Banking In China: Are New Tigers Supplanting the Mammoths?

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Summary

The paper addresses the manifest problems of the banking system in China. Within a development success story – in which China recorded average annual growth of around 9% over 25 years – progress was modest in the service sector. Within it, the banking system showed poor performance and high NPL ratios which, according to many observers, could possibly put the continuation of the Chinese economic miracle at risk. We argue that the weakness of the banking system in a country experiencing such a high and prolonged growth is only an apparent puzzle, and that the crux of China's banking problem lies in the unhealthy link between loss-making state-owned enterprises and state-owned commercial banks, the "Old Mammoths" that still dominate banking in China. We posit that this link did not materialize by chance but, rather, was the negative side of the policy choice for gradual transition, which left unprofitable state-owned enterprises in business while, due to political interference, state-owned commerical banks could not stop lending to them and, later, had to bear the losses created by their inefficient operations.

Next, we discuss how to bring better banking to China. In particular, we ask whether the emergence of a new breed of dynamic banks (the "New Tigers"; banks formed as companies limited by shares, including city commercial banks) can be the answer. We provide details on the growth of the New Tigers, comparing their performance with that of the Old Mammoths. We consider whether the New Tigers offer China an option of "growing out" of its banking problem. Although extrapolating the New Tigers' growth might suggest that they are rapidly supplanting the Old Mammoths, we gauge that an accurate answer requires carefully evaluating the sources of the New Tigers' better performance. Specifically, we need to understand whether this is simply caused by better corporate governance or whether – and to what extent – the New Tigers are better simply because they do business in the most developed area of the country. To address this, we draw on the results of a field survey to check whether the performance of the New Tigers differs according to the level of development of their area of operation. This is precisely the rationale behind looking at city commercial banks, a vibrant segment within the New Tigers, which include banks operating throughout the whole of the country.

By focusing on 20 city commercial banks located in three provinces with differing levels of development, we keep corporate governance (relatively) constant and can thus ascribe any significant difference in performance across provinces to their relative underlying prosperity. The results show that these banks' performance is systematically and positively related to the level of economic prosperity in their provinces.

The main result of our econometric analysis implies that the New Tigers may be unable by themselves to bring better banking to the whole of the country. This suggests that the authorities are right to stress the need to restructure and rehabilitate the Old Mammoths. While the authorities' push to transform the state-owned commercial banks into companies limited by shares goes in the right direction, it is not clear that stock-exchange listing can really, per se, improve these banks' corporate governance. Given their size and considering that the government could continue to be the largest shareholder, doubts are legitimate. Perhaps, as suggested by some authors, it would be advisable for China's authorities to consider breaking up their Old Mammoths. Together with stock-exchange listing, this would help streamline the Old Mammoths and could also facilitate the introduction of foreign strategic investors, thus contributing to improve their governance.