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Inside the black box: Bank credit allocation in China's private sector

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ABSTRACT

This study examines how the Chinese state-owned banks allocate loans to private firms. We find that the banks extend loans to financially healthier and better-governed firms, which implies that the banks use commercial judgments in this segment of the market. We also find that having the state as a minority owner helps firms obtain bank loans and this suggests that political connections play a role in gaining access to bank finance. In addition, we find that commercial judgments are important determinants of the lending decisions for manufacturing firms, large firms, and firms located in regions with a more developed banking sector; political connections are important for firms in service industries, large firms, and firms located in areas with a less developed banking sector.

1. Introduction

China's transition from a centrally-planned socialist economy to a vibrant and fast expanding commercially oriented economy is well documented (Allen et al., 2005; Lardy, 1998). This transformation involves moves toward the adoption of free-market policies, improvements in the commercial banking system, developing modern financial markets, and the writing and enforcement of commercial laws. At the corporate level, the reorganization of wholly-owned state enterprises into listed joint-stock companies with minority private ownership, has led to some improvement in efficiency (Chen et al., 2008). However, the biggest spark for economic growth has been the emergence of privately owned non-listed firms. According to the National Bureau of Statistics, the private sector accounted for roughly 50% of GNP in 2005 and this is expected to rise to at least 75% by 2010.[1]

One interesting, and as yet unresolved, question relates to the role that the banking sector has played in helping finance the expansion of private firms. The focus of our study, therefore, is to shed some light on this issue and, in particular, to gain an understanding of how banks make lending decisions with regard to non-listed private businesses. Our interest in this issue is piqued by the seemingly mixed messages from prior research.

International evidence provides some background on the conditions that are deemed necessary for economies to flourish. La Porta et al. (2000) argue that the rule of law (including law enforcement), private ownership, and corporate governance are crucial elements in explaining economic success and corporate value. Other studies have stressed the need for highly developed capital markets and financial intermediaries to help foster a successful corporate sector (e.g. Rajan and Zingales, 1998). Using this "law-finance-growth" research as a backdrop, Allen et al. (2005) conclude that China does not display the conditions necessary for a vibrant private sector. For example, it is argued that despite some recent improvements, China still has an underdeveloped and capricious legal system, weak investor protection, a chronic lack of law enforcement, and overarching government interference and control. This suggests that China's private sector should be subdued at best and completely irrelevant at worst, but this clearly flies in the face of the available evidence.[2] Allen et al. (2005) seek to explain the paradox by arguing that private firms make use of informal financing channels such as trade credits and private credit agencies that rely on alternative governance mechanisms such as family connections

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[1] http://www.chinadaily.com.cn/china/2006-09/22/content_694432.htm.

[2] In this sense, China has been regarded as a significant counter-example to the findings of the existing literature on law, institutions, finance and growth (Allen et al., 2005).

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and the personal reputation of the entrepreneurs. By implication, banks do not play an active role in financing private firms in China. However, international evidence has shown that the support of formal financing to private firms determines the sustainability of this sector (Beck and Demirgüç-Kunt, 2006) and informal financing based on relationships is detrimental to business exchange, competition and innovation (Biggs and Shah, 2006). Thus, the importance of informal finance, especially in the longer-term, is a controversial topic and one that deserves additional investigation. In this study, we focus on the formal financing and governance mechanisms of non-listed private Chinese firms using survey data from the World Bank.

There are numerous criticisms of China's banking system including factors that inhibit it from providing finance to the private sector. These include the stylized facts that the banks are state-controlled (almost 100% owned by the government during the period of our study)[3], carry out policy lending that follows government directives rather than commercial considerations, and discriminate against private firms (Brandt and Li, 2003; Cull and Xu, 2003). As support for the latter stylized fact, bank statistics show that although the private sector accounts for 50% of the economy, it accounts for just 7% of bank lending. In light of these and other criticisms, the Chinese government has introduced a series of reforms to the banking sector to promote the availability of bank loans to private firms. However, systematic evidence on how bank loans are allocated to private firms in China remains scarce. Based on a World Bank nation-wide survey, this paper attempts to look inside the black box of bank lending decisions and answer the following questions about the determinants of bank financing to the private sector: Do the banks allocate loans to private firms according to a firm's financial performance? Do political connections still matter in the allocation of loans to the private sector? Does managerial experience and corporate governance facilitate private firms' access to bank loans? Do the determinants of lending decisions vary with industries, firm size and level of market development?

We find that banks tend to allocate loans to private non-listed firms with higher profitability, more experienced and incentive-compatible CEOs, and more independent corporate boards. The results suggest that the banks are extending loans to financially healthier firms and better-governed firms. As a complement to the conclusions in Allen et al. (2005) regarding the importance of informal channels of finance, we present evidence that the banking sector uses commercial judgments in lending decisions. We also find that having some state ownership helps firms gain access to bank finance. Thus, political connections do carry weight in the decisions to lend to the private sector. Further analyses reveal that the determinants of the lending decisions vary across industries, firm size and levels of institutional development. Specifically, commercial judgments are important determinants of the lending decisions for manufacturing firms, large firms, and firms located in regions with a more liberalized banking sector. Political connections are important for firms in service industries, large firms, and firms located in areas with a less liberalized banking sector. Our results indicate that, after 30 years of reform, China's banks have begun to behave more like the commercial corporate banks in the developed world. We find that the influences of political connections still persist, although the weaker role of political connections in regions with a more liberalized banking sector suggests that the banks are becoming more and more market-oriented as the reforms take effect. Our findings add to the recent literature on the structure, performance and functioning of China's banking sector (e.g. Berger et al., 2009; Fu and Heffernan, 2009; Lin and Zhang, 2009).

This paper is structured as follows. Section 2 discusses the research background. Section 3 describes the data and the empirical models. The empirical results and their interpretations are reported in Section 4. Section 5 concludes.

2. Institutional background

2.1. The development of the Chinese private sector

One of the most far-reaching changes in China's economy brought about by the economic reforms is the gradual shift away from complete reliance on state-owned and collective enterprises to a mixed economy, where private enterprises play a major role in promoting growth, innovation, and employment. The private sector, which consists of mainly small and medium-sized enterprises (SMEs hereafter), is rightly considered as the major engine of China's rapid growth. In contrast, public ownership is regarded as a defining feature of socialism. The rise of China's private sector reflects the government's compromise between ideological correctness and economic pragmatism.

Since the late 1990s, there has been a dramatic change in sentiment towards private capital. The 15th Congress of the Chinese Communist Party, in September 1997, lifted many legal and economic barriers to private sector growth. Among the actions giving rise to private sector development was the granting of approval for banks to lend to private businesses. In 2004, the National Congress approved a constitutional amendment to protect private property rights, granting "private property" an equal legal status to "public property". Despite the constitutional changes and official encouragement of the private sector, some commentators continue to believe that the government's ownership of formal external financing sources inevitably leads to a biased capital allocation policy that discriminates against private businesses (Brandt and Li, 2003; Ge and Qiu, 2007).

The economic reforms have reduced significantly the size of the state sector in the economy, with non-state enterprises' production to total production increasing from 50.37% in 1998 to 66.72% in 2005. The proportion of total employment provided by private firms increased from 58.1% to 76.26% in the same period (see Table 1). Table 1 presents official statistics that show the rapid growth of the economy and the even faster growth of the private sector. The decline of the state sector in China is supposed to emancipate the banking sector from the obligation to provide policy loans to the ailing state-owned enterprises. As we shall discuss shortly, a series of reforms have been introduced with the objective of transforming China's banking sector from a conduit of government policies into a fully-commercialized modern financial intermediary that channels funds to the most efficient economic units regardless of their ownership identity (Podpiera, 2006). Next, we briefly review China's banking sector reforms in order to justify the variable selection of our model and to provide further institutional background for our study.

2.2. The evolving status of the Chinese banking sector

A salient characteristic of China's banking sector is the dominant state ownership of banks, which allows for government involvement in the decision making of those banks. Before the late 1990s, the Chinese banking sector had little latitude but to serve as a conduit for channeling low-cost capital to SOEs, because SOEs were assumed the task of employment and social welfare provision. The private sector was virtually excluded from the formal

[3] According to La Porta et al. (2002), the government owns 99.45% of the ten largest banks in China.