protracted process of equitization of China's large commercial banks. This can be observed in Figure 3, in which total assets percent share of SOCBs decreased from roughly 49% in 2009 to roughly 42% in 2014. This decrease in percent share of SOCBs results for a number of reasons. First, an increasing number of shares are being equitized and listed. Second, the 2011 CBRC policy incentive of re-allocating credit on a commercial basis. And, lastly, general market reform efforts aimed at consolidation and re-arrangement of SOEs and their assets. As for foreign banks, they represent an extremely small share of total assets and this share slightly decreased in 2014 making them a very minimal player in financial intermediation. This indicates that the capital account of China still remains closed, which reaffirms the Party's influence with respect to its financial champions. As of yearend 2014, the Party is firmly in control of the country's banking and financial sector.

## 5. Party Direction and Intervention

There are two specific instances in which the CPC directs its financial champions of providing preferential loans to selected enterprises. The first is that the selected enterprises are provided a disproportional share of credit and/or loans. Second, the selected enterprises receiving preferential treatment are ensured through interest rates below the market rate (Martin, 2012). Interest rate controls set in place by the state have played an important role in a disproportional distribution of credit. In 2011, Caxin, an independent online economic news agency in China reported that the Unirule Institute of Economics, an independent think tank in Beijing, conducted a study of SOEs and determined the average annual interest rate for SOEs was 1.6 percent compared to the annual interest rate for private companies of 5.4 percent (Wang, 2011). Additionally, there have been numerous allegations from U.S. industry that China provides preferential loan and credit subsidies to its SOEs, in which it petitions the United States Department of Commerce (DOC) to investigate and potentially conduct a countervailing duty (CVD) analysis. Since 2007, the DOC has received multiple CVD petitions in regards to preferential loan programs. However, the preliminary assessments of the DOC generally have stated that the petitioners provided insufficient evidence to continue investigation into the loan subsidy claims (Martin, 2012). Traditionally, SOCB lending patterns have favored C-SOEs and large non-financial SOEs. For banks and their management, it was widely thought that C-SOEs and large non-financial SOEs were "Too Big to Fail", in which it is more acceptable for NPL accumulation to occur in SOEs compared to large private corporations (Deng *et al.*, 2011). The preferential loans helped ease criticism of bank management partly because lending to SOEs was regarded to be alignment with the policy agenda of the state, specifically in promoting the growth and expansion of China's strategic and pillar industries. Even with NPLs decreasing and SOCB profitability increasing, market reforms have been partially responsible in aiding this process. However, it is equally important to note that specific state tools have also increased the efficiency and productivity of bank operations, including continuing practices of transferring bad assets to AMCs, loan growth, recapitalization, write-offs, and in large part to the strength of China's economy (Kyle and Szamosszegi, 2011). In an interview with the Congressional Research Service in 2010, Xiao Gang, who served as Chairman of the Board of the Bank of China, stated that lending practices of equitized banks have changed due both to a decrease of state intervention and market reforms aimed at improving bank management and ensuring that lending occurs on a commercial basis. Moreover, Xiao Gang denies Party intervention in the bank's operations: *"As a chairman of a bank, I have never received any instructions from the government to lend money to any project. All decisions relating to business were made either by the board, or by the management"* (Martin, 2012). This statement is important because the CPC-OD appoints all senior Party personnel throughout virtually all SOE Banks, fundamentally ensuring that Party policy is addressed and implemented. However, the irony in this statement is that Xiao Gang himself constitutes "senior Party personnel", thus resulting in the bank's operations to be in alignment with the agenda of the Party. Also, regardless of the equitization level of the Big Four, the Party maintains sufficient equity share through the Central Huijin Investment Ltd. and Ministry of Finance, resulting in its primary ownership structure as a de facto extension of the CPC Committee. The CPC and its agencies appear to be conflicted in regards to the operations of its financial champions and its non-financial SOEs. On the one hand, there is an attempt to maintain the primacy of the

established socialist base, in which the Party is unsure if Market Socialism remains the best road in facilitating economic development for the country. On the other hand, through a fusion model, which the CPC has identified as a “Modern Enterprise System with Chinese Characteristics”, in which relative degrees of equitization and market reform have served as the core tools utilized by the CPC to ensure an equilibrium of public and private ownership.

## 6. Conclusions

Regardless of whether the banking and financial industry is formally or informally included in the State Councils official list of strategic and/or pillar industries, it is clear that the CPC maintains a firm presence over the operations of its banking and financial champions. This paper introduces and identifies key parameters of the regulatory and institutional framework of the PRCs public sector banking and financial industry. More specifically, correlating this framework with the market platform of the CPC of Building Socialism with Chinese Characteristics, or more commonly identified as Market Socialism. With specific references of how the CPC and the State Council and its institutions maintain a decisive role in the policy-setting agenda in regards to key financial champions.

Nonetheless, China has embraced capitalist sentiments to a degree, which have been illustrated through multiple reform efforts taken by the Party. However, this model of supply-side economics and laissez-faire characteristics serves the fundamental purpose of supplementing the expansion of the socialist base, in which the CPC maintains a firm grasp on the commanding heights of the economy. More importantly, from the research gathered it appears that the Organization Department of the CPC is a vital component that holds together Party co-ordination and influence in regards to the public sector's position in serving as the foundational organ of economic development.

Ultimately, if growth is to persist, the Party must maintain a genuine meritocracy in a culture that esteems family ties, and *must* overcome Friedrich A. Hayek's (1944) argument that information flows less freely through command and control structures as they expand and become increasingly complex. Essentially, China's Market Socialism has delivered and it is clear that the socialist base of the country has been influential in aiding national economic development. Under the Party's guidance, China will continue to forge a venue of sustainable prosperity as long as the socialist base remains the prime facilitator of this process. While Hayek's critique of socialism remains unrefuted pertaining to information flow in command and control economies, his premise will continue to challenge the Party and how they handle control and consolidation efforts. In conclusion, further analysis is warranted. The ideas presented in this paper are complex and challenging. This paper lays a foundation in understanding the institutional framework of the CPCs involvement of the banking and financial industry, however, its application in providing empirical evidence is limited.

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