Rational Cost Inefficiency in Chinese Banks

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Summary

Cost inefficiency in a firm is usually defined as the excess costs of production relative to a 'best practice' enterprise. Cost inefficiency can be separated into allocative inefficiency and X-inefficiency. X-inefficiency is usually associated with management failure to use resources optimally so as to approximate 'best practice' cost relative to income. Allocative inefficiency represents the wrong combination of inputs to produce a target level of outputs at the minimum cost position defined by the 'best practice' enterprise. According to a frequently cited study by Berger et al (1993), X-inefficiency contributes 20% to cost-inefficiency in western banks. Empirical studies of Chinese banks tend to place cost-inefficiency in the region of 50%. Such estimates would suggest that Chinese banks suffer from gross cost inefficiency. This study decomposes cost-inefficiency in Chinese banks into X-inefficiency and allocative-inefficiency. It argues that allocative inefficiency is the outcome of rational decision making by bank managers to meet former employment targets given by various authorities in the pre-reform period. It finds that Chinese banks have been working to reduce allocative inefficiency over this period but that the state-owned banks have a higher level of allocative inefficiency than the joint-stock banks. In 2007, the average cost inefficiency in Chinese banks was 36% of which allocative inefficiency accounted for 16%. If allocative inefficiency can be viewed as part of a rational decision making process, then Chinese bank managers are no better or worse than their western counterparts.