Competition in China's Domestic Banking Industry
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Once China has been accepted into the Word Trade Organization (WTO), all the business and geographical limitations that previously restricted the activities of foreign banks there will be removed gradually. China is expected to allow foreign banks to conduct foreign-currency business for all foreign customers immediately, to allow them to conduct foreign currency business involving Chinese clients beginning one year from now, and to allow them to conduct wholesale reminbi business two years after that. Five years later, foreign banks will be able to offer individual services to Chinese citizens, and all geographic restrictions will be eliminated.

WTO entry implies an increase in competition in China's banking industry. In this paper we examine the level and conditions of competition that have existed within the domestic banking industry since 1994. We show that existing institutional arrangements have inhibited effective and efficient competition in the industry. Competition within the industry is weak, and its role in improving banking efficiency has been limited. Fundamental institutional changes must be made before China can reap the full benefits of increasing competition once it has attained membership in the

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WTO.

This paper is organized as follows. In section 2 we provide a historical review of structural changes in the banking industry since 1978. In section 3 we quantitatively evaluate the level of competition that existed between 1994 and 1998. Section 4 is devoted to an investigation of the rules that have governed competition in the industry. We discuss recent developments in section 5, and in section 6 we conclude by suggesting the implications of creating an institutional environment that fosters more effective competition in the industry.

Historical Background

Before China's 1978 reform it had a mono-bank system. The People's Bank of China (PBOC) combined the roles of central and commercial banking. The whole banking industry was regulated by strict cash and credit plans that were set in accordance with the production plans laid down by the State Planning Commission.[1] Banks were part of the administrative hierarchy; they ensured that the national production plans would be fulfilled, and they had no incentive to compete with each other.

[1] Under the cash plan, households obtained their wages in cash from their work units through banks.

Between February 1979 and January 1984 the Agriculture Bank of China (ABC), the People's Construction Bank of China (PCBC), the Bank of China (BOC), and the Industrial and Commercial Bank of China (ICBC) were split from PBOC. PBOC formally became the country's central bank. Each of these four specialized banks was to provide services to a designated sector of the economy. ABC's main responsibility was to receive deposits in rural areas and extend loans to agricultural production projects and township industries. PCBC focused on appropriating funds for capital construction from the state budget through the Ministry of Finance. BOC focused mainly on deposits and loans for foreign exchange and international transactions. ICBC focused on the financing of commercial and industrial activities in urban areas. This prevented competition among the newly established state specialized banks.

The state specialized banks began competing with one another in 1985, when the restrictions limiting each to its own designated sector were lifted. The four banks were allowed to expand their scope of business and to compete with each other in providing loans and deposit services. Competition among them was very limited from the mid-1980s to the mid-1990s, however. This is because they served mainly as policy-lending conduits for the government. They lacked the requisite autonomy to

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Under the credit plan, banks were obliged to provide working capital and investment fund to enterprises.

compete with each other.

Competition among the four banks increased in 1994, when China established three policy banks to take over from the specialized banks the task of extending policy loans. The China Development Bank (CDB) was chartered to provide long- and medium-term lending to finance construction projects in infrastructure, and in basic and pillar industries. The Export-Import Bank of China was to provide loans for the export and import of capital goods. The Agricultural Development Bank of China (ADBC) was responsible for agricultural lending. With the establishment of these policy banks, the state specialized banks were officially named "commercial banks." The four state commercial banks were expected to operate on market principles and to improve their profitability. The rules governing the new commercial banks were laid out within the Commercial Bank Law, which was passed in March 1995. The most important feature of the law is that it grants all commercial banks operational independence except in the case of a national emergency. The separation between policy banks and commercial banks was, however, far from neat and complete. The policy banks lacked sufficient branch networks or capital to engage in the level of policy lending previously provided by the specialized banks, and the commercial banks continued to engage in policy lending in one form or another in response to pressures from central and local governments.

Although competition among state commercial banks was straitjacketed by policy lending, the entry of new banks created a new source of competition in the industry. The Bank of Communications (BOCOM) was reestablished in 1986 after 38 years of inactivity in China. In 1987 the Shenzhen Development Bank (SDB) and the China Merchants Bank (CMB) were established. SDB is a joint-equity bank that was formed by consolidating six rural credit cooperatives. It is listed on the Shenzhen stock exchange. CMB also came into existence in Shenzhen and was solely funded by the China Merchants Group.[2] The Guangdong Development Bank (GDB) was set up in 1988 and was converted into a shareholding bank in 1992. Its shareholders are the Ministry of Finance, the Bank of China Group in Hong Kong, and the Hong Kong Chinese Banking Group. In 1996 the China Minsheng Banking Corporation was founded. It was owned by shareholders representing private industry, making it the only private bank in China. Since 1986, 14 joint-equity commercial banks have been established[3] In 1998 the Hainan Development Bank was shut down by PBOC because

[2] In 1998 the ownership of the bank has been diversified to include 107 shareholders, see Xiao (1999)
[3] These are Bank of Communication, Shenzhen Development Bank, Guangdong Development Bank, China Merchants Bank, China Everbright Bank, China Minsheng Banking Corporation , Hua Xia Bank, Pudong Development Bank, CITIC Industrial Bank, Fuijin Industrial Bank, Hainan Development Bank, China Investment Bank, Yantai Housing Saving Bank, and Bengbu Housing Saving Bank

the former was unable to pay its debts.[4] In March 1999 China Everbright acquired the commercial operations of the ailing China Investment Bank from the State Development Bank. By the end of 1999 there were a total of 12 joint-equity commercial banks, with total assets reaching RMB1447.7 billion yuan. The total deposits outstanding and total loans outstanding amounted to RMB 1031.4 billion yuan and 695.7 billion yuan (PBOC 2000).

In addition to establishing the joint-equity commercial banks, the central government allowed local governments to establish local banks in the mid-1990s. The local banks were formed by consolidating local urban cooperatives. They take the form of shareholding banks; their business scope is restricted to their own localities. They were first called city cooperative banks and later became known as city commercial banks. As of the end of 1999, 90 such banks were operating in China, with total assets reaching RMB 554.7 billion yuan, deposits outstanding reaching RMB 441.3 billion

[4] The Hainan Development Bank was founded in August 1995. The Hainan Provincial government held a 30% stake in the bank; other shareholders included state-owned enterprises such as China North Industries and China Ocean Shipping. In 1996 the bank made pretax profits of 125 million yuan and boasted deposits of 4.1 billion yuan. In 1997 the Hainan provincial government asked the bank to merge 28 credit unions that were plagued by serious bad-debt problems. The credit unions that the bank took over had assets (virtually all loans) of 13.7 billion yuan and liabilities of 14.2 billion yuan; about two-thirds of the loans were nonperforming. PBOC allocated 4 billion yuan to cover the credit unions' bad loans, leaving another 4 billion yuan shortfall on the bank's doorstep. The credit unions finally brought the bank down, even though the bank's performance in 1997 was respectable. PBOC closed the bank on 21 June 1998. It was the first bank in the country to be shut down since the establishment of the People's Republic of China in 1949. The bank, however, was not declared bankrupt. Instead, the central government called in ICBC to pay in full all the bank's overseas and domestic creditors. Depositors were also insured by the government. See Brue Gilley (1998).

yuan, and loans outstanding reaching RMB 271.1 billion yuan (PBOC 2000)

Competitive Conditions: Quantitative Evaluation

Over the past two decades significant structural changes have taken place in China's domestic commercial banking industry. It has evolved from a mono-bank system to a more diversified one including 4 wholly state-owned commercial banks, 12 joint-equity commercial banks, and 90 city commercial banks.[5] Have the structural changes made the domestic banking industry more competitive? The answer to this question depends on the dimensions we measure.

In term of assets, deposits, and loans, there was only a slight decrease in overall concentration during the period 1994–98. The four largest banks in China are the state-owned commercial banks. They have taken up the majority of total assets, deposits, and loans, with four-firm concentration ratios decreasing from 93.04%, 90.14%, and 93.24%, respectively, in 1994 to 84.93%, 84.26%, and 88.51%, respectively, in 1998 (Table 1).

Table 1:

[5] In addition to these official banks, dozens of illegal banks have sprung up in provinces such as Guangdong, Liaoning, and Hubei. It is reported that in the city of Chonqing alone, 162 illegal banks have been set up since 1993. See Ian Johnson (2000).

Concentration of Assets, Deposits, and Loans: Four-Bank Concentration Ratios

Concentration Ratio (n=4)			
	Assets	Deposits	Loans
1994	93.04%	90.14%	93.24%
1995	92.00%	89.54%	92.39%
1996	88.90%	87.08%	90.42%
1997	87.03%	85.20%	88.70%
1998	84.93%	84.26%	88.51%

Source: Calculated by the authors based on data obtained from *Almanac of China's Finance and Banking*, various years

The Herfindahl indices for assets, deposits and loans shows that the market structure of China's domestic banking industry is oligopolistic in nature, with approximately four banks of equal size (Table 2). With respect to assets and liabilities, China's banking industry is still dominated by four state commercial banks.

Table 2

Concentration of Assets, Deposits, and Loans: Herfindahl Index

1/Herfindahl Index			
	Assets	Deposits	Loans
1994	4.203	4.235	4.092

1995	4.197	4.503	4.272
1996	4.155	4.611	4.358
1997	4.161	4.636	4.431
1998	4.785	4.689	4.486

Source: Calculated by the authors based on data obtained from *Almanac of China's Finance and Banking*, various years

Note: The Herfindahl index is the sum of the squares of individual firms' market shares expressed as decimal fraction. So calculated, the index could take on values ranging from 0 to 1. It gives a single-firm monopoly an index value of 1, and an industry of five equal-sized firms gets an index of 0.2. The reciprocal of the Herfindahl index has been used as a number-of-firm equivalent, indicating approximately the number of equal-sized firms in an industry.
The computation of the "full" Herfindahl index needs shares of all firms in an industry. Owing to the lack of information on the assets and liabilities of each city commercial bank, the indexes have been calculated by excluding the city commercial banks and treating the domestic commercial banking industry as consisting only of the state commercial banks and the joint-equity commercial banks. The indexes, therefore, are "truncated" ones. They overestimate the level of concentration in the industry. The overestimation should not be great because all city commercial banks' total assets, outstanding loans, and outstanding deposits made up less than 5% of the whole industry in 1998.

A very different picture, however, emerges when we look at banks' profitability. The overall concentration of bank profits has apparently decreased sharply, with the four-firm concentration ratio declining from 83.64% in 1994 to 55.33% in 1998. From

1994 to 1996 the four largest profitmakers were BOC, BOCOM, ICBC, and the Construction Bank of China (CBC). In 1997 the China Merchants Banks replaced CBC and became the fourth-largest profitmaker in the industry.

Table 3

Concentration of Profits: Four-Bank Concentration Ratios

	1994	**1995**	**1996**	**1997**	**1998**
Top Four Profitmakers	BOC (41.7%) BOCOM (17.6%) ICBC (14.66%) CBC (9.68%)	BOC (28.38%) CBC (16.84%) BOCOM (15.35%) ICBC (12.74%)	BOC (28.38%) ICBC (14.22%) BOCOM (14.15% CBC (11.83%)	BOC (22.03%) BOCOM (19.58%) ICBC (11.44%) CMB (10.77%)	BOC (16.74%) ICBC (16.40%) BOCOM (12.69%) CMB (9.51%)
Concentration Ratio (n=4)	83.64%	73.3%	68.51% 62.01%**	63.8% 56.65 %**	55.33%

Source: Calculated by the authors based on data obtained from *Almanac of China's Finance and Banking*, various years

Note: Owing to the lack of information on the profits of city commercial banks, the index has been computed by excluding these banks. The indexes, therefore, overestimate the concentration of profits in the industry. The indexes with ** for the years 1996 and 1997 include city commercial banks.

The Herfindahl index for profits shows that there is a significant decrease in the level of concentration in the industry. The number of domestic banks with comparable profitmaking capacities increased from about four in 1994 to about nine in 1998. Given that profits earned by city commercial banks have been excluded from the calculation of the index, therefore the decrease in level of concentration should be even greater.

Table 4:

Concentration of Profit: Herfindahl Index

	1994	**1995**	**1996**	**1997**	**1998**
1/Herfindahl Index	4.166	6.004	6.463	7.707	9.339

Source: Calculated by the authors based on data obtained from *Almanac of China's Finance and Banking*, various years

Note: Owing to the lack of information on the profits of each city commercial bank, the index has been calculated by excluding these banks and treating the domestic commercial banking industry as consisting of state commercial banks and joint-equity commercial banks only. The truncated indexes, therefore, overestimate the concentration of profits in the industry.

Competitive Conditions: Institutional Analysis

The concentration indexes that we have calculated show that the deposits-and-loans market is dominated by state-owned commercial banks. These banks, however, fail to capture a comparable share of the profits. The quantitative analysis provides important information on the market structure of the industry. The data, however, do not answer the important questions of (1) how and why such a market structure has emerged and (2) how the market structure affects the efficiency of the banking industry. In this section we tackle these issues by examining the underlying rules that have governed competition among banks in China. The institutional investigation not only enriches our understanding of the industry's competitive conditions but also provides insight as to how to improve them.

Rules Governing Competition in the Deposits Market

The most important determinant of the level and nature of competition in China's deposits market has been the central bank's interest rate control. PBOC has strictly controlled the interest rates for different kinds of deposits. This has effectively ruled out price competition in the deposits market. Consequently, market competition has been in the form of nonprice competition. Under nonprice competition, banks that capture a larger share of deposits may not be the most profitable and efficient ones.

When nominal interests paid to deposits by different banks are identical, depositors' choice of banks depends essentially on banks' financial fundamentals and on the quality of services they provide. For risk-averse depositors, putting deposits in a bank with poor financials means a higher level of risk and hence a lower expected return on deposits. Putting money in a bank that provides better services, however, means a higher actual return on deposits. When interest rates are controlled, market forces will dictate that deposits be concentrated in banks with sound financial fundamentals and better services.

Banks' financial fundamentals, however, have not been an important set of rules determining the distribution of deposits among domestic banks in China. As we have shown in the previous section, deposits have been concentrated in the four state commercial banks whose financials are poor. These banks are saddled with an extensive portfolio of nonperforming loans. According to the Chinese government, nonperforming loans account for 20% to 25 % of their total lending. International observers estimate that the nonperformance rate actually exceeds 40% (EIU 1999). Joint-equity commercial banks, on the other hand, exhibit lower nonperforming loan ratios than the big four (Table 5).

Table 5:

Nonperforming Ratios of Joint-Equity Commercial Banks

Bank	**1997 (year end)**	**1998 (year end)**	**1999 (June)**
China Merchants Bank	9.1	10.5	14.5

Bank of Communication	13.9	19.3	22.41
China Everbright Bank	7.7	13.7	20.9
CITIC Industrial Bank	11.2	15	17.84
China Minsheng Bank	2	6	10.93
Hua Xia Bank	4.3	5.7	6.64
Pudong Development Bank	6.7	8.9	10.07
Guangdong Development Bank	15	21.5	23.28
Shenzhen Development Bank	15.4	20.4	30.67
Fuijin Industrial Bank	12.3	14	14.08
Average	11.8	13.5	17.13

Sources: Research Department of Head Office of the China Merchants Banks (1999), An Investigation on the Development of the Commercial Banks (Dui Wo Gauo Shang Ye Yin Hang Fa Zhan Qing Kuang De Diao Chao Yan Jiu Bao Gao), *Research Report No. 14;* Statistics Office, Credit Planning Department of Head Office of the China Merchants Bank (1999), Comparison of the Operating Conditions of the Joint-Equity Commercial Banks in the Second Quarter of 1999 (1999 Nian Dier Ji Du Tong Ye Jing Ying Zhuang Kuang Dui Bi Fen Xi), *Inquiry on the Management of China Merchants Banks* (Zhao Yin Guan Li Shu Ping), Vol. 336

The returns of joint-equity commercial banks are much higher than those of state commercial banks, with returns on assets exceeding 1% while returns on equity are close to 20% (Table 6).

Table 6

Performance of State Commercial Banks and Joint-Equity Commercial Banks

		Return on Asset	Return on Equity	Return on Paid-in Capital
1994	State	0.28	7.35	15.39
	Joint Equity	1.71	26.33	52.36
1995	State	0.34	10.49	13.92
	Joint Equity	1.43	23.52	51.28
1996	State	0.34	10.63	13.90
	Joint Equity	1.44	24.92	51.15
1997	State	0.13	3.9	5.11
	Joint Equity	1.52	21.78	39.16
1998	State	0.09	1.68	2
	Joint Equity	1.07	17.08	36.54

Source: Calculated by the authors based on data obtained from *Almanac of China's Finance and Banking*, various years

Depositors care about banks' financial fundamentals only when different financials imply different levels of risk. Depositors in China have put their deposits in state commercial banks because these banks provide more protection. In order to maintain public confidence in state commercial banks, which have shouldered the important responsibility of keeping state-owned enterprises alive, China's central government has explicitly guaranteed state-owned commercial banks' deposits. The government guarantee means that large state banks will never be allowed to fail.

On the other hand, the government's guarantee to joint-equity banks remains implicit and vague. There is a general belief that joint-equity banks are much riskier than state commercial banks. The demise of the Hainan Development Bank in 1998 reinforced this conception. Even though all deposits have been paid in full by the government, deposits have shifted from joint-equity commercial banks to state commercial banks because of depositors' loss of confidence in the former (An Gang and Yang Zhi Yong, 1999).

Even if depositors in China have an incentive to put their deposits in banks with good financials, it is very difficult for them to ascertain banks' true status. Analyzing the financial conditions of state commercial banks is difficult. The financial statements they disclose are highly aggregated. Their unconventional accounting standards also render their reported assets and earnings highly suspect. For example, they record interest income on overdue loans as received income even though it has not actually been received.

The disclosure of some joint-equity banks is more transparent and detailed than that of state commercial banks. Minsheng publishes both international- and domestic-standard accounts, both of which are audited by PriceWaterhouseCoopers. China Everbright's accounts are audited by Arthur Andersen. BOCOM's disclosure, however, lags behind that of other joint-equity banks; it produces financial reports similar to those of the state commercial banks. The overall quality of information provided by domestic banks in China is far below international standards and does not provide good signals to depositors.

As far as services to depositors are concerned, state commercial banks have a number of advantages over other banks, even though state banks are less efficient in their overall operation. Some of these advantages are derived from their established networks. Some,, however, come from the restrictive policies imposed by the government on joint-equity commercial banks and city commercial banks.

The four state commercial banks established their branches along the country's administrative structure, with branches in every province, city, and county. In 1998 they operated about 145,000 branches across the country and employed more than 1.6 million workers (Table 7). The administrative approach to branching is not consistent with economic logic, and some researches indicate that state commercial banks are operating beyond their efficient scales (Wei Yu and Wang Li 2000, Huang Xian 1998). The wide network, however, gives them an immense advantage in absorbing deposits, especially in term of accessibility.

Table 7

Number of Branches and Workers

	Number of Branches	
	State Commercial Banks	Other Commercial Banks
1996	153070	3748
1997	153704	4675
1998	144148	4501
	Number of Workers	
	State Commercial Banks	Other Commercial Banks
1996	1686883	85505
1997	1563542	95537
1998	1667784	92034

Source: *Almanac of China's Finance and Banking*, various years

Joint-equity commercial banks, however, have only a small number of branches. Some of these banks are local banks with branches only in their own localities. The networks of so-called national joint-equity commercial banks are also not extensive; they have branches only in the economically advanced regions of the country. The limited presence of joint-equity commercial banks is mainly due to the control imposed by PBOC. Each year PBOC imposes quotas on the number of new branches that each joint-equity commercial bank can set up. The quotas have effectively slowed down the network building of the joint-equity commercial banks and has hindered their ability to compete with state commercial banks.

In addition to restrictions on setting up branches, there are also a number of artificial barriers limiting competition in the deposits market. Each domestic enterprise in China is allowed to open a basic account for handling daily transactions. The account usually has to be opened in the bank that provided loans for the enterprise. This rule favors state commercial banks because they provide most enterprise loans. After the closure of Hainan Development Bank, each administrative and nonprofit unit was allowed to open only one special deposit account for accumulated revenue and one special deposit account for charge of extra-budgetary funds. The accounts must be opened in state commercial banks.[6] As a consequence, many ministries, departments, big enterprises, and local governments give similar orders requiring their subordinate units to open their accounts in state commercial banks (Chen Zhengzong 2000).

[6] The measure was introduced by PBOC to monitor the cash flows of the units. It, however, became a rule that hinders the ability of joint-equity commercial banks and city commercial banks to compete for that source of deposits.

Rules Governing Competition in the Loans Market

Interest rates in the loans market are controlled by PBOC as they are in the deposits market. Currently, loan interest rates must be within a range set by the central government. Price competition, therefore, has been restrained in the loan market. The interest rate control has not only denied banks in China a means to compete for low-risk borrowers but has also limited the flows of loans to high-risk borrowers.

While there is no limit on the total amount of deposits that state commercial banks can absorb, the amount of loans they can extend has been restricted by PBOC's credit control. Before 1998 the central bank attempted to control state commercial banks' credit by setting mandatory credit quotas. Although PBOC imposed the quota system for the purpose of monetary control, the quantity restrictions in effect reduced state commercial banks' ability to compete with other banks.

Joint-equity commercial banks and city commercial banks have not been subject to the control-of-credit plan. Their expansion in the loans market, however, is constrained by restrictions on their fund-raising. They have not been allowed to issue bonds internationally. PBOC has been discriminating against them in its lending policy; it extends only a very small portion of its loans to them. PBOC's loans to these banks accounted for less than 1 % of its total outstanding loans from 1994 to 1998 (Table 8).

Table 8

Loans from Central Banks to Commercial Banks

	1994	**1995**	**1996**	**1997**	**1998**
State Commercial Banks	10182.2	11095.2	14088.5	13885.1	11867.2
Other Commercial Banks	92.6	43.7	81.2	59.7	77.8
Share of Other Commercial Banks	0.9%	0.39%	0.57%	0.43%	0.65%

Source: *Almanac of China's Finance and Banking*, various years

In addition to having their funding restricted, joint-equity commercial banks and city commercial banks have been limited in the loan services they are permitted to provide. For loans backed by securities, all state commercial bank branches, together with the head offices, can conduct business. Such business can, however, only be handled at the head offices of joint-equity commercial banks. City commercial banks are totally excluded from this business. Joint-equity commercial banks have to pay a much higher licensing fee in order to enter the credit card business (Chen Zhengzong 2000).

In a market economy banks tend to compete for borrowers who are creditworthy. This has not been the case in China's loan market. The majority of China's bank loans have gone to state-owned enterprises whose financial viability is poor (Table 9). Furthermore, debt-laden state-owned enterprises have been able to ignore interest and principal payments on the grounds that they are impossible to foreclose. The failure to harden the budget constraints of state-owned enterprises has finally adversely affected domestic banks' credit risk and profitability.

Table 9

Percentage of Loans to Private Sector

	State Banks[1]			**All Financial Institutions**[2]		
	Loans to Town-village Enterprises	Loans to Foreign-Fund Enterprises	Loans to Private Enterprises and Individuals	Loans to Town-Village Enterprises	Loans to Foreign-Fund Enterprises	Loans to Private Enterprises and Individuals
1994		2.27	0.16		1.94	0.38
1995		2.28	0.08		1.97	0.39
1996		2.56	0.11		2.20	0.46
1997	2.57	2.89	0.27	6.72	2.52	0.52
1998	2.56	3.25	0.30	6.44	2.87	0.55

Source: *Almanac of China's Finance and Banking, various years*

Note: 1. State banks include state commercial banks, policy banks, BOCOM, and

CITIC Industrial Bank.
2. All financial institutions include policy banks, state commercial banks, joint-equity commercial banks, city commercial banks, and all nonbank financial institutions.

There are two reasons for the composition of bank loans in China. First, it is a result of directed credit lending. Although the Commercial Bank Law grants commercial banks operational independence and freedom of choice in their lending decisions, the majority of the domestic banks lacked the autonomy to choose their customers. They are under pressure from both central and provincial authorities to make loans to favored sectors and enterprises. Before 1998 the central government influenced the lending decisions of state commercial banks through its credit control plan. The plan not only established a credit ceiling for the banks but also specified their general usage. State commercial banks therefore lacked the independence to decide on the allocation of credit among different sectors. When banks allocated the specified credit quota to local branches, these branches also lacked the freedom to choose borrowers. As local governments practically decided on the senior appointments of local banks, these governments were able to exert strong pressure on the banks to extend loans according to the governments' preferences. Two decades of policy lending created a large burden in the loan portfolio of the four state-owned commercial banks and placed them at a huge competitive disadvantage in relation to their competitors.

Directed lending is not unique to China's state commercial banks. Joint-equity commercial banks and city commercial banks are not immune from state interference as long as their major shareholders are local governments and state institutions. The level of state interference in these banks is critically dependent on the relationship between the shareholders and the government. Banks with a close relationship with central and local governments tend to be more susceptible to political pressures in their lending decisions. Among joint-equity commercial banks, the Huaxia was owned by enterprises covering the metallurgy, tobacco, energy, petrochemistry, transportation, and building industries. The shareholders are scattered in 10 provinces and municipalities and lack a close identification or affiliation with the central government or any particular local government. The bank was relatively free from the influences of central and local governments, and it has one of the cleanest balance sheets among joint-equity commercial banks. By the end of 1999 the bank's nonperforming loans ratio was only 6.64 %, whereas the average of all commercial banks' ratios had climbed to 17.13 (see Table 5). On the other hand, locally based joint-equity commercial banks such as GDB and SDB tend to have a close relationship with their local governments;

their nonperforming loan ratio trails behind that of other joint-equity banks (see Table 5).

The role of direct lending in determining the distribution of loans in China has been diminishing, especially since the abolition of the credit plan in 1998. In recent years, the central bank has encouraged domestic banks to open consumer credit and expand credit to private enterprises. Its efforts, however, have been hampered by the lack of credit-tracking tools, a national accounting standard, and a sound legal framework including collateral and bankruptcy legislation. While all these are of little use when most banks' credits are directed to state-owned enterprises, they are badly needed when banks start to act as commercial entities.

Owing to the poor national accounting standards and the lack of credit history records, it is very difficult for domestic banks in China to obtain a fair assessment of loan applications except for those of state-owned enterprises that have long-term connections with the banks. Domestic banks simply do not have sufficient information to select trustworthy and efficient new fund users and to monitor their behavior. The deficiencies in the enforcement of collateral and bankruptcy legislation further increases credit risks. The high credit risks explain why the banks, which have been relatively free from policy lending, also have high nonperforming loan ratios. For example, Mensheng's exposure to debt-laden state enterprises is low; more than 85% of its loans went to the private sector in1998 (Xaio Gang 1999). The banks' nonperforming loans ratio, however, increased from 2% in 1994 to 10.93 % in 1999. One of most serious consequences of high credit risks has been the low incentive to extend loans to privatized and new start-up enterprises and to consumers. This low incentive has held back financial deepening in China, with negative implications for the development of the banking industry and the growth of the economy. [7]

Recent Developments

Empirical evidence and institutional analysis show that market discipline has yet to be established in China's domestic banking industry. Owing to government interference, information problems, and a weak legal infrastructure, deposits have been concentrated in the less-efficient state commercial banks, and loans have been extended to ailing state-owned enterprises. China's existing institutional arrangements have not only reduced the level of competition in the industry but have also generated adverse effects for the industry's efficiency.

[7] Bossone (1999) has built a theoretical model to analyze how financial-sector development is affected by incomplete trust, see Bossone Biagio (1999). For how the low level of trust has blocked financial intermediation in China , see Anonymous (1999), .

Spurred on by the lessons of the Asian economic crisis and pushed by market-opening measures laid out in the WTO accession agreement with the United States, China has taken concrete steps to reform the banking industry in recent years. Some of these measures have helped create a more competitive and efficient banking environment.

One of the most important problems restricting and retarding the emergence of market discipline in China's domestic banking industry has been state interference. There have been four major types of government interventions: credit and interest rate controls, directed policy lending, discriminating and restrictive policies, and state guarantee. As far as credit and interest-rate controls are concerned, PBOC abolished credit quotas in January 1998. Interbank market rates were also liberalized in early 1999.

At the end of 1998 PBOC replaced its provincial-level branches with regional branches. Instead of having a local branch in each province, municipality, and autonomous region, the streamlined regional branches of PBOC have been located in nine cities: Shenyang, Tianjin, Jinan, Nanjing, Shanghai, Guangzhou, Wuhan, Chengdu, and Xi'an. Furthermore, local governments no longer determine who should be appointed as senior officials at local branches. Instead, the bank's headquarters do this.

The reorganization of the central bank is expected to protect commercial banks from local government interference.

Efforts have also been made to clean up the balance sheets of the state commercial banks so as to remove their competitive disadvantage that has resulted from policy lending. Last year, 270 billion yuan in new capital was allocated to the four state-owned commercial banks. Four asset-management companies were created to help the banks unload their nonperforming loans. The objective of this effort is to restore the financial health of state commercial banks so that they can compete with other banks in a market-driven environment.

In addition to enhancing the competitiveness of state commercial banks, the central bank is preparing to give joint-equity commercial banks and city commercial banks more room to expand. Some joint-equity commercial banks will be allowed to boost their size by listing on local stock markets, an option that had already been taken up by Pudong Development Bank. In April the central bank pledged to give more financial resources to the city commercial banks to support their payment and lending business.

In order to maintain the public's faith in the banking industry, the central government has continued its explicit guarantee of state commercial banks. Smaller banks have been lobbying for the establishment of a deposit insurance scheme in China so that they can provide the same level of protection to depositors. The issue has been debated intensively. Supporters consider such a scheme a means to enhance competition and deepen financial intermediation. Skeptics, however, worry that it may introduce additional moral hazard, with negative consequences for the health of the financial system.

In addition to reducing government interference, PBOC has made efforts to tackle the information problems that have limited competition in the industry. In early 1999 all domestic banks were required to adopt a new loan-classification standard scheme with five-categories: pass, special mention, substandard, doubtful, and loss. In April a banking rule requiring true names of depositors took effect, replacing the old system that allowed people to open personal savings accounts under false names. While the system was introduced with an eye toward tax collection and curbing corruption, it could facilitate the establishment of a personal credit record system. In May the central bank introduced a pilot scheme requiring banks in the Shanghai region to submit lists of defaulters to a national "blacklist." The program is now being expanded throughout the country and has been effective in deterring delinquent debtors (EIU 2000).[8] A

[8] When the Guangzhou PBOC published its blacklist in June 1999, dozen of defaulting companies

comprehensive national credit-rating system was activated in February 2000; under it all financial institutions have to submit information on their borrowers to a national database.

Implications for Improving Competitive Conditions

During the past two years much headway has been made in improving competitive conditions in China's domestic banking industry. State commercial banks have started to take active measures to enhance their competitiveness in the market. In addition to diversifying their loan portfolio into new markets such as consumer loans and mortgages and loans to small private companies, they have made efforts to reduce the number of branches and to hire better-educated new staff (Tables 7 and 10).

Table 10:

Percentages of State Commercial Banks' Staff with at least Post-secondary Education

	1996	1997	1998
ICBC	N/A	34.6	38.99
ABC	24.3	27.8	32.05
BOC	41.3	44.9	48.6

reportedly took steps to pay up. See EIU (2000).

CBC	41.2	44.5	48.8

Source: *Almanac of China's Finance and Banking, various years*

Furthermore, state commercial banks are attempting to enhance their risk-management and credit-analysis capacity by setting up credit and risk-management departments and providing risk-control education and training for staff. All these indicate that state commercial banks are better actuated in improving efficiency. Nevertheless, the reforms introduced so far have failed to create a competitive and efficient institutional environment. Effective market discipline can emerge in China only with the introduction of more fundamental institutional changes.

As far as removing state interference is concerned, the objective of the reform is to transfer final decision making to the banks themselves, with the government acting only as a regulator. The government, however, has not disentangled itself completely from the industry. First, the industry's operation is still circumscribed by government-imposed constraints, including high entry barriers and artificial business restrictions. Second, banks have not been completely freed from political obligations. The central government, for example, has attempted to make use of state commercial banks to support state-enterprise reform during the past two years. At the National

People's Congress in March 1999, state banks were reminded of their "political responsibility" to lend to money-losing enterprises. In June 1998 PBOC advised state commercial banks to increase their financial support of ailing state-owned enterprises and to boost economic growth (EIU 1999). It has been reported that state commercial banks have increased their backing of local economic development in different localities (China Business Information Network 1998). The local governments, in their capacities as major shareholders, also continue to interfere with joint-equity commercial banks and city commercial banks.

The competitive conditions of China's banking industry could be improved if China lowered entry barriers, especially for private banks. Experience demonstrates that transition economies' banking sector can benefit by allowing the private banking industry to develop. First, new banks established by state enterprises in transition economies are of poor quality (Stijn Claessens 1996). Second, the institutional capacity of banks in transition economies improves faster when a new or parallel private banking system is allowed to emerge than when the government tries simply to reform existing state-owned banks (Stijn Claessens 1996). This is a particularly important lesson for China in light of its banks' poor institutional legacy.

The role of competition in improving resource allocation is limited or even distorted if the competitive behavior of economic actors is circumscribed by artificial restrictions. The removal of various restrictions on the provision of deposit and loan services could provide a leveler playing field for different banks so that they could compete with each other through efficiency and innovation. Furthermore, their efficiency could increase if they enjoyed greater autonomy in their management. For example, one of the biggest problems confronting state commercial banks is cutting back on staff. In 1998 the four state commercial banks employed 95 % of the employees in the domestic banking industry (see Table 7), while these banks' market shares of deposits and loans were only 84.26% and 88.51%, respectively (see Table 1). Banks' profitability could be enhanced in the long run if employees could be terminated and high-quality staff hired with better remuneration packages.

Domestic banks have been lobbying for listing on the stock exchange on the grounds that the transformation and diversification of the ownership structure could give them operational independence. Listing on the stock exchange is in fact partial privatization. It is a very important step that could pave the way for an even higher degree of privatization by allowing banks to sell more shares to the public.

The experience of joint-equity commercial banks and city commercial banks, however, clearly indicates that commercial banks in China fully shed their roles as policy tools as long as their major shareholders are local governments or state institutions. An effective way to make China's domestic banks independent of state interference is to privatize them, with partial and complete divestiture of the state-held ownership share of the commercial banks.

Argentina has been a leader among developing countries in restructuring its banking industry. The privatization of roughly half of its publicly owned provincial banks has been one of the country's most important reform measures. It has been demonstrated that post-privatization banks show improvements in both their loan-portfolio quality and the efficiency with which they generate income. The provincial banks that remained in the public sector in Argentina did not demonstrate the same performance gains as privatized provincial banks (George R. G. Clarke and Robert Cull 1998).The level of competition in China's domestic banking industry will improve if China can privatize some domestic banks.

In addition to privatizing state-owned commercial banks, China can further improve its banking industry's competitiveness by deregulating bank interest rates and increasing foreign entry. In late 1999, following the liberalization of interbank market rates, the central bank announced that more discretion would be given to commercial banks to set interest rates. Interest-rate liberalization, if it is implemented, will pave the way for price competition in the industry. On the other hand, China will have to remove many existing restrictions on foreign banks after its accession to the WTO. This will stimulate foreign entry and increase competition between domestic banks and foreign banks. To reap the full benefits of interest-rate liberalization and increased foreign competition, China must remove existing business restrictions on foreign banks rather than erecting new barriers to prevent foreign banks from taking a dominant market position after China's accession to the WTO.[9]

Privatization and liberalization of the banking industry in China should be approached cautiously. Banking crises are more likely to occur in liberalized financial systems where institutions to ensure legal behavior, contract enforcement, and effective prudential regulation and supervision are weak.[10] China must therefore erect a sound legal, regulatory, and supervision infrastructure together with privatization and liberalization. Such an infrastructure will not only help reduce the banking industry's fragility but will also contribute positively to industry efficiency by reducing the transaction costs involved in financial intermediation.

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[9] In March 2000 PBOC told some foreign banks that they were not allowed to make local currency loans worth more than eight times their branch capital. Others have been given a limit of just four times their capital. The move raises the concern that China intends to stiff foreign banks by erecting barriers permissible under the WTO framework. See Anonymous (2000)

[10] A World Bank empirical study on the relationship between banking crises and financial liberalization in a panel of 53 countries for the period 1980–95 shows that the impact of financial liberalization on banking-industry fragility is weaker where the institutional environment is strong. See Asli Demirgue Kunt and Enrica Detragiache (1998).

Competition is more than rivalry among economic actors. Whether competition can contribute to economic efficiency depends critically on the set of institutions—including economic, political and legal institutions—that govern competitive behavior. This study shows that existing institutional arrangements have inhibited effective and efficient competition in China's domestic banking industry. Improving competitive conditions requires fundamental institutional changes. Interest rates and credit controls, directed lending, artificial business restrictions, and state guarantee have to be abolished. More important, state-owned banks must be privatized so as to completely insulate bankers' decisions from political pressures. On the other hand, legal and regulatory institutions that support and enhance the efficient functioning of the banking industry have to be developed in tandem.

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