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Refinancing and decentralization: Evidence from China☆

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Abstract

Decentralization can complement market liberalization by strengthening incentives of agents to respond to market signals. However, in China banks centralized lending authority following financial reforms in the mid-1990s. We present a new theory of financial decentralization in which centralization provides a credible commitment not to refinance bad projects by reducing available information. Using data from Chinese rural financial institutions, we empirically assess the determinants of decentralization and the likelihood of collateral seizure, strongly confirming the predictions of the refinancing model. We conclude that weak institutional environments may limit the efficiency of financial intermediation despite financial market liberalization.

JEL classification: G2; D8; P3

Keywords: Banking; Decentralization; Refinancing; Transition; China

1. Introduction

In recent years, financial liberalization has been a main focus of reform in developing countries and more recently in transition economies (e.g., Haggard and Lee, 1995). Financial liberalization transforms a heavily regulated system into a market-oriented one by reducing barriers to entry, reducing government influence over credit allocation, and increasing reliance on market-determined interest rates. Conventional wisdom holds that decentralization of control rights goes hand-in-hand with market liberalization. With greater decision-making authority,

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local managers may have greater incentives to exploit local information in response to market signals, which increases the efficiency of resource allocation. Effective use of local information may be especially important when there are large information asymmetries between central and local managers. In banking, this is likely to occur in weak institutional environments in which credit ratings, high quality appraisal and auditing services, standardized reporting systems, and well-developed legal systems are absent.

Surprisingly, in China most banks responded to financial reforms in the mid-1990s by centralizing rather than decentralizing control rights. The reforms intended to further the commercialization of state-owned banks and improve the responsiveness of lending to economic fundamentals, but they did not liberalize interest rates.[1] This contrasts with the history of key reforms in China's agricultural and industrial sectors that decentralized decision-making authority to households and firm managers and liberalized prices (Naughton, 1995), but it is consistent with evidence from developing and transition economies that financial liberalization and decentralization may have unintended effects if underlying institutional factors are left unaddressed (Cho, 1986; Buch, 1996; Koford and Tschoegl, 1999; Schmidt, 1998).[2]

This paper provides a new theory of financial decentralization that explains why decentralization may not always be desirable, especially in developing and transition economies. The model's key insight is that by improving local information, decentralization can reduce the ability of lenders to commit credibly not to refinance bad projects, the effect of which is to soften the budget constraint of borrowers. In the context of a corporation, Crémer (1995) shows that more information may hurt the principal's ability to refuse renegotiation. Berglof and Roland (1998) find that when liquidation costs are sufficiently high, lenders may lack the credibility to liquidate financially distressed projects, leading to soft budget constraints. In this paper, we present a model in which centralization can provide a credible commitment not to refinance bad projects, which improves project performance and loan repayment by increasing the effort incentives of firm managers. In China, financial centralization increased as concerns about refinancing grew in the mid-1990s when the economy slowed and increasing numbers of firms encountered financial difficulties.

Our argument uses the key insight from Dewatripont and Maskin (1995) to come to an exactly opposite conclusion. They argue that decentralization in the form of a division of large banks into small ones can serve as a commitment device that helps lenders harden the budget constraint of borrowers. This is because, unlike large banks, small banks are incapable of refinancing ongoing projects independently. However, other potential lenders may be unwilling to refinance projects when they have poor information about firm quality. Entrepreneurs with questionable projects will anticipate that refinancing is less likely and will not seek financing in the first place or will exert greater effort to make projects successful once the project is financed. In both our model and that of Dewatripont and Maskin, credible commitment not to refinance is achieved by taking lending authority out of the hands of bank managers who have better information. However, in our case this is accomplished by centralizing lending authority rather than dividing large banks into small banks, which Dewatripont and Maskin describe as "decentralization."

[1] See Park and Sehrt (2001) for a detailed description of financial reforms in the mid-1990s.

[2] Cho (1986) shows that poorly developed capital markets and the preponderance of bank loans in corporate financing may have prevented financial liberalization from having its intended effects. Based on the experiences of Eastern European countries, Buch (1996) argues that successful domestic financial liberation and banking reform requires the creation of a market-based incentive system and a new institutional framework (e.g., mechanisms of corporate control for both banks and enterprises) to facilitate banks hardening the budget constraints of enterprises and coping with the asymmetric information problem in financial markets.