

# Are New Tigers supplanting Old Mammoths in China's banking system? Evidence from a sample of city commercial banks

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## Abstract

“New Tigers” (including city commercial banks) outperform state-owned commercial banks burdened with non-performing loans from unprofitable state-owned enterprises. We study whether this is solely due to superior corporate governance (multiple shareholders versus total government ownership) or also to the favorable environment (the New Tigers target affluent China, while state-owned commercial banks operate nationwide).

Using a field survey on 20 city commercial banks from three provinces at different levels of economic development, we find better performance at those in the East and worse performance at those controlled by state-owned enterprises. Geography and policy do matter, and reform of state-owned commercial banks is necessary to bring better banking to China.

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## 1. Introduction

Why are there banking problems in China, an economy that has been growing at an average rate of 9% over the last 25 years? Usually, we expect banking problems to emerge when a country's entire economy is gripped by a crisis, and so the Chinese case seems puzzling. In reality, the puzzle is only apparent, not real. To grasp this, we need to recall the special features of China's transition. This will help us understand how the combination of strong economic growth and a weak banking system are not contradictory but the natural outcome of policy choices. In contrast with most ex-centrally planned economies and well before the others followed their “shock therapy” to the market, China opted for a gradual transition strategy. As most economists now concur, this choice was far-sighted because it: (i) avoided the acute strains generated by the abrupt disman-

tlement of state enterprises (e.g. mass unemployment and destructive disruption of production) and (ii) allowed some institution-building before the privatization of key sectors of the economy, without which China risked moving from the problems of state ownership to those of private monopoly (Stiglitz, 2002; Black and Tarassova, 2003; Lau et al., 2000). The gradual transition allowed China to keep its robust growth while rooting the new domestic private economy (now accounting for more than 75% of GDP) in international production networks.

Nevertheless, there was a darker side of the story: State-owned enterprises (SOEs) outlived the planned economy, thanks to the gradual transition, and kept making large losses (Opper, 2001). The four big state-owned commercial banks (SOCBs) absorbed the bulk of those losses. The unhealthy link between SOEs and SOCBs is among the chief worries concerning the future of China's economic miracle.

In this respect, we show that China's banking system is not monolithic: alongside the problematic “Old Mammoths” (as we dub the SOCBs), a breed of dynamic

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“New Tigers” (banks organized as companies limited by shares) is rapidly emerging. These banks show much better performance, possibly because the state was not their single shareholder as with the SOCBs. We conclude that even the New Tigers will not be able by themselves to solve China’s banking problem. As we will show, part of their success seems due not so much to their better corporate governance, as to the fact that their business is concentrated in the Eastern belt, the most developed area of China. Thus, solving China’s banking problem means dealing with the SOCBs. Although the Chinese authorities have taken steps to tackle the issue, the outlook is still rather murky.<sup>1</sup>

The rest of this paper is organized as follows. In Section 2 we review the negative impact of state ownership on the corporate governance of banks, with a specific focus on China. Then, we provide details on the rapid growth of the New Tigers, the new breed of banks, and ask whether they offer China an option to grow out of its banking problem. In this respect, we posit that an accurate answer requires distinguishing between the impact of better governance (contrary to the SOCBs, the New Tigers were not wholly state-owned) and that of the fact that, unlike the SOCBs, their business lies prevalently in the most developed area of China. Section 3 sheds light on this issue. We report the results of a field survey that offers evidence on the extent to which the performance of the New Tigers differs depending on the level of economic development of the geographical area where banks do business. This is exactly the rationale for looking at city commercial banks (CCBs), a vibrant segment of the New Tigers, as these are banks operating widely across the country. By focusing on 20 CCBs located in three provinces of China at different levels of economic development, we hope to keep corporate governance (relatively) constant and thus be able to ascribe any significant difference in performance across provinces to their relative underlying prosperity. After describing the structure of the survey, we report our main econometric results. They confirm that CCB performance is systematically and positively related to the level of economic development in the provinces in which they are located. Furthermore, the richness of the information obtained allows us to gain additional insight into other factors affecting bank performance in China. Section 4 summarizes our main findings and briefly discusses policy implications.

## 2. Banking in China: The Old Mammoths vs. the New Tigers

### 2.1. The negative impact of state ownership on the corporate governance of banks

While China experienced its unique economic miracle, featuring average annual growth rates of about 9% over

some 25 years, not all sectors progressed at the same pace, possibly providing bottlenecks for future growth. Progress was slowest in the service sector (Dutta, 2005). And, within the service sector, advancement was particularly sluggish in the financial sector. Much of the issue hinges on the link between SOCBs and SOEs, which has received much attention. In turn, this raises the important question of the negative impact of state ownership on the corporate governance of banks.

One of the key issues is the state control of banks. La Porta et al. (2002) directly address the issue of government ownership of banks. The authors maintain this is a very special case to verify the “political” theories of the distortions induced by state intervention in financial markets. Their main finding is that, in a cross-country comparison, after state ownership of banks increases, the growth of financial markets, of per capita income and of productivity are all lowered. Thus, the general consensus in the literature is that state ownership of banks is detrimental to bank efficiency, to the development of financial markets and, through these channels, also to economic growth.

In the specific context of China, various authors have shed light on the negative impact of state ownership on bank performance. We cite just a few of them. Using city-level data over the early period of 1989–1991, Wei and Wang (1997) find evidence that China’s bank loans favored state-owned industrial enterprises and argued that such lending bias diminished the effectiveness of other measures designed to promote the growth of non-state sectors or to induce SOEs to restructure. In line with this, Brandt and Li (2003) find that, as a result of discrimination, private firms resort to more expensive trade credit. Using provincial data from 1991 to 1997, Park and Sehr (2001) show that the financial reforms of the mid-1990s were ineffective at lowering policy lending by SOCBs, thus negatively impinging on these banks’ performance, while SOCB lending did not respond to economic fundamentals. Moreno (2002) points out that banks in China traditionally met government policy goals by financing the operations of SOEs, regardless of their profitability or risk, and that while bank exposure to SOEs tended to decline over time, SOEs still accounted for over one-half of outstanding bank credit in 2000, while exposure to poor-performing SOEs had a major impact on bank performance. Chang (2003) argues that China’s (mostly unprofitable) SOEs have been kept afloat with loans from SOCBs while, conscious that they could not force SOEs to pay back their loans without causing their collapse and the inevitable political crisis that would ensue, SOCBs continued to lend to SOEs. This fact is confirmed by a survey performed by the People’s Bank of China (PBOC) in 2003, finding that of the total non-performing loans (NPLs) of SOCBs, 30% was due to intervention by the central and local governments, 30% resulted from mandatory credit support to SOEs, 10% arose from the poor legal environment and weak law enforcement in some regions, and 10% stemmed from industrial restructuring in some enterprises, thus leaving only 20% that origi-

<sup>1</sup> Three of the four SOCBs (China Construction Bank, Bank of China and Industrial and Construction Bank of China) were successfully IPO-ed recently. Whether listing per se is enough for better governance remains to be seen.

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