



A Tale of Two Financial Systems: A Comparison of China and India

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Preface

This perspective is based on two recent reports, *Putting China's Capital to Work: The Value of Financial System Reform* and *Accelerating India's Growth through Financial System Reform*. That research, in turn, was the result of two six-month research projects on China's and India's financial systems, in collaboration with McKinsey offices in those countries and financial institutions experts globally. 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, India, 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 included MGI fellows Ezra Greenberg and Fabrice Morin, and MGI senior consultant Jaeson Rosenfeld. Niyati Gupta, Raj Doshi, Nishith Jardosh, and Tim Beacom also contributed to the research.

We have benefited enormously 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.

Our aspiration is to provide a fact base to policy makers and business leaders in China, India, 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
September 2006
San Francisco

A tale of two financial systems:

China's problem is that capital costs zero.

India's problem is zero capital.

5

Much ink has been spilled comparing prospects for the very different economies of China and India, and on the obstacles that could get in their way. One of the most significant potential risks is posed by their respective financial systems. These have grown from quite dissimilar roots. India's venerable private banks and its equity market were founded under British colonial rule, while almost all China's financial institutions started up during the past 25 years of economic liberalization. Nevertheless, the two systems today face many similar problems. Both countries are now pursuing growth strategies based on relatively free markets, yet neither has the financial system it needs to sustain rapid and efficient growth in the years ahead.

The most striking similarity between the two financial systems is their inefficient allocation of capital.¹ In both countries, the government is distorting the financial system to achieve social ends – in India, to fund the government's persistently large budget deficit and its rural investment priorities; in China, to ensure a continued flow of funding to its many inefficient but massive state-owned enterprises in order to preserve jobs. While these goals are understandable, the current policies have similar unfortunate consequences in both countries – wasteful investments that yield negligible returns; restricted funding options for the private companies that are driving growth; high levels of state ownership of financial institutions, which limits competition and lowers their efficiency; underdeveloped corporate bond markets; and few choices of financial products for consumers. To move to the next stage of development, both China and India must develop modern financial sectors that efficiently allocate capital and meet the needs of savers.

There are also, however, fundamental differences between the two financial systems that make their reform challenges unique. China's system is significantly larger than India's, and does an impressive job at gathering up the nation's prodigious savings; but it squanders much of this capital by lending to the least productive parts of the economy. Reforms are beginning to enable more economically-rational capital allocation, but transforming China's massive banking system, developing its nascent capital markets, and creating the institutional framework, incentives, and commercial mindset needed to

1 This article is based on research by the McKinsey Global Institute on the performance of China's and India's financial systems. For more details on the underlying research, see *Putting China's Capital to Work*, May 2006, and *Accelerating India's Growth Through Financial System Reform*, May 2006. Both are available online at www.mckinsey.com/mgi/.

support a modern financial system will necessarily take time. The value from doing so would be tremendous, boosting GDP by up to 17 percent.

India's challenge is more complex. It needs to make its financial system much larger and deeper, as well as to improve the way that the system allocates capital. Enacting the necessary financial system reforms will require closing the government's gaping budget deficit and this is fraught with political difficulty. But India also has some advantages. Its private sector and equity markets are more developed than China's, hence its terrific stock market performance over the last several years. It also has several high-performing private banks, as well as some foreign ones which, under more liberal conditions, could gain market share and create the kind of consumer products that will attract more savings. With the right policies, India's financial system has real potential to evolve much faster than it has to date, raising real economic growth to 9.4 percent.

For both countries, the road to financial reform will be long but the potential benefits are enormous. And the truth is that financial reform is much more likely to achieve the social objectives that are currently used to justify the diversion of capital from the financial system by the government in both countries. Faster and more far-reaching reforms in the financial system should therefore be among the highest priorities for the leaders of China and India.

CHINA: SQUANDERING A GLUT OF CAPITAL

China is awash with capital. Last year, Chinese households saved an estimated 36.6 percent of their income, producing nearly \$500 billion of new savings.² However, because capital controls prevent households from investing in foreign assets, these savings flow directly into the domestic financial system which now has \$4.3 trillion of assets. Nearly three-quarters of these assets are in the banking system, since there are currently few investment alternatives to bank deposits.

But China's financial system makes poor use of this wealth. State-owned companies (wholly or partially) account for 73 percent of bank loans, even

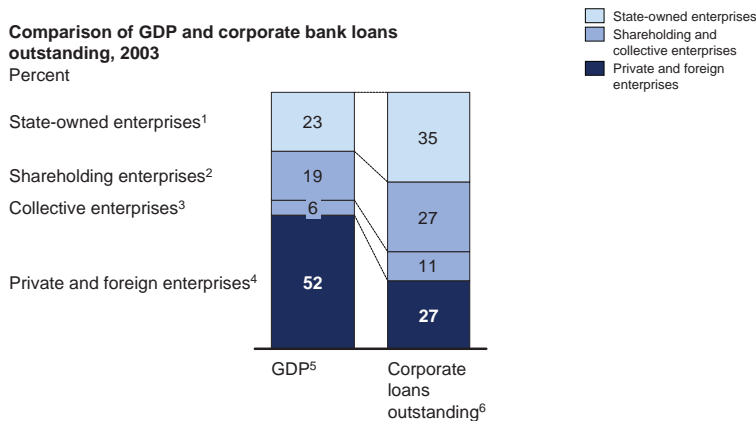
² This is estimated from the 2005 GDP by expenditure data released in May 2006 and historical flow of funds information. According to these data, the household savings rate is substantially higher than previously thought. See The McKinsey Global Institute's forthcoming report on China's consumers for more detail.

though their average productivity is just half that of private companies. Private companies now produce over half of China's GDP but they get only 27 percent of loans (Exhibit 1). The country's equity and corporate bond markets, although tiny by international standards, have also been open exclusively to state-owned companies. The poor performance of many listed companies is the main reason why China's equity markets lost half their value between 2001 and mid-2005, despite the country's soaring economic growth.

Exhibit 1

TOO LITTLE FUNDING FOR PRIVATE COMPANIES IN CHINA

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

The most conspicuous outcome of this misallocation of capital is China's large volume of non-performing loans (NPLs), a problem that we believe is likely to persist. Although the ratio of NPLs to total assets has declined dramatically for China's largest banks since 2001, most of this reduction has been achieved by moving bad loans off banks' books and into state-owned asset management companies. The government will spend approximately \$215 billion to recapitalize some of the largest banks, and the bill is likely to rise further when the bonds issued to facilitate the transfer of bad loans come due. But China has failed to tackle the underlying causes of NPLs – poor quality information on borrowers, poor lending and risk management skills, and a lack of incentives to lend more sensibly.

Potentially more costly to China's economy is the much larger volume of loans to underperforming ventures that may not go bad but yield negligible returns and keep unproductive enterprises in business. This lowers the overall productivity of the economy. Moreover, credit in China is artificially cheap, due to a regulated ceiling on deposit rates that prevents banks from competing for deposits. Our research finds that a sample of listed Chinese companies pays an average real interest rate on debt of 3 percent, lower than the 3.9 percent for listed US companies – this despite the much smaller size of Chinese companies, and the more volatile economic environment in which they operate.

The combination of misdirected lending and cheap credit has fueled an investment boom – and a sharp decline in the returns the country reaps on these investments. During the first half of the 1990s, China needed to invest \$3.30 for every additional \$1.00 of GDP. Since 2001, however, it has had to invest \$4.90 to get the same return – 40 percent more than the investment required by South Korea or Japan during their high-growth periods. This is particularly striking given that both those countries followed growth paths that relied primarily on increases in inputs used, not increases in productivity. As a result, investment as a share of GDP in China has been steadily rising, while domestic consumption has been falling.

Not surprisingly, Chinese households earn very poor returns on their savings. With 86 percent of household financial assets in savings accounts, this means that, over the last ten years, Chinese households have earned just 0.5 percent annually after inflation, compared to 1.8 percent in South Korea, 2.6 percent in India, and 3.1 percent in the United States. This necessitates more savings, in turn depressing domestic demand and consumption, a situation China now wants to reverse.

INDIA: NOT ENOUGH CAPITAL FOR THE ECONOMY

India's financial system is much smaller than China's, even adjusted for differences in the size of their economies. India's financial assets amount to \$1.1 trillion, or 160 percent of GDP, compared to China's \$4.3 trillion, or 220 percent of GDP. India's shallower financial depth indicates that a large portion of savings and investment in the economy happens outside the formal financial system. We estimate that India's informal lending market is worth around \$85

billion, or approximately 30 percent of outstanding bank credit. In China, the equivalent figure is thought to be much larger – about \$100 billion – but this is equivalent to only 5 percent of bank loans.

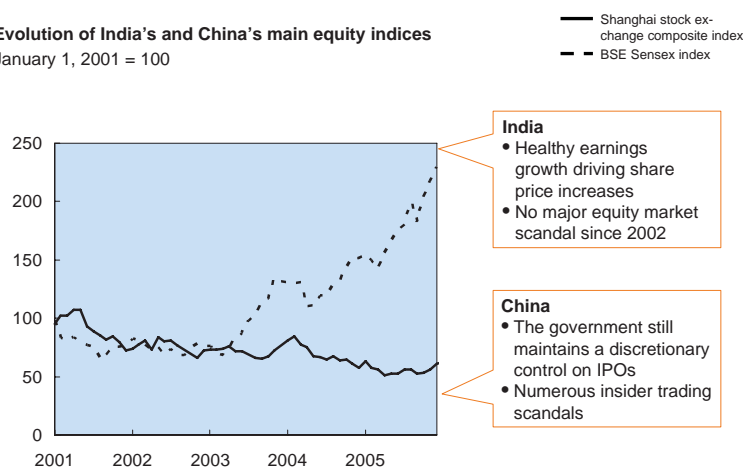
The main reason for the lack of financial depth in India is the failure of its financial system to capture half of household savings. Indian households save 28 percent of their disposable income – a very high rate compared with most other countries – but invest only half of this in bank deposits and other financial assets. They put the remainder into housing and into their tiny household proprietorships which, lacking scale and technology, have very low levels of productivity. Indian households are also the world's largest consumers of gold, arguably another form of non-financial saving (although it is officially counted as consumption, not saving). In 2005, they purchased more than \$10 billion of the metal – to put that in perspective, that's nearly twice the amount of foreign direct investment India received that year.

However, despite its small size, India's financial system has some clear advantages, one being its equity markets. Over the past three years, the Bombay Stock Exchange index has more than tripled in value – a stark contrast with China's mainland equity markets which, between 2001 and the market's trough in mid-2005, *lost* half their value (Exhibit 2). The difference between the two mainly reflects differences in the health of the two countries' listed

Exhibit 2

STRONGER EQUITIES IN INDIA

Evolution of India's and China's main equity indices
January 1, 2001 = 100



Source: McKinsey Global Institute analysis

companies. In China, only state-owned enterprises list shares, and the majority of listed companies are destroying economic value.³ Our research confirms that the best-performing Chinese companies list in Hong Kong, and only the laggards on mainland markets. In India, by contrast, 70 percent of equity market capital represents the shares of private companies. Rapid growth in India's equity market capitalization between 2002 and 2006 mirrored rapid improvements in the performance of the country's private corporate sector.

India's banking system, albeit smaller, is also in better shape than China's. Its stock of non-performing loans has fallen from 10 percent of loan balances in 2001 to below 5 percent today. Although the state still owns 70 percent of the banking system, India's few high-performing private banks together with the presence of some foreign players together create some competition for the state banks and provide consumers with the services they need.

It remains the case however, that India's financial system continues to suffer from poor allocation of capital. India's dynamic private sector includes some world-class companies with average productivity ten times higher than that of household enterprises and double the level of state-owned ones. However, state-owned companies and government-designated sectors are given priority in the queue for lending, and India's private companies receive only 43 percent of total commercial credit (Exhibit 3).

The corporate bond market could be an alternative source of debt for Indian companies, but its value amounts to just 2 percent of GDP. The resulting scarcity of available capital makes finance very dear for Indian companies – adjusted for inflation, some sectors pay nearly double the interest rates charged in China. It is hardly surprising, therefore, that Indian companies rely on retained earnings for nearly 80 percent of the funds they raise, and have very low levels of debt by international standards.

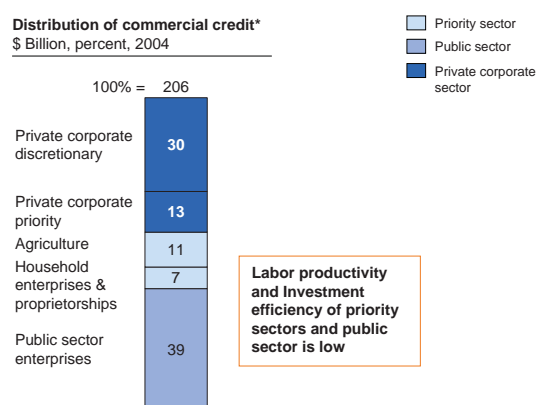
The root of this capital squeeze is government dominance of India's financial system. Banks and other financial intermediaries are required to hold a large portion of their assets in government securities, largely to fund the government's persistently large deficit. Together with an obligation on banks to devote 36

³ This means that these companies' return on invested capital is less than their weighted average cost of capital.

percent of their loan portfolios to the government's priority sectors, this means that India's public sector absorbs the majority of capital flows into the financial system.

Exhibit 3

INDIA'S PUBLIC SECTOR ABSORBS THE MAJORITY OF CAPITAL



* Gross bank credit to non-financial companies, corporate bonds and private placements, and loans and investments from the government to public sector enterprises

** The incremental capital output ratio

Source: CSO; RBI; McKinsey Global Institute analysis

Such regulations reduce the financial system's ability to fuel growth. Indian banks lend out just 61 percent of their deposits, compared to 130 percent in the case of Chinese banks. If Chinese banks lend too freely, Indian ones don't lend enough – bank loans outstanding amount to 44 percent of GDP in India compared with 200 percent of GDP in China.

While China's financial system continues to lend money at low rates at the expense of savers, India's savers get a good deal. A variety of government-regulated deposit accounts and provident funds offer them above-market rates of return—although there are limits on the size of these accounts to ensure that the government can satisfy its appetite for capital. This, together with India's roaring equity markets, means that Indian households earn far higher rates of return on their financial assets than their Chinese counterparts. Over the past decade, Indian households' financial assets have earned around 2.6 percent in real terms, compared to 0.5 percent for Chinese ones. However, by offering generous rates to savers, India increases future demands on the public purse and expands the government's deficit. Also, by diverting funding

from the country's dynamic private companies, these policies restrict growth and, ultimately, living standards.

DIFFERENT REFORM AGENDAS

Neither China nor India yet have the financial systems they need to support growth in their increasingly market-oriented economies. However, the challenges they face in reforming their two systems are very different. India's economy would grow faster if its financial system could attract more of the nation's savings and direct them to productive investments. Its main challenges, therefore, are to expand the financial system and, at the same time, to muster the political will to end government involvement in it. These are both complex tasks, which will necessarily take time to complete.

China's financial system is already very deep but it has fueled increasingly inefficient investment-led growth, and provides the nation's prodigious savers with meager returns. Although the government is vigorously pursuing reforms, shaping the behaviors, incentives, and institutions necessary to support a modern financial system will also take considerable time, no matter how quickly reform measures are rolled out.

Building political consensus in India

India's financial system has some obvious strengths that could underpin the rapid evolution that it needs. The country's biggest challenge will be to build the political consensus and sense of urgency necessary to push through further reforms. At issue is the broader debate over India's development strategy. Many people in India today do not believe that the best way to address poverty is by spurring growth in job-creating companies. Others argue that financing infrastructure investments is more important than reducing the government budget deficit. But MGI's research in India and other countries,⁴ as well as the experience of the countries that have successfully developed during the postwar era, shows that the best way to raise people out of poverty is to expand the most productive parts of the economy and create good jobs. A modern financial sector is necessary to support this development. India's

4 See the McKinsey Global Institute report, *India: The Growth Imperative*, 2001, available for free online at www.mckinsey.com/mgi. Also see Diana Farrell, *The Productivity Imperative*, coming in January 2007 from the Harvard Business School Press.

own recent experience of faster growth supports this view. But more of India's leaders must adopt this view if they are to muster the political will necessary to enact further reforms.

Among the potential financial sector reforms, the first priority for the government is to relax its control over capital raised by the financial system. The most important reforms, therefore, will be to lift restrictions on the asset allocation of banks and other intermediaries, phase out directed lending regulations, and remove the government guarantees on returns to savings in provident funds and other deposit accounts that put mutual funds and commercial banks at a disadvantage. These measures would immediately release more capital for investment in India's private sector and, by forcing other borrowers to compete commercially for funding, raise productivity in the economy overall.

However, this will require difficult decisions for the government. The motivation for the bulk of these regulations is the need to fund India's persistently large fiscal deficit. Over the past 25 years, the combined deficits of the state and central governments have hovered between 6 and 10 percent of GDP, despite widely divergent macroeconomic conditions over this period. When the government releases the formerly captive demand for government securities, interest rates on government debt are likely to rise. Reducing the government budget deficit is therefore a necessary precondition for success in this most critical area of need in the financial system. Among other things, this will require restructuring and privatizing many of India's state-owned enterprises, since their financing explains some of the government's budget deficit. But rapid growth will help allow India to outgrow the budget deficit as well.

A further challenge for India is, indeed, to realize that financial system reform is pressing. India's government initiated an urgent liberalization of its financial system in 1991, in the wake of a balance of payments and financial crisis. Fifteen years later, that liberalization remains incomplete and yet many government leaders see no visible need for further change – they point to a booming stock market, growing foreign portfolio investments, and stability in the banking system. And the government is all too aware that further reforms will involve difficult political trade-offs. So, many of the reforms now on the government agenda – including measures in the pension system and bond market – have been debated for a year or more, with no sign of when action might be taken. The recent report from the Reserve Bank of India on further

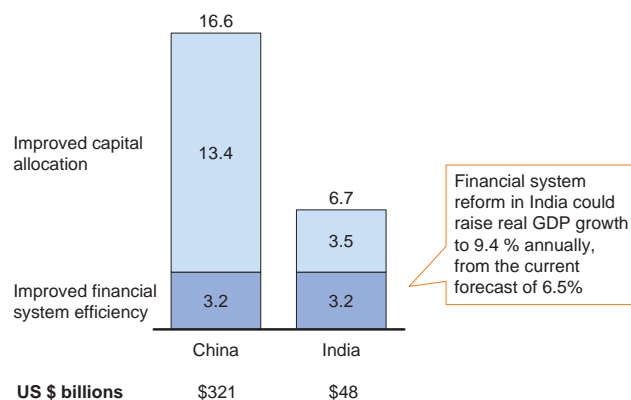
capital account liberalization will likely also face significant resistance.

What should prompt policymakers to grasp the nettle are the enormous potential benefits of financial system reform which, combined with further liberalization throughout the economy, our research shows could boost India's real GDP growth rate to the level of China's. Reforms to raise the efficiency of the financial system would add \$22 billion per year to GDP. Lifting restrictions on the lending and asset allocation of banks and other financial intermediaries would improve capital allocation which, along with reforms to capture more the country's savings, could raise GDP as much as an additional \$25.5 billion a year (Exhibit 4). Together with further liberalization of India's product and labor markets, these reforms would boost real GDP growth to 9.4 percent annually over the next ten years, up from the current forecasts that range between 6.5 percent and 7.0 percent. This would raise per capita income levels by a third compared to the current trend, lifting millions more households out of poverty.

Exhibit 4

THE VALUE OF FINANCIAL SYSTEM REFORM

The annual increase in GDP due to financial system reform
Percent of GDP



Source: McKinsey Global Institute analysis

The government could therefore meet its social objectives more effectively by reforming the financial system than by controlling the way it lends. Banks are currently obliged to lend to priority sectors because the government wants to ensure a flow of credit to rural households engaged in farming and small businesses. Yet India's rural poor, as well as its entrepreneurs, would be better

served if the financial system allocated all its available capital to the country's productive businesses.

India's economy is undergoing the transition from agriculture to industry and services that has accompanied rising living standards in all developed countries. Freeing the financial system is a key to completing this transition without undue hardship, because it will release capital for the massive investments in companies and infrastructure required. The faster productive companies can expand, the more wage-jobs they will create to employ those leaving the land. Moreover, the \$48 billion of extra GDP that we calculate will result from financial system reform will increase tax revenues without the need to increase tax rates. This, rather than distorting flows of capital from the financial system, will allow the government to spend directly on social programs to maintain rural living standards throughout the transition.

Building from the ground up in China

China's regulators have been moving swiftly to reform the financial system. Over the past 18 months, several of the largest commercial banks have listed shares in Hong Kong and others have entered deals with foreign banks; the commercial paper market has greatly increased in volume, albeit from very low levels; and even the country's lackluster equity market is finally rising, in part due to the government's decision to sell off its portion of formerly non-tradable equity shares.

Yet developing China's financial system to the point at which it will operate as a true market will take a lot more time. Consider the challenge of transforming the enormous banking sector. Not only must the government completely deregulate lending and deposit rates, but it must also create the conditions to improve the lending skills and risk management abilities of institutions that have thousands of branches. These institutions have traditionally had fairly decentralized structures, and regional bosses wield considerable independent authority over them and this risks holding back the pace of centrally-directed change. To make available to bankers the information on potential borrowers they need for sound lending decisions, China must not only expand consumer credit bureaus and corporate rating agencies, but also improve the quality of financial reporting and auditing in all companies. The challenges the authorities face in developing the nascent bond market and fixing the floundering equities markets are equally daunting.

China's economy has transformed over the past 25 years at a truly remarkable rate. Yet even if the pace of development in its financial system accelerates, the scale of change required means it will take many more years. It is nevertheless worth speeding up reforms because their benefits, as in India, are potentially huge. We calculate that reforms to increase the efficiency of the system could raise GDP by \$62 billion per year, or 3.2 percent. This will require deregulating interest rates, increasing competition in the banking system, developing a corporate bond market, and accelerating the development of an electronic payments system. Reforms to enable a more market-driven allocation of capital would, over time, raise the productivity of state-owned firms, or force more of them to close. This would enable more efficient investment and higher overall economic productivity, boosting GDP by up to \$259 billion a year, and improving the returns on savings. Greater efficiency and productivity would in turn enable a healthier combination of higher domestic consumption and less investment.

The pace and scope of financial system reforms to date have been dictated in part by understandable political and social concerns among China's leaders. They want an orderly transition to a market economy, avoiding multiple mass lay-offs from state-owned enterprises (SOEs). But, as in India, a liberalized financial system would meet this objective better than deploying capital from the financial system to keep SOEs going because it would allow faster expansion among those successful private companies that will create the jobs required to employ workers now unproductively employed by SOEs. And in China too, the government will be able to use rising tax revenues stemming from financial liberalization to fund social programs for displaced workers, as well as to extend the provision of education and health services, important contributors to living standards in any economy. China today is investing huge amounts in capital intensive industries, such as modern steel plants. These investments require advanced technology but create relatively few jobs. China would be better off allowing banks and other financial intermediaries choose investments on a commercial basis, which would result in more funding for services (which are more labor-intensive) and more financing for consumers.

* * *

China's and India's spectacular growth has attracted a lot of attention, but flaws in their financial systems have been largely overlooked as factors that may hold back their momentum. Yet both countries can reap substantial benefits if they fix these shortcomings now. Not only will financial system reforms lead to faster and more sustainable rates of economic growth in both countries; they will also help to achieve their long-standing social objectives.