How **financial-system reform** could benefit China

A more efficient financial system could have a profound and far-reaching impact on China's economy.

Diana Farrell, Susan Lund, and Fabrice Morin

2006 Special Edition: Serving the new Chinese consumer

**China's transition** to a market-based economy over the past quarter century has unleashed unprecedented economic growth, and the country's financial system had to develop fast to support that metamorphosis. But the transition hasn't been even, nor is it complete. Social tensions are rising, particularly in rural areas, where some people feel left behind by China's voyage to prosperity.

Over the past year, the country's leaders have made reducing the disparities among economic classes and pursuing balanced growth high priorities. But China must further develop and reform its financial system to achieve these goals, according to a new study from the McKinsey Global Institute (MGI). The full report, *Putting China's Capital to Work: The Value of Financial System Reform*, along with an interactive exhibit are available free of charge online. This research shows that China could not only raise its GDP by as much as 17 percent, or $320 billion a year, but also distribute its new wealth more evenly.

The chief tasks of any financial system are to attract savings and channel them to productive investments as efficiently as possible. China's financial system already does an outstanding job of mobilizing savings, but it could considerably improve its overall efficiency and allocation of capital. The system's main shortcoming is that it directs a relatively small share of the country's savings to the economy's most productive enterprises. The most obvious effect is the huge amount of money—more than $100 billion so far and at least that much again going forward—the government has spent and will spend in the future to reduce the level of nonperforming loans. This practice of lending freely to many poorly performing, mostly state-owned enterprises (SOEs) costs China's economy far more, however—even if these loans never turn bad.

Reforms that channeled more funds to private companies—the engine of growth in China's economy—would generate a significantly higher return for the same amount of investment, raising China's GDP by up to $259 billion, or 13 percent, a year. Such reforms would also give Chinese savers appreciably higher returns and thus raise living standards and possibly consumption throughout the country.

The potential benefits of raising the financial system's operating efficiency are also substantial. Steps such as making China's banks as efficient as those in other emerging markets, moving from paper-based payments to an electronic system, and diversifying the sources of funding available to companies could save the economy $62 billion a year, or 3.2 percent of GDP (Exhibit 1)—an amount that is almost equal to the total foreign direct investment that China receives annually.
China’s regulators understandably fear that shifting funds to more productive borrowers could accelerate the pace of layoffs in the less productive SOEs and therefore cause more social unrest. But this reallocation will create massive numbers of jobs in the strongest areas of China’s economy and increase tax revenues to support social programs. Indeed, by prompting rapid economic growth that is both more fairly and evenly distributed, accelerating the move to a fully market-based financial system will relieve rather than exacerbate social tensions in the long run.

**Financing the most productive enterprises**

Over the past ten years, private companies in China—domestic, foreign owned, and joint ventures—have grown more quickly than the country’s GDP. They now account for more than half of all output and for many new jobs. Meanwhile, the share of production from SOEs has shrunk to barely one-quarter of GDP. Although many such companies have been restructured, and some are highly profitable, their productivity as a group is still half that of private companies, both in the aggregate and by industry (Exhibit 2).
Despite these trends, wholly and partially state-owned enterprises continue to receive most of the funding from the financial system (Exhibit 3). Private companies have received just 27 percent of all loan balances. Many of them must turn to China's large informal lending market, with around $100 billion in assets but higher interest rates as well.

This pattern of lending not only explains the large volume of nonperforming loans in China's banking system but also decreases the economy's overall productivity. As a result, China's investment efficiency is declining. During the first half of the 1990s, $3.30 of investment was needed to produce $1.00 of GDP growth. Since 2001, however, each $1.00 of growth has required $4.90 of new investment—40 percent more than the amount required in South Korea or Japan during their higher-growth periods.

China's productivity would rise greatly if a larger share of the funding went to private enterprises. Less productive SOEs would either have to improve their operations to attract financing or shut down. Over time this approach would close the productivity gap between state-owned and private companies and raise China's GDP by as much as 13 percent annually.¹

Chinese households will benefit as better capital allocation raises returns on savings. China's citizens save a lot by international standards—on average, from 20 to 25 percent of their

---

1. Most shareholding enterprises are partly owned by the state; collectives are owned by the people but often run like private enterprises.
2. Includes local privately owned enterprises, foreign joint ventures, wholly owned foreign enterprises.
3. Gross fixed assets + output; net fixed assets not available.
4. State-owned auto companies, though active in different segments, are comparable and display significant differences in productivity growth. For more details, see the China auto case in New Horizons: Multinational Company Investment in Developing Economies, McKinsey Global Institute, October 2002 (www.mckinsey.com/mgi).
5. Figures do not sum to 100%, because of rounding.

Source: National Bureau of Statistics, China; McKinsey Global Institute analysis
India's financial system is more effective than China's in allocating capital, largely because of increasing market share of foreign and private banks. See "Reforming India's financial system."  

Yet the combination of poor capital allocation by banks and the comparatively high cost of financial intermediation means that returns on bank deposits have been dismal. Over the past ten years, Chinese households have earned just 0.5 percent a year on their savings after inflation. In contrast, households in South Korea earned 1.8 percent on their financial assets during the same period. If real returns on savings in China doubled, to 1 percent, households there would gain $10 billion annually—and at South Korea's current level of returns they would gain $25 billion annually. In this way, Chinese households could afford to save less and consume more.

Despite the clear benefits of a better capital allocation, China's regulators have resisted such changes in order to preserve jobs. But developing a market-based financial system is a more attractive way to achieve and sustain higher overall employment in the long term from both an economic and a social standpoint. Although jobs will be lost at the SOEs that can't compete for financing in the open market, the burgeoning private sector will create many new jobs. Net losses are likely to be negligible even in the short to medium term. The experience of China's auto industry, which is now being liberalized, supports this assertion: restructured SOEs have shed many jobs, but total employment in the industry has increased. Moreover, we estimate that the boost in GDP from a more efficient capital allocation will raise the government's tax revenues by 13 percent, without any increase in rates. The state could draw on these funds to support and retrain displaced workers rather than use the financial system to support social-welfare goals.

**Improving the financial system's efficiency**

The state's understandable concerns about economic and social problems only partially explain why China's financial system continues to allocate capital to many underperforming companies. Other important factors include the banking sector's inefficient operations and China's relatively immature debt and equity markets. Such problems not only skew the allocation of capital but also raise operating costs.

Since none of China's financial institutions even existed 25 years ago, their performance can't be expected to match that of their counterparts in mature economies. But if these Chinese institutions could measure up to systems in other emerging markets, such as Malaysia and South Korea, we estimate that China's GDP would increase by a total of $62 billion a year, with most of the savings accruing to households and companies. Greater efficiency would also improve the country's capital allocation, since the root causes of both problems are largely the same.

**The banking sector**

Despite improvements in recent years, China's banks continue to suffer from operational weaknesses. They gather only sketchy information on their borrowers' credit histories and financial performance, and independent credit-rating agencies offer only limited coverage. Despite recent efforts to improve, loan officers in many branches have rudimentary loan-pricing and risk-management skills and thus tend to be highly risk averse. When rating loan prospects, banks therefore favor SOEs—even poorly performing ones—given their scale and the government's ownership. There may also be local political pressure for banks to grant loans to enterprises that are still the largest local employers in many regions: China's huge banks—some have 20,000 branches—are decentralized and have loose governance systems, leaving some branches susceptible to lobbying by local businesses.

The dominance of banks in China's financial system amplifies the impact of this poor capital allocation. In market economies, the share of bank deposits as a proportion of total financial assets typically ranges from less than 20 percent in developed countries to about half in emerging markets. In China, banks intermediate almost 75 percent of the economy's capital—more than 1.5 times the level in most other economies (Exhibit 4). At the end of 2004, deposits with financial institutions—roughly half from households—totaled $2.6 trillion.
An inefficient banking sector also raises operating costs. A bank’s main source of revenue is the spread between its average borrowing and lending rates, particularly in China, where fee-based income is low. With a spread of 3.3 percent, the country’s banking system appears to be about as efficient as more mature systems: the average net interest margin for our benchmark countries—Chile, Malaysia, Singapore, South Korea, and the United States—is 3.1 percent. In reality, however, Chinese banks have needed roughly $215 billion in government money to recapitalize their balance sheets since the late 1990s. Once you add these funds to the banks’ net interest margin, the true cost of intermediation in China’s banking sector rises to 4.5 percent. In other words, Chinese banks require $25 billion more in annual revenues than do banks in our benchmark countries to carry at the same amount of lending. Raising the efficiency of Chinese banks to the benchmark level would eliminate this added cost. Further, banks would gain the ability to lend more money to smaller private businesses, thereby saving these companies the premium they now pay to borrow on the informal market—worth an additional $2 billion a year, by our estimates.

Payment system
The creation of the fully electronic China National Advanced Payment System could greatly reduce the cost of payment transactions throughout the economy. But the system’s impact to date has been limited because many smaller local banks, and even some autonomous bank branches of the larger ones, have resisted investing the capital they need to connect to the system. Moreover, most retail payments still take the form of cash. Promoting the more widespread adoption of electronic payments would not only generate $20 billion in savings each year but also help the government by reducing tax evasion. This prize is sufficiently large to justify offering incentives to persuade retailers, consumers, and banks to make payments electronically.

Debt and equity markets
China’s equity and bond markets are among the world’s smallest (Exhibit 5). The capitalization of the equity markets is equivalent to just 33 percent of GDP, compared with 60 percent or more in other emerging markets. Excluding nontradable state-owned “legal-person” shares, the market capitalization of Chinese companies falls to just 17 percent of GDP. Meanwhile, the corporate-bond market is equivalent to just 13 percent of GDP (and nonfinancial companies issued only 1 percent of these bonds), against an average of 50 percent in other emerging markets.
Moreover, China's small capital markets are used almost exclusively by SOEs to raise money. Until a few years ago, state regulators selected companies for IPOs in line with the government's industrial policies, a practice the regulators still follow for bond issues. The criteria for equity listings have since become more independent, but government regulators still retain a great deal of discretion over which companies enter the market. So far, private investors have held a majority of the shares in very few companies when they initially listed, though some were privatized subsequently.5

Chinese companies need more fully developed capital markets to give banks competition as well as to provide companies with a better selection of financing vehicles. In our benchmark countries, companies borrow roughly 60 percent of their debt from bond markets and 40 percent from banks. In China, however, bonds account for just 1 percent of corporate debt, informal loans for 4 percent, and bank loans for an overwhelming 95 percent. If China developed a vibrant corporate-bond market and moved to the mix of bonds and bank loans prevailing in our benchmark countries, Chinese companies would lower their cost of capital by $14 billion a year. Meanwhile, more efficient equity markets would reduce the cost of issuing and trading shares by $1.5 billion, even with today's small volumes. Chinese households would benefit from the reform of both bond and equity markets because flourishing capital markets will then underpin the development of financial products—such as mutual funds, pension funds, and insurance—that could offer more attractive investment options than bank deposits.

Priorities for reforming the financial system

The current shortcomings of China's financial system are rooted in the relationships among its components—banks, bond and equity markets, the payment system, and institutional investors. For this reason, China's regulators must implement a coordinated, systemwide program of reforms (rather than market-by-market adjustments) to improve the allocation of capital and increase the system's overall efficiency.

China needs a vibrant corporate-bond market, for example, to provide funding for large companies and infrastructure projects and to spur banks to allocate more lending to smaller companies and consumers. But the bond market probably won't flourish until banks develop more accurate, risk-based loan pricing. They will then be able to charge higher rates to borrowers and extend their lending to more productive companies and consumers. In addition, the number of domestic institutional investors must rise more quickly, since few retail investors anywhere buy corporate bonds directly. All these relationships are interconnected, so financial intermediaries, capital markets, and the banking sector will have to evolve together (see sidebar, "A reform agenda for China's financial system").
The four main regulatory bodies that oversee China's financial markets are already pursuing many essential reforms. But to realize the full potential benefits of systemwide improvements in efficiency and capital allocation, additional reforms should be implemented at the same time.

Measures to increase competition in the banking sector will play a critical role by giving institutions the impetus they need to upgrade their lending skills, management, IT systems, and governance. China's regulators have taken some steps to prepare for new competition from foreign banks, which will enter the domestic currency market in December 2006. But even the foreign banks already in China have relatively few branches—a problem that will limit their immediate impact on competition—and it will take them considerable time to grow organically. Regulators should therefore allow more private domestic banks to enter the market and relax the restrictions on foreign ownership of such banks ahead of the current schedule. They should also promote transparency by raising the sector's requirements for governance, financial reporting, and auditing.

In a more competitive environment, banks will probably lose their largest corporate customers to the capital markets and therefore have to focus on small and midsize private enterprises and on consumers. But to lend successfully to these segments, banks must assess the credit quality and risks of the borrower accurately, so they need the services of an independent consumer credit-rating bureau. To help develop a network of such bureaus—for both consumer and business lending—regulators should encourage investment in the necessary infrastructure and give all lenders and utilities incentives to report the borrowers' payment histories. To increase the number of loans to creditworthy smaller enterprises, regulators should also ease the current strict collateral rules and allow banks to accept assets other than real estate.

China's corporate-bond market has developed slowly, in large part because of overly restrictive regulations. To speed up its expansion, regulators should abolish preferential access for policy banks, allow more private companies to issue bonds, shorten the approval process to a week (the maximum in most Southeast Asian countries) from the 14 to 17 months it now takes, and abolish limits on the interest rates of corporate bonds. They should also encourage the expansion of sophisticated corporate credit-rating agencies, such as Moody's Investors Service and Standard & Poor's.

Excessive regulation holds back institutional investors as well. Regulators should therefore consider easing the restrictions on the types of investments that domestic intermediaries can make and adopt more favorable tax laws for these investments. In addition, domestic intermediaries should get permission to invest some of their assets abroad to improve returns for Chinese households, which should also be offered investment guidance and financial-planning services.

An aging population and the rising demand for higher-skilled labor will also require new policies from the government. See "The aging of China."

regulators should work out clear roles for each of the exchanges.

Last, China should consider taking staged moves to modify the strict capital controls that prevent its people from investing in foreign financial markets and thus earning higher returns. These controls also protect China's banks and capital markets from competition that would spur their development. As a first step toward converting capital accounts, regulators should gradually allow domestic intermediaries to invest in some assets in Hong Kong. Over the longer term, they should consider removing more restrictions on investments abroad.

Integrating all these reforms will require coordination among China's regulatory bodies. The government has already started to consider the possibility of creating one commission to oversee the reforms—an idea that has considerable merit. Alternatively, the government might appoint a single commissioner to encourage cooperation among agencies and ensure that each of them has a reform agenda that meets the broader goal of developing the financial system.

Understandably, China's leaders want the country to make the transition to a market economy in a way that avoids the social disruption that mass layoffs by declining SOEs could cause. So far, the uninterrupted flow of financing from the country's banks has been essential in fulfilling this aim. But the faster China's modern economy develops, the more the government will be able to...
separate its social goals from the operations of the financial system. A more market-oriented approach will spur efficiency and create more wealth and jobs. Higher tax revenues will then help the government finance social programs directly rather than through the financial system. At the same time, efficiency gains will translate into higher returns for savers and lower costs for borrowers. The far-reaching reform of the financial system should be one of the government's highest priorities.

A reform agenda for China's financial system

China is pursuing many important and necessary reforms of its financial system. Because a lot of the system's shortcomings are connected, the reforms have to be coordinated, transparent, and system-wide. The government must not only support the rapid growth of the economy but also shift it onto a more sustainable development path, so taking the following steps should be a priority. Each of them will benefit the whole financial system, since its elements are linked.

Improving capital allocation

1. Improve governance and increase competition in the banking sector
   Given the distribution of China's population over a wide geographic area and the country's history of decentralized power, local political influence still encumbers many bank branches. Moreover, despite the progress in some large commercial banks, the sector as a whole must still optimize lending decisions, upgrade the skills of loan officers, and improve performance-management systems in order to compete with foreign banks, which are scheduled to enter the local currency market in December 2006. China has already taken some steps in this direction, most notably in its commitments to the World Trade Organization (WTO). Regulators should ensure that the country meets them in full and that reform continues at an aggressive pace.

   To this end, the China Banking Regulatory Commission (CBRC) should adopt a number of additional reforms: creating a level playing field for private banks; giving local investors more access to the banking market; raising foreign-ownership limits on banks ahead of the WTO time line, particularly for the smaller city and regional banks that badly need the banking skills and technology foreign investors bring; continuing to improve bank governance by making boards more independent and offering training programs for directors; and raising financial-reporting standards and auditing procedures to promote transparency in corporate performance.

2. Change the collateral requirements for small businesses
   Currently, small businesses can borrow bank capital only by using real estate and some types of equipment as collateral. Thus unclear property rights in many parts of China deprive small businesses of the collateral they need. Moreover, Chinese real-estate prices are soaring, so the use of these assets as the main form of collateral could involve a high level of risk because a bust may be imminent. The CBRC must undertake two specific reforms. First, it should allow banks to accept more types of equipment and accounts receivable as loan collateral; meanwhile, the government should expand the current program of loan guarantees to small businesses. Second, since banks have had trouble taking possession of collateral in any form other than fixed assets, it is imperative that China further develop its legal infrastructure to give banks the ability to retrieve mobile collateral.

3. Improve the information and data available for good lending decisions
   Consumers and small and midsize businesses need to secure a greater share of the banking system's capital. Before banks approve such loans, however, they will need better tools to assess the credit of borrowers—and the ability to price such risks accurately. In early 2006, China expanded its consumer credit bureau so that it would cover most of the country. This is an important step, whose usefulness will increase as more consumers use credit. But China would also benefit from better information on corporate borrowers, particularly private companies and small and midsize enterprises. To this end, regulators should continue to strengthen financial-reporting standards and auditing as well as support the further development of independent rating agencies, such as Moody's Investors Service and S&P, which have limited coverage today.

4. Deregulate the corporate-bond market
   The financial system would be significantly more efficient if large enterprises could use corporate debt instead of bank loans as their main source of financing. This shift would have the added advantage of leaving more bank capital for small and midsize enterprises, which are currently underfunded. To spur the development of the corporate-bond market, regulators must ease the rules that govern it. Specific actions should include eliminating quotas for issuers, allowing more private companies to issue bonds, streamlining the approval process...
from the 14 to 17 months it takes today, abolishing limits on interest rates for corporate bonds, and taxing income from them and from bank deposits at the same rate.

Creating a balance within the financial system

1. **Deregulate bank interest rates ahead of the current schedule**
   In 2004 China removed the ceiling on lending rates for banks and the floor on deposit rates, thus opening the door for more lending to private businesses, particularly smaller ones. The floor on lending rates will gradually be removed, starting in 2006. Even more important, the ceiling on deposit rates will remain until 2008 to 2010. The rationale is that this delay will prevent bank margins from declining too rapidly when foreign competitors enter the market, at the end of 2006. But these regulations limit competition and guarantee that Chinese banks will continue to enjoy a low-cost source of money, which allows them to provide cheap corporate loans that reduce returns to savers. To create demand for bonds, regulators must liberalize lending rates in conjunction with the corporate-bond market. The CBRC should therefore deregulate interest rates ahead of the current schedule.

2. **Spur the growth of domestic institutional investors through deregulation**
   The mainland needs more domestic financial intermediaries to provide its securities markets with professional institutional investors—such as mutual funds, pension funds, and insurance companies—and to offer Chinese households more diversified investment options. The current regulations for these intermediaries and their operations impede their development. To address this problem, regulators can take several specific actions: loosening restrictions on investment types, offering investment education and financial-planning services to Chinese households, creating favorable tax conditions for investments, and partially opening the capital account to let domestic intermediaries invest a small portion of their assets abroad, thus creating additional investment opportunities that could offer households more attractive returns.

3. **Create a more strategic relationship between the Hong Kong Stock Exchange and mainland equity markets**
   The Chinese government has made significant investments in the Shanghai and Shenzhen stock exchanges. They, however, compete directly with the well-established Hong Kong Stock Exchange (HKEx) and have a long way to go before they match the operational performance of its international counterparts. As stock exchanges become increasingly global, China should adopt a strategy that reinforces the leadership of one exchange and helps it compete against international players such as the London and New York stock exchanges. One possible strategy could be to have each location handle the trading of specific types of financial products. Quite recently, the HKEx and the mainland exchanges publicly stated their intention to form a more strategic relationship—a move the government should encourage.

4. **Change equity IPO procedures to let private companies and small and midsize enterprises compete for funds**
   Equity markets are essential for providing long-term funding to corporations and start-up financing to newer ventures. In addition, these markets spur the development of private equity and venture capital firms by giving them a way to exit investments. In China, SOEs constitute the bulk of all listings on the equity markets. Although the equity IPO process was recently reformed with the establishment of a more independent committee to approve companies, listing decisions are still conditional on approval from regulators. The China Securities Regulatory Commission (CSRC) should allow more private companies that qualify for IPOs to list on its exchanges. It should also continue to develop Shenzhen's nascent small-cap exchange by raising the number of IPOs and increasing access to foreign investors. These moves would give households more diversified and more high-risk, high-return investment options and improve the stock market's performance.

Making the overall system more efficient

1. **Accelerate improvements in the payments system**
   Many business-to-business transactions are conducted using paper-based vehicles—significantly less efficient than electronic fund transfers. Business-to-consumer transactions almost always involve cash, which creates other types of inefficiencies for corporations and individuals. The current payment system, operating at the local and national levels, prevents bank branches from optimizing their fund balances with parent banks on the national level. Fixing the system's problems and encouraging the use of electronic-payment vehicles would help banks and corporations save money and simplify transactions for individuals. These changes would also strengthen the government's control over the economy (since most black-market activities involve cash), create new business opportunities for banks, and stabilize the financial system. Regulators can adopt several measures to develop a payment system: giving local banks and bank branches incentives to build electronic links with the China National
Advanced Payment System, offering consumers incentives to use electronic-payment vehicles and retail businesses incentives to adopt the technology to accept them, and encouraging the government to use the electronic-payment system.

2. **Further liberalize the capital account**

China now maintains strict capital controls that prevent its citizens from investing in foreign financial markets. This policy ensures that domestic savings stay within the country, maintains a high level of liquidity in banks, and helps control the exchange rate. But it also lowers returns for savers and sharply limits the competitive pressure on banks and domestic capital markets, which enjoy a very large pool of captive savings as a result. To overcome this disincentive, China’s regulators should begin to open the capital account slowly for foreign investments. A first step would be to allow domestic intermediaries to invest a small part of their assets in Hong Kong, thereby making it possible for them to create attractive products for savers while boosting the level of competition for mainland banks and equity markets. Over the long term, China should remove more restrictions on investments abroad.

**About the Authors**

Diana Farrell is director of the McKinsey Global Institute, where Susan Lund is a consultant. Fabrice Morin is a consultant in McKinsey’s Montréal office.

**Notes**

1. This calculation is based on data from the Organisation for Economic Co-operation and Development (OECD) on the total factor productivity of state-owned and private companies. According to these data, the total factor productivity of SOEs is, on average, 39 percent lower than that of privately controlled ones. Raising the total factor productivity of SOEs to the level of their private counterparts would allow them to produce as much output as privately owned companies do, with 15.6 percent less capital and labor than they use now. Once these resources are reinvested, China’s GDP would increase by $259 billion.

2. In December 2005, however, the government restated its calculation of GDP for 2004, raising it by nearly 17 percent. Although detailed figures that would make it possible to restate the household savings rate have not yet been released, we estimate that it is from 20 to 25 percent, a level that is still high by international standards.


4. This figure includes government spending of $105 billion since 1998 to recapitalize the top four banks, plus an additional $110 billion—the amount S&P estimates that the government will need to inject in the coming years.

5. Initial public offerings were all but canceled from June 2005 to May 2006 while regulators looked for ways of floating the huge stock of government shares that have thus far been off limits to investors.

6. The People’s Bank of China (PBOC), playing a role similar to that of central banks in most developed countries, is responsible for monetary policy and the payments system. The China Banking Regulatory Commission (CBRC), which emerged from the PBOC in 2003, is an independent regulator for banking institutions, asset-management companies, trust and investment companies, and other depository financial institutions. The China Securities Regulatory Commission (CSRC) oversees the securities and futures markets, and the China Insurance Regulatory Commission (CIRC) is responsible for the insurance industry. A fifth regulatory body, the National Development and Reform Commission (NDRC), sets macroeconomic policy.

7. China’s consumer credit bureau, Shanghai Credit Information Services (SCIS), is currently expanding its coverage.

8. China has established three policy banks that make loans to targeted economic sectors, including exporters, agriculture, and infrastructure. These banks raise money not by accepting deposits but by issuing bonds, which are purchased mostly by commercial banks.