BANKING SECTOR REFORMS IN INDIA AND CHINA –
A COMPARATIVE PERSPECTIVE

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ABSTRACT
India and China have both started banking sector reforms after decades of heavy state involvement. This paper takes a comparative perspective on the reforms in the two countries by analyzing the reform progress made since the early 1990s along the lines of the policy recommendations of transformation studies, evaluating the results using the CAMEL framework, and discussing political-economy factors that may have contributed to the respective reform outcomes.

The key findings are: (1) India and China have followed most of the policy recommendations in the areas of liberalization, institution building and structural change, while privatization of state-owned banks has lagged in both countries; (2) India has generally proceeded faster with banking sector reforms and outperforms China on most indicators; (3) from a political-economy perspective, a common restraining factor on the reforms are the ailing state-owned enterprises that lack hard-budget constraints, and the influence of interest groups in areas such as privatization and directed credit, while the political system appears to be less important than commonly assumed.

JEL-Classification: O53, O57, P52.

Key words: Banking sector reforms, CAMEL, China, India, transformation.

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1 INTRODUCTION

China and India have managed an impressive economic take-off since the opening of their economies in 1978 and 1991 respectively. Both countries have attempted to liberalize and modernize their economies by for example lowering trade barriers, opening their countries for foreign investments and deregulating industries.

Despite the impressive progress made in many parts of the economy, the banking sectors of both countries are not fully liberalized yet and continue to be state-dominated. In addition, both banking sectors still suffer from years of state-intervention as can be seen for example by the comparatively high level of non-performing loans (NPLs) or the overstaffing of state-owned banks. This can have significant implications for the overall economic performance of the two countries since studies have shown that a well-developed banking sector positively influences growth through the mobilization of savings and the allocation of capital to the highest value use.\(^1\) While the benefits of a well-functioning banking sector are apparent, pursuing the necessary reforms towards this goal is not without pitfalls. From a political-economy perspective the reform of a banking sector poses major challenges due to special interest groups, the repercussions on the enterprise sector, and the linkage with a country's fiscal situation.

How to manage the transition from a state-directed to a market-based system is the main focus of transformation studies. The recommendations along the process elements of transformation studies can provide a framework to evaluate the progress of banking sector reforms in China and India. Knowing how the reforms have proceeded is however only the first step in an overall evaluation since reforms are no means by themselves, but should contribute to an improvement of the economics of the banking sector. This is evaluated along the lines of the CAMEL framework.\(^2\) To provide possible explanations for the results, relevant political-economy factors that have shaped the reforms and their outcomes are discussed.

This paper contributes to the scarce comparative literature on banking sector reforms in India and China in three ways: (1) it provides an evaluation along the lines of transformation studies on the reform process in the two countries, (2) performance indicators are used to provide a

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\(^2\) The acronym CAMEL stands for Capital adequacy, Asset quality, Management soundness, Earnings and profitability, and Liquidity
holistic view on the relative performance of the two banking sectors, and (3) political-economy factors affecting reform outcomes are evaluated in a systematic manner.

The rest of the paper is organized as follows: section 2 provides an overview of the main elements and recommendations of transformation studies as the theoretical basis for the evaluation of the reforms. The influence of political-economy factors on the reform process in the banking sector is discussed in section 3. In section 4 the development and major reforms in the banking sectors in India and China are presented. This is followed by a discussion in section 5 of how the recommendations of transformation studies were followed in the reform process of both countries and which performance effects the reforms had. In section 6, the influence of political-economy factors on the reform process and results is discussed. Section 7 concludes.

2 OVERVIEW OF TRANSFORMATION STUDIES

Transformation studies\(^3\) attempt to explain the trigger, process and result of long-run systemic changes. A transformation is frequently triggered by a political or economic crisis and involves a fundamental change of the underlying economic, political or cultural order, which often entails a redistribution of relative power and wealth.\(^4\)

A frequently used early blueprint for the transformation from a state-directed to a market-based system was the Washington Consensus that emphasized liberalization, stabilization and privatization. It was at the beginning of the 1990s widely adopted in Latin America and in Central and Eastern Europe (CEE).\(^5\) However, soon after the start of the transition in the CEE countries, the Washington Consensus came under increasing scrutiny for offering an overly simplistic model of transformation. The experiences in the transition countries have shown that especially two factors have to receive more attention. First, institutions are needed to ensure the functioning of the market system. Second, in most transition countries the

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\(^3\) There is disagreement in the literature whether a general "transformation theory" exists. Because of the controversy, the more neutral term "transformation studies" is used in this paper to refer to a set of hypothesis describing the process of transition from a state-directed to a market-based system.

\(^4\) See Kloten (1991), p. 9; Wagener (1996), p. 9. According to Wagener (1996) the main difference between a transformation and a reform is the depth of the changes. While in a reform, the underlying economic order is preserved, a transformation involves the substitution of the underlying economic order with a new one. Despite these conceptual differences the terms transformation, transition and reform are used interchangeably in this paper.

economic structure was distorted through state interventions, which make significant structural changes necessary. Thus, the main policy recommendations of liberalization, stabilization and privatization have to be complemented by institution building and structural change.\(^6\) These five elements as well as issues that relate to the timing and sequencing of reforms are now briefly described in the context of banking sector reforms.

*Liberalization* of the banking sector is a part of the internal liberalization of an economy. As for the overall economy, liberalization refers to the establishment of a market-determined price and allocation mechanism.\(^7\) An extensive literature starting with the seminal works of McKinnon (1973) and Shaw (1973) argues for the reduction of repressionist policies such as interest rate restrictions, reserve requirements and directed credit programs.\(^8\)

The rationale for sequencing the liberalization of interest rates is that more sophisticated economic agents need a shorter adjustment period, as well as to reduce overly fierce competition for deposits at the start of liberalization. Thus, interest rate liberalization should start with wholesale interest rates, followed by lending rates and finally deposit rates. For interest rate liberalization to be successful, economic agents should be subject to hard-budget constraints to ensure sound borrowing and lending, and banks should have a certain degree of stability to avoid break-downs due to price competitions in liberalized markets.\(^9\)

Reserve requirements are a tool of monetary policy. They can however become an instrument of financial repression, if they are used as a source of cheap funds for the budget deficit since they then constitute a distortionary tax on the banking sector. The policy recommendation consequently is to only employ reserve requirements for monetary policy.\(^10\)

Under a directed credit program banks have to channel credit to certain priority sectors due to perceived market failures or development objectives. Should market failures exist that limit the access to credit of certain parts of the population or the enterprise sector, measures to ensure access to credit should be implemented before liberalization. For the abolishment of a


\(^{7}\) The removal of entry and exit barriers can be regarded as part of the liberalization of an economy as well. Here, these points are regarded as enablers for structural changes in a sector.

\(^{8}\) See for example Fry (1997), McKinnon (1991), or Roubini and Sala-i-Martin (1992).


\(^{10}\) See Joshi and Little (1997), p. 125.
directed credit program, a dual-track approach with nominal credit targets should be used so that economic agents have time to adjust and potential reform losers are compensated.\textsuperscript{11}

\textit{Stabilization} of the banking sector is another important reform element. In the context of banking sector reforms, stabilization refers especially to the recapitalization of banks that are likely to be burdened by a legacy of non-performing loans (NPLs) and low levels of capital. To avoid moral hazard, this should be done through a "once-and-for-all" program. Pre-conditions for a successful recapitalization of banks are the correct measurement and classification of NPLs to be able to determine the capital need, a stable macroeconomic environment, transparent accounting standards and a legal framework to enforce claims.\textsuperscript{12}

One of the main levers to create a market-based banking system is the \textit{privatization} of state-owned banks (SOBs). In light of the often inadequate systems of governance under state ownership, privatization is regarded as a way to enhance the performance of SOBs and avoid costly bailouts. A successful program of bank privatization should lead to entities that are both independent of the state and of insider control. Pre-conditions towards this goal are a disengagement of the state from direct governance of banks and the build-up of a regulatory framework as a means of indirect control. For the disengagement of the state to be credible, banks must be able to operate independently which may make a recapitalization before privatization necessary. The main policy recommendation for bank privatization is to sell state-owned banks through a transparent bidding process to strategic partners. This should help to quickly upgrade banks' operations to best practice levels, and to fully divest the government's holding to avoid continued interference. This view is however not undisputed since large-scale sales to foreign investors might lead to a popular backlash against reforms.\textsuperscript{13}

The experience of the transition countries made it clear that the incentives created by privatization and liberalization of the economy would not work in the absence of proper \textit{institutions}. In terms of necessary institutions for the banking sector, countries at least need to have the following in place. First, accounting and disclosure rules to promote transparency for outside stakeholders and supervisors. Second, a regulatory system to supervise market participants so that consumers are protected, competition is promoted, and risk-taking is not

\textsuperscript{11} For a discussion of dual-track liberalization in China see Lau, Qian and Roland (2000).
threatening the stability of the overall system. Third, capital adequacy standards following the Basel capital accord to have a cushion against losses and reduce risk-taking. These institutions have to be embedded in the overall institutional and legal structure that includes for example commercial and business laws.\(^{14}\)

Managing *structural changes* constitutes one of the central tasks of transition. In the context of a banking sector, a key lever for structural changes is the entry of domestic and foreign banks. Before new banks – and especially more sophisticated foreign banks – can enter the market, it is important to have a bank supervisory agency in place. In addition, it is important that the incumbent banks have sufficient net worth to avoid undue risk taking in a more competitive environment. If these conditions are met, the general policy recommendation is to allow entry of new banks into the market. Experience has shown that the threat of entry alone can force incumbent banks to improve and upgrade their operations, which ultimately enhances consumer welfare.\(^ {15}\)

The successful management of the transformation process does not simply depend on executing the five previously described process steps, but also on managing the interaction between these elements. Since a transformation strategy will almost inevitably contain gradual reforms, the *sequencing* of the policy reforms as well as the *timing* of their implementation become important considerations. Since the sequence depends at least partially on country specific initial conditions, it is difficult to draw general conclusions from the experiences of other countries. There are however some generally applicable recommendations.\(^ {16}\) First steps in a banking sector reform program should be the creation of market-based institutions and if needed the stabilization of banks. From this basis, interest rates can be liberalized in the sequence described above. The next steps are the lowering of statutory pre-emptions and the step-wise removal of directed credit. When the necessary regulatory structure has been established and domestic banks are accustomed to market mechanisms, entry barriers for domestic and foreign players can be lifted, and the privatization of state-owned banks can start.\(^ {17}\)

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3 POLITICAL-ECONOMY CONSIDERATIONS FOR BANKING SECTOR REFORMS

Banking sector reforms do not occur in isolation: the transformation of the banking sector affects other parts of the economy, and developments in the rest of the economy in turn have a profound influence on banking sector reforms. A further complication is that the reforms in the banking sector affect different interest groups such as savers, borrowers, or bank employees. Consequently, political-economy considerations are important for the successful management of banking sector reforms. Two important factors, the inter-connection of banking sector reforms with the enterprise sector and the fiscal situation, as well as the role of interest groups, are discussed in more detail.

The banking sector serves as an intermediary between providers and users of capital in an economy. In a market-oriented banking system, banks will try to channel capital to the ventures with the best risk-return trade-off in order to minimize credit losses and maximize profits, which will ensure an efficient allocation of capital in the economy. This may however change in a system where the state has an important influence over the credit allocation of the banking sector and enterprises face soft-budget constraints. If enterprises face soft-budget constraints, losses can either be covered by subsidies from the government budget or with further loans from the banking sector. The extension of loans to loss-making enterprises adversely affects the profitability and capital base of the banking sector, which may make a bailout of banks with government funds necessary. To avoid costly recapitalizations of banks due to unsustainable lending practices, enterprises have to abide to hard budget constraints. There are two implications from these arguments for banking sector reforms. First, banking sector reforms need to be complemented by reforms in the enterprise sector if soft budget constraints are present. Second, the financial capability and resources of the government affect the pace of banking sector reforms.

While the introduction of hard-budget constraints is an important complementary element for banking sector reforms, the extent of available financial resources has direct implications on the transformation process in the banking sector. First, low or moderate public debt may slow down the privatization process, because with funds available for subsidies for loss-making

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18 For a discussion of the soft-budget constraint see for example Kornai (1986).
public enterprises and banks, there is no urgent pressure to privatize.\textsuperscript{19} Second, high budget deficits are likely to lead to a persistence of repressive policies in the form of interest rate controls and statutory pre-emptions since they constitute sources of cheap funds for the government, and thus lower its financing costs. Third, higher public debt and deficits may result in a slower reform pace if compensation transfers have to be made.\textsuperscript{20} Fourth, high public debt and deficits make a "once-and-for-all" recapitalization less likely because the necessary resources are lacking. Thus ceteris paribus, the higher the public debt and deficits, the slower the pace of banking sector reforms will be.

The speed of reforms is not only influenced by the fiscal position of the government, but to a major extent by the existence of interest groups that are affected by the reform process. Since the seminal work by Olson (1965) the effects of interest groups have been a recurrent topic in the political-economy literature. The analysis of interest groups is also important in the context of banking sector reforms since they may profoundly affect the liberalization process. Without going into an in-depth discussion, interest groups may have ceteris paribus the following effects on the transition process. First, the higher the number of veto players such as in a coalition government or with well-organized trade unions, the less likely is privatization.\textsuperscript{21} Second, interest rate restrictions and directed credit program provide rents to certain interest groups, which will oppose the abolition and try to delay a full liberalization.\textsuperscript{22} Third, the opening of the market for new entrants depends on the strength of incumbents to block new entrants vis-à-vis the existence and degree of organization of outsiders that would benefit from the reform. In general it can be assumed that incumbents are better organized and have closer ties to relevant decision-makers, which will delay reforms.\textsuperscript{23} Fourth, interest groups may also affect the speed of reforms. A "war of attrition" between different interest groups, in which the group that gives in first loses more, will lead to a delay of reforms.\textsuperscript{24}

\textsuperscript{19} See Opper (2004), p. 571.
\textsuperscript{20} See Roland (2002), p. 45.
\textsuperscript{22} This can however be solved by using a dual-track liberalization approach in which pre-existing rents are preserved. For a discussion see Lau, Qian and Roland (2000).
\textsuperscript{24} See Alesina and Drazen (1991), p. 1171.
addition, uncertainty about the distribution of gains and losses from the reforms will induce
economic agents to prefer the status quo, which may also lead to a delay of reforms.\textsuperscript{25}

It can be concluded that political-economy factors can have a profound influence on the
reform process in the banking sector, and therefore can help to explain reform outcomes.
Before these factors are applied to explain the reform progress in India and China, an
overview of banking sector reforms in the two countries is given.

4 DEVELOPMENT OF THE BANKING SECTORS IN INDIA AND
CHINA

4.1 India
At the time of Independence in 1947, the banking system in India was fairly well developed
with over 600 commercial banks operating in the country. However, soon after Independence,
the view that the banks from the colonial heritage were biased against extending credit to
small-scale enterprises, agriculture and commoners gained prominence. To ensure better
coverage of the banking needs of larger parts of the economy and the rural constituencies, the
Government of India created the State Bank of India (SBI) in 1955. Despite the progress in
the 1950s and 1960s, it was felt that the creation of the SBI was not far reaching enough since
the banking needs of small scale industries and the agricultural sector were still not covered
sufficiently. Additionally, there was a perception that banks should play a more prominent
role in India's development strategy by mobilizing resources for sectors that were seen as
crucial for economic expansion. As a consequence, in 1967 the policy of social control over
banks was announced, which aimed to cause changes in the management and distribution of
credit by commercial banks.\textsuperscript{26}

In 1969 the 14 largest public banks were nationalized which raised the Public Sector Banks'
(SOB) share of deposits from 31% to 86%. The two main objectives of the nationalizations
were rapid branch expansion and the channeling of credit in line with the priorities of the five-
year plans. To achieve these goals, the newly nationalized banks received quantitative targets
for the expansion of their branch network and for the percentage of credit they had to extend

\textsuperscript{25} See Fernandez and Rodrik (1992).
to the so-called priority sectors, which initially stood at 33.3%. Six more banks were nationalized in 1980, which raised the public sector's share of deposits to 92%. The second wave of nationalizations occurred because control over the banking system became increasingly important as a means to ensure priority sector lending, reach the poor through a widening branch network and to fund rising public deficits. In addition to the nationalization of banks, the priority sector lending targets were raised to 40%. Besides the establishment of priority sector credits and the nationalization of banks, the government took further control over banks' funds by raising the statutory liquidity ratio (SLR) and the cash reserve ratio (CRR). From a level of 2% for the CRR and 25% for the SLR in 1960, both increased steeply until 1991 to 15% and 38.5% respectively.27

However, the policies that were supposed to promote a more equal distribution of funds, also led to inefficiencies in the Indian banking system. To alleviate the negative effects, some reforms were enacted in the second half of the 1980s. The main policy changes were the introduction of Treasury Bills, the creation of money markets, and a partial deregulation of interest rates.28 Despite the reform attempts, the Indian banking sector had like the overall economy severe structural problems by the end of the 1980s. By international standards, Indian banks were even despite a rapid growth of deposits extremely unprofitable. In the second half of the 1980s, the average return on assets was about 0.15%. The capital and reserves of Indian banks stood at about 1.5% of assets, which was significantly below other Asian countries that reached about 4-6%.29

The 1991 report of the Narasimham Committee served as the basis for the subsequent banking sector reforms. The objective of banking sector reforms was in line with the overall goals of the 1991 economic reforms of opening the economy, giving a greater role to markets in setting prices and allocating resources, and increasing the role of the private sector.30 In the following years, reforms covered the areas of (1) liberalization including interest rate deregulation, the reduction of statutory pre-emptions, and the easing of directed credit rules; (2) stabilization of banks; (3) partial privatization of state-owned banks; (4) changes in the

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institutional framework, and (5) entry deregulation for both domestic and foreign banks. The main reforms are now briefly described.

**Interest rate liberalization**

Prior to the reforms, interest rates were a tool of cross-subsidization between different sectors of the economy. As a result the interest rate structure had grown increasingly complex with both lending and deposit rates set by the Reserve Bank of India (RBI). The lending rate for loans in excess of Rs200,000 which account for over 90% of total advances was abolished in October 1994. Banks were at the same time required to announce a prime lending rate (PLR) which according to RBI guidelines had to take the cost of funds and transaction costs into account. For the remaining advances up to Rs200,000 interest rates can be set freely as long as they do not exceed the PLR. On the deposit side, there has been a complete liberalization for the rates of all term deposits, which account for 70% of total deposits. From October 1995, interest rates for term deposits with a maturity of two years were liberalized. The minimum maturity was subsequently lowered from two years to 15 days in 1998. The term deposit rates were fully liberalized in 1997. As of 2004, the RBI is only setting the savings and the non-resident Indian deposit rate. For all other deposits above 15 days banks are free to set their own interest rates.31

**Statutory pre-emptions**

Until 1991 the CRR had increased to its maximum legal limit of 15% from a level of around 5% in the 1960s and 1970s. From its peak in 1991, it has declined gradually to a low of 4.5% in June 2003. In October 2004 it was slightly increased to 5% to counter inflationary pressures, but the RBI remains committed to decrease the CRR to its statutory minimum of 3%. The SLR has seen a similar development. The peak rate of the the SLR stood at 38.5% in February 1992, just short of the upper legal limit of 40%. Since then it has been gradually lowered to the statutory minimum of 25% in October 1997.32

**Priority sector lending**

Besides the high level of statutory pre-emptions, the priority sector advances were identified as one of the major reasons for the below average profitability of Indian banks. The Narasimham Committee therefore recommended a reduction from 40% to 10%. However, this


recommendation has not been implemented and the targets of 40% of net bank credit for domestic banks and 32% for foreign banks have remained the same. While the nominal targets have remained unchanged, the effective burden of priority sector advances has been reduced by expanding the definition of priority sector lending to include for example information technology companies.\textsuperscript{33}

\textit{Stabilization}

Due to directed lending practices and poor risk management skills, India's banks had accrued a significant level of NPLs. Prior to any privatization, the balance sheets of SOBs had to be cleaned up through capital injections. In the fiscal years 1991/92 and 1992/93 alone, the Indian government provided almost Rs40 billion to clean up the balance sheets of SOBs. Between 1993 and 1999 another Rs120 billion were injected in the nationalized banks. In total, the recapitalization amounted to 2% of GDP.\textsuperscript{34}

\textit{Privatization}

Despite the suggestion of the Narasimham Committee to rationalize SOBs, the Government of India decided against liquidation, which would have involved significant losses accruing to either the government or depositors. It opted instead to maintain and improve operations to allow banks to create a starting basis before a possible privatization. In 1993 partial private shareholding of the SBI was allowed, which made it the first SOB to raise equity in the capital markets. After the 1994 amendment of the Banking Regulation Act, SOBs were allowed to offer up to 49% of their equity to the public. This led to the partial privatization of an additional eleven SOBs. Despite those partial privatizations, the government is committed to keep the public character of these banks by for example maintaining strong administrative controls.\textsuperscript{35}

\textit{Institution building}

The report of the Narasimham Committee was the basis for the strengthening of prudential norms and the supervisory framework. Starting with the guidelines on income recognition, asset classification, provisioning and capital adequacy the RBI issued in 1992/93, there have been continuous efforts to enhance the transparency and accountability of the banking sector.


The improvements of the prudential and supervisory framework were accompanied by a paradigm shift from micro-regulation of the banking sector to a strategy of macro-management.\textsuperscript{36}

The Basle Accord capital standards were adopted in April 1992. The 8% capital adequacy ratio had to be met by foreign banks operating in India by the end of March 1993, Indian banks with a foreign presence had to reach the 8% by the end of March 1994 while purely domestically operating banks had until the end of March 1996 to implement the requirement. Significant changes where also made concerning NPLs since banks can no longer treat the putative ‘income’ from them as income. Additionally, the rules guiding their recognition were tightened. Even though these changes mark a significant improvement, the accounting norms for recognizing NPLs are less stringent than in developed countries where a loan is considered nonperforming after one quarter of outstanding interest payments compared to two quarters in India.\textsuperscript{37}

\textit{Structural changes}

Before the start of the 1991 reforms, there was little effective competition in the Indian banking system due to strict entry restrictions for new banks, which effectively shielded the incumbents from competition. Over 30 new banks – both domestic and foreign – have entered the market since 1994. By March 2005, the new private sector banks and the foreign banks had a combined share of almost 20% of total assets.\textsuperscript{38}

\section*{4.2 China}

Like in other countries the development of the banking sector in China has been strongly influenced by the pre-dominant political philosophies. Since the foundation of the People's Republic of China (PRC) the Chinese banking sector has undergone several distinct policy changes. Before the reforms conducted after 1994 are described in more detail, the earlier developments in the banking sector are briefly described.

The banking system of the Soviet Union in the 1930s served as a blueprint for the Chinese system after the declaration of the PRC in 1949. The People's Bank of China (PBC) stood at

\begin{thebibliography}{99}
\bibitem{ReserveBankIndia2005b} See Reserve Bank of India (2005b), pp. 231-233 and p. 258f.
\end{thebibliography}
the center of a virtual mono-banking system since it had the main responsibility for cash, credit and settlements. Even though at the beginning of the 1950s other banks and rural cooperatives existed, they de-facto functioned as extensions of the PBC, and were eventually merged into the PBC system in 1955. As the de-facto mono-bank, the PBC combined central banking and commercial banking functions, and served as a tool for the implementation of the Five-Year Plans. As such, the PBC did not have any degrees of freedom in its lending decision – size, term and interest rates of loans were all administratively set.\(^{39}\)

In 1979 China established a two-tier banking system with the foundation of three state-owned banks. These were the Agricultural Bank of China (ABC), the Bank of China (BOC) and the People's Construction Bank of China (PCBC). The ABC was charged with the task of providing banking services to rural areas and townships, the BOC which was separated from the PBC was supposed to act as an urban bank providing different banking services, while the PCBC took responsibility for financing large capital intensive projects. This was an important first step in creating a more diversified and specialized banking system. In 1984, the Industrial and Commercial Bank of China (ICBC) was established and complemented the three other state-owned commercial banks by taking over the commercial banking functions and the vast branch network of the PBC. In 1984 the PBC became the official central bank after ICBC had taken over its commercial banking functions.\(^{40}\)

Several important steps were taken to further commercialize the banking system between 1985 and 1994. Among them was the replacement of direct grants with interest-bearing loans to harden the budget constraints of state-owned enterprises (SOEs), the granting of formal responsibility for the PBC in 1986 over monetary policy and the supervision of the financial system, and the formulation of a credit plan that instituted an aggregate credit ceiling for each PBC branch. Within those credit ceilings, the branches gained increasing autonomy to make credit decisions. In 1993 the State Council initiated further reform steps that included the transformation of the PBC into a modern central bank with responsibility for monetary policy and financial system supervision, and the decision to separate policy and commercial lending

\(^{39}\) See Lo (2001), p. 16; Nanto and Sinha (2002), p. 472; Wolken (1990), p. 54; Yang (2004), p. 2. Under the central planning system, enterprises had two sources of funds: the state budget and the banking system. Companies received most of their funds through the official state budget. The remainder of the funds – primarily for working capital – was provided by the PBC based on a national credit plan that was prepared by the State Planning Commission of the State Council. See Wolken (1990), p. 55.

which was the basis for the transformation of the state banks into commercial banks. In addition to the foundation of the policy banks, major reforms in the areas of reserve requirements, interest rate deregulation, reduction of directed lending, entry deregulation, improvement of prudential regulation, and NPL management have been started since 1994. These reforms are now described in more detail.

*Interest rate liberalization*

The initial attempts to liberalize interest rates started in the late 1980s, when Chinese banks received the flexibility to adjust interest rates for lending within a certain range around the administered rate. Further progress was made in 1998 and 1999 when attempts were made to increase the flow of credit to SMEs by first increasing the interest ceiling on loans to SMEs to 20% in 1998 and then to 30% in the following year. From 2002, banks received more flexibility in setting their interest rates on loans since they could charge up to 1.3 times the central lending rate. This was in 2004 raised to 1.7 times the central lending rate. Despite the progress made on the lending side, deposit rates continue to be largely set by the state.

*Statutory pre-emptions*

Attempts have been made to ease the burden of statutory pre-emptions. After an increase of reserve requirements from 13% to 20% in 1992, they were lowered to 8% in 1998 and to 6% in 1999. The statutory reserves are remunerated by the PBC.

*Priority sector lending*

The main instrument for directed lending in China has been the credit plan. An important step towards a more market-based allocation of credit came with the Commercial Banking Law of 1995, in which the four SOBs were given responsibility to operate as commercial entities with accountability for profits and losses. Besides the establishment of the policy banks, this marked an important step to ensure the extension of loans based on economic and not political criteria. The credit plan for working capital loans and fixed investment loans was in 1998 replaced with an indicative, non-binding target. Today, even though banks are in general able

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to extend loans based on commercial considerations within the framework of the existing regulations, the government is still able to intervene to some extent in credit decisions.44

Stabilization
Stabilization of state-owned banks is one of the foremost issues in the Chinese banking system. The need to stabilize the SOBs arises from a combination of a large stock of NPLs and low equity capital that could serve as a cushion for loan losses. Despite rapid credit growth over recent years, the stock of NPLs has not declined sufficiently so that even today NPLs stand at around 15-20% of total loans, which implies that the banking sector is technically insolvent. The Chinese government has tried to solve the problem by recapitalizing the Big Four banks with almost USD 260 bn in three successive rounds of recapitalization since the late 1990s and by shifting NPLs to asset management companies.45

Privatization
Privatization of state-owned banks in China has not proceeded beyond the selling of minority stakes. The first partial privatization of a Big Four bank was the global initial public offering of China Construction Bank in October 2005, which was followed by the listing of Bank of China in June 2006. Besides that foreign investors have taken ownership stakes in second-tier banks starting in December 2001 with HSBC’s purchase of an 8% stake of the Bank of Shanghai, a local joint-stock commercial bank.46

Institution building
Important upgrades to the institutional infrastructure of the Chinese banking sector were made between 1995 and 2002. The Commercial Banking Law included provisions that required banks to focus on efficiency and liquidity in their operations, as well as to make inquiries into the creditworthiness of their customers. In addition, the Commercial Banking Law required banks to maintain an 8% equity cushion and to adopt a classification system for NPLs. The loan classification system was further upgraded in 2002 with the introduction of a five-tier system which all banks had to adopt by the end of 2005. Important progress in the area of regulation and supervision was made in 2003 with the establishment of the China Banking Regulatory Commission (CBRC) that took over these responsibilities from the PBC. The

44 See Mo (1999), p. 99; Shirai (2002a), p. 24. For example according to the Commercial Banking Law state banks have to provide credit for projects approved by the state council. See Shirai (2002a), p. 24
current main priorities of the CBRC are the reduction of NPLs, ensuring sufficient levels of bank capital and the upgrading of banks' internal indicators to international standards.47

Structural changes

Starting in the second half of the 1990s, the SOBs saw an increase in competition through the establishment of new commercial banks whose shares were owned by public authorities, and at times by individuals. These new commercial banks include for example Shenzhen Development Bank, Guangdong Development Bank and Everbright Bank. Under China's WTO commitment, the banking sector has to be opened successively between 2002 and 2006 in terms of business reach and geography. Until 2002 foreign banks were only allowed to serve foreign companies and foreign individuals. This was extended to Chinese domestic companies in 2005, with the commitment to lift all restrictions in 2006, so that services can be offered to Chinese individuals as well. In geographic terms, the liberalization also proceeds in a phased manner with 2006 being the deadline for lifting all geographic restrictions for foreign banks' business in China.48

5 COMPARATIVE PERSPECTIVE ON BANKING SECTOR REFORMS

As the overview of the reform progress in table 1 shows, there is a remarkably high degree of similarity between India and China despite the different starting points for both countries and different reform environments. Both countries have followed the general recommendations for interest rate liberalization, the lowering of reserve requirements, and the enabling of structural changes through the entry of new players. Institution-building is a somewhat special case, because both countries have upgraded their institutions and relevant regulations. However, the enforcement of these rules seems to have been particularly in China, at least until recently, an issue. In the areas of directed credit and privatization both countries have made relatively little progress towards a market-oriented banking system. In the area of stabilization both countries have not followed the recommendation of a "one-time" recapitalization of banks. It is interesting to note that in all areas with the exception of

directed credit, India has started in general 5-10 years earlier with reforms than China. While this can to a certain extent be attributed to China's mono-bank legacy and fragility of its banking sector, this marks an important deviation to the overall reforms where China is in general perceived to be the first-mover.

Concerning the timing and sequencing of reforms, both countries have followed – like for the rest of their reforms – a gradual reform path. The generally proposed sequence of reforms has been followed quite well by both countries with only some smaller deviations. For example the initial partial privatizations were conducted quite early in the reform process in India. The selling of minority stakes should however be interpreted more as a means to generate funds, and not to cede control. China started with institution building relatively late, which again can be attributed to the legacy of the mono-banking system, which first required the build up of a two-tier banking system. It is interesting to note that both countries have despite their gradual and cautious reform not always had all the necessary pre-conditions in place.

Overall it can be concluded that India and China followed the policy recommendations fairly well. It is noteworthy that reform progress has been limited in the contentious areas of directed credit, privatization and stabilization, which would be expected from a political-economy standpoint since these are the reforms that most likely affect various interest groups, and are intricately linked to enterprise reforms and the fiscal situation of the government.

Banking sector reforms are no means by themselves, but should contribute to a better functioning of the sector. Therefore, it is necessary not only to evaluate the reform process, but also the performance effects of banking sector liberalization. This is done with the indicators of the CAMEL framework that analyzes capital adequacy, asset quality, management soundness, earnings and profitability, and liquidity. To provide a more holistic view of the reforms, indicators for financial development and sectoral concentration are included in the analysis.

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49 See International Monetary Fund (2000), p. 4. Sensitivity to market risks is sometimes used as an additional factor. Due to lack of data it is however not included here.
Table 1: Reform progress in India and China

<table>
<thead>
<tr>
<th>Process step</th>
<th>Pre-conditions</th>
<th>Policy recommendation</th>
<th>Status</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liberalization Interest rates</td>
<td>(1) Hard-budget constraints in the enterprise sector</td>
<td>Liberalize wholesale rates first, followed by lending rates and deposit rates</td>
<td>Pre-conditions only partially fulfilled</td>
<td>Pre-conditions only partially fulfilled</td>
</tr>
<tr>
<td></td>
<td>(2) Stability in the banking sector</td>
<td></td>
<td>Wholesale rates liberalized in the late 1980s, lending rate liberalization started in 1994; deposit rate liberalization started in 1995</td>
<td>Wholesale rates liberalized first, widening corridor for the setting of lending rates (starting in 1998), deposit rates largely set by the state</td>
</tr>
<tr>
<td>Directed credit</td>
<td>Ensure access of broad population groups to credit</td>
<td>Directed credit should be abolished via a dual track liberalization</td>
<td>Directed credit program remains in place</td>
<td>De-facto government retains some influence over credit distribution</td>
</tr>
<tr>
<td>Reserve requirements</td>
<td>Control over budget deficits</td>
<td>Only use reserve and liquidity requirements for monetary policy</td>
<td>From peak in 1991, SLR lowered to statutory minimum of 25% (1997); CRR with 5% slightly above minimum of 3%</td>
<td>Reserve requirements were lowered from a peak of 20% in the early 1990s to 6% (1999). Effective reserves however above this level</td>
</tr>
<tr>
<td>Stabilization</td>
<td>(1) Correct measurement and classification of NPLs</td>
<td>Recapitalize banks with a “once-and-for-all” program</td>
<td>Pre-conditions not fulfilled at start of reforms</td>
<td>Pre-conditions except for stable macro environment not fulfilled</td>
</tr>
<tr>
<td></td>
<td>(2) Transparent accounting standards</td>
<td></td>
<td>Several rounds of recapitalization between 1991 and 1999</td>
<td>Big Four banks received three rounds of capital injections between 1998 and 2005</td>
</tr>
<tr>
<td></td>
<td>(3) Legal framework for claim enforcement</td>
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<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(4) Stable macro-economic environment</td>
<td></td>
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</tr>
<tr>
<td>Privatization</td>
<td>(1) Disengagement of state from direct governance of banks</td>
<td>Fully divest government’s holding by selling state-owned banks to strategic partners</td>
<td>Minority stakes in SOBs sold starting with the SBI in 1993; government however committed to keep public character of banks, other pre-conditions fulfilled</td>
<td>Pre-conditions except for the disengagement of the state largely fulfilled</td>
</tr>
<tr>
<td></td>
<td>(2) Build up of regulatory framework for indirect control</td>
<td></td>
<td></td>
<td>Selling of stakes in Big Four banks to strategic foreign investors; listing of China Construction Bank in Oct 2005 and Bank of China in June 2006</td>
</tr>
<tr>
<td></td>
<td>(3) Recapitalize banks if needed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Institution building</td>
<td>· · ·</td>
<td>(1) Accounting and disclosure rules</td>
<td>Upgrading of rules and regulations started in 1992/93, with further tightening in the mid-1990s</td>
<td>Rules have been upgraded in the mid-1990s; full enforcement is however still questionable</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(2) Regulato ry and supervisory system</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(3) Capital adequacy standards in line with Basel capital accord</td>
<td></td>
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</tr>
<tr>
<td>Structural change</td>
<td>(1) Supervisory agency</td>
<td>Allow entry of domestic and foreign players</td>
<td>Entry of new domestic and foreign banks started in 1994</td>
<td>Phased opening following the WTO agreements</td>
</tr>
<tr>
<td></td>
<td>(2) Sufficient net worth of incumbents</td>
<td></td>
<td>Net worth of incumbent banks however relatively low at the beginning of reforms</td>
<td></td>
</tr>
</tbody>
</table>

**Capital Adequacy:** India’s banking sector has on average a higher capital basis than the Chinese as measured by the ratio of capital to risk-adjusted assets and the equity share (Figure 1). The Chinese banking sector has however shown some improvements in recent years following the recapitalization of the SOBs.\(^50\)

**Asset Quality:** Both countries have started the reform process with a huge burden of NPLs. India has however so far more successfully managed to gradually reduce the burden of NPLs and to introduce hard-budget constraints. In China the ratio of NPLs has despite capital injections and strong loan growth not declined significantly (Figure 2).

**Management Soundness:** The cost-income ratio is lower in China. India has since 1992 shown a steady improvement and has lowered the CIR from 90% to 70% (Figure 3)

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\(^{50}\) The aggregate capital adequacy ratio in India has since 1996 exceeded 10%. For China, data is not available for all years, but the level is likely significantly below the 8% threshold of the Basel capital standards.
Earnings and Profitability: With the exception of the immediate aftermath of the balance-of-payment crisis, India's banks have been consistently more profitable than China's banks as measured by the return on assets (Figure 4). While the profitability of China's banks has improved somewhat, it remains low by international standards.

Liquidity: Credit from monetary authorities to deposit money banks was not of great importance in India (Figure 5). However in China it was an important tool for refinancing and capitalization of banks. The importance has however declined in the last years as well. One possible reason for the high share is the former mono-bank system were no distinction between the central bank and commercial banks was made.

Other indicators: Two further indicators to evaluate the reforms are liquid liabilities to GDP and the M-4 concentration ratio. Liquid liabilities to GDP is an indicator of the depth of the financial system. China by far exceeds India in this respect (Figure 6). The M-4 concentration ratio is the sum of the market shares of the four largest banks in the market. Due to the larger institutional diversity in the Indian banking sector in the pre-reform period, the concentration of the banking sector is significantly lower compared to China, which should result in more intense competition that benefits banks' customers (Figure 7).

Thus, it can be concluded that on a sectoral level the Indian banking sector outperforms the Chinese with the exception of the cost-income ratio. The relatively weak performance of the Chinese banking sector as measured for example by the equity share or NPLs is exacerbated by the great importance of the Chinese banking sector for the overall economy as indicated by the high ratio of liquid liabilities to GDP.

Possible factors that may explain the better performance of the Indian banking sector are an earlier start of reforms, a less difficult institutional legacy since India had no mono-banking system, and a lower concentration, which may lead to a higher degree of competition.
Figure 1: Equity share


Figure 2: Non-performing loans as % of total loans


Figure 3: Cost-income ratio


Figure 4: Return on assets

Source: BankScope (2006); Garcia-Herrero and Santabarbara (2004), p. 42; Reserve Bank of India (2005a);
Figure 5: Credit from monetary authorities to banks as % of total credit

Source: International Monetary Fund (2005b).

Figure 6: Liquid liabilities to GDP

Source: International Monetary Fund (2005b).

Figure 7: M-4 concentration ratio assets

The comparison of the reform experiences has shown that India and China have largely followed the same reform path, with India being ahead in most reform areas. This has also led to an overall better performance of the Indian banking sector. Looking at the reforms, it appears that both countries followed the general policy recommendations where they found little opposition from interest groups such as the lowering of reserve requirements or the introduction of capital adequacy standards, while reforms in areas that could likely affected larger constituencies such as privatization, credible stabilization or directed credit where not implemented as suggested by the general policy recommendations. Possible reasons for these outcomes are discussed in the next section.

6 DISCUSSION OF REFORM RESULTS

The political-economy factors discussed in section 3 are now used to interpret and explain the experiences of India and China with banking sector reforms. In both countries the reform outcomes have been influenced by the interaction of fiscal constraints, the performance in the enterprise sector and the influence of interest groups.

Contrary to expectations the relatively weak fiscal situation in both countries appears to have had no major influence on the reform process: despite the relatively high debt levels in both countries, privatization of state-owned banks has not proceeded far, while statutory pre-emptions as well as interest rate restrictions have been lowered more than expected.\(^51\) In these areas interest groups appear to have played a more influential role. The same is true for stabilization of banks. The inability to pursue a "once-and-for-all" stabilization program appears to have been influenced more by the lack of political will to do so than by the budgetary situation.\(^52\)

The pace of reform in the enterprise sector appears to have had some influence on the reform process in the banking sector, especially due to the linkage between state-owned banks and state-owned enterprises. In both countries, banks were – and to some extent still are – burdened by legacy NPLs from SOEs. Since it was politically not feasible to directly introduce hard budget constraints in the enterprise sector at the start of the reforms due to the likelihood of large job

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\(^51\) India has annual budget deficits of around 10% of GDP and government debt of around 80% of GDP. China has a relatively moderate official deficit and debt levels of 3-4% of GDP and about 40% of GDP respectively. However, China has relatively high contingent liabilities from the bad loans that are accumulated in the banking sector, which are estimated to stand at 30% of GDP. See Mukherji (2005), p. 64f.; The Economist (2004), p. 18f.

\(^52\) As discussed above, India's bank recapitalization program in the 1990s for example amounted to a relatively modest 2% of GDP; China appears to have sufficient foreign currency reserves to pay for a recapitalization.
losses, banks had to extend further loans to non-viable SOEs, which in turn adversely affected the quality of banks' loan portfolios. Since the respective governments were not prepared to let large SOEs and SOBs go bankrupt, credible stabilization of banks was not possible, and privatization difficult at best since banks did not fully operate according to commercial principles.

While the fiscal situation has not had the expected effect in shaping reform outcomes, interest groups had a major influence. Especially in India, there has been strong opposition by interest groups against privatization of SOBs and the reduction of directed credit; a situation that has been exacerbated by relatively weak coalition governments that are particularly vulnerable to a loss of voters' support. An important interest group against the opening of the banking sector to new competitors in both India and China were the ailing SOBs themselves, which at least at the beginning of the reform process were not in a position to compete with best-practice players. These factors are more likely to have slowed down the reform process than a "war of attrition" between different interest groups, or uncertainty about the distribution of gains and losses from banking sector reforms.

A surprising feature of the banking sector reforms in both countries is the similarity of the reform process despite a different political, economic and institutional situation in both countries. This is especially striking in terms of the political system since the general assumption is that China as a one-party authoritarian system is in a position to pursue faster reforms than the Indian multi-party democracy. The comparison of the reforms in the banking sector and the faster reform pace in India provide some evidence that the political system has less importance on the reform process and outcome than commonly assumed.

7 CONCLUSION

The goal of this paper was to evaluate the recent banking sector reforms in India and China along the lines of transformation studies and to discuss political-economy factors that have shaped reform outcomes. The analysis showed that the reforms in both countries have proceeded quite far and that many of the general policy recommendations have been followed. There were however important deviations in areas such as stabilization, directed credit and privatization. A likely reason

53 The distribution of bank loans in China shows that this pattern continues: private enterprises received only 27% of bank loans in 2003, but accounted for 52% of GDP. See McKinsey Global Institute (2006), p. 11.

54 As reported by Saez and Yang (2001) this not only appears to be the case in the banking sector, but also in the electricity and telecommunications sector. See Saez and Yang (2001), p. 90.
is higher pressure from interest groups in these areas, and the close connections between the ailing SOEs and state-owned banks. In terms of performance, the Indian banking sector is on most indicators ahead of the Chinese banking sector.

Several implications for policy makers arise from the reform experiences in India and China. First, banking sector reforms are closely intertwined with the real sector of an economy. Therefore, hard-budget constraints in the enterprise sector are an important pre-condition for further reforms in the banking sector in India and China. Second, interest groups can have a profound influence on the reform process especially in "visible" areas such as privatization and directed credit. Thus going forward it is necessary to either incorporate the concerns of diverse stakeholder groups in the reform strategies, or to design compensation mechanisms for potential reform losers to ensure their buy in. The dual-track approach for price liberalization in China for example is a mechanism that could also be applied in the banking sector. Third, the political system of a country is likely less important for successful reforms than the management of interest groups.

There are two areas that warrant further research. First, political-economy factors have only been discussed qualitatively in this paper. An econometric analysis would help to yield further insights into which factors have a significant influence on the reform process. Second, the timing of the banking sector reforms showed that most reforms started in the mid-1990s after the growth acceleration in the two countries. The relationship between banking sector reforms and economic growth in the two countries is therefore a topic that deserves further investigation.

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