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Putting China's Capital to Work: The Value of Financial System Reform

May 2006

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Putting China's Capital to Work: The Value of Financial System Reform

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April 2006

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Preface

This report is the result of a six-month research project by the McKinsey Global Institute, in collaboration with our McKinsey offices in China and the Asia region. This research builds on MGI's previous work on global capital markets and on our proprietary database of the financial assets of more than 100 countries around the world, and it draws on the unique perspectives of our colleagues who have worked extensively with financial institutions in China and around the world.

Susan Lund, a senior fellow at the MGI based in Washington, DC, worked closely with me to provide leadership on this project. The project team also included Jaeson Rosenfeld, an MGI senior consultant and McKinsey alumnus, MGI fellows Ezra Greenberg and Fabrice Morin, and McKinsey consultant Niyati Gupta.

We have benefited enormously from input received from Dominic Barton, director of McKinsey's Asia-Pacific region; Andrew Grant, director of McKinsey's Greater China office; Gregory Gibb, leader of McKinsey's banking practice for Greater China; Jack Stephenson, a director in McKinsey's New York office with expertise in payments systems; and Stephan Binder, Christopher Ip, George Nast, and Yi Wang, all principals in the Greater China office, who have worked extensively with financial institutions. Glenn Leibowitz, a senior communications specialist in the Greater China office, also contributed to this effort.

We have also benefited from the extensive and thoughtful input received from our Academic Advisory Board members. Our board included Martin Baily, senior adviser to MGI, senior fellow at the Institute for International Economics, and

formerly chief economic adviser to President Clinton; Richard Cooper, professor of international economics at Harvard University; Nicholas Lardy, a senior fellow at the Institute for International Economics; and Kenneth Rogoff, professor of economics and public policy at Harvard University and former chief economist at the International Monetary Fund.

Essential research support was provided by Tim Beacom, a senior analyst at MGI, along with Rebecca Chen, Yuan Luo, Wendy Wong, Yang Yao, Vivian Yu, and Yanfen Zhao, all researchers in McKinsey's Greater China office. Gina Campbell, MGI's senior editor, provided thoughtful input and editorial support. Rebeca Robboy, MGI's external relations manager; Deadra Henderson, MGI's practice administrator; and Terry Gatto, our executive assistant, supported the effort throughout.

Our aspiration is to provide a fact base to policy makers and business leaders in China and around the world so they can make more informed and better decisions. As with all MGI projects, this work is independent and has not been commissioned or sponsored in any way by any business, government, or other institution.

Diana Farrell
Director, McKinsey Global Institute

April 2006
San Francisco

Executive summary

This report shows that further, more comprehensive reforms are required if China is to create the modern financial system it needs to support growth in its increasingly market-based economy. Drawing on our experience of working with financial institutions and regulators around the world, we have analyzed how China's financial system performs its job of channeling savings from households to the best available investment opportunities throughout the economy. Our research shows that the system has been highly successful in mobilizing savings, reflected in the doubling of China's stock of financial assets relative to GDP over the past ten years. But it has fallen short in its task of allocating capital to the most productive players in the economy.

Of course, there have been steady advances since the first moves toward economic liberalization in 1978. Recent foreign investments reflect this: in 2005, foreign banks invested $18 billion in strategic stakes in several of China's biggest banks, and China Construction Bank, the country's third largest, raised $9.2 billion in the world's biggest IPO that year. Progress among China's banks in cleaning up their nonperforming loans (NPLs) and strengthening corporate governance has impressed investors. Government plans to adopt international accounting standards in 2007 and preliminary sales of state-owned equity shares also encourage them.

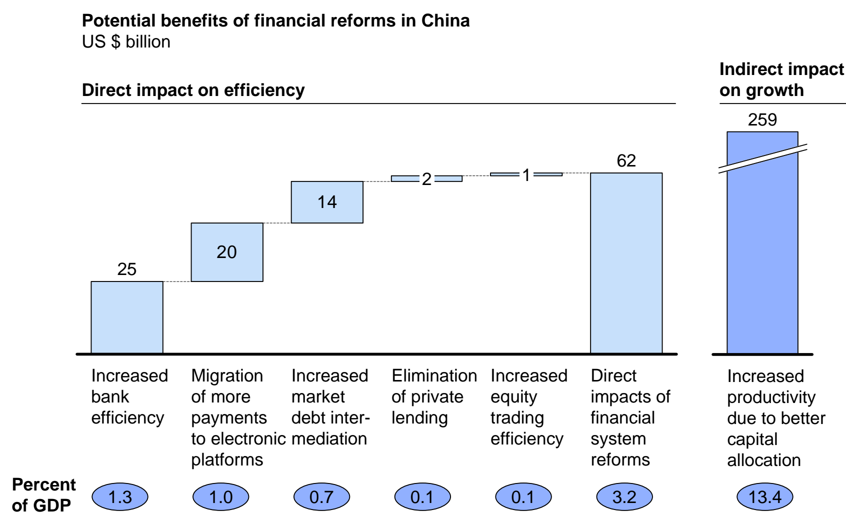
Underlying these reforms, however, is capital misallocation by the system. Nonperforming loans are the most conspicuous outcome of this misallocation, but our research shows that the much larger volume of loans to underperforming ventures that don't go bad but yield only negligible returns are potentially more costly to China's economy. The benefits of reform, therefore, would be substantial. We calculate that increasing the operating efficiency of China's

financial institutions and improving the mix of financing vehicles would boost GDP by $62 billion a year (Exhibit 1). In addition, reforms that enabled a larger share of funding to go to more productive enterprises would increase investment efficiency, raise GDP by up to $259 billion, or 13 percent a year, and bring higher returns for Chinese savers, thus enabling them to raise their living standards and consumption.

China's financial system's remaining problems are intricately linked across its component markets. Reform will therefore require a more integrated approach among regulators than is being employed today.

Exhibit 1

REFORMING CHINA'S FINANCIAL SYSTEM COULD BOOST GDP BY UP TO $321 BILLION ANNUALLY



Source: McKinsey Global Institute analysis

BETTER FUNDING FOR THE MOST PRODUCTIVE ENTERPRISES

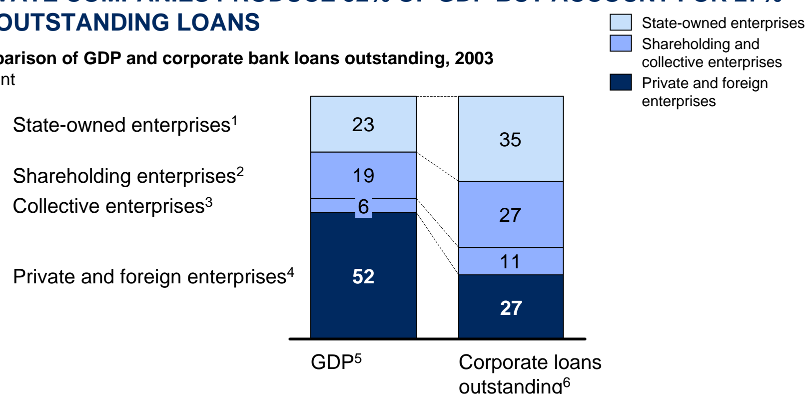
Over the past ten years, private companies in China—whether they are Chinese owned, foreign owned, or joint ventures—have grown faster than GDP. These companies now account for half of all output and much of net new job creation. The share of production from wholly state-owned enterprises (SOEs), meanwhile, has shrunk to barely one-quarter of GDP.

Nevertheless, wholly and partially state-owned companies continue to absorb most of the funding from the financial system. Wholly state-owned companies receive 35 percent of bank credit and account for all equity and bond issues. The many shareholding enterprises that are partially state-owned and the collective enterprises take up another 38 percent of credit, although producing only 25 percent of output. Private enterprise, the engine of China's growth, account for only 27 percent of loan balances (Exhibit 2).

Exhibit 2

PRIVATE COMPANIES PRODUCE 52% OF GDP BUT ACCOUNT FOR 27% OF OUTSTANDING LOANS

Comparison of GDP and corporate bank loans outstanding, 2003
Percent



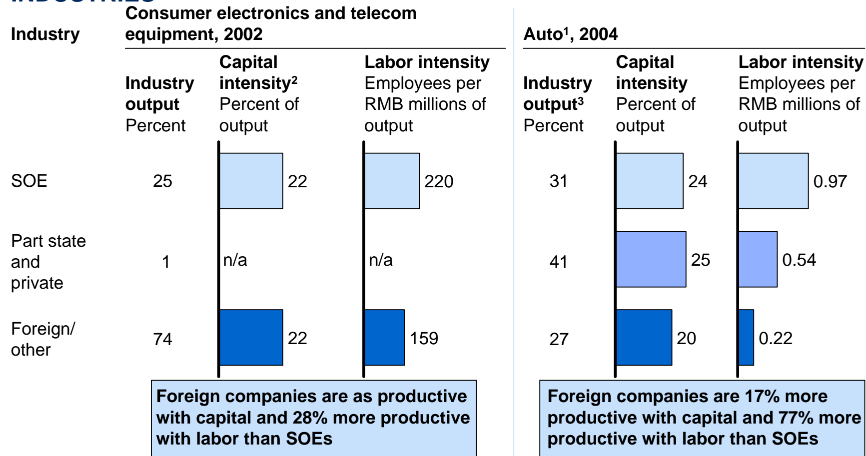
1 SOEs are defined as wholly state owned.
2 Most of the shareholding enterprises are partly state owned. Some are state controlled, some are not.
3 Collective enterprises are owned by the population. Many are run like private enterprises, but some are effectively controlled by local political interests.
4 Fully private enterprises include local privately owned enterprises, foreign joint ventures, and wholly owned foreign enterprises.
5 Breakdown of industrial value added by ownership type, 2003, as determined by the Organisation for Economic Co-operation and Development.
6 Total corporate and government bank lending, based on a survey on commercial bank new loans conducted in 2002 by the People's Bank of China. This is the most recent publicly available data on lending by company type. In the absence of more recent data, we are making the assumption that new lending in 2002 reflects the stock of outstanding credit in 2004. A higher portion of new lending today may go to private companies, but we have no evidence of this.

Source: OECD; PBOC; McKinsey Global Institute analysis

This pattern of lending has lowered overall productivity in the economy. Although many SOEs have been restructured and some are highly profitable, their productivity level as a group is still half that of private companies. This is true both in aggregate, and within specific industries (Exhibit 3). As a result, China is seeing its investment efficiency decline. Whereas it required $3.30 of investment to produce $1.00 of GDP growth in the first half of the 1990s, each $1.00 of growth since 2001 has required $4.90 of new investment—40 percent more than the amount required by other Asian Tigers in their high-growth periods.

Exhibit 3

PRIVATE ENTERPRISE IS MORE PRODUCTIVE THAN SOE, EVEN WITHIN INDUSTRIES



[1] Auto is considered as a comparable sector even if SOEs are not active in the same segment as foreign firms (trucks and cars, respectively). The two industry segments are relatively similar, and a significant difference is observable in productivity growth as well. See China auto case in McKinsey Global Institute's "New Horizons" report for more details.
[2] Gross fixed assets/2x output; net fixed assets not available.
[3] Numbers do not add to 100% due to rounding.
Source: NBS, McKinsey Global Institute analysis

Further reforms that enabled banks to channel a larger share of funding to more productive private enterprise could greatly increase in the average productivity in the economy, and hence standards of living. It could raise GDP by as much as 13 percent, or $259 billion annually.

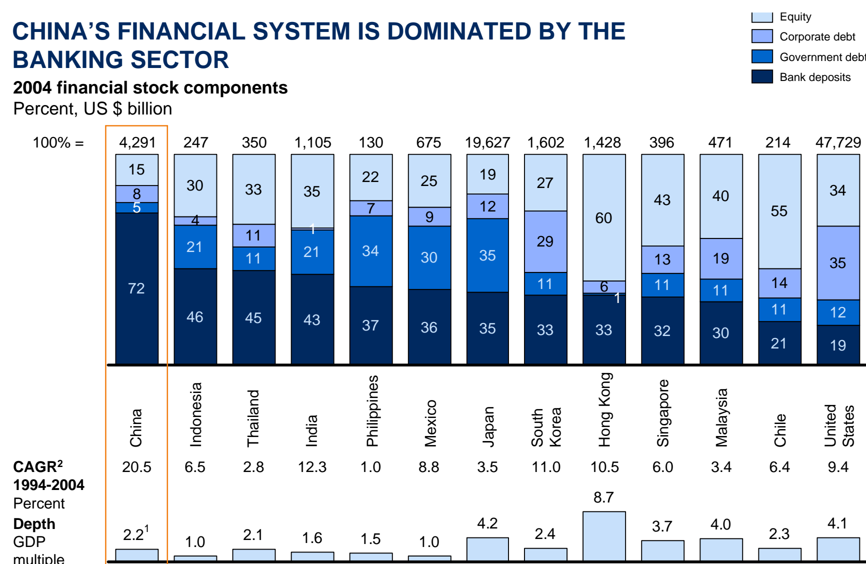
China's regulators have so far taken a cautious approach for fear of accelerating unemployment in state-owned companies. But these reforms would boost GDP, thereby increasing the tax revenue available to fund job retraining and social programs for displaced workers. Over time, this will help to raise living standards and provide jobs for China's vast pool of underemployed rural labor.

IMPROVE BANK OPERATIONS

China is allocating capital ineffectively for two related reasons. First, China's operationally weak banking sector plays an unusually large role in its financial system. In market economies, the share of bank deposits in the financial system typically ranges from under 20 percent in developed economies to about half in emerging markets. But in China, banks intermediate nearly 75 percent of the capital in the economy—nearly twice as high as other developing Asian

economies (Exhibit 4). Bank deposits and savings accounts, roughly half of them from households, now total $2.6 trillion, even though they yield negligible real returns.

Exhibit 4



1 Reflects China's recently restated GDP.
2 CAGR = compound annual growth rate.
Note: Numbers may not add to 100 percent due to rounding.
Source: McKinsey Global Institute Global Financial Stock Database

China's bank have difficulty lending to private companies because it is difficult to get good-quality information on borrowers' credit histories and financial performance. Banks themselves have not rigorously collected such information in the past, nor is there extensive coverage by private rating agencies. The first national credit bureau was launched in early 2006. Moreover, loan pricing and credit-assessment skills of loan officers remain poor in many bank branches despite recent efforts to improve, and risk-management skills are deficient. It is no wonder, then, that so many banks continue to lend heavily to large SOEs: their scale and apparent government backing makes them seem a low-risk option. Inadequate governance and incentives compound banks' difficulty in making good lending decisions. And although they are huge (some have thousands of branches), their decentralized structures prevent them from reaping the benefits of scale and make branch staff vulnerable to local political influence over lending decisions.

All this indicates that China's nonperforming loan problem is likely to persist. It is true that officially reported nonperforming loans for large commercial banks fell from 31 percent of total balances in 2001 to 10 percent in 2005. Almost 60 percent of this decline, however, is explained by transfers of bad loans from banks into state-owned asset-management companies. The remainder is due to a rapid expansion in bank lending in 2003 and 2004 and to the success of a few banks in reducing their NPLs. These factors have lowered the nonperforming loan ratio for the moment, but more defaults may be in store for those banks that have seen little change in the underlying factors that lead to poor lending decisions.

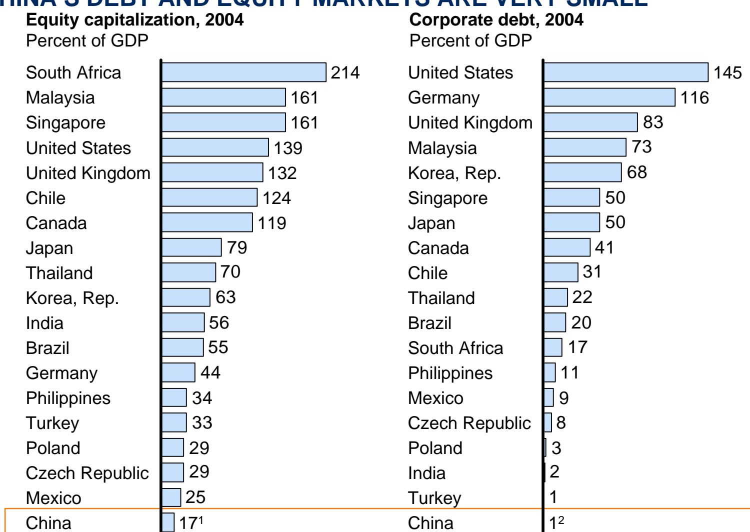
Aside from the cost of nonperforming loans and misallocation of capital, inefficiencies in China's banking system raise its operating costs, in turn lowering the returns banks can pay to savers and increasing the cost of capital for borrowers. Reforms in the financial system that prompt Chinese banks to move to international standards of operating efficiency would result in $25 billion of savings annually for China's savers and borrowers.

Small local banks have hindered the spread of China's new wholesale payments system (CNAPS), as many resist making the considerable capital investment necessary to connect to the system. Along with the predominance of cash transactions, inefficiencies in the payments system cost China's economy 1 percent to 1.5 percent of GDP annually, or at least $20 billion.

STRENGTHEN THE EQUITY AND DEBT MARKETS

The second reason China's financial system misallocates capital is that it offers large companies few alternatives to banks as sources of funds. China's equity and bond markets are among the smallest in the world (Exhibit 5). Equity market capitalization, excluding nontradable state-owned shares, is equivalent to just 17 percent of GDP, compared with 60 percent or more in other emerging markets. Corporate bond issues by non-financial companies amount to just 1 percent of GDP, compared with an average of 50 percent in other emerging markets.

Exhibit 5



[1] Adjusted for nontradable equity, depth would otherwise be 33% of GDP.
[2] Excludes bonds issued by policy banks, which can be bought only by commercial banks and represent more than 90% of the nongovernment bond volume in China.
Source: McKinseyGlobal Institute Global Financial Stock Database; McKinsey Global Institute analysis

China's capital markets, to the extent that they do raise capital, are used almost exclusively by state-owned companies. Until a few years ago, state regulators selected companies for equity offerings in line with industrial policy concerns, and the same remains true for bond issues. Although equity listing criteria have since become more independent, government regulators still maintain a high degree of discretion over market entry. So far, almost no companies have had a majority of private ownership at the time they initially listed shares, although some were privatized after listing. From June 2005 to May 2006, regulators have essentially canceled all initial public offerings while they grapple with the nontradable share problem.

More fully developed equity and bond markets would provide competition to banks, underpin the growth of retail savings products such as mutual funds, pensions, and life insurance, and give companies more varied funding options. If China were to develop a vibrant corporate bond market and move to the mix of bonds and bank loans seen in other economies such as South Korea and Singapore, Chinese companies would lower their funding costs by $14 billion annually.

The immaturity of China's capital markets further skews the distribution of capital because companies that would normally seek funding from them turn to banks instead. This crowds out lending to banking's natural customers, which are smaller companies and consumers. These, in turn, are forced to either borrow from family and friends or turn to China's informal finance market, estimated to be $100 billion, where interest rates are high. Reducing informal lending by expanding formal bank lending to small businesses would save borrowers $2 billion a year.

IMPROVE RETURNS ON HOUSEHOLD SAVINGS

The misallocation of capital and comparatively high cost of financial intermediation limit the returns that Chinese households earn on their financial assets. Chinese households hold 86 percent of their financial assets in low-yielding bank deposits and in cash. Given the low average returns earned over the past ten years on equity and bonds and their high volatility, their choice is rational.

But reforms to develop the country's capital markets further, and to improve capital allocation and operational efficiency in the banking system, would raise overall productivity in the economy. This would boost the financial performance of business and, if regulators allowed it, increase the returns households earn on financial assets. Over the past ten years, returns on Chinese households' financial assets increased just 0.5 percent a year after inflation. In contrast, South Korean ones earned 1.8 percent. If real returns in China doubled to 1 percent, Chinese households would gain $10 billion annually. If real returns were closer to South Korean returns, Chinese households would earn $20 billion more annually. In the long term, this might allow Chinese households to consume more and save less—a shift that would improve living standards and allow China to achieve more balanced and sustainable growth.

INTEGRATE THE REFORMS

Interlinkages across China's financial system mean that integrated reforms will be the most effective. To illustrate, China needs a healthy corporate bond market to provide funding to large companies and infrastructure projects, enabling banks to focus more on lending to smaller companies and consumers. The bond market, however, is unlikely to flourish until banks develop more accurate risk-

based loan pricing and, as a result, charge higher rates to borrowers than the government-set floor rate that prevails today. An expanding bond market will also depend on a growing number of domestic institutional investors from mutual funds, pension funds, and insurance companies, because few retail investors in any country buy corporate bonds direct. Yet all these relationships work both ways. Financial intermediaries, debt markets, equity markets, and banking have to evolve in tandem.

A comprehensive and integrated approach to reforming the financial system requires close coordination among China's four financial regulatory bodies, so that each focuses on broader development of the financial system, in addition to the performance and problems in their domain. Increasing the size and liquidity of equity and debt markets is also required, thereby reducing the outsized role that the banking system currently plays in financial intermediation, as well as improving the operations and capital allocation of each market. These reforms may cause some job losses as the least efficient companies shut down. But they will also create the wealth that will provide the means to compensate displaced workers and create new jobs in more productive companies.

This report includes a detailed discussion of the analyses and conclusions highlighted here. It is organized in six chapters: 1. Introduction; 2. Benchmarking China's financial system performance; 3. Effect of financial system perfromance on China's economy; 4. The value of financial system reform; 5. Priorities for the reform agenda; 6. Closing remarks.

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06/05/01
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