Transactions of the Institute of British Geographers
Royal Geographical Society with IBG
Advancing geography and geographical learning

Hybrid property, path dependence, market segmentation and financial exclusion: the case of the banking industry in China

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This paper investigates the role of the state in the liberalisation of the banking industry in China and the implications for the conventional convergence thesis of market segmentation and financial exclusion. I argue that the usefulness of the convergence thesis is constrained because it does not take region-specific institutional systems into consideration. This limitation is clearly illustrated by the experience of Chinese banking reforms. As China is still undergoing a series of institutional reforms to create a functioning market economy, the banking reforms implemented in China have created a 'hybrid property'. 'Hybrid property' refers to a mixed public–private ownership structure that has been adopted for previously wholly state-owned commercial banks (SOCBs). This transformation of the property structure blurs the conventional boundaries between public and private property, while the state still plays an important role in the regulation and operation of these banks. I further argue that financial geographers have to account for the institutional path dependency of non-market economies and the consequent state response to public–private initiatives of 'hybrid property' in transitional economies. The 'region-specific segmentation' policy implemented by the Chinese state is a response to these public–private initiatives of 'hybrid property'. Under this *de facto* rural–urban market segmentation policy, the state has to open up the banking industry to foreign banks in lucrative urban markets while maintaining much stronger control in rural areas to lower the level of financial exclusion. This intervention policy is inefficient but it is an acceptable compromise between the needs of corporate governance and private initiatives, and socio-economic and political stability in China. This is an indication of the institutional path dependency of the planned economy. Therefore, liberalisation in the Chinese banking industry and the resultant rural–urban market segmentation is spatially contingent on the public–private initiatives of 'hybrid property' in the transitional economy.

key words financial geographies hybrid property path dependence financial exclusion market segmentation banking industry

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revised manuscript received 22 August 2008

Introduction

The convergence thesis is influential in the literature of retail banking. Based on the experience of the Anglo-Saxon banking industry, the thesis argues that the competition-oriented regulatory regime drives industrial practices and organisational structures towards the so-called post-Fordist banking system

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Table I Abbreviations used in this article

ABC:	Agricultural Bank of China
BOC:	Bank of China
BOCOM:	Bank of Communications
CBRC:	China Banking Regulatory Commission
CCB:	China Construction Bank
CRA:	Community Reinvestment Act
EBACFB:	Editorial Board of Almanac of China's Finance and Banking
ICBC:	Industrial and Commercial Bank of China
IPOs:	initial public offerings
JSCBs:	joint stock commercial banks
NBS:	National Bureau of Statistics
NPLs:	non-performing loans
OECD:	Organisation for Economic Co-operation and Development
PBoC:	People's Bank of China
RCCs:	rural credit cooperatives
SAR:	Special Administrative Region
SOCBs:	state-owned commercial banks
SOEs:	state-owned enterprises
WTO:	World Trade Organization

in developed countries, hence the convergence of banking practices between countries. In the wake of financial deregulation, the consolidation (through mergers and acquisitions) of the industry has led to market concentration and profit-oriented cost-cutting largely through the marginalisation of bank branches in the provision of banking services and the centralisation of banking operations (Berger *et al*. 1999; Dymski 1999; Martin 1999). As a result of the rationalisation of branch networks and introduction of fees to bank customers for services, there is a shift from the provision of credit-related services to investment-oriented products and fee-generation activities in bank branches to justify their existence (Leyshon and Thrift 1993 1999; Leyshon *et al*. 1998; Leyshon and Pollard 2000). As banks focus their customer bases around high-income individuals while charging fees for low income individuals to use previously free services and close down branches in low income neighbourhoods, the banking market is determined largely by an individual's income (market segmentation) and poor households are excluded from basic banking services (financial exclusion). The extent of financial exclusion in deprived areas in the US, the UK and other developed countries has been well documented (e.g. Dymski and Veitch 1996; Ford and Rowlingson 1996; Pollard 1996; Leyshon and Thrift 1995 1996; Morrison and O'Brien 2001; Argent 2002; Midgley 2005). Whether the convergence thesis in the Anglo-Saxon banking industry is applicable to transitional economies where the state plays a more active role in industrial regulation is an interesting issue to investigate. As Pollard and Samers have argued, non-Anglo-Saxon banking and financial industry is not only 'an important empirical, theoretical and political phenomenon worthy of investigation', but also 'a site from which to reflect back upon the selective geographical imaginations that fuel Western (academic) economic geographies' (2007, 326).

China is an interesting case as its economy is moving toward capitalism after three decades of economic reforms and rapid economic growth while the state still plays an important role in the economy, especially in the banking and financial sectors. The retail banking industry in China exhibits features typical of a transitional economy, with some of the largest publicly listed banks in the world co-existing with hundreds of thousands of less-regulated rural cooperative institutions. The existing literature provides a comprehensive review of the banking reforms in China (such as Huang 2001; Sáez 2004; Cousin 2007) and/or assesses the potential impacts of the accession to the World Trade Organization (WTO) (e.g. Guo 2002; Bonin and Huang 2002; Chen and Shih 2004; Hope and Hu 2006). There is, however, limited discussion of the role and impact of state policy on market segmentation and financial exclusion.

This paper investigates the role of the state in the liberalisation of the banking industry in China over the last decade and its implications for the conventional convergence thesis of market segmentation and financial exclusion. I argue that the usefulness of the convergence thesis is constrained because it does not take *region-specific institutional systems* into consideration. This limitation is clearly illustrated by the experience of Chinese banking reforms. As China is still undergoing a series of institutional reforms to create a functioning market economy, the banking reforms implemented in China have created *'hybrid property'*. 'Hybrid property' refers to a mixed public–private ownership structure that has been adopted for previously wholly state-owned commercial banks (SOCBs). To reduce the financial burden of the state, the State Council allows a number of Chinese SOCBs and state-owned enterprises (SOEs) to issue initial public offerings (IPOs) of minority equities in local and/or overseas stock markets. This transformation of the property structure (from wholly

Trans Inst Br Geogr NS 34 177–194 2009
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publicly-owned to a mixture of public and private property) blurs the conventional boundaries between public and private property. There could be a conflict between public and private initiatives while the state still plays an important role in the regulation and operation of these enterprises. Therefore, I further argue that financial geographers have to account for the institutional path dependency of non-market economies and the consequent state response to public–private initiatives of 'hybrid property' in transitional economies.

To achieve the research objective, three rounds of field surveys were conducted in China between November 2004 and December 2006. Through personal networks, a total of 15 sessions of in-depth interviews were conducted by the author in China to examine the role of the state in the liberalisation of the Chinese retail banking industry. The role of the state in the banking industry, particularly the potential impact of branch rationalisation on financial exclusion in rural areas, was focused on during the interviews. The field survey included several interviews with an informed banker with extensive experience and extremely familiar with the operation of the 'Big Four', the four largest banks in China, namely: the Bank of China (BOC), the China Construction Bank (CCB), the Agricultural Bank of China (ABC) and the Industrial and Commercial Bank of China (ICBC). All the interviews were conducted in a semi-structured manner to facilitate conversational flow, and each interview lasted for at least an hour. The interviewees included senior bankers (either Presidents, Vice-Presidents, Branch Managers, Managers in the Credit Department, or Directors of the Credit Research Department) of major SOCBs (including two of the 'Big-Four' – the CBC and the BOC), four major joint stock commercial banks (JSCBs) and two major foreign banks in China. The evidence collected from the field surveys is complemented by secondary sources of data collected in the public domain, e.g. yearbooks and the annual reports of the regulatory authority, China Banking Regulatory Commission (CBRC) and banks, etc.

The literature on the convergence of the banking industry and the role of institutional rigidity in former planned economies will be reviewed briefly in the next section. The ownership reforms implemented in the Chinese banking industry, the scale-constraints experienced by foreign banks and the role of Asian banks will be discussed before analysing the influence of the state's banking policies on market segmentation and financial exclusion in China. The role of the state in the banking industry and its policies and theoretical implications will then be discussed before the conclusion.

Financial geographies in the East and West: convergence thesis vs 'hybrid property'

Without taking region-specific institutional systems into consideration, the convergence thesis is a reflection of the neo-liberal ideology of competition and freedom in the Anglo-Saxon banking industry rather than a framework to explain the impact of the consolidation of the banking industry on non-market economies. The necessary condition – a functioning market in an advanced capitalist economy – of the convergence thesis does *not* exist in the transitional economy of China, which is undergoing extensive institutional reforms, including the demarcation of property rights between publicly and privately owned enterprises. The convergence thesis is reviewed briefly to contextualise the usefulness of 'hybrid property'.

Convergence of the Anglo-Saxon banking industry

From the political economy perspective, the structural deregulation of a financial regime to a more open and prudential regulatory space led to the convergence of the Anglo-Saxon banking industry. Instead of limiting competition between domestic financial institutions in order to contain the financial instability that might lead to a wider systematic crisis in the economy, as in the 1930s (Helleiner 1993), banks are pushed by the new regulatory space (and their shareholders) to compete with one another to improve economic efficiency. The introduction of the Financial Services Act and the Building Societies Act in the UK in 1986 were examples of such regulatory rules. The former allowed the investment industry to operate as a self-regulatory body and the latter allowed building societies to diversify into new markets and participate in wholesale money markets with up to 25 per cent of their total deposits. These regulations broke down the institutional divisions in the retail financial market (between the conventional banks and building societies) and encouraged financial institutions to compete across market sectors (Marshall *et al.* 1992). The abolition of laws prohibiting inter-state banking

Trans Inst Br Geogr NS 34 177–194 2009
ISSN 0020-2754 © 2008 The Author.
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in the US intensified industrial consolidation through mergers and acquisitions as this is an effective way for large banks to capture a market share and create synergy (Berger *et al*. 1999; Dymski 1999; Martin 1999). As they can enter each other's geographical and product markets, banks are under tremendous competitive pressure to cut operating costs, normally through branch closures and labour downgrades (using part-time and temporary workers to replace full-time employees), etc. In other words, the governments and regulatory authorities in the US and UK share a similar neo-liberal ideology of competition and these play an important role in the deregulation of the Anglo-Saxon banking industry, and hence, the convergence of practices in the retail banking industry.[1]

Leyshon and Pollard (2000, 205) and Argent (2002, 316) suggest that there are four characteristics of the convergence thesis of the Anglo-Saxon banking industry. First, there is the centralisation of banking operations and the marginalisation of bank branches in the provision of banking services. This is illustrated by the widespread usage of automated telephone and electronic banking rather than face-to-face interaction in the provision, assessment and processing of what used to be counter and other banking services, e.g. credit, funds transfer, etc. (Pollard 1996; Leyshon *et al*. 1998; Leyshon and Thrift 1999). According to the estimates of the US financial sector, internet banking could be six to 100 times cheaper than the personal service provided at a physical branch (Willis *et al*. 2001, 1379).

Second, bank branches historically not only act as service points for conducting their clients' daily transactions, but also play an important role in the collection of market and credit information, and the retention of existing and the recruitment of new customers. As a result of the rationalisation of branch networks and the introduction of fees to bank customers for services, there has been a shift from the provision of credit-related services to investment-oriented products and fee-generation activities in bank branches to justify their existence (Leyshon and Thrift 1993 1999; Leyshon *et al*. 1998).

Third, market segmentation and financial exclusion are two specific features of the converged banking industry. The increasingly competitive environment in the banking industry has resulted in the 'flight to quality' (Gentle and Marshall 1992) and the subsequent segmentation of the market. That is, banks provide tailored services for their high-value customers and withdraw the full range of services to poorer customers, charge fees to maintain low balance accounts under the 'user pays' principle or even close branches in deprived neighbourhoods to cut costs and improve competitiveness (Dymski and Veitch 1996; Leyshon and Thrift 1995 1996; Fuller 1998).[2] Those without bank accounts are unable to access the wide range of services for which bank accounts provide gateways, and are thus financially excluded and have to settle their transactions in cash. Without credit records and access to direct debit, they may not be able to obtain credit from mainstream lenders and may also have to pay higher utility bills (Marshall 2004, 242–3). It is estimated that up to 9 per cent (3.5 million) of Britons have no bank account (and 14 per cent of households have no current account), and almost half of these are living in some of the most deprived areas in the UK (Kempson and Whylet 1999; Marshall 2004, 241).

Fourth, following the closure of bank branches to reduce operating costs is the restructuring of the established industrial 'paternalistic' labour relations to create greater workplace flexibility and competitiveness in the banking industry. There are no more 'jobs for life' and full-time employees may be replaced with part-time and temporary workers, etc. (Leyshon and Thrift 1993; Pollard 1995; Wills 1996).

The state plays an important role in the deregulation and thus subsequently the convergence of the Anglo-Saxon banking industry. Arguably, the state is playing an even more important role in the opening up of retail banking in China as the state is still the majority owner of all the largest banks in China. Thus, it is essential to have a brief review of the relevant debates on ownership reforms, one of the most important factors distinguishing the formerly planned economies from market economies.

Institutional rigidity in transitional economies

Scholars and policy analysts in formerly planned economies in Eastern Europe and China have debated the role and mix of plans and markets for decades (Stark and Nee 1989). Szelényi (1988) used the term 'socialist mixed economy' to describe the economic structure of a planned economy moving towards a market economy. The debate shifted from the combination of plan and market to the combination of public and private property in the mid-1980s. Instead of a 'socialist mixed economy' with well-defined public and private sectors, Stark (1989,

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167–8) argued that the institutional reforms implemented in these formerly planned economies resulted in 'hybrid mixtures of public ownership and private initiative' that crossed and blurred the conventional boundaries between public and private property. Based on his field surveys of 220 of the largest Hungarian enterprises and banks, Stark (1996) further argued that the blurring of conventional boundaries between public and private property suggests the emergence of a distinctively Eastern European capitalism in post-socialist Hungary. Stark (1996, 997) coined the term 'recombinant property' to explain a distinctive form of organisational hedging through diversification, redefinition and recombination of assets by actors. This form of organisational hedging resulted from actors responding to uncertainty created by the institutional reforms in Hungary.

Similar ideas were also expressed by scholarly research in China. For instance, Oi (1992) introduced the concept of 'local corporatism' to explain the fiscal reforms of taxation (especially the local retention of foreign exchange) that had allowed local governments to be involved in the establishment of township and village enterprises in China. Based on transaction costs and new institution economics, Nee (1992, 2) argued that the ownership reforms implemented in China resulted in 'hybrid organizational forms' (a mixed form of public and private property) rather than a simple mixed economy. When the structure of property rights is poorly defined in a transitional economy, actors can use their personal connections (*guanxi*) to lower the transaction costs of 'hybrid organisational forms' and be more responsive to market demands (see also Nee and Young 1990). Based on the property rights school, Walder (1994) argued that the property reform implemented in China was not equivalent to privatisation (transformation from public to private ownership). It is the clarification of property rights in Chinese fiscal reforms (which thus define the reward recipients) that has contributed to the rise of township and village enterprises in China.[3] Therefore, there could be a transformation of property without privatisation (from the fully publicly-owned to 'hybrid property') and economic efficiency could be improved in this way. This paper uses the term 'hybrid property', proposed by Nee (1992) and further conceptualised by Stark (1996), to explain the blurring of boundaries between public and private property rights in the Chinese banking industry.

'Hybrid property', state policies and scale-constraints

As with the market-oriented reforms in manufacturing sectors, there has been a massive restructuring of ownership in the Chinese banking industry during the last six decades. The change of ownership structure of banks reflects the changing role of the state in the economy and thus institutional stickiness in China. With the increasingly close economic relationship between China and other Asian countries, non-Anglo-Saxon banks are playing an important role in the Chinese market. This section provides a brief overview of the relevant issues to help contextualise 'hybrid property' in the Chinese banking industry.

Ownership reforms in the Chinese banking industry

After the establishment of the People's Republic of China in 1949, the central bank basically monopolised almost all the banking services in the Chinese banking system. This situation remained unchanged for almost three decades until the economic reforms were implemented in China in 1979. There was still no direct competition between the commercial banks due to the 'sector-specific segmentation' policy in China: industrial enterprises dealt with the CCB, peasants banked with the ABC, while trade or foreign-financed companies had to channel their foreign exchange through the BOC. This policy literally created three monopolies in the agricultural, industrial and trade sectors (Ma 2000, 59–61). This institutional setting was too rigid and unable to fulfil the needs of the economy.

The present Chinese banking industry, regulated by the People's Bank of China (PBoC, the central bank) and the CBRC, includes the SOCBs, JSCBs, rural credit institutions, foreign banks and the three policy banks (Figure 1).[4] The SOCBs include the 'Big Four' and the Bank of Communications (BOCOM). With the exception of ABC, SOCBs became by definition international holding financial institutions after their IPOs on the Stock Exchange of Hong Kong in 2005–06. For the sake of simplicity and because the state is still the majority equity holder in all SOCBs (ranging from 54.7 per cent in the BOCOM to 100 per cent in the ABC), this paper groups the 'Big Four' plus BOCOM as SOCBs following the classification system used by the CBRC. In 2006, the SOCBs controlled 55 per cent of the 43.95 trillion *yuan* (US$5.51 trillion) banking assets

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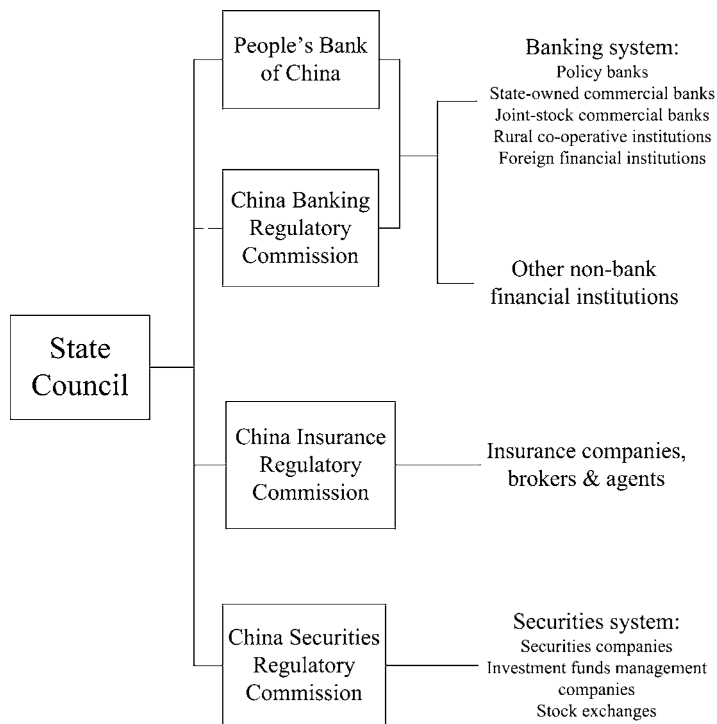

Figure 1 Structure of the financial system in China
Sources: CBRC (2007) and Hope and Hu (2006, 43)

in China (CBRC 2007, 133). With the exception of twelve JSCBs, both SOCBs and SOEs are ultimately owned by the central or local government. A number of other city commercial banks are partly owned by foreign investors but the local governments are the majority stakeholders. In 2007, 33 foreign investors had equity stakes in 24 Chinese banks (*Financial Times* 24 September 2007). Therefore, the boundaries between public and private property rights in the Chinese banking industry are blurred and thus have the strong characteristics of 'hybrid property'.

The Chinese government is under tremendous pressure to reform the banking system. On the one hand, the state is under internal economic pressure to improve governance and thus reduce the financial burden upon the Ministry of Finance.[5] On the other hand, the state had no choice but to open up the (urban) banking market to foreign banks as this is stipulated in the WTO accession treaty, signed in 2001. Foreign banks were allowed to provide local currency services to Chinese companies from 11 December 2003 and to individual customers from 11 December 2006. By 11 December 2006, foreign corporate and retail banks had full market access all over China, i.e. the same rights (national treatment) as Chinese banks within designated geographical areas, and all non-prudential market access constraints in the form of ownership, operation and juridical forms of foreign financial institutions were removed (Bonin and Huang 2002, 1079). In other words, foreign banks could expand their scale of operation (vertically in the form of ownership, including mergers and acquisitions, and horizontally, in the form of geographical reach) rapidly in China.

State policies and the scale-constraints of foreign banks

Under the CBRC's policy of ownership control, especially the principle of 'long-term holding and avoidance of excessive competition', the pace of opening up the banking sector was scheduled to allow the Chinese banks to develop competitiveness before the market was fully opened in late 2006. Foreign banks wishing to establish 'first mover' advantages in China before 2007 were encouraged

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to establish joint ventures with Chinese banks. Ownership by a single foreign investor was limited to 20 per cent, while the combined share of all foreign investors in one bank was limited to 25 per cent (before December 2006). In addition, CBRC does not normally allow any foreign bank to hold a significant share in more than two Chinese banks (CBRC 2007, 45). It was expected that Chinese banks would improve their competitiveness in terms of governance, risk management, the provision of sophisticated products through learning by doing and working alongside the established global giants. The Bank of America, UBS, Royal Bank of Scotland and Goldman Sachs injected capital into CCB, BOC and ICBC before their IPOs in 2005–06 and are examples of high-profile investment by foreign banks in China. SOCBs are under pressure from their foreign banks' stakeholders to maximise profits, and yet are still majority owned by the state. These are typical 'hybrid properties'.

After the promulgation of the *Regulations of the People's Republic of China on the Administration of Foreign-funded Banks* and the *Rules for Implementing the Regulations of the People's Republic of China on the Administration of Foreign-funded Banks* in December 2006, foreign banks were under other constraints to expand their operations in China. First, foreign banks must have had at least three years' operating experience in China and have been profitable for two consecutive years before being allowed to apply to offer full domestic currency services to Chinese individuals. Second, foreign banks have to establish an incorporate affiliate in China with a registered capital of one billion *yuan* (US$125 million) and operating capital of 100 million *yuan* (US$12.54 million) for each branch before being allowed to accept deposits in *Renminbi* below the value of one million *yuan* (US$125 000). Third, they have to comply with the loan–deposit ratio of 75 per cent by 2011. The newly implemented loan–deposit ratio of the CBRC restricts foreign banks' aggressive lending of *Renminbi* to Chinese firms, as none of them is able to accumulate a substantial amount of deposits in *Renminbi* within a short period of time (field survey December 2006). Foreign banks are able to borrow *Renminbi* through the inter-bank market in China, but the profit margin is much lower than sourcing funds through their own deposits. The CBRC so far has granted *Renminbi* business licences to 115 foreign banks. The total assets of foreign banks (*Renminbi* and foreign currencies together) amounted to 927.9 billion *yuan* (US$116.4 billion) in 2006, accounting for only 2.1 per cent of the total assets of the Chinese banking institutions (CBRC 2007, 44–5).

Furthermore, the pace of market penetration by foreign banks is restricted by the CBRC's regulations on opening branches. Organic growth is extremely time-consuming as foreign banks can only open branches one by one, incrementally. It takes a minimum of four months for foreign banks to navigate through the bureaucracy and respond to the logistics of opening a new branch in the same city: foreign banks can submit an application for a new branch in the same city only after the last branch approved has been formally opened for business (field survey December 2006). Acquisition appears to be the only cost-effective and feasible way for foreign banks to expand their market penetration in China, but all acquisition deals have to be approved by the CBRC.

State policies and Asian banks in China

All foreign banks in China are subject to regulation by the CBRC. Banks with headquarters in Hong Kong and Macau Special Administrative Regions (SARs) technically became 'Chinese banks' when the sovereignty of these two regions was returned to China in 1997 and 1999 respectively. But these banks are still regulated by the corresponding independent banking authorities and charters in Hong Kong and Macau SARs, which closely resemble international banking practices. The CBRC also regards these banks as 'foreign' in its statistical classification.

In 2006, Asian banks accounted for 56 per cent of the branches and representative offices established by foreign banks in China. Banks based in Hong Kong SAR alone accounted for half the branches operated by foreign banks in China (CBRC 2007, 43). This is to be expected, given the heavy investment of Hong Kong's SAR-based entrepreneurs in China since the implementation of the economic reforms in 1979.[6] It is interesting to note that banks based in Hong Kong SAR, such as the Bank of East Asia, have followed their clients' investment pattern by establishing branches in Beijing, Shanghai and Guangzhou rather than forming joint ventures with Chinese banks (Leung *et al*. 2003; see also Cheung *et al*. 2005; Leung and Young 2005). The purchase of 16 per cent of the Industrial Bank of Fujian for US$208 million by Hang Seng Bank (majority owned by the HSBC) is a rare exception. To create stakeholder value, Asian banks in China take similar profit-oriented initiatives to their Anglo-Saxon

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counterparts. This economic nexus became more important after the Chinese central government signed the Closer Economic Partnership Agreements with Hong Kong and Macau SARs in 2003 (Whalley 2006; Wang 2006), and the acquisition of the Asian operations of the Bank of America in Hong Kong SAR by the CCB in 2006 (CBRC 2007, 46).[7]

Compared with (family-owned) Asian banks, foreign banks with extensive businesses in Asia and institutional investors are more pro-active in their market penetration policies in China.[8] Typical players are HSBC, Standard Chartered and Temasek. HSBC and Standard Chartered are both official currency issuers in Hong Kong SAR and were actually early movers in establishing their representative offices in Beijing in 1980 and 1982 respectively. The purchase of 19.9 per cent of BOCOM at US$1.75 billion in 2004 by HSBC effectively transformed it as the first and only foreign bank to own the maximum equity allowed by the CBRC in a SOCB. In addition to nominating two members (one on the audit committee) on the Board of Directors and providing technical assistance for general banking operations, HSBC assisted BOCOM in setting up and co-managing a 50:50 joint venture credit card business. Temasek Holdings, an investment vehicle from Singapore, injected US$2.5 billion for 6 per cent equity in CCB and US$1.5 billion for a 4.8 per cent stake in BOC before their IPOs in 2005–06. Other lower profile investment includes the US$123 million (for 19.9 per cent equity) of capital injection by Standard Chartered into Bohai Bank, and another 15 per cent stake in the Evergrowing Bank (both are JSCBs).

Instead of simply deregulating the financial market and letting the banks compete with each other, the state justifies controlling the pace of the opening up of the banking industry to foreign investors in order to reduce the uncertainty associated with 'hybrid property' and meet domestic economic needs and financial stability.[9] Apparently, the operational scale of foreign banks is spatially contingent with financial liberalisation and hence the subsequent 'hybrid property' in the Chinese banking industry. What other state policies may have an impact on the banking industry?

'Region-specific segmentation' policy in the Chinese banking industry

With both internal and external pressure to improve efficiency and open up the banking industry, the Chinese state has redirected the segmentation policy of the banking system from 'sector-specific' to 'region-specific'. 'Region-specific segmentation' policy refers to the state's opening up of the banking industry to foreign banks in urban areas while maintaining much stronger state control in rural areas.[10] This is *de facto* a policy of rural–urban market segmentation.

Spatial contingency of 'hybrid property' in the transitional economy: rural–urban segmentation

The closure of bank branches is one of the most visible indications of market segmentation and financial exclusion. Experience in the US (Pollard 1996; Dymski and Veitch 1996), the UK (Leyshon and Thrift 1995 1996; Midgley 2005) and New Zealand (Morrison and O'Brien 2001) suggests that branch closures have both negative real and symbolic impacts on local society. For instance, reduced inflows of people into city centres where bank branches are normally located may lead to the closure of other complementary industries, e.g. local shops and restaurants. It is unfortunate that the data (such as urban and rural branch closures over the last decade) allowing a direct assessment of the extent of rural–urban market segmentation are not available from the CBRC, NBS or other relevant publications, including the *Almanac of China's Finance and Banking* (EBACFB). As about half of its outlets and employees are located in urban areas, ABC *per se* is not a good indicator of the development of rural banking. In addition to the competition strategies of foreign banks, a comparison of the development trends of rural credit cooperatives (RCCs) specifically established to serve rural communities, and SOCBs could at least provide some circumstantial evidence of the impact of 'region-specific segmentation' policies.

Due to the scale constraints and high sunk costs of providing good geographical coverage in rural areas, global banking giants understand that they cannot compete with Chinese banks in terms of geographical coverage. With extensive branch networks all over China, Chinese banks have a clear edge over foreign banks in being accessible to a huge client base of hundreds of millions of individual customers. For example, BOCOM, the smallest SOCB, has about 2600 outlets in China, while only 200 outlets were operated by 74 foreign banks in China at the end of December 2006 (CBRC 2007). In Shanghai, the most important financial centre in China, Citibank and the Standard Chartered Bank have only six and five outlets,

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Table II The major banks in China

	Number of units					Employees (in 1000 persons)				
	PBoC	SOCBs	Policy banks	JSCBs & others	RCCs	PBoC	SOCBs	Policy banks	JSCBs & others	RCCs
1995	2438	157 704	–	–	50 219	188	1735	–	–	634
1996	2448	155 779	1836	–	49 692	189	1743	40	–	649
1997	2440	156 492	2241	–	50 513	187	1728	52	–	650
1998	2290	111 371	2251	–	44 258	182	1715	51	–	645
1999	2551	105 669	2270	1634	41 755	179	1764	57	51	642
2000	2222	123 788	2272	1888	37 624	169	1648	62	58	646
2001	2228	112 055	2315	2093	37 270	167	1582	64	66	616
2002	–	–	–	–	33 020	–	–	–	–	628
2003	2199	90 634	2328	2641	33 984	160	1471	65	81	676
2004	2189	80 522	2328	3111	32 869	140	1451	65	89	652
2005	2167	74 712	2230	3344	27 101	139	1494	65	103	627

Notes: PBoC: People's Bank of China; SOCBs: state-owned commercial banks; JSCBs: joint stock commercial banks; RCCs: rural credit cooperatives
Sources: Compiled from NBS (various years) and EBACFB (various years)

respectively (field survey November 2004–December 2006). Although there is US$4 trillion in personal deposits sitting in the Chinese banking system, the average deposit is small (US$3470/person) and the majority of customers demand services at rock bottom prices, which means minimal profit margins for banks.

Foreign banks are strategically targeting the highly lucrative market of private banking business in China, which has an average profit rate ten times higher than that of the European and American retail business. According to the Boston Consulting Group report, the number of households with more than US$1 million in liquid assets in China increased from 124 000 in 2001 to 310 000 by the end of 2006. It is expected that this number will double by 2011 (*China Daily* 31 October 2007). Foreign banks realise that they are able to provide more sophisticated personal banking products than Chinese banks, even though publicly listed SOCBs are aggressive in their 'flight to quality'. According to a recent survey of 113 outlets of major SOCBs in Beijing conducted by the *People's Daily*, customers have to wait in hour-long queues at ICBC and CCB outlets, and basic complementary facilities are very limited. For example, only 7.1 per cent of these outlets have toilet facilities (*China Daily* 12 July 2007). Moreover, it could take Chinese banks several years to achieve the institutional restructuring required to separate the responsibilities of personal banking from those of corporate banking, as is the practice of foreign banks, requiring the retraining of front-line staff and the sharing of power between different managers (field survey November 2004–December 2006). Obviously, foreign banks are happy to conquer the lucrative urban market rather than explore the even larger but low profit-margin market in rural areas.

To compete with foreign banks, SOCBs are at the forefront of industrial consolidation in the Chinese banking sector through reducing the high fixed and operational costs embedded in the branch networks by closing branches and making staff redundant. More than half the original 157 704 branches have closed over the decade and the pace of branch closures has accelerated rapidly since 2001, when China joined the WTO (Table II). In 2005, there were 74 712 SOCBs branches (17 400 persons per branch) left.[11] Branch closure in China was at a much faster rate than the 20 per cent in Australia between 1981 and 1998 (Argent 2002, 319), and the 17 per cent of bank branches (plus another 5 per cent of building societies) that closed in the UK between 1994 and 1999 (Willis *et al*. 2001, 1374).[12] It is interesting to note that the number of employees at SOCBs was reduced by only 16 per cent, to 1.49 million between 1995 and 2005, but the scale of redundancy was still much faster than the 7.4 per cent (15 300 jobs) reduction in banking jobs between 1986 and 1996 in Australia (Argent 2002, 325), and the loss of 100 000 jobs in the UK banking industry between 1991 and 1994 (Leyshon and Pollard 2000, 206). By contrast with banks in developed countries, where redundancy is partly due to mergers, as in the case of Australia in the

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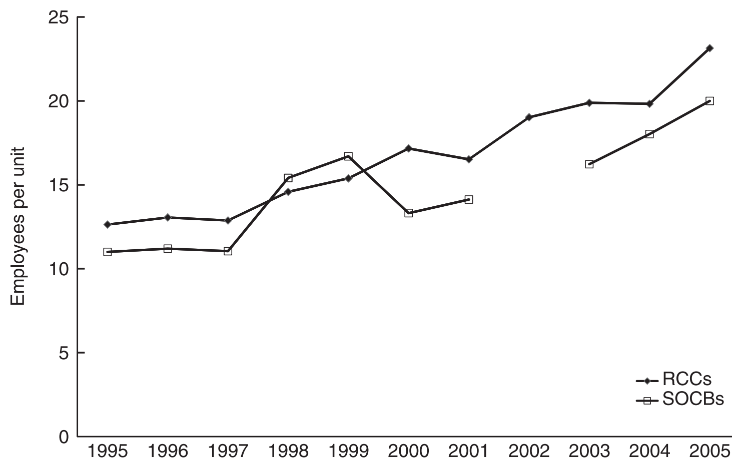

Figure 2 Employees per unit in Rural Credit Cooperatives (RCCs) and State-owned Commercial Banks (SOCBs) in China, 1995–2005

Sources: Compiled from EBACFB (various years) and NBS (various years)

1980s (Argent 2002, 326), or the Bank of America's takeover of Security Pacific in the US (Leyshon and Pollard 2000, 206), redundancy in the Chinese banking industry is largely due to the CBRC's response to the public and private initiatives of 'hybrid property'. On the one hand, SOCBs have to bear the social responsibility of being state-owned (a sign of institutional path dependency, see the next section) and hence may not have the same level of autonomy to implement massive retrenchment policies (hence the much lower reduction rate of the workforce). On the other hand, SOCBs have to carry out their private initiatives before their IPOs: a smaller workforce results in higher profitability and thus the bank's balance sheet is more attractive to institutional investors and investment banks who may sponsor the IPO. For instance, ICBC trimmed its army of employees by more than 200 000, from 569 983 in 1995 to 351 448 just before its IPO in 2006 (NBS various years).

RCCs experienced massive restructuring during the last decade, largely to legalise numerous institutions which used to be operated on an *ad hoc* basis and which transferred their overall management to provincial governments in 2006. In terms of branch closures, the pace of the restructuring of RCCs was slightly less severe than that of the SOCBs, e.g. its outlets decreased by 46 per cent from 50 219 in 1995, to 27 101 in 2005 (Table II). Perhaps the most interesting evidence was that the number of employees at RCCs remained more or less the same during the decade at around 630 000. The average number of employees per outlet increased from about 12 persons per outlet in 1995 to over 23 persons per outlet in 2005, rising faster than the SOCBs (at about 20 employees per outlet in 2005) (Figure 2). This suggests that a number of previously unregistered RCCs closed down or merged during the transfer of management rights to their respective provincial governments, while the level of geographical coverage of rural banking may not have decreased after the restructuring (see below).

In contrast to the segmentation of the market based on individual incomes in the Anglo-Saxon banking industry, largely a result of competitive pressure from the market economy and the response to industrial deregulation by the state, rural–urban market segmentation in the Chinese retail banking industry is spatially contingent upon the public–private initiatives of 'hybrid property' in the transitional economy.

Spatial contingency of 'hybrid property' in the transitional economy: 'financial exclusion with Chinese characteristics'

Blanket financial exclusion in the Chinese banking industry may not materialise due to the 'region-specific' segmentation policy implemented by the state. That is, the listed SOCBs, efficiency-oriented national champions, target middle-class customers,

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while ABC and rural credit institutions are inclusion-oriented, targeting low to middle income customers in rural and remote areas and so lower the level of financial exclusion. The resulting rural–urban market segmentation without the blanket financial exclusion of poor households in rural areas could be termed 'financial exclusion with Chinese characteristics'. This phenomenon can be analysed from three perspectives.

First, the widespread use of *cash* by the Chinese general public lowers the degree of financial exclusion due to various banking charges. According to the PBoC, 80 per cent of retail transactions for social commodities in 2006 were still conducted in cash, mainly due to the unacceptability of personal cheques and credit cards (as well as their low credit limits) in China. This is the case even though Chinese citizens possess the largest number of bank cards in the world. Chinese banks have issued more than 1.1 billion debit cards and some 50 million credit cards. By comparison, only 20 per cent of retail transactions are completed on a cash basis in the US. Moreover, many employees' salaries in China are still paid in cash rather than by company cheque or direct credit through the banks (*China Daily* 26 June and 12 July 2007, see also Bonin and Huang 2002, 1086–7). To alleviate the degree of financial exclusion of poor households, the 'Big Four', the State Postal Savings and Remittance Bureau waived various banking charges for households receiving subsistence allowances from the Ministry of Civil Affairs in 2007. Under this new policy, 22.33 million recipients of subsistence allowances in cities and another 13 million in the countryside are no longer charged for opening bank accounts, receiving financial advice, managing low balances in their accounts, etc. (*China Daily* 19 January 2007). Thus, the impact of banking charges in China upon the poorer households is not as severe as in other developed countries.

Second, the massive consolidation of branch networks among SOCBs *per se* does not represent blanket financial exclusion, partly due to the extensive geographical coverage of the branch networks. China's banking sector comprises a total of 19 797 banking institutions, with almost 184 000 outlets (over 50 outlets in every county on average) and over 2.7 million staff (CBRC 2007, 30). ABC plays an important role in the accessibility of banking services to the general public as it is the only SOCB with service outlets and electronic banking networks reaching every county in China. In fact, 60 per cent of the bank's outlets and about half its employees are located in rural areas (*China Daily* 26 September 2007). The President of ABC publicly announced 'we are dedicated to becoming the leading service provider and the backbone [of] the financial services sector in the rural areas of China' (ABC 2007, 7).

Third, the state has recently restricted the *scale* of financial liberalisation by implementing two major policies for the opening of bank branches in rural areas. In December 2006, the CBRC promulgated *Guidelines on Adjusting the Market-entry Threshold for Banking Institutions in Rural Areas* (CBRC 2006). Under these guidelines, the entry criteria for banks to establish new branches, subsidiaries or affiliates in rural areas underserved by banks are lower to ensure banking services cover the whole of China. Any local or foreign bank that wants to open branches at city level in these underserved areas is required by the CBRC to open at least one other branch at county level. To expand the coverage of rural lending and facilitate credit provision to farmers, the CBRC implemented other policy guidelines in 2006 to encourage retail lending to farmers, cross-guarantee lending between rural households, expand lending terms, raise credit lines and syndicated loans, etc. (CBRC 2006 2007, 52–3).

To reduce the financial exclusion of poor and remote areas, the state has intervened in the banking industry directly by restructuring the RCCs and establishing the China Postal Savings Bank. With a deposit base of 1.7 trillion *yuan* (US$213.3 billion) and over 36 000 (postal network) outlets throughout the country – more than two thirds of which are located in rural areas – the China Postal Savings Bank has the largest inter-city/rural financial network in China. By the end of 2006, total rural lending by rural cooperative institutions, the ABC and the Agricultural Development Bank of China had reached 4.5 trillion *yuan* (US$564.5 billion), an increase of 65 per cent from the end of 2003. Rural lending accounted for about 19 per cent of total banking sector lending. Specifically, rural cooperative institutions' lending exceeded 1.2 trillion *yuan* (US$150.5 billion), of which 1 trillion *yuan* (US$125.44 billion) was lent to 70 million rural households, which in turn accounted for 31.2 per cent of the total number of rural households in China (field survey December 2004; CBRC 2007, 32, 40–1, 53).

From the above, this paper argues that rural–urban market segmentation may not result in the blanket

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financial exclusion of poor households in rural areas due to the state's intervention in the transitional economy. What are the possible reasons for the Chinese state to intervene in the banking industry?

'Hybrid property' and institutional path dependence

Despite the tremendous competitive pressure from foreign banks during the post-WTO accession era, I argue that the consolidation of the retail banking industry in China is largely a result of *a political compromise between efficiency-driven and socio-economic and political stability-driven agendas*. In other words, the banking reforms implemented by the CBRC are the state's response to the public–private initiatives of 'hybrid property' – a compromise between the needs of corporate governance and private initiatives, and the need for socio-economic and political stability in China.

On the one hand, the state is well aware of the need to improve the competitiveness and governance of the banking sector while opening up the market to foreign banks as part of the WTO accession treaty. As an emerging market in a transitional economy, the consolidation of the Chinese banking industry takes a different approach to its Western counterparts. In contrast to other developed countries where the state largely plays a regulatory role and the consolidation of the banking industry is largely efficiency-driven (i.e. profit-oriented), the Chinese state still maintains tight control over the 'hybrid property' in the post-WTO accession era. Whilst the efficiency-oriented SOCBs target higher value-added customers in cities, ABC, RCCs and the China Postal Savings Bank are inclusion-oriented candidates selected by the state to ensure geographical coverage by branch networks and the dispensing of credit for agricultural purposes in rural areas (to minimise financial exclusion and the subsequent rise in inequality and even possibly accelerated rural–urban divide). In these circumstances, the market behaviour of ABC is like that of mutual building societies in the UK, which have strong local affinities and hence are reluctant to rationalise branch networks by closing branches in relatively remote areas with a small customer base (Marshall *et al.* 2000; Willis *et al.* 2001, 1380), and credit unions and regional banks in other developed countries (French 2001; Fuller and Jonas 2002).[13]

On the other hand, the regulatory authority has to implement policies that maintain the legitimacy of the Chinese Communist Party's leadership and political stability in its quest for a 'harmonious socialist society'.[14] This is especially the case given the increasingly frequent mass demonstrations about inequality and other major concerns (up to 74 000 incidents in 2004; Shirk 2007, 57), e.g. corruption (field survey December 2004–December 2006). China's leaders have

> a deep sense of *domestic insecurity*. . . . The worst nightmare of China's leaders is a national protest movement of discontented groups – unemployed workers, hard-pressed farmers, and students – united against the regime by the shared fervor of nationalism. . . . The two previous dynasties fell to nationalist revolutionary movements. (Shirk 2007, 6–7; italics added)

The opening up of the Chinese banking sector could be interpreted as the rolling-back of the state's provision of banking services to the general public and even giving up parts of the Chinese market to foreign banks. The state is surely concerned about the rising rural–urban divide (including financial exclusion in rural areas) and the subsequent implications for socio-economic and political stability, as well as suffering from institutional inertia to change in the banking industry. As policy makers are fixated on socio-economic and political stability (or 'social stability' – *shehui wending* – in the official documents), domestic security takes higher priority, thus resulting in the state intervention in the banking industry. Given the fact that the rural peasantry still accounts for more than 57 per cent of the total population and is where the political power base of the Chinese Communist Party lies, it is a logical (or calculated) political decision to minimise the extent of financial exclusion in rural areas. This could be an issue that requires further research.

I nonetheless argue that the inclusion-oriented policies implemented by the CBRC may not generate the level of investment in local (rural) communities necessary to negate the extent of financial exclusion linked to the efficiency-oriented national champions policy in the long term. Based on the experience of the Community Reinvestment Act (CRA) in the US and New Labour's Third Way in the UK,[15] state intervention may not be effective if the wider interconnections between local communities and the areas that underlie financial exclusion are not fully addressed. In other words, the policy to reduce the extent of financial exclusion of poor households in rural areas could be effective in the short term but may not be sustainable in the long term without

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continuous intervention (including the injection of capital) from the state.

The experience of consolidation in the Chinese banking industry also illustrates the potential influence of the institutional path dependency of the planned economy, where SOCBs were used to support SOEs and other government development policies, i.e. they performed the functions of a development rather than a commercial bank. SOCBs were de-merged from the PBoC and only established as commercial financial institutes in the early 1980s. Due to the blurring of boundaries between the public and private ownership of 'hybrid property', especially the private initiatives to maintain low non-performing loans (NPLs), SOCBs were unable to 'lock-in' as did the state-owned development banks in their banking policies, but they may not have had the same level of autonomy as other profit-oriented privately-owned commercial banking institutes. The inertia to change in SOCBs is well illustrated by the comment of a very experienced sub-branch president in one of the 'Big Four':

> After all, we are a SOCB and we have to *follow* the major policies implemented by the central government. As long as we think that we can do a deal, we will do so. . . . We may not earn any profit from the loan itself but we may be able to gain some profit by providing other banking services to the client. (field survey November 2004)

A similar comment was made by the deputy manager of a major JSCB: 'the management of [our bank] is closer to SOCBs than a shareholding bank' (field survey December 2006). This mentality among senior management is different from the conventional Western banking business model, which regards this attitude as non-commercial. The emphasis on blanket geographical branch coverage is also regarded by the conventional banking model as a financial burden due to the high sunk and operating costs with substantial overheads (e.g. too many small bank branches without scale economies, etc.), and results in an inefficient (sub-Pareto) allocation of resources in the Chinese banking industry. This inefficiency is revealed indirectly by the higher NPLs as a percentage of total credit in rural commercial banks (5.9 per cent) than the city commercial banks (4.8 per cent), and JSCBs (2.8 per cent) in 2006 (CBRC 2007, 139). This explains the rationale of the conventional critiques of the Chinese banking sector: banking reforms in China cannot be efficient until the government liberalises and privatises the banking sector fully, as argued by Bonin and Huang (2002, 1092–3), Steinfeld (2005, 51) and Cousin (2007, 52). The inefficiency of the Chinese banking industry is surely unsustainable in the long term; nonetheless, this sub-Pareto efficiency could be 'tolerated' by the state given the importance of political stability for the country. The state's intervention in the banking industry, especially the recent restriction on the scale of financial liberalisation in the rural banking market, could be interpreted as the institutional path dependency of the planned economy. This paper thus argues that mainstream criticism of the Chinese banking reforms based on conventional Anglo-Saxon banking indicators of efficiency and NPLs has not taken the public–private initiatives of 'hybrid property' and the political economy of banking reforms in China into consideration.

Conclusions

It is undeniable that financial geographies have benefited tremendously from the convergence thesis literature. In addition to the positive effects of financial liberalisation in the form of improved efficiency and the creation of stakeholder value, we are reminded of the potential negative impacts of massive consolidation of the banking industry in the form of market segmentation and financial exclusion. This is clearly demonstrated by the works of Pollard (1996), Berger *et al*. (1999), Leyshon and Thrift (1995 1996), Leyshon and Pollard (2000), Willis *et al*. (2001), Argent (2002), Fuller and Jonas (2002), etc. However, financial geographies may rely excessively on the conventional convergence thesis, which is based on the experience of financial liberalisation in developed countries, and thus probably underestimate the importance of region-specific institutional systems and their potential impacts on the banking industry. This is especially the case for transitional economies that are undergoing a series of institutional reforms. I therefore argue that financial geographers have to account for the institutional path dependency of non-market economies and the consequent state response to the public–private initiatives of 'hybrid property' in transitional economies. China is one such example.

As China is still undergoing a series of institutional reforms towards the goal of a functional market economy, the banking reforms implemented in China have created a distinctively 'hybrid property', while

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the state still plays an important role in the regulation and operation of the banking industry. Under both internal and external pressure to improve efficiency and the accession to the WTO, the Chinese state has no choice but to open up the banking sector to foreign banks. Instead of simply deregulating the financial market and letting the banks compete with each other, the state controls the pace of the opening up of the banking industry to foreign investors in order to maintain a certain level of control over this 'hybrid property'. Under the state-imposed constraint of ownership ceilings and other regulations on branch opening, the operational scale of foreign banks is spatially contingent on financial liberalisation and hence the subsequent development of 'hybrid property' in the Chinese banking industry.

As part of the opening up of the banking sector to foreign investors, the Chinese state has implemented a 'region-specific segmentation' policy. The state opened up the banking industry to foreign banks in urban areas while maintaining much stronger state control in rural areas to mitigate the inequalities produced by the market economy and thus lower the level of financial exclusion. This has effectively contributed to the rural–urban segmentation of the market in the Chinese retail banking industry.

China is a transitional economy where the state still maintains considerable influence over certain strategic sectors vital to the socio-economic and political stability of the country. The banking sector is one such sector and this is exactly why it was only opened up to foreign banks at the end of 2006, according to the requirements of the WTO accession treaty. The political agenda of maintaining the socio-economic and political stability internally could force the state to hold out against the tremendous external pressure from foreign banks to accelerate the pace of the opening up of the sector in the post-WTO accession era. The banking reform implemented by the CBRC is a compromise between the needs of corporate governance and private initiatives that are efficiency-driven and aimed at reducing rent-seeking opportunities in SOCBs and the financial burden of the state, and the need for socio-economic and political stability in China to maintain the legitimacy of the regime. This 'second best' policy option may result in an inefficient allocation of resources in the Chinese banking industry by conventional Western banking standards. Nonetheless, this is a compromise that may have been necessary during the period of rapid economic and social transformation experienced in the country, where the institutional path dependency of the planned economy could still have a real impact on the economy. As SOCBs still performed the functions of development banks by supporting the SOEs and other development projects rather than those of commercial banks as recently as two decades ago, the mainstream criticisms of the Chinese banking reforms have not taken the political economy of the banking reforms – the need to maintain socio-economic and political stability at all costs – in China into consideration. Therefore, liberalisation in the Chinese banking industry and the resulting rural–urban market segmentation is spatially contingent on the public–private initiatives of 'hybrid property' in the transitional economy.

This paper shows that the banking reforms in China are not only an important empirical example to highlight the potential limitations of the conventional convergence thesis, but also argue for the need to develop and theorise the financial geographies (and indeed economic geography in general, see Yeung and Lin 2003; Pollard and Samers 2007) to account for the different institutional systems in Asia. In the case of the Chinese banking industry, 'hybrid property' does matter. Given the enormous change in the economic landscape in Asia, in particular the rapid economic transformation in China and India, it is important for economic geographers to develop a set of analytical tools capable of analysing the economic phenomena embedded in region-specific institutional systems.

Acknowledgements

The author would like to express his gratitude to a number of anonymous bankers and individuals who facilitated and participated in the survey. The British Academy's Sino-British Research Fellowship and Hong Kong Polytechnic University financed the author's field surveys between 2004 and 2006. He is particularly grateful to Prof. Xiaoping Xu at the Shanghai University of Finance and Economics and Dr Vincent Mok at the Hong Kong Polytechnic University for helpful assistance in the field survey, and the members of the Political Economies of Regional Transformations in Asia research group at the NUS, particularly Prof. Henry Yeung, for their invaluable comments on the earlier version of this paper. He also benefited greatly from the inspiring comments and suggestions

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made by the *TIBG*'s editor and three anonymous referees.

Notes

1 Leyshon and Pollard (2000, 209) argued that the top-down political economy analytical approach is a partial explanation of the convergence in the banking industry. They argued that the place and space should be taken into full consideration in the analysis of the reorganisation of retail financial services.

2 Fuller and Jonas (2002, 86) argued that the dualist approach based around formality (formal vs informal), regulatory aspects (regulated vs unregulated), visibility (high-street-based vs network-based), dominance (mainstream vs non-mainstream) and orientation (profit-oriented vs community-oriented) is a simplification of the reality of the banking industry.

3 In cases of extremely complex cross-holding equities, Sabel (1990) deviates from the property rights school by arguing that ambiguity rather than clearly defined property rights allows actors to adapt to dynamic market demands.

4 The PBoC 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. The CBRC formulates the rules and regulations governing the banking institutions, and supervises all banking institutions and their business activities in China. The JSCBs includes CITIC Industrial Bank, Everbright Bank of China, Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Banking Co. (the first JSCB in China, established in 1996), Evergrowing Bank, China Zheshang Bank and China Bohai Bank. Rural cooperative institutions include all legitimate financial institutions based in rural China: rural credit cooperatives, rural cooperative banks and rural commercial banks. The three policy banks are China Development Bank, The Export-Import Bank of China and Agricultural Development Bank of China.

5 Between 1998 and 2003, SOCBs began to restructure their loan portfolios by adopting the strategy of commercial lending. In addition to an injection of 270 billion *yuan* (US$32.61 billion) into the banking system in 1998, the central government transferred 1.4 trillion *yuan* (US$169.1 billion) of pre-1996 non-performing loans (NPLs) to the four newly created Asset Management Corporations, i.e. SOCBs became responsible for the NPLs made after 1996. The international five-tier risk-based classification system (*Guiding Principles on the Classification of Loan Risk Management* issued by the CBRC) which ranks loans from 'pass' to 'loss' was piloted in 1998 and formally implemented in 2004 to improve the internal assessment and monitoring capabilities of SOCBs (CBRC 2007, 72–3; OECD 2005, 42, 145; field survey November 2004–December 2006).

6 This point was kindly pointed out by an anonymous reviewer. For the causes and effects of Hong Kong SAR-based investment in China, see Thoburn *et al.* (1990), Leung (1993) and Yeung (2001).

7 Closer Economic Partnership Agreements (CEPAs) are the first free trade agreements in goods and services concluded by mainland China, Hong Kong and Macau SARs.

8 Some literature reported that foreign banks aggressively entering domestic markets through acquisition could result in a reduction of the market share of domestic banks (Seth *et al*. 1998).

9 To maintain the economic stability, the CBRC stipulates that the opening up of the Chinese banking industry has to follow four fundamental principles: (i) to meet the ongoing *needs of domestic economic development*; (ii) to improve the overall *competitiveness* of the Chinese banking sector; (iii) to honour the commitments to the WTO, and create an environment for fair competition between Chinese and foreign banks; and (iv) to maintain China's *financial stability* (CBRC 2007, 42, italics added).

10 The official administrative boundaries are used to demarcate urban and rural areas.

11 It is interesting to note that there has been a rapid increase in JSCBs since 1999. Partly as a result of capital injection from strategic investors, including major foreign fund managers and banks such as Temasek's US$100 million investment in China Minsheng Bank, JSCB branch networks and employees more than doubled to 3344 and 103 000 respectively in 2005.

12 However, one should not assume the closure of bank branches in deprived neighbourhoods and peripheral areas automatically leads to financial exclusion as the geographical proximity of bank branches is no longer a necessary condition for accessing banking services (Cairncross 1997; O'Brien 1992, 1), e.g. customers are still able to access banking services remotely via automated and electronic banking, etc. Based on the UK experience, financial exclusion is also an emotional issue. It is suggested that 70 per cent of small- and medium-sized enterprise owners in the UK visit a bank branch every week, and internet banking is not regarded as an ideal substitution for counter services (French 2001). It is the loss of the relationship through personal contact (and the feeling of being abandoned by the state) that matters in financial exclusion, i.e. geography still matters in the provision of financial services (Kempson and Jones 2000; Chakravarty 2006, 420).

13 Mutual building societies and community credit unions are financial cooperatives owned and operated by their members, usually local, and aim to serve local

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communities by providing low-cost loans, i.e. as a 'poor person's bank'. Arguably, these financial institutions have different agendas from conventional commercial banks as they have much closer affiliations with local communities and have no external institutional shareholders to answer to. Most of the biggest mutual building societies in the UK, such as the Halifax, are demutualised and operate like conventional commercial banks (Marshall 2004, 248).

14 The 'harmonious socialist society' was proposed by President Hu Jintao in 2006. It aims to build a harmonious society in China by 2020, e.g. to reduce interpersonal and inter-regional inequalities in terms of wealth and maintain the balance between resource exploitation and the sustainability of the environment, etc.

15 The CRA requires banks planning to close branches to provide evidence to the Federal Reserve or US courts that branch closures will not affect the banking needs of the community. There are no such laws in the UK and this is why Marshall (2004) argued that the effectiveness of New Labour's policy of financial exclusion demands the cooperation of financial institutions. As the financial sector is highly integrated into the economy, the CRA *per se* is no panacea for financial exclusion (Marshall 2004, 254). The recent sub-prime crisis in the US could be a major setback for the financial inclusion policy.

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