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The Political Origin and Firm-Level Consequences of Bank Proliferation in China

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Export-Import Bank of India (India Exim Bank) instituted the BRICS Economic Research Annual Award in 2016. The objective of the Award is to promote advanced doctoral research in international economics, trade, development and related financing, by nationals of any of the five member nations of BRICS, from any University/ educational institution globally. This study is based on the doctoral dissertation titled "Building Markets within Authoritarian Institutions: The Political Economy of Banking Development in China" selected as the award winning entry for the India Exim Bank BRICS Economic Research Annual Award (BRICS Award) 2020, written by Dr. Adam Yao Liu, currently Assistant Professor at the Lee Kuan Yew School of Public Policy, National University of Singapore, Singapore. Dr. Liu received his doctoral degree in 2018 from the Stanford University, USA.

Introduction

Limited government is often argued as the political foundation for market development. Without it, a two-sided commitment problem undermines market: the state cannot commit to non-expropriation, and the private actor cannot commit to preserving the state-dominated market after entry. This should be particularly true for markets that are contract-intensive and future-oriented. The established wisdom, however, is unable to explain the development of the world's largest banking market in authoritarian China. There not only did a highly competitive banking market emerge but, because of it, credit is being distributed widely.

It is argued that the Chinese solution to market formation is what is termed as "organizational spinoff"—distributing bank charters and transferring financial resources and knowhow to lower level governments, much like a firm setting up subsidiaries to increase internal competition and overall return. Avoiding the aforementioned commitment problem, the state made private actors irrelevant in this first stage of market development. In essence, the Chinese state embedded the process of marketization in existing political institutions that not only incentivize state agents to compete economically but also constrain how they compete. After market competition was set in motion and state control consolidated, private actors were allowed to enter subsequently but only as shareholders of the spinoffs. This strategy allowed the Chinese state to simultaneously capture gains from market competition and exercise continuing control over the market.

Evolution of the Chinese Banking System

Tracing the evolution of the Chinese banking system, the study draws primarily from government documents, official data and field interviews. What Beijing did to its banking system was much akin to a firm spinning off subsidiaries to increase internal competition and overall return. First, local governments did not simply receive central permission and then build banks from scratch; the center not only handed out charters, but also transferred part of its own financial assets, namely urban credit unions created by the Big 4, to local governments, with which the latter organized commercial banks of their own. Second, it was not a simple split up of balance sheets; also involved was the replication of organizational structures and the transfer of human resources—all the newly created local state banks (LSBs) had to have the same organizational structure as the Big 4, with a party committee sitting at the top, and all had bankers from the Big 4 and even the central bank as their founding management.

Why did China's central state end its own monopoly in banking? It is argued that the central motivation was two twofold, one political and one economic. The political rationale explains the timing of the transformation; bank charters were used explicitly as a quid pro quo for eliciting localities' support for the center's fiscal recentralization reform in

1994, which took a large chunk of local fiscal revenue away. Substantiating this finding from fieldwork, the history of every major commercial banks in China was traced, and it is shown that the year 1994 presents a structural break in the development of Chinese banking. The number of banks increased rapidly since then, and concomitantly, the market dominance of the center's banks (i.e. the Big 4) began to shrink.

Organizational Spinoff

The economic rationale of organizational spinoff is directly comparable to corporate spinoff. For example, one motivation for the latter is to allow the parent firm to focus on core business. What the Chinese state was also focusing on—in addition to rebalancing the fiscal system—was to prepare for an overhaul of the financial system, the key to which was to clean up the NPL-ridden Big 4 and then get them listed in Hong Kong. Localities were therefore called upon to be in charge of part of the financial system during this process. Another economic rationale, also analogous to the corporate case, was to identify and appreciate undervalued assets. Spinning off separate firms (new banks) would allow investors to more accurately value assets and make selective investments. For instance, private and foreign investors immediately began to hold shares in profitable LSBs, and only later did they hold shares in the reforming Big 4.

The spin-off process was planned out carefully rather than done in a one-shot, ad hoc fashion. In 1994, only major cities and special economic zones were given bank charters. Two years later, the State Council rolled out the policy to other prefecture-level cities across the country. In yet another two years, the center declared that LSBs with sufficient high-quality assets could set up branches in other cities within their home provinces. By 2005, LSBs were allowed to set up branches anywhere in the country, a privilege still contingent on asset and performance as assessed by the central state. In a nutshell, banking market development in China proceeded under central planning. By 2015, China had 2,214 banks with 223,444 branches.

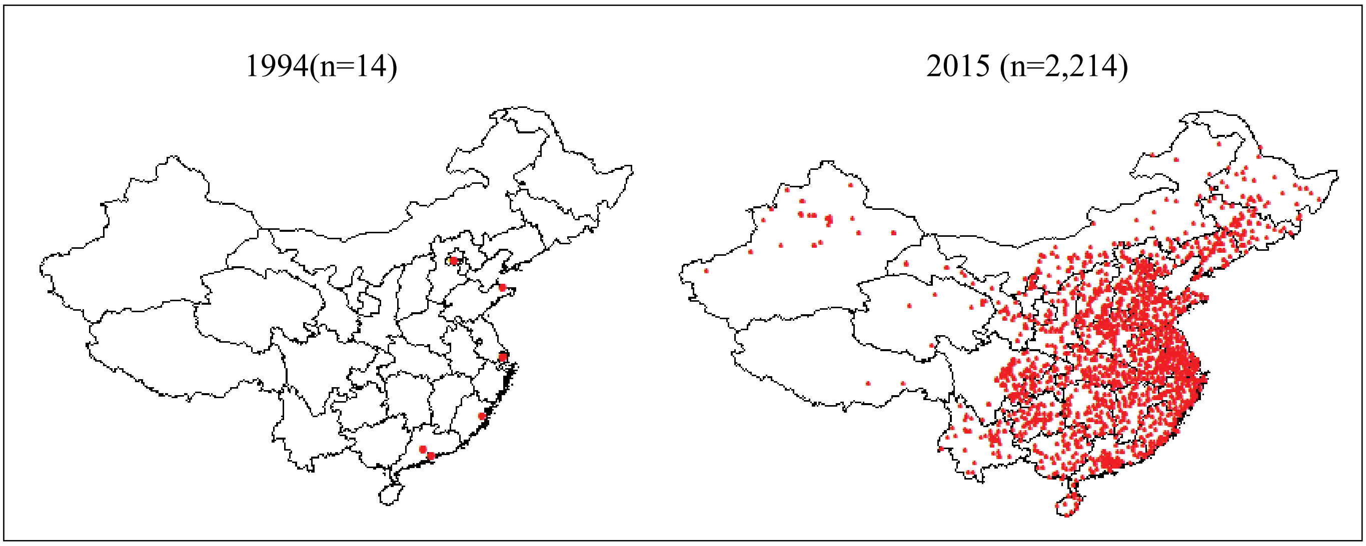
How exactly did localities end central monopoly in banking? And what prevented the LSBs from downgrading to ATM machines of local governments? Addressing these, the study primarily draws from fieldwork. A total of 278 interviews were conducted in six economically disparate provinces and regions (e.g. Shanghai vs. Gansu). In addition to spatial variation, the process of banking market development was traced in a number of different localities in detail by interviewing bankers and officials who have participated in the process of LSB development in different time periods since the mid-1990s.

Building Market

At the center of local banking market formation are local governments. They use a variety of strategies to assist LSBs to grow, effectively chipping away the center's monopoly. For example, local governments all used "fiscal deposits" to help LSBs getting started in their formative years; they assisted the banks in collecting information about local firms and securing deposits from local enterprises; they mobilized local media instruments to promote LSBs marketing; and they let LSBs take care of local bureaucracies' payroll systems, which made it practically hard not to use the banks' additional services.

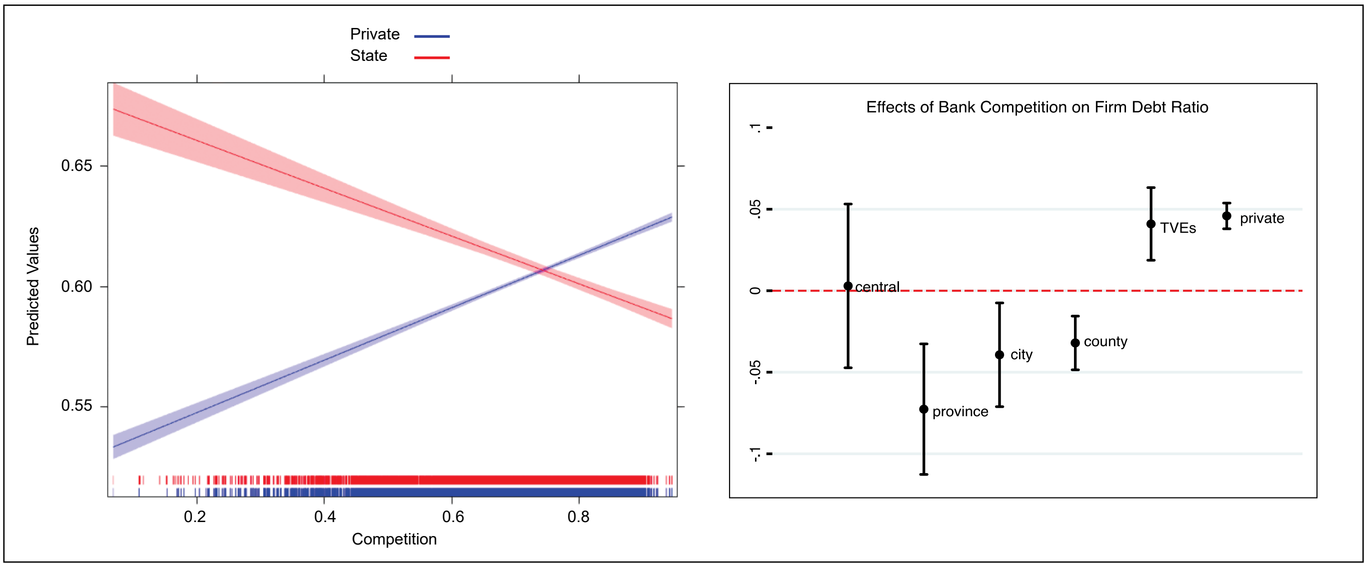
While necessary, local government support alone is insufficient for LSB development. To effectively compete against the center' Big 4, LSBs had to offer better deals and services to remain competitive in both the deposit and loan markets, while remaining innovative. Most new financial products that had appeared in China over the past twenty years were first issued by LSBs.

Figure 1: Geographical Distribution of Bank Headquarters



Source: China Banking Regulatory Commission

Figure 2: Bank Competition and Firms' Access to Finance



Preserving Market

Organizational spinoff alone does not produce market competition; banks can simply serve as governments' fiscal agents. Moreover, even in free markets without state intervention, it is not necessarily the case that market players will compete at margins that are socially effective; they must not compete by threatening or killing each other.

Two sets of institutions tie localities' grabbing hands and motivate their helping hands. The first disciplines and the second incentivizes. While some of these institutions are specifically designed for managing and structuring the banking market, most are deeply embedded in existing political institutions that appeared in post-Mao China.

Market Discipline

Market discipline hinges on the power of the central state. First, the center maintains oversight of the entire banking system and decides the pattern and pace of banking market development. Organizational spinoff is not financial decentralization, because local autonomy is highly limited; they cannot issue new bank charters, nor can they prohibit outside entry. Bank expansion of any kind requires central approval. Second, the center punishes bad performers. Localities do not obtain a bank charter for once and forever; the center retains the ability to revoke charters. Third, also disciplining is the party's nomenclature system. Whereas the existing literature tends to focus on how it incentivizes officials, it has not stressed sufficiently that the same system also disciplines and punishes. Expropriation of banks can lead to local financial instability, something Beijing has constantly warned against.

Incentives

Both bankers and local government officials are incentivized to promote banking market development. The bankers—though still first and foremost financial agents of the state rather than private entrepreneurs—are incentivized to pursue market share as well as profitability. Unlike in the early years of economic reform, when their career advancement was still contingent on faithfully following government orders, now their promotions and monetary interests are both explicitly tied to bank performance. The incentive is arguably the strongest for bankers at LSBs, i.e., the new spinoffs, who serve at their posts for much longer than bankers at the Big 4 or local officials. With longer time horizons, the "stationary" bankers are naturally more inclined to ensuring the healthy development of the banks than are the "roving" officials.

Local officials are also incentivized to support banking market development. In addition to competition for bank investors, interjurisdictional competition also quickly emerged. While LSBs initially all relied on local governments as their primary shareholders, they have to attract new investors—private and foreign—to survive and compete with the Big 4. Consistent with the market-preserving federalism literature, interjurisdictional competition for mobile capital does deter arbitrary government expropriation. What that literature does not explain, however, is the rise of the market in the first place. If there were no market, nothing would need to be preserved. In China, the "Tiebout condition," i.e., factory mobility, is the outcome of market formation and reform, not a precondition for it.

Interjurisdictional competition also goes well beyond attracting new bank shareholders. Local government not only are interested in growing their own banks, but are incentivized to be equally enthusiastic—if not more so—in getting new banks to enter their jurisdictions. There is no beggar-thy-neighbour commonly associated with decentralization, but only invite-thy-neighbour. The reason is straightforward: officials have no interest in turning their LSBs into local monopolies because that is impossible to achieve in their short tenure, and more importantly, new entry means new sources of lending for development. Bank entry is often accompanied by a "strategic agreement" between the local government and the entrant, with the latter promising to issue a certain amount of credit in the locality in a specified number of years. This is not expropriation; the targeted recipients are usually private entrepreneurs that are still financially constrained.

Dataset and Observations

However, fine-grained statistical tests require first solving a tremendous data challenge: most Chinese banks do not put up their annual reports online. Even for those that do, i.e. large listed SOCBs, information cannot be found for their local branches. The study builds a dataset that contains the geocoded information of all types of Chinese banks and their branches to develop proxy measures for local bank competition.

The following observations were made: (1) state bank competition increases private firms' access to finance; (2) it lowers private firms' cost of borrowing from banks; (3) it reduces private firms' reliance on informal finance; and (4) it facilitates the formation of new private firms in a given locality. These findings collectively challenge the myth/ stylized assertion that Chinese banks are basically irrelevant for private sector growth. In addition, evidence is also found for bank competition hardening local SOEs' budget constraint. Yet, this constraining effect is also evident for local SOEs, not central SOEs.

Bank Competition and Firms' Access to Finance

Figure 2 shows two things. The left panel shows that bank competition eases private firms' access to external finance (blue line), but hardens that of SOEs (red line). The right-hand-side panel breaks the firms (N=675,657) into sub-categories, showing that central SOEs are not affected by bank competition (controlling for a set of their performance measures), indicating continued political protection. Other types of local SOEs are negatively affected vis-à-vis private firms and privatized TVEs.

Conclusion

Focusing on banking market development in China, this research attempts to look into a critical yet hitherto unaddressed question: Why do contract-intensive markets develop without limited government? Limited government—which features institutions that constrain the arbitrary power of the state—is often argued to be the foundation for market development. This study suggests that it need not be. Harnessing the institutions of a non-limited government can achieve comparable results, at least in the early stages of market development. Reform in this way also minimizes political risks for the incumbent regime, thereby preserving political stability—a prerequisite for any development. If banking market development entailed the loss of financial and even political control, Beijing would not have pursued it. No reforming government wants to be reformed away.

This study also raises two additional broader questions, one analytical and one substantive. Analytically, it points to the limits of our current understanding of authoritarian states as unitary actors. Much of the existing literature models the state, and the authoritarian state in particular, as a "revenue maximizing autocrat," a "stationary bandit" or a single-person representative agent. While parsimonious, the one-actor approach inevitably misses how the internal dynamics of the state influence its interaction with the larger society, and it is incapable of explaining dramatic institutional changes without societal demands or so-called exogenous shocks. The emergence of a competitive banking market in China is unfathomable without understanding the dynamics of central–local politics, that is, without treating the authoritarian state as an "organization of organizations."

Substantively, the findings of this research raise a fundamental question: where is the boundary of government in market development? The dominant view is that the government should protect property rights, enforce contracts and be separate from markets. In contrast, this work, joining other existing research, argues that governments from developing countries need not just be providers of market infrastructures or coordinators for resource allocation, but, with proper institutional constraints and incentives, can be market players. Somewhat paradoxically, this might be especially true when it comes to initiating contract-intensive markets that are prone to expropriation. Authoritarian governments do not necessarily stifle the market; they can build, preserve and expand it as well.

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