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The Impact of Inflation on Commercial Banks in China

Yao Cai[1,a,*]

[1]Durham University, Durham, DH1 3LE, the UK
a. caiyao680@gmail.com
**corresponding author*

Abstract: Inflation is an important issue that affects the profitability and operational stability of commercial banks. Conducting an in-depth analysis of these influences while putting forward effective countermeasures can be beneficial to ensuring the stable operation of commercial banks. This paper focuses on the period from 1937 to 1949 where the Second Sino-Japanese War and the Chinese Civil War, which had contributed to severe inflation and disrupted the banking sector, and the formation of the modern Chinese banking system. This study critically examines the main causes behind inflation, evaluates their implications on the functioning of commercial banks. It also assesses both the positive and negative impacts on commercial banks, pointing out the challenges commercial banks face during different periods. For example, the market turmoil and policy changes in the 1940s have made it difficult for commercial banks to retain normal operation; therefore are suffering from making profits and inflation has made the situation even worse. In addition, this paper provides short-run and long-run strategies for reducing the negative effects of inflation, with consideration of China's unique economic structure and historical context. By integrating insights from historical and contemporary perspectives, this analysis aims to offer valuable views on the micro and macro impacts inflation could bring.

Keywords: Inflation, Inflation Influences, Commercial Banks, Financial Instability.

1. Introduction

Inflation is the rate of increase in price level, usually measured by the consumer price index (CPI). Rising inflation typically leads to higher interest rates, which may compress net interest margins and reduce lending profitability. This environment increases the cost of borrowing for consumers and businesses, potentially leading to higher default rates and elevated credit risk. Furthermore, inflation can erode the real value of banks' assets and capital, complicating balance sheet management. Operational costs, including wages and technological investments, also tend to rise, squeezing bank margins further. Given China's unique economic structure and regulatory environment, commercial banks must adopt different strategies and enhance their inflation forecasting capabilities to mitigate these risks. During the period from 1937 to 1949, China experienced severe inflation driven by the Second Sino-Japanese War and the Chinese Civil War. The wars disrupted the economy, leading to government decisions of extensive money printing, which impacted the banking sector significantly. Commercial banks lost control over money supply due to government's concentration of the power to issue banknotes, which further exacerbated the economic instability and inflationary pressures. In modern China, the causes of inflation are more complex and multifaceted. Due to economic reforms

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and the transition towards a market-oriented economy that have introduced new dynamics, public inflation expectations, price reforms, structural changes, and policy implementation have emerged as significant factors. The long-standing fixed price system, heavy state subsidies, and excess demand from businesses, consumers, and government spending contribute to inflationary pressures.

This paper critically examines the main causes behind inflation, evaluates their implications on the functioning of commercial banks, and also assesses both the positive and negative impacts on commercial banks, points out the challenges commercial banks face during different periods, so as to offer some valuable views on the micro and macro impacts inflation could bring.

2. Close Analysis

2.1. Causes of Inflation in Different Periods

The period from 1937 to 1949 in China has experienced profound turbulence and transformation, as it was heavily influenced by the Second Sino-Japanese War (1937-1945) and the Chinese Civil War (1946-1949). This era was influenced by extreme inflation, which had significant impacts on the banking sector. After the implementation of the legal currency policy in November 1935, the power to issue banknotes was concentrated in the four national banks of the central government from 1937 to 1949. Since then, the first way commercial banks create credit, the right to issue money, has been deprived [1]. Without the right to issue currency, commercial banks gradually lost their control over the money supply within the economy, reducing their ability to quickly respond to changes in economic conditions and manage liquidity. The government's monetary policy during times of war has exacerbated this situation. The Chinese government resorted to quantitative easing as a means of financing the war effort, resulting in extensive money printing and subsequent severe inflation. Prices for goods and services skyrocketed without a corresponding rise in output, eroding the purchasing power of the yuan and limiting the operations of commercial banks. With lower Purchasing Power Parity (PPP), the relative value of the yuan decreases compared with other currencies. Therefore, the price of imports increases and the value of exports decreases, ultimately causing a decline in the real value of Gross Domestic Product (GDP) [2].

In the contemporary Chinese economy, changes in the public's inflation expectations rather than changes in the aggregate money supply have emerged as a significant cause of inflation. The relationship between money supply and inflation, especially when measured by the CPI, has increasingly weakened due to rising income and wealth levels. Consequently, policymakers should prioritize managing the public's inflation expectations through policy instruments that are directly perceived by them, as these measures may exert a more substantial impact on shaping such expectations. Other policy measures targeting monetary aggregates may not be as effective in the short term [3].

Price reforms and structural changes associated with economic reforms, as well as mistakes in the formulation and implementation of economic policies, are also among the primary causes of inflation in China. The inflation experienced during China's reform period is attributed to artificially low prices caused by heavy state subsidies for food, housing, cooking fuel, and other goods and services. This longstanding fixed price system, which has been in place for more than 30 years, has distorted resource allocation and economic development [4]. The pressure of institutional reform led to price adjustments that contributed to an overall increase in price levels. Excess demand inflation in China originates from three sources: businesses, consumers, and the government. Newly granted corporate autonomy has led to a significant surge in autonomous investment demand, while consumer demand for durable goods has been pent up [5]. Moreover, government spending on capital investment exerts upward pressure on aggregate demand. The growth rate of China's money supply is determined by

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government spending; thus, increased spending by state entities results in greater money creation, leading to high inflation.

2.2. Impacts of Inflation on Commercial Banks

2.2.1. Negative Impacts

The wars resulted in extensive infrastructure and industrial destruction, causing severe disruptions to trade and production. Major cities and industrial centers were bombed or occupied, leading to the displacement of businesses and workers. Therefore, most people's demands shifted towards meeting their basic needs. The shortage of supply led to price hikes and high inflation rates, which could dismantle the critical role played by commercial banks step by step. Inflation eroded the value of money, diminishing the real value of customer deposits and, consequently, reducing public confidence in the banking system [6]. As a result, individuals sought to withdraw their deposits and reinvest in assets that retained value better than cash did. Apart from that, investors were likely to postpone their investment decisions or move their money abroad. During the 1940s, many savers transferred their funds into more stable currencies like the Hong Kong dollar or invested in tangible assets like gold. While the remaining parts were not all absorbed by commercial banks; instead, the majority portion was centralized within state banks, further shrinking the amount of deposits received by commercial banks [7].

After the conclusion of the Second Sino-Japanese War, economic instability still persisted. Due to the extensive devastation inflicted upon its infrastructure, trade networks, and industrial base, post-war China faced the enormous task of reconstruction. The war effort exhausted the government's financial, labour, and material resources. Worse still, efforts to rebuild the economy were hampered by continued internal strife. The resumption of the Chinese Civil War between the Nationalists and Communists exacerbated the country's economic difficulties. The economic instability and wartime destruction led to a significant increase in bad debts. Many businesses and individuals defaulted on their loans, which negatively impacted the balance sheets of commercial banks. These lingering bad debts continued to burden commercial banks even after the Civil War had ended, impending their ability to generate profits. Shanghai Commercial Savings Bank has been the largest depositor among major commercial banks since 1930. Even so, the real value of their deposits has shrunk sharply as prices have accelerated. On July 7, 1937, the deposit amount of Shanghai Commercial Savings Bank was 201.94 million yuan, equivalent to 1,769,851 tael of gold. In December 1946, after the victory of the Anti-Japanese War, although the absolute amount of deposits expanded to 4,528,555 million yuan, equivalent to only 142,947 yuan in gold, the real value dropped to 8.01% of the pre-war value [1]. In the worst situation, the commercial banks that failed to find a way of survival ended up bankrupt. While some international aid was available, it was insufficient to meet the massive reconstruction needs. Additionally, political alliances and the onset of the Cold War influenced the distribution and effectiveness of aid. More importantly, it takes time to raise funds and build new infrastructure. So, in the short run, the economy will be in a recession.

2.2.2. Positive Impacts

Just as everything has two sides, inflation still has its positive effects. Although inflation erodes the value of assets, it also reduces the debt burden of commercial banks. During periods of inflation, the real value of loans decreases, this means that the debt they owe becomes less burdensome in real terms, making it easier for them to repay their loans [8]. This can reduce the level of non-performing loans in a bank's portfolio. Banks can also increase interest rates on loans during inflationary periods, leading to higher interest income. This profit margin may compensate for the part they lose from their

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asset. For instance, in post-WWII China, banks raised interest rates to keep up with inflation, thereby maintaining their profitability [3].

In addition, inflation often leads to an increase in the nominal value of real estate and other assets. Banks holding these assets can see an increase in the value of their asset portfolios. For example, Chinese banks that held substantial real estate assets saw significant appreciation in those assets during the late 1940s inflation period. In the long run, inflation can create an incentive for saving and investment. When inflation is expected to occur, individuals may be motivated to spend or invest their money rather than hold onto it, as the value of money is expected to decrease over time. This can help to stimulate economic activity and promote investment in productive assets [4].

3. Strategies to Reduce the Negative Effects of Inflation

3.1. Short-run Measures

Because of China's unique blend of government intervention and market-oriented reforms, it is described as a "socialist market economy." In this case, government adjustments would be necessary. Firstly, the People's Bank of China (PBOC) can tighten monetary policy by raising interest rates to reduce consumer spending and business investment. Increasing the reserve requirements for banks can reduce the amount of money available for lending, thereby reducing the money supply. And encouraging the Yuan to appreciate can reduce the cost of imports, which can help lower domestic inflation. A stronger currency makes imported goods cheaper, helping to control prices. Supply-side measures such as reducing tariffs on imported goods can make them cheaper, increasing supply and reducing inflationary pressures [8].

3.2. Long-run Measures

In the long-run, the government can formulate more effective and appropriate policies to avoid inflation caused by government policies by collecting more and more accurate relevant data as well as the implementation intensity and effectiveness of previous policies.

In addition, the establishment of the People's Republic of China after the wars marked the beginning of a new era in Chinese economic history. Opening the economy facilitated trade liberalization, allowing China to export goods and earn foreign exchange, which increased trade opportunities and helped boost industrial production and economic growth. This also enabled foreign currency to join the Chinese market, and formed foreign direct investment, which could accelerate the speed of rebuilding infrastructure. Over the period of 2003-2009, the banking sector is experiencing the final round of reform focusing on banking modernization and partial privatization. The government and banking regulatory authority allow foreign share purchases of any domestic bank, and the banks are encouraged to be listed on Chinese stock exchanges in order to improve their management, all of which are supposed to have a positive effect on bank profitability [9]. During that period, the transfer of technology and knowledge from more advanced economies was crucial for modernizing China's industrial base and improving productivity in all sectors. Modernization efforts especially strengthened the banking sector by introducing better financial practices and technologies as well as the collaboration of foreign commercial banks and domestic commercial banks. By the mid-1950s, China had established trade relationships with several countries, exporting agricultural products and raw materials in exchange for machinery and technology [10].

4. Conclusion

This paper examines the impacts of inflation on commercial banks in China in different periods. The findings indicate that severe inflation, primarily driven by the Second Sino-Japanese War and the

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Chinese Civil War, significantly disrupted the banking sector. Commercial banks lost their control over the money supply, leading to diminished customer deposits, increased bad debts, and overall financial instability. Despite these negative impacts, inflation still has some positive effects. Inflation reduced the real value of debt, making it easier for banks to repay loans, and allowed banks to increase interest rates, which helped maintain their profitability. The complexity of inflation affects commercial banks, highlighting both the challenges and opportunities it presents. Effective strategies in the short term such as tightening monetary policy, raising interest rates, and appreciating the yuan can help control inflation. In the long term, implementing more effective government policies, collecting accurate data, and facilitating economic reforms can stabilize the banking sector and enhance its resilience to inflationary pressures. However, the analysis of this essay relies on historical records and expert interviews, a more comprehensive understanding could be achieved by incorporating qualitative insights from quantitative data. Future research should focus on the long-term impacts of inflation on banking sector reforms and the role of international financial cooperation in stabilizing economies during periods of high inflation. In conclusion, understanding the multifaceted impacts of inflation on commercial banks is beneficial for developing effective strategies to mitigate these effects. From current Chinese economic policy, it would be worth sacrificing short run growth to achieve a long run target to stabilize the economy.

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