BANKING SECTOR REFORMS IN INDIA AND CHINA: DOES INDIA'S EXPERIENCE OFFER LESSONS FOR CHINA'S FUTURE REFORM AGENDA?

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India and China both carried out banking sector reforms in the 1990s. Despite taking a gradual approach, India's reforms have been the more comprehensive and have been implemented at a faster pace than in China. India's experience suggests that the following four issues would be relevant in China's future reform agenda: (1) privatizing the wholly state-owned commercial banks (WSCBs) and introducing measures to improve corporate governance; (2) removing Government intervention to make WSCBs more commercially oriented; (3) reducing the dominance of WSCBs by rationalizing weak banks and downsizing large WSCBs; and (4) if adopted, relaxing the stringent statutory liquidity requirement, which seems to discourage banks from lending. There are also lessons to be learned from India's reforms. First, the entry of new banks should be promoted provided they are sufficiently capitalized and are technology-oriented. Second, diversification of banks' business should accompany interest rate liberalization in order to compensate for the expected decline in net interest income and prevent banks from taking excessive risks. Third, strict regulations should be introduced to prevent connected lending.

One of the features of the East Asian financial crisis was that short-term, massive foreign capital inflows, which were largely intermediated by domestic banks, greatly exposed them to both currency and maturity mismatches (so-called "double mismatch"). Sudden shifts in market sentiment driven by the burst of bubbles revealed the vulnerability of these banking systems and triggered a reversal of capital flows, easily leading to a currency crisis and a banking crisis. The occurrence of these "twin crises" in East Asia deepened the economic downturn by generating a free fall of the exchange rate and expanding the local currency value of foreign debt.

Since the crisis, a consensus has been emerging among policy makers, academicians and media that avoiding a serious double mismatch is one of the most important policy objectives to prevent another crisis in the near future and thus, strengthening the soundness of the banking system in the borrower country is essential

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(Yoshitomi and Shirai, 2000). Sound banking systems also serve as an important channel for achieving economic growth through the mobilization of financial savings, putting them to productive use, and transforming various risks (for example, Beck and others, 1999).

The East Asian financial crisis also revealed that excessive risk taking and weak monitoring functions by domestic banks were directly associated with a lack of clear relations between Governments, banks and large family businesses. This system may have worked effectively for these economies at the take-off stage and promoted rapid industrial development in the process; however, once capital account liberalization was introduced the systems became inappropriate in the management of massive capital inflows. This system now calls for drastic reforms to promote stronger incentives for financial institutions, particularly banks, to improve risk management and at the same time to improve prudential regulations adjusted for the new environment. The East Asian financial crisis gave rise to an opportunity to recognize the importance of balancing financial liberalization with adequate regulation and supervision prior to full capital account liberalization.

This liberalization issue is even more important and relevant for countries such as India and China, which have not yet launched full capital account convertibility and where state-controlled banks still remain dominant. In such countries, financial sector liberalization comes against more politically difficult issues than those that have already opened up their capital account to a substantial degree, since they have to first restructure predominantly state-controlled commercial banks (called "public sector banks" in India and "wholly state-owned commercial banks" [WSCBs] in China).

This paper focuses on banking sector reforms in India and China, which have been attracting increasing attention since their initiation in 1991 and 1994, respectively. While India's banking sector reforms have been regarded as following a gradual approach, they have been more comprehensive and have, in fact, been implemented at a faster pace than those of China. This paper assesses whether such differences in the reform programmes have brought any significant differences in the performance of public sector banks and WSCBs. Given that the two economies have similarities such as taking a cautious approach with respect to capital accout liberalization and gradually moving away from planned economic development, this paper also examines whether India's reform experiences can offer any lessons for China's future reform agenda.[1]

1 With respect to data availability and limitation, data on banks in India were obtained from the Prowess database for 1993-2000 compiled by the Center for Monitoring the Indian Economy Pvt. Ltd. This is the database mostly frequently used by researchers and covers all commercial banks excluding regional rural and cooperative banks. The database does not cover the initial reform period of 1991-1992. However, the assessment on the impact of the banking sector reforms without covering this period remains valid, as major elements of the reforms have begun since 1993. As for data on banks in China, data were obtained from the Bankscope data base. It should be noted that the quality of data in China is often questioned and, thus, the quantitative analysis should take into account this aspect. This paper does not cover foreign joint-venture banks and branches in China, since their scope and location of business are highly restricted, meaning these banks do not operate on a level playing field. Even though data on some of these banks are available, the coverage is small. However, the major domestic banks in terms of asset size (accounting for a little more than 80 per cent of assets held by all financial institutions) are covered.

The paper consists of five sections. Section I focuses on India's and China's banking sector reforms. Section II assesses these reforms by examining trends and patterns of performance over the reform period. Section III discusses six issues related to India's banking sector reforms (privatization, entry deregulation, statutory liquidity requirement, directed lending, diversification of business, and connected lending) and identifies lessons that might be applicable to China's future reforms by analyzing the policies adopted in India. Section IV discusses China's remaining reform agenda.

I. BANKING SECTOR REFORMS IN INDIA AND CHINA

Background of the reforms: India

India's commercial banking system mainly consists of 27 public sector banks (that are further classified as 19 nationalized banks and eight State Bank of India (SBI) banks (SBI and seven independently capitalized banking subsidiaries); 31 private sector banks (that are further classified as 23 old private sector banks and eight new private sector banks that emerged after 1991; 42 foreign banks; 196 regional rural banks; and 67 cooperative banks. The banking system had 959,955 employees and 51,267 branches in 2000; of which, public sector banks had a 90 per cent share. The SBI was originally established in 1806 and acquired its present status through an act of parliament in 1955. Nationalized banks refer to private sector banks that were nationalized (14 banks in 1969 and six in 1980) by the central government. In 1993, Punjab National Bank merged with another nationalized bank, New Bank of India, leading to a decline in the total number of nationalized banks from 20 to 19.

Prior to the 1991 reforms, India's banking sector had long been characterized as highly regulated and financially repressed. The prevalence of the reserve requirement (i.e., a cash reserve ratio [CRR] that requires banks to hold a certain amount of deposits in the form of deposits with the RBI), liquidity requirement (i.e., statutory liquidity ratio [SLR] that requires banks to hold a certain amount of deposits in the form of Governmentand eligible securities), interest rate controls and allocation of financial resources to the so-called priority sectors (i.e., agriculture, small scale industries and exports) increased the degree of financial repression and adversely affected the country's financial resource mobilization and allocation. Quantitative loan targets were imposed on nationalized banks to expand their networks in rural areas and extend credit to priority sectors. These banks were then increasingly used to finance fiscal deficits. Although non-nationalized private sector banks and foreign banks were allowed to coexist with public sector banks at that time, their activities were highly restricted through entry regulations and strict branch licensing policies.

As a result of elaborate Government intervention, many banks remained unprofitable. The average return on assets for public sector banks in the second half of the 1980s was only about 0.15 per cent and their non-performing assets (NPA)

amounted to 24 per cent of credit. Against this background, the first wave of financial liberalization took place in the second half of the 1980s, mainly taking the form of introduction of Treasury Bills (TB), development of money markets and partial interest rate deregulation. In 1986, the 182-day TB were introduced through an auction system. In 1988, the Discount and Financial House of India was established as an institution that would provide liquidity in the financial market. In 1989, both commercial paper and CDs were introduced. Coupon rates on Government bonds were gradually increased to reflect demand and supply conditions. In 1988, the maximum lending rate and ranges in minimum rates were unified and switched to a minimum lending rate (MLR) in 1988. As a result, this enabled banks to set interest rates more flexibly. In 1989, the maximum interest rates on call money were liberalized.

Banking sector reforms since 1991

Following most of the recommendations made in the 1991 report of the Narasimham Committee, the Government launched comprehensive banking sector reforms in that same year. India's banking sector reforms since 1991 can be summarized in the following six areas: first, the CRR declined from 15 per cent in 1991 to 5.5 per cent in 2001. The SLR declined from 38.5 per cent in 1991 to 25 per cent in 1997 and has remained at 25 per cent until today. A decline in the CRR and SLR increased banks' flexibility in allocating credit and hence gave banks an opportunity to improve their profitability. Second, interest rates became flexible with respect to all term deposits rates and lending rates on advances over Rs 200,000. Interest rate deregulation has encouraged banks to improve their cost efficiency and diversify into non-traditional business as a result of declining net interst income (table 1). Third, reform in priority sector lending – mainly through the expansion of coverage and interest rate decontrols on advances over Rs 200,000 – helped banks to mitigate the negative impact arising from such policy loans, while the targets of 40 per cent (of advances) on domestic banks and 33 per cent on foreign banks have not changed during the reform period.

Fourth, entry barriers were reduced both on private sector and foreign banks and their full ownership was granted. As a result, eight private sector banks and 26 new foreign banks entered the banking sector. With respect to branch barriers, public sector banks were allowed to rationalize some branches. Following India's commitment to the 1995 World Trade Organization (WTO) agreement in respect of the services sector, foreign banks have been permitted to open up to 12 branches a year. Also, these banks can be exempted from meeting branch requirements in rural and semi-urban areas provided that they, for example, contribute to the Rural Infrastructure Development Fund of the National Bank for Agriculture and Rural Development (NABARD), a refinance institution, or make deposits with the NABARD. Fifth, various prudential norms and more appropriate accounting standards were

Table 1. India: selected indicators of the commercial banking sector, 1993-2000

(percentage of assets)

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Cash and Balances with the RBI								
Nationalized Banks	11.9	11.7	13.9	13.2	10.2	10.4	10.1	8.8
SBI Banks	9.9	13.2	12.9	14.1	13.6	10.6	9.5	8.5
Old Private Sector Banks	17.8	16.5	14.4	12.6	10.1	10.1	9.3	8.7
New Private Sector Banks	–	–	9.0	9.2	8.3	9.0	7.3	6.8
Foreign Banks	12.9	9.2	9.7	7.4	5.8	5.4	4.1	3.6
Investments								
Nationalized Banks	32.2	40.0	37.5	36.7	40.4	40.7	40.6	41.2
SBI Banks	29.5	32.5	32.2	29.0	31.5	33.2	36.6	38.2
Old Private Sector Banks	28.4	32.5	32.4	27.8	30.8	32.7	33.7	34.4
New Private Sector Banks	–	–	23.2	18.5	30.5	34.4	38.1	40.2
Foreign Banks	29.5	36.9	29.4	19.3	24.9	26.1	32.9	34.1
Advances								
Nationalized Banks	45.4	39.9	40.8	41.2	39.3	39.0	39.1	40.5
SBI Banks	47.6	40.9	44.4	44.9	43.6	43.9	41.3	41.9
Old Private Sector Banks	42.2	42.0	44.2	48.0	46.8	43.5	43.3	44.6
New Private Sector Banks	–	–	28.3	51.2	47.7	42.0	39.7	39.2
Foreign Banks	44.4	44.7	45.2	48.6	46.3	45.5	38.2	42.9
Deposits								
Nationalized Banks	87.9	90.2	87.9	86.7	89.5	89.4	89.4	89.2
SBI Banks	77.4	77.2	78.1	76.2	77.9	79.6	79.5	79.5
Old Private Sector Banks	87.5	89.4	87.5	83.6	87.1	88.7	87.8	87.7
New Private Sector Banks	–	–	39.5	59.4	78.2	83.0	78.3	79.8
Foreign Banks	66.7	73.6	64.8	45.1	48.7	50.5	47.2	46.7
Net Interest Income								
Nationalized Banks	-0.9	-0.6	-0.5	-0.7	-1.1	-1.5	-1.6	-1.8
SBI Banks	0.0	-0.3	-0.3	0.3	0.2	-0.3	-0.6	-1.0
Old Private Sector Banks	0.4	0.1	0.4	0.2	-0.1	-1.0	-1.5	-1.3
New Private Sector Banks	–	–	0.3	1.9	0.5	-0.8	-1.5	-1.7
Foreign Banks	1.7	1.7	1.1	1.3	2.0	1.4	0.8	0.3
Income from Diversification								
Nationalized Banks	1.0	0.9	0.9	1.0	0.9	1.0	0.8	1.0
SBI Banks	1.6	1.6	1.7	1.7	1.5	1.6	1.4	1.6
Old Private Sector Banks	1.0	1.0	1.0	0.9	1.0	1.3	0.9	1.2
New Private Sector Banks	–	–	-0.9	1.5	1.4	1.9	1.2	1.3
Foreign Banks	1.8	1.6	1.4	1.5	1.8	3.3	2.1	2.1
Income from Investment								
Nationalized Banks	2.6	2.9	3.3	3.7	4.2	4.4	4.4	4.5
SBI Banks	3.1	3.3	3.7	3.3	3.5	3.8	4.0	4.1
Old Private Sector Banks	2.8	3.1	2.9	3.1	3.2	3.7	3.8	3.8
New Private Sector Banks	–	–	0.8	1.8	2.4	3.3	3.7	3.6
Foreign Banks	3.2	3.5	3.5	2.2	2.1	2.7	3.0	3.8

Source: PROWESS Database, Center for Monitoring Indian Economy Pvt. Ltd.

introduced. All banks have to meet an 8 per cent capital adequacy requirement. Better accounting standards have revealed part of the true status of NPA problems of public sector banks. This has not only increased pressure on these banks in terms of improving their balance sheets, but has also enabled the Government to conduct appropriate policies to deal with NPA problems. Sixth, nationalized banks were recapitalized by the Government and 11 public sector banks have been partially privatized.

However, these reforms should be regarded as a gradual approach for the following reasons. First, India's banking sector has been highly dominated by public sector banks, even though entry deregulation has taken place. Based on the asset base, the share of public sector banks remained more than 80 per cent, despite a decline from 87.2 per cent in 1995 to 80.5 per cent in 2000. The share of foreign banks remained at 7.5 per cent during 1995-2000, while that of private sector banks increased from 5.3 per cent in 1995 to 13 per cent in 2000. This suggests that the entry of new banks has exerted competitive pressures only at the lower end.

Second, while the SLR of 25 per cent has remained at a high level, banks currently hold Government bonds in excess of the SLR (table 1). Traditionally, banks' holdings of Government securities were heavily affected by the requirement of the SLR. Thus, one would expect that a gradual and steady decline in the SLR would have lowered the ratio of investment in Government securities to assets in line with the declining pace of the SLR. However, the share of investment has indeed increased during 1997-2000 and this phenomenon has taken place regardless of the ownership of banks. The increased holding of Government securities may reflect that (1) interest rates paid on Government bonds have increasingly become more market-based through auctions (table 1); (2) greater capital gains are expected as a result of declining interest rates; (3) stringent prudential norms and accounting standards have induced banks to become more cautious in terms of lending to the private sector and thus to prefer safer, more liquid Government securities; (4) lack of high-quality borrowers due to mild recession; (5) substitution of a decline in the CRR to maintain sufficient liquidity, and (6) banks' reluctance to increase advances because banks have to increase advances to the priority sectors proportionally. Meanwhile, the increase in Government bonds held by nationalized banks from 32 per cent of assets in 1993 to 40 per cent in 1994 can be attributed to the Government's recapitalization programme. As for the ratio of cash and balances with the RBI to assets, it has declined steadily owing to the decline in the CRR. The decline has also contributed to the increase in the ratio of investment to assets.

By contrast, public sector banks have reduced the share of advances to assets from 1992 to 2000, from 45.4 per cent to 40.5 per cent for nationalized banks and from 47.6 per cent to 42 per cent for SBI banks generating a shift from lending activies to investment in Government securities. Private sector and foreign banks followed the same pattern, although the latter increased their share in 2000. At this

stage, the issues of credit crunch have not yet become serious social problems thanks to a mild economic recession. Once economic growth accelerates, however, a decline in advances together with excess holdings of Government securities is likely to be binding and could crowd out the private sector, given that the fiscal deficit remains at a high level.

Third, interest rates on saving deposits as well as other saving schemes – such as, postal savings, public provident funds and national savings certificates – have also remained regulated. To the extent that some of these rates constitute the floor, an effective monetary policy is rendered more difficult. As for lending rates, those on advances over Rs 200,000 remain subject to the prime lending rate (PLR) and some spread guidelines, despite interest decontrols. The degree of divergence among each bank's lending interest rates is limited, partly because large, dominant public sector banks tend to be leaders in setting rates. Many banks offer lending rates below the PLR to high-quality borrowers in the presence of increasing competition from the CP market, making the PLR ineffective. In addition, lending rates on advances up to Rs 200,000 remain regulated and protected in a sense that rates are set below the PLR regardless of the risk and return involved in each lending project. These remaining regulations make it difficult for banks to increase lending activities since it is difficult for them to reflect the true credit risk of firms on the rates. Because of these factors, net interest income as a share of assets has declined for all banks. All banks except foreign banks have maintained negative net interest income.

Fourth, foreign banks do not compete with other banks not only in terms of customer base, but also in terms of deposit acquisition, implying that their impact on competition is limited. These banks focus on wholesale business and thus do not compete with domestic banks that concentrate on retail business. Foreign banks have also lowered their dependence on deposits from 67 per cent of assets (or equivalently, liabilities and equity) in 1993 to 47 per cent in 2000, while new private sector banks have increased the ratio from 40 per cent in 1995 to 80 per cent in 2000 and all other banks have more or less maintained 80-90 per cent of deposits during 1993-2000. Foreign banks mainly deal with other financial institutions and large corporate firms. This is evident from the fact that deposits per account are much higher in foreign banks, as compared with SBI banks, or nationalized banks, or private sector banks. Instead, foreign banks have increased equity rapidly from 6.8 per cent of assets in 1993 to 20.5 per cent in 2000, and borrowing from 21.8 per cent in 1993 to 28.5 per cent in 2000.

Fifth, the pace of partial privatization has been limited owing to the sluggish equity market. Another reason for the slow pace of privatization is that the balance sheets of some nationalized banks as well as their management and operational skills have remained very weak so that the cost of restructuring these banks would be presumably prohibitively high. As a result, investors have hardly showed interest in investing in these banks.

Background of the reforms: China

China's banking system consists of the four WSCBs, three policy lending banks, more than 100 commercial banks (mostly, city commercial banks), about 3,000 Urban Credit Cooperatives (UCCs), some 42,000 Rural Credit Cooperatives (RCCs), and about 190 foreign banks with branches or representative offices. The four WSCBs dominate the banking sector in terms of branches (108,507 as of the end of 1998) and employment (1.67 million staff).

Prior to 1979, China's banking system played only a limited role in promoting economic growth. It reflected the limited role of banks in a highly centralized planning system whose primary functions were collecting revenue from SOEs and allocating investment through budgetary grants (Ma, 1997). In these circumstances, banks simply provided credit needed by the state-owned enterprises (SOEs) for their production plans and provided/monitored cash used principally to cover labour costs and purchases of agricultural products.

The Government has embarked on a series of banking sector reforms since 1979. The programmes in the 1980s focused on the establishment of a two-tier banking system comprising primarily of a central bank and four specialized banks that are already owned fully by the central Government. This is in contrast to India, where a number of private sector and foreign banks existed in the early 20th century under colonialism and many of these banks were later nationalized under the planned economic development regime. Further, the reforms replaced direct grants with interest-bearing loans in an attempt to solve SOEs' soft-budget problems. From 1986, the People's Bank of China (PBC) was explicitly made responsible for monetary policy and the supervision of the financial system, including the money and capital markets. With the objective of containing inflation, moreover, the PBC took responsibility for formulating a credit plan that set an aggregate credit ceiling on each PBC branch according to the national economic plan and authorized each branch to allocate credit under the ceiling. Autonomy was given to every PBC branch, leaving room for them to act on behalf of the local governments, who intervened with respect to credit allocation. Moreover, PBC was not an independent regulatory body, functioning more as a line ministry under the State Council and thus its monetary policy decisions were subject to the approval of the Council.

Financial reforms since 1994

Once the two-tier banking system was formed, the Government launched the second wave of financial reforms. The Government separated policy lending activities from specialized banks by establishing three policy lending banks and introducing the Commercial Bank Law of 1995. Under the law, the four specialized banks became commercial banks (WSCBs) and are now subject to prudential regulations and are

supervised by the PBC, while the three policy lending banks are not subject to the law and their operations are guided by individual charters. The central Government reduced intervention by local governments in WSCB's credit allocation. For example, the PBC now selects the managers of its local branches at its headquarters.

Other reforms since 1994 are summarized thus: first, the reserve requirement was lowered from 20 per cent (including an excess reserve requirement of 7 per cent) in 1992 to 8 per cent in 1998. Second, banks were allowed to set lending interest rates freely within the specified range. In 1993, the PBC imposed a lending rate ceiling at 20 per cent and floor at 10 per cent on commercial banks, ceiling at 30 per cent and floor at 10 per cent on UCCs, and ceiling at 60 per cent and floor at 10 per cent on RCCs. In 1996, the PBC set the ceiling and floor both at 10 per cent with respect to commercial banks, and the ceiling at 40 per cent and floor at 10 per cent with respect to RCCs. In 1998, the ceiling was set at 20 per cent for loans to small and medium enterprises (SMEs) and at 50 per cent for UCCs. In 1999, the ceiling for SMEs was raised to 30 per cent. Moreover, the interbank markets were unified and the ceiling on interbank rates was lifted. Third, some private and local banks have been established. Fourth, the loan classification system was reformed in 1998 by introducing an internationally accepted five-tier classification. In 2001, moreover, prudential regulations and accounting standards were tightened in the face of the increasing challenges from globalization and China's accession to the WTO. Fifth, the Government recapitalized the WSCBs by injecting Y270 billion in capital in 1998 and transferred Y1.4 trillion of assets (about 20 per cent of combined outstanding loans) to the respective asset management companies (AMCs) in 1999. These exercises have improved the balance sheets of these banks.

Nevertheless, the speed and coverage of reforms are still very limited for the following reasons. First, the degree of concetration by WSCBs has barely changed, accounting for about 70 per cent of deposits. Even though the number of new banks has increased, most of them are largely owned by local governments or SOEs. Moreover, tight entry regulations continue to prevail. There are no explicit and transparent rules set by the Government with respect to entry criteria. Foreign banks have been closely regulated, since engagement in local currency-denominated transactions was largely limited to only Shanghai and Shenzhen and was allowed only against foreign capital enterprises. Following WTO accession, foreign banks will be allowed to engage in local currency-denominated transactions with resident firms within two years, and retail banking business with Chinese citizens will be allowed within five years. However, the dominance of WSCBs with an extensive branch network makes it difficult for foreign and new banks to penetrate into the retail banking sector and may have to depend on WSCBs' networks in some cases (for example, customers' remittance).

Second, all banks have lowered the ratio of advances to assets (for WSCBs in recent years), and instead, increased investment in Government securities, especially

since 1998 when the interbank bond market was established (table 2). The shift from advances to investment indicates the presence of credit crunch problems in all banks. Compared with WSCBs, moreover, other commercial banks (OCBs) tend to invest in bonds more intensively. This may reflect their preference for investing in safer, liquid assets and the avoidance of high cost to establish branch networks and thus penetrate into retail markets. Further, OCBs maintain the ratio of deposits with the PBC to assets at a high level of 15 per cent, while WSCBs have maintained only about 8 per cent – reflecting (1) the interest rate paid by the PBC even for excess reserves, (2) cushions needed for settlement and clearing accounts, and (3) OCB's greater preference toward liquid asssets rather than lending activities.

Table 2. China: asset structure of the commercial banking sector, 1994-2000

(percentage of assets)

	1994	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Deposits with the PBC							
Wholly State Owned Commercial Banks	5.2	9.9	12.7	13.0	9.6	8.7	7.9
Other Commercial Banks	14.7	12.1	14.9	17.7	14.5	15.3	14.5
Cash and Bank Deposits							
Wholly State Owned Commercial Banks	6.3	4.6	3.6	1.6	1.3	1.8	1.0
Other Commercial Banks	0.8	2.2	1.4	1.0	2.1	3.5	2.0
Investment in Securities							
Wholly State Owned Commercial Banks	2.9	3.3	3.7	3.4	8.4	7.9	10.9
Other Commercial Banks	10.4	8.9	14.5	9.1	15.7	15.7	17.1
Advances							
Wholly State Owned Commercial Banks	47.3	51.5	56.7	62.4	63.5	59.6	56.7
Other Commercial Banks	52.2	47.8	45.3	43.9	45.0	44.8	45.5
Net Interest Income							
Wholly State Owned Commercial Banks	3.1	1.7	1.9	2.2	2.3	1.9	1.8
Other Commercial Banks	2.5	3.4	3.3	3.4	3.1	2.3	2.2

Source: Bankscope, Fitch IBCA.

Third, interest rate liberalization was achieved only to a limited degree – largely in the wholesale market. While some flexibility was introduced on lending rates, ceiling rates have remained at well below the market clearing level. This is closely associated with an upsurge in illegal lending and corruption scandals in recent years involving the WSCBs. There are some cases that lending practices by WSCBs are based on personal connections, bribery, and pressure from local governments. Consequently, ordinary borrowers find it difficult to obtain loans from WSCBs. While the low lending interest rate policy aims at subsidizing SOEs, it has given rise to

collusive behaviour among financial institutions despite the penalties faced. The fact that black markets exist and their prevailing lending interest rates are two to three times higher than those of regulated lending rates indicates that banks have strong incentives to lend at higher lending rates. Deposit interest rates have remained regulated and banks have continued to be protected by relatively wide interest rate margins. PBC's continuation to control official lending and deposit interest rates prevents WSCBs from operating according to market principles. Given that banks are able to obtain cheap financing through deposits, interest rate deregulation in the wholesale market is expected to exert a minimum impact on banks' behaviour.

Fourth, banks' decisions to allocate resources are still subject to guidance and interference from the central Government, even though intervention by local governments in banks' allocation of credit has declined. Given that the Government continues to face high credit demand for infrastructure projects and development in the western region, the implicit and explicit influence by the central Government on WSCBs is likely to remain in the foreseeable future. Fifth, recapitalization of WSCBs and transfer of their NPA to the AMCs have been conducted without major reforms in the corporate governance of these banks and removal of central Government intervention. Thus, there are no guarantees that NPA of WSCBs will not increase in the near future. Even though Y1.4 trillion of NPA was transferred to the AMCs, the four WSCBs still held 26.6 per cent of NPA as of the end of September 2001. If proper accounting methods were applied, moreover, it is believed all WSCBs would have a negative net worth and thus would have been categorized as insolvent.

Between banking sector reforms in India and China, there are thus several similarities. Both countries lowered the statutory reserve requirement. The sequence of interest rate deregulation was similar: initiated in the wholesale market first, followed by an introduction of flexibility in the lending rates. Both countries made efforts to mitigate directed lending. Entry deregulation was reformed and prudential regulations and supervision were improved. The Government attempted to restructure state-controlled commercial banks through recapitalization programmes in both countries.

II. BANKING SECTOR PERFORMANCE IN INDIA AND CHINA

Based on an overview of the two countries' banking sector reforms, this section examines developments in the commercial banking sector of each country by evaluating changes in performance in the sector.

Profitability, earnings- and cost-efficiency

India: Foreign banks' profitability (defined as after-tax profits divided by return on average assets [ROA]) exceeded that of public sector banks in 1993-1997 (table 3). New private sector banks' ROA also exceeds that of public sector banks

Table 3. India: selected indicators of the performance of commercial banks, 1993-2000

(percentage)

	1993	1994	1995	1996	1997	1998	1999	2000
Profit after Tax/Assets (ROA)								
Nationalized Banks	-1.5	-3.2	0.0	-0.7	0.4	0.7	0.3	0.5
SBI Banks	0.4	0.2	0.4	0.6	0.7	1.2	0.7	0.9
Old Private Sector Banks	-0.2	0.5	1.2	0.8	1.0	0.9	0.6	0.9
New Private Sector Banks	–	–	1.1	2.3	2.2	1.9	1.3	1.2
Foreign Banks	2.0	2.0	2.0	1.6	1.6	1.1	0.4	-0.2
Income/Assets (INCOME)								
Nationalized Banks	10.6	10.1	9.9	10.7	11.1	10.5	10.3	10.4
SBI Banks	11.8	10.7	11.0	11.9	12.0	11.5	11.0	10.9
Old Private Sector Banks	10.9	10.5	10.5	11.4	11.8	11.8	11.4	11.3
New Private Sector Banks	–	0.3	3.2	11.0	11.1	11.3	10.8	9.3
Foreign Banks	14.9	13.0	12.2	13.4	13.3	13.8	12.4	12.8
Operating Expenses/Operating Income (COST)								
Nationalized Banks	96.7	94.5	89.1	90.0	89.3	87.0	88.6	87.5
SBI Banks	86.0	84.7	81.1	82.1	80.5	79.8	81.7	80.0
Old Private Sector Banks	86.4	84.5	81.6	82.5	83.1	82.5	87.5	82.4
New Private Sector Banks	–	74.5	76.4	73.2	72.4	72.1	77.8	73.8
Foreign Banks	67.7	60.9	80.7	81.7	87.2	68.6	81.2	72.2
Provisions for NPA, Contingencies, etc. /Advances								
Nationalized Banks	5.0	10.4	3.3	4.6	2.2	2.4	2.0	1.9
SBI Banks	4.8	3.8	4.2	3.7	3.0	2.5	2.8	2.5
Old Private Sector Banks	4.5	3.7	3.1	3.1	2.0	2.1	1.6	2.0
New Private Sector Banks	–	–	4.1	1.5	1.5	2.1	1.6	2.8
Foreign Banks	14.0	10.5	8.0	3.0	2.6	5.1	6.9	8.5
Capital plus Reserve/ (Liabilities and Equity)								
Nationalized Banks	1.7	2.3	3.9	3.4	4.1	4.8	4.3	4.0
SBI Banks	1.7	2.0	2.2	3.2	3.9	4.8	4.5	4.6
Old Private Sector Banks	3.2	3.6	4.0	5.6	5.4	5.5	5.6	5.6
New Private Sector Banks	–	–	9.0	25.5	10.0	7.8	6.3	6.0
Foreign Banks	6.8	7.9	17.4	25.0	28.4	25.2	25.4	20.5
Capital Adequacy Ratio[1]								
Nationalized Banks	–	–	–	8.2	10.2	10.5	10.9	11.1
SBI Banks	–	–	–	10.0	10.4	12.5	11.9	12.0
Old Private Sector Banks	–	–	–	10.5	11.3	12.0	12.6	12.3
New Private Sector Banks	–	–	–	42.7	15.9	13.9	12.0	13.4
Foreign Banks	–	–	–	–	41.4	38.0	43.9	31.9

Source: PROWESS Database, Center for Monitoring Indian Economy Pvt. Ltd.; Report on Trend and Progress of Banking in India, 1997-2000, RBI.

Note: [1] Excludes nationalized banks with negative networth.

during 1995-2000. However, the profitability of foreign and new private sector banks has shown a declining trend from the middle of 1990s, in part because of the entry of new banks, establishment of new branches, and expansion of business during this period. By contrast, both nationalized and SBI banks have improved their profitability in the latter half of the 1990s.

However, caution should be exercised particularly with regard to the improved performance of the nationalized banks, since profits of nationalized bonds include income from recapitalized bonds. ROA of nationalized banks was only 0.03 per cent in 1997, 0.05 per cent in 1998, -0.15 per cent in 1999, and 0.01 per cent in 2000, if income from recapitalized bonds were to be excluded. The ROA excluding income from recapitalized bonds has remained low and has even deteriorated during 1997-2000. This suggests that the improvement in the performance of nationalized banks is attributable to holdings of recapitalization bonds, not so much because of their efforts to restructure their management and governance systems. On the other hand, the improvement of the performance of SBI banks, all of which did not get recapitalized, may reflect an improvement of their management and governance. Overall, a decline in net interest income lowered banks' ROA, but the decline was offset mainly by an increase in income from investment and profits from diversification (defined as income arising from securities and foreign exchange transactions, and commissions and brokerage).

As for earnings efficiency (defined as income divided by assets or INCOME), foreign banks have been generally better performers. According to INCOME, foreign banks have consistently performed better than private sector and public sector banks, although foreign banks' income generating capacity deteriorated somewhat from 15 per cent in 1993 to 12.8 per cent in 2000. The poorer performance of domestic banks relative to foreign banks can be attributed to more stringent requirements imposed on domestic banks with respect to advances to priority sectors, greater Government intervention, concentration on the retail market and hence greater competition, poor management, and lower interest rate margins. Further, foreign and new private sector banks are generally more cost-efficient (defined as operating expenses divided by operating income or COST) than public sector banks. However, foreign banks have deteriorated in cost-efficiency during 1995-1997 and 1999, because of expansion of business. Indeed, nationalized banks and SBI have improved cost-efficiency over the sample period.

China: WSCBs have maintained profitability at a very low level – below 0.2 per cent throughout 1994-2000 (table 4). This level of profitability (measured by ROA) is remarkably small, especially when compared with OCBs, which achieved nearly 2 per cent profitability in 1994-1995. Meanwhile, it should be noted that OCBs' profitability has rapidly deteriorated from 1.8 per cent in 1994 to 0.6 per cent in 2000 – as against WSCBs, whose profitability has improved slightly in 2000.

Table 4. China: selected indicators of the performance of commercial banks, 1994-2000

(percentage)

	1994	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Profit after Tax/Average Assets (ROA)							
Wholly State Owned Commercial Banks	0.1	0.2	0.1	0.1	0.1	0.1	0.2
Other Commercial Banks	1.8	1.7	1.6	1.4	1.2	0.8	0.6
Income/Assets (INCOME)							
Wholly State Owned Commercial Banks	16.0	12.6	11.2	12.4	6.2	5.0	4.4
Other Commercial Banks	6.8	8.3	8.1	8.3	6.3	4.9	3.9
Operating Expenses/Operating Income (COST)							
Wholly State Owned Commercial Banks	85.9	70.2	69.3	67.5	79.9	78.7	77.0
Other Commercial Banks	45.1	43.8	59.9	49.9	56.9	63.6	66.1
Capital plus Reserve/(Liabilities and Equity)							
Wholly State Owned Commercial Banks	3.5	3.3	3.0	3.2	5.8	5.4	5.3
Other Commercial Banks	8.8	6.4	8.2	6.8	9.5	8.4	5.3
Loan Loss Reserves/Loans							
Wholly State Owned Commercial Banks	0.5	1.1	0.9	0.7	0.8	1.2	1.0
Other Commercial Banks	0.6	0.7	0.9	1.3	1.6	1.7	1.4

Source: Bankscope, Fitch IBCA.

Interest income is the major source of income, accounting for more than 90 per cent of income. Although interest income includes income from investment, the major source of interest income is from advances. This is in sharp contrast to Indian banks, whose income sources are more diversified and interest income from advances accounts for only about 50 per cent of income. According to the net interest income ratio (net interest income divided by average assets), OCBs' net interest income ratio has consistently exceeded that of the WSCBs during 1995-2000. This may reflect the fact that OCBs are more conscious of returns and risk than WSCBs and thus charge higher lending rates that are allowed within the ceiling. However, net interest income has declined for the OCBs during 1998-2000 and the WSCBs during 1999-2000, contributing to a decline in profitability. This happened even though interest rate spreads expanded during this period. This may reflect a delay in interest rate payments on bank loans by borrowers as well as a cautious attitude toward new bank loans and refinancing previous loans. With respect to profitability related to non-interest income (such as commissions and income from trading), OCBs have constantly obtained more returns from non-traditional services than WSCBs. Thus, it can be said that OCBs have diversified more successfully than WSCBs, even though greater diversification is limited by the Commercial Bank Law.

As for the indicator of earnings efficiency proxied by INCOME, WSCBs have performed better than OCBs during 1994-1997. However, the difference was small during 1998-2000. Earnings-efficiency of both types of banks has deteriorated in recent years. With respect to the indicator of cost-efficiency proxied by COST, OCBs have been more cost-efficient than WSCBs throughout the reform period. However, OCBs' cost-efficiency deteriorated in 1998-2000, while that of the WSCBs improved slightly in 1998-2000. The increase in COST by OCBs during 1998-2000 reflects mainly an increase in operating expenditure, such as personnel expenditure. The increase in personnel expenditure is attributable to staff wage rises and an expansion of employment as the number of branches and offices rose.

Capital, asset quality, management and liquidity

India: The overall soundness of the banking sector is assessed from four aspects: capital adequacy, asset quality, management, and liquidity. In the case of the capital adequacy ratio, two indicators were used: equity plus reserves over assets and risk-weighted capital adequacy ratio. According to the first indicator, the ratio of foreign banks increased from 7 per cent in 1993 to 21 per cent in 2000 (table 3). In terms of the risk-weighted capital adequacy ratios, foreign banks have maintained the ratios above 30 per cent during 1997-2000, albeit at a decelerating trend. These ratios are significantly high not only from the global standard but also compared with other domestic banks. While these indicators have reported an increasing trend for old private sector and public sector banks, the scale of increase has been small. This suggests that foreign banks have greater incentives to lend prudently and remain well capitalized than other banks. This reflects in part that foreign banks have steadily reduced their deposit dependence ratio, while other banks have maintained their deposit-dependence ratio throughout the sample period.

Asset quality can be measured by (1) the ratio of contingent liabilities to assets, (2) asset growth, (3) the ratio of investment in Government securities to assets, and (4) the ratio of provisions for NPA to assets. The first indicator reports that the ratio of foreign banks (at around 25-30 per cent) has been greater than that of private and public sector banks (about 10 per cent). While this indicates that foreign banks are more exposed to high potential losses in cases of default, this outcome may simply reflect that foreign banks provide more complex and sophisticated services than domestic banks, given that their activities are concentrated in urban areas, wholesale markets and large clients. The second indicator reports that foreign banks (about 30 per cent) and new private sector banks (about 100 per cent) have faced rapid asset growth in 1996-2000 compared with other banks (about 20 per cent), signaling some kind of risk-taking behaviour. However, this may be explained simply by their early stage of establishment, not necessarily by risk-taking behaviour. The third indicator shows that all banks invested about 40 per cent of assets in Government securities,

which can be used as a large cushion against NPA. The fourth indicator reports that foreign banks generally allocated greater provisions for NPA. Given that more stringent accounting and auditing standards of their mother countries are applied to foreign banks, foreign banks are more resilient to adverse shocks.

With respect to management performance, the ratio of advances to deposits was used. Foreign banks attempt to improve their income by expanding their lending operations as compared with other domestic banks. The ratio of foreign banks surged from 56 per cent in 1993 to 94 per cent in 2000, while domestic banks maintained the ratio at about 40 per cent over the same period. Given that foreign banks' ratio of advances to assets is similar to other domestic banks (about 40 per cent of assets), this simply suggests that foreign banks lowered the deposit dependency ratio, as pointed out above. Finally, all banks have to maintain sufficient liquidity in terms of cash and balance with banks and the RBI and investment in Government securities, suggesting that they are relatively resilient to systemic banking crises.

China: As measures of soundness, the following four indicators were adopted: capital and reserves divided by assets, loan loss reserves as a share of loans, asset growth, and liquidity ratio. With respect to the first indicator, OCBs were more capitalized than WSCBs in 1994-1999 (table 4). Although WSCBs have increased capital from 3.5 per cent of assets in 1994 to 5.3 per cent in 2000, the improvement has been modest. In addition, OCBs had greater loan loss reserves as a share of loans than WSCBs in 1997-2000. Even though regulations require banks to set aside only 1 per cent of their outstanding credit, this suggests that OCBs have tended to put aside more provisions than WSCBs. As for asset growth, OCBs (44 per cent) were higher than WSCBs (12 per cent), but like Indian banks, this could be attributed to the entry of new banks. OCBs also held more liquid assets (proxied as deposits with the PBC divided by customer deposits) than WSCBs in 1997-2000. In particular, OCBs tended to hold excess reserves during 1998-2000, even after the reserve requirement sharply dropped from 20 per cent in 1993 to 8 per cent in 1998 and to 6 per cent in 1999. Moreover, the sum of deposits with PBC and bank deposits divided by assets shows that OCBs held more liquid assets (about 16 per cent) than WSCBs (about 10 per cent) during 1998-2000.

Comparison between India and China

There are several common features with respect to the banking sectors in India and China. First, in both state-controlled banks are dominant financial institutions. This phenomenon has not changed despite banking sector reforms adopted in both countries. While the number of public sector banks is greater in India than in China, the largest public sector bank, the SBI, accounts for over 20 per cent of deposits or assets in India, suggesting that the banking sector is oligopolistic. While Government involvement in the banking sector can be justified at the initial stage of economic

development, the prolonged presence of excessively large public sector banks often results in inefficient resource allocation and concentration of power in a few banks. Further, once entry deregulation takes place, it will put newly established banks in an extremely disadvantageous position.

Second, foreign and private sector banks generally performed better than public sector banks in terms of profitability in India. In China, OCBs were better performers than WSCBs. This suggests that state-controlled banks were generally poor performers than non-state-controlled banks in both countries, suggesting the need for restructuring state-controlled banks and at the same time promoting the entry of new banks. Nevertheless, it should be pointed out that this superiority of non-state-controlled banks was pronounced particularly in the initial reform stage in both countries.

Third, foreign banks have been more capitalized and more provisioned than other banks in India. Similarly, in China, OCBs have been more capitalized and more provisioned. This suggests that the balance sheets of state-controlled banks are less sound than non-state-controlled banks in both countries. Fourth, banks in India and China have displayed a tendency to increase holdings of Government bonds in recent years. This has happened in India even though the SLR declined. In China, there is no statutory liquidity requirement applied to Government bonds, but preference toward investment in securities was pronounced.

Fifth, both public sector banks as well as other banks in India have reduced the share of deposits with the RBI in assets, in line with a decline in the CRR. Instead, these banks have increased investment in Government bonds and have done so even by lowering advances. Similarly, WSCBs in China have lowered the share of deposits with the RBI in assets during 1998-2000 in line with a decline in the reserve requirement (to a lesser extent for OCBs). These banks have instead increased investment in securities and has done so even by lowering the share of advances in assets. This suggests that there may be some cases of crowding out the private sector. Indeed, both countries have informal credit markets, where credit is expended by unregulated non-bank financial institutions at substantially higher rates.

Sixth, WSCBs are not illiquid and they are able to operate in practice despite the weak structure of their balance sheets. This is because households have increasingly deposited their savings at these banks believing that they are protected by the central Government, which retains full ownership. Also, the underdeveloped state of the financial markets has left households no other choice but to save in banks or Government bonds. In India, many public sector banks in India have improved their performance and have been competing with small savings schemes, provident fund systems, and the capital market. However, like China, there are still a few weak public sector banks and they continue to remain operational. This reflects the public perception that public sector banks are protected by the Government and are thus safer than private sector banks.

Despite these similarities, there are clear differences in terms of performance between the two countries. First, public sector banks in India have improved their performance measured by profitability and cost-efficiency, and their differences compared with private sector and foreign banks have diminished over the reform period. On the other hand, there was no sign of improvement with respect to profitability; indeed, there was a decline in earnings-efficiency for WSCBs in China. Moreover, even though WSCBs improved cost-efficiency during 1994-1997, the cost-efficiency has since deteriorated.

Second, the decline in the difference with respect to profitability and cost-efficiency between public sector banks and other banks in India has emerged as a result of an improvement of performance of public sector banks and a deterioration of performance of foreign and new private sector banks. On the other hand, the decline in the difference with respect to profitability between WSCBs and OCBs in China has occurred as a result of a deterioration of performance of OCBs. In the meanwhile, the decline in the difference as for cost-efficiency has happened as WSCBs improved cost-efficiency while OCBs worsened it. These observations suggest that there was a non-negligible impact of the reforms on the performance of public sector banks in India (although caution has to be exercised on the interpretation of nationalized banks' performance, as indicated above), while no clear impact of reforms was observed with respect to the performance of WSCBs in China.

Third, the banking sector reforms have not generated a noticeable improvement in the soundness of WSCBs. Their capital adequacy and loan loss provisions have remained low. Paid-in capital (comparable to Tier-1) of WSCBs declined relative to bank assets from 12.1 per cent at the end of 1985 to 2.2 per cent at the end of 1997 (Lardy, 1999). Meanwhile, the soundness of public sector banks in India has improved especially based on the risk-weighted capital adequacy ratio and greater capitalization over the period.

Fourth, WSCBs continue to be agents of the central Government. Although explicit policy lending practices have been reduced, lending to SOEs still constitutes a large share of WSCBs' credit. Credit decisions by WSCBs are often influenced by central Government guidance. While banks in India are subject to priority sector lending requirement, the negative impact of this policy lending was reduced through expanding the defnition of priority sector lending and liberalizing interest rates on advances over Rs 200,000. Banks are allowed to choose sectors and projects with more flexibility under the target and sub-target requirements. While domestic banks are often asked to extend credit to specific individuals and projects under lending requirement to the weaker sections, this share accounts for only 10 per cent of advances.

III. LESSONS FROM INDIA'S EXPERIENCE

This section focuses on six issues related to India's banking sector reforms and identifies lessons that could be obtained from them and be applied to China's future reform agenda.

Privatization

The Indian Government did not engage in a drastic privatization of public sector banks. Rather, it chose a gradual approach toward restructuring these banks by enhancing competition through entry deregulation of foreign and domestic banks. This reflects the view of the Narasimham Committee that ensuring integrity and autonomy of public sector banks is the more relevant issue and that they could improve profitability and efficiency without changing their ownership if competition is enhanced.

Since this approach was introduced, some criticisms have been expressed (Joshi and Little, 1996). First, public sector banks continue to be dominant thanks to their better branch coverage, customer base and knowledge of the market compared with newcomers. Second, public sector banks would find it more difficult to reduce personnel expenditure because of the strong trade unions. Third, the Government would find it difficult to accept genuine competition within public sector banks. In response to these concerns, the Government decided to gradually expand private sector equity holdings in public sector banks, but still avoided the transformation of their ownership. However, many public sector banks have remained fully or largely owned by the Government.

Meanwhile, a consensus is emerging among academicians that state ownership of banks is bad for financial sector development and growth (World Bank, 2001). Based on data of the 10 largest commercial and development banks in 92 countries for 1970-1995, La Porta and others (2000) have found that greater state ownership of banks in 1970 was associated with less financial sector development, lower growth, lower productivity and that these effects were greater at lower levels of income. Barth and others (2001) have shown that greater state ownership of banks tends to be associated with higher interest rate spreads, less private credit, less activity on the stock exchange and less non-bank credit, even after taking into account other factors that could influence financial development. This suggests that greater state ownership tends to be anti-competitive, reducing competition both from banks and non-banks. Barth and others (2001) have also noted that applications for bank licenses are more often rejected and there are fewer foreign banks when state ownership is greater. Moreover, Caprio and Martinez-Peria (2000) have shown that greater state ownership at the start of 1980-1997 was associated with a greater probability of a banking crisis and higher fiscal costs.

With respect to privatizing banks, the World Bank (2001) takes the view that privatization can yield real benefits to economies provided that an appropriate accounting, legal and regulatory infrastructure is in place. It should be noted that premature privatization may give rise to banking crises. Clarke and Cull (1998) have demonstrated that Argentina promoted privatization of public sector banks in a reasonably developed regulatory and infrastructure environment, and thus, privatized banks improved productivity remarkably.

Based on panel data, Shirai (2002a) has reported the results of regression estimation that India's privatization has not produced any significant impact on improving the performance of public sector banks. Partial privatization has not improved their corporate governance so far through greater shareholder supervision. This is partly because individual voting rights have remained limited by rules to a maximum of 10 per cent, and partly because the share of the public sector (central Government or the RBI) has remained large. While privatization of viable public sector banks should be promoted further, information, legal, and judiciary infrastructure that is needed for developing a sound capital market should be strengthened. Mere privatization without institutional changes, where external shareholders and independent boards of directors cannot practice corporate governance properly, will not produce a favourable impact on the performance of partially privatized public sector banks.

In addition, the Government of India is of the view that the public sector nature of nationalized banks should continue even if the Government stake drops to the proposed 33 per cent (Raje, 2000). To improve the performance of public sector banks, the Government should alter this view and transform public sector banks to purely commercial-oriented banks with greater autonomy with respect to operations and human resources policies. This is particularly so if it wishes that these banks could become more profitable and efficient, thereby being able to compete with private sector and foreign banks in a level playing field and lowering their dependence on Government financial support. Moreover, the board of directors should be reformed by increasing the number of competent external directors, guaranteeing independence of the board from Government and political interference, improving accounting and disclosure standards and strengthening minority shareholders' rights. It is important to ensure a clear separation of management and ownership. The improvement of corporate governance in the banking sector would also help increase the price of initial public offerings and hence promote privatization.

Entry deregulation

Imposing entry barriers in the banking sector often gives rise to an inefficient resource allocation across sectors and projects and, at the same time, collusive behaviour among creditor banks and between banks and borrowers. On the other hand, such a policy can be justified theoretically if it improves banking sector efficiency, provided

that commercial banks perform a unique role that cannot be undertaken by non-bank financial institutions and capital markets. Commercial banks collect, analyze and process internal information about borrowers by forming long-term relationships with them. With these skills and expertise, banks are able to finance SMEs whose information is largely idiosyncratic (Yoshitomi and Shirai, 2001). Information held by banks can be idiosyncratic and non-transferable, but cannot and/or need not be standardized – whereas standardization of information about issuing firms is necessary for corporate securities. These features of banks are important especially when disclosure, auditing, and accounting requirements are loosely or inadequately implemented against borrowers, in the absence of sophisticated legal and institutional infrastructures.

This may explain partly why the banking system is likely to dominate at the early stage of economic development. Further, Rajan and Zingales (1998) have pointed out that in countries where corporate governance is inadequate and bankruptcy laws are virtually non-existent, the specific expertise of commercial banks – which know how to exercise power over borrowers even when explicit protections for the banks are inadequate – is necessary when extending loans to firms. They have also demonstrated the existence of a negative correlation between the degree of sophistication of accounting standards and the size of the banking sector.

When bank regulators determine entry criteria they need to ensure that commercial banks have an incentive to perform their information collecting and monitoring functions. To do so, bank regulators need to balance between allowing banks to maintain profitability (or earn economic rents that offset risks borne by banks in the process of providing various financial services) by limiting the entry of new banks and preventing them from extracting excessive rents by encouraging the entry. Without sufficient rents, banks may have no choice but to engage in risky activities because they need to fight for their market shares or profit margins. As a result, such risk-taking behaviour would reduce the value of banks' future earnings and associated incentives to avoid bankruptcy (Allen and Gale, 2000). To maintain sufficient profitability in the banking process, therefore, excessive competition among banks needs to be avoided through granting a relatively small number of them the privilege of offering demand deposits and payment services (Rajan, 1997).

While attempting to maintain adequate rents for banks, nevertheless, regulators need to introduce measures to prevent banks from engaging in excessive risk-taking behaviour and extracting rents from their borrowers more than is justified by risks that they bear. Otherwise, borrowers are discouraged from undertaking innovative, profitable ventures, thereby resulting in slower economic growth (Rajan, 1992). Thus, regulators need to carefully consider the extent of competition in the banking sector by taking account of the trade offs and supplement this policy with other prudential measures, such as capital adequacy requirements, that contribute to limiting excessive risk-taking by banks.

The analysis in section III has indicated that in India, foreign and new private sector banks were more profitable than public sector banks initially, although their profitability has deteriorated in recent years. Based on INCOME and COST indicators, foreign and private sector banks were relatively earnings- and cost-efficient in earlier periods, but public sector banks have gradually improved their performance in the reform period. This suggests that the performance of public sector banks has become comparable to the foreign and private sectors. These results show that ownership mattered initially in terms of performance differentials, but became less so in the later part of the reform period. In other words, entry deregulation has exerted some pressure on public sector banks and has encouraged them to perform better (however, caution should be exercised for nationalized banks with respect to this statement since an increase in their profits comes largely from interest income from recapitalization bonds).

Furthermore, despite entry deregulation, public sector banks have remained dominant. The SBI, the largest public sector bank, has even increased its share both in terms of deposits and assets. Given that public sector banks have scale advantages with nation-wide branch networks (especially as compared with private sector banks that tend to compete in the retail market), the current approach of improving their performance without rationalizing weak public sector banks and downsizing large public sector banks may not produce further and substantial benefits for India's banking sector. Furthermore, new banks continue to be prevented from competing on the same level playing field. This would encourage new banks to enter into different segments of markets such as niche or wholesale markets, thereby exerting less competitive pressure on existing dominant public sector banks.

Liquidity requirements

Imposing statutory liquidity requirement may be necessary as a policy to develop a Government bond market. The Asian Policy Forum (2001) has pointed out that over-dependence on bank-based financing and the underdeveloped state of bond markets in Asia have significant adverse implications, such as lack of measurement of the opportunity cost of capital, inefficient use of high savings and excessive short-term debt. The development of a local currency-denominated bond market can provide stable sources of longer-term local currency funding, in the process of helping to reduce a double mismatch and strengthen financial sector resilience. Moreover, bond markets help to improve the efficiency of resource allocation through market-determined interest rates; spread various borrowers' credit and market risks among a large number of dispersed investors; and, serving as a buffer when banking sector problems occur. Development of a Government bond market is a prerequisite for developing a corporate bond market. In addition, investment in Government securities could help to lower the share of high risk-weighted assets and would thus improve the capital adequacy and liquidity ratios.

On the other hand, the diversion of financial resources away from lending activities owing to the SLR requirement may increase banks' cost of operations from these activities. This is because banks may be able to reduce the costs of collecting and evaluating information regarding creditworthiness of their borrowers through economies of scale. The economies of scale occur in the presence of the fixed cost of hiring professional staff with special expertise in loan evaluation. Also, the economies of scale arises from banks' provision of settlement and checking accounts and other financial services to their borrowers, which gives them an opportunity to monitor the economic activities and cash flow movements of their borrowers. Moreover, large holdings of Government securities may crowd out the private sector. Shirai (2002a) has found that in India, investment in Government securities has tended to lower the performance of the whole banking sector. The regression estimation has found that this investment has affected adversely banks' profitability (based on ROA) and cost efficiency (based on COST).

Based on these factors, the statutory liquidity requirement should not be dismissed. Rather, it might be used not only as a policy to promote the development of a Government bond market, but also as a policy to strengthen banks' ability to manage with various shocks. However, as the Government bond market develops and banks' risk management improves, a reduction of the requirement should be considered. Large holdings of Government bonds, as is the case of banks in India, may not help them to improve their risk management in lending activities and give an incentive to banks in processing and evaluating information about borrowers and monitoring them.

Directed and subsidized lending

India's Government has attempted to mitigate the adverse impact of directed lending on banks' performance by expanding the coverage and gradually liberalizing lending interest rates on advances over Rs 200,000. Thus, the adverse impact of priority sector lending is expected to decline over the period and to contribute to improving banks' performance. Meanwhile, banks continue to be asked to extend credit to weaker sections, frequently to particular individuals and projects. Shirai (2002a) has reported regression estimation results that while priority sector lending has contributed to improving cost-efficiency (measured by COST) and earnings-efficiency (measured by INCOME), it has lowered the profitability of public sector banks, calling for a further reform in priority sector lending.

Also, the current practice of setting lending interest rates below the PLR for advances less than Rs 2,000,000 appears problematic. Banks should be allowed to set lending interest rates more flexibly by considering returns and risk of each project. The practice of setting below-PLR lending rates indicates the presence of subsidized lending by banks, making it difficult for banks to improve their performance further. This is particularly so when the Government does not provide explicit compensation

for this type of lending. Such lending, if performed by commercial banks, should be exercised at market terms and at banks' initiatives. In the long run, the Government of India should reform existing state-controlled development banks and other financial institutions and transfer all policy lending activities to these finiancial institutions. It is important to ensure a separation of commercial lending and policy lending, which would be a prerequisite for enhancing banks' accountability and management skills.

Scope of business

Financial conglomeration gives banks an opportunity to gain non-interest income, thereby sustaining profitability. This enables banks to maintain long-term relationships with clients throughout their life cycles and thus gives them an incentive to collect and produce internal information and monitor them. Such practices lower banks' incentives to take excessive risks. Also, banks can obtain diversification benefits by diversifying their activities whose returns are imperfectly correlated, thereby stabilizing their profitability. This in turn cuts the costs banks charge their lending and underwriting customers. Close multi-dimensional relationships between banks and firms can reduce the costs of obtaining funds for firms, improve their performance, make investment decisions less dependent on retained earnings, and make it easier for firms to resolve financial distress (Yoshitomi and Shirai, 2001).

Financial conglomeration also promotes efficiency by allowing banks to utilize internal information. Through long-term lending relationships, banks already possess internal information about creditworthiness of borrowers and features of their investment projects that are not readily available to outsiders. Thus, banks do not need to spend a great deal of resources in collecting information about their clients that is necessary for underwriting securities issued by them. So banks may be able to underwrite securities at lower costs than non-bank underwriters. Firms issuing information-sensitive securities may receive higher prices when banks underwrite them than when independent investment firms do so, because of perceived monitoring advantages of the banks that are a by-product of their lending activities.

Thanks to reputation, moreover, investors may be willing to purchase securities underwritten by bank underwriters rather than independent underwriters. To the extent that it is easier to gain a reputation in some businesses than in others and to the extent that there are spillovers in reputation, banks can use the reputation gained in offering one service to recommend their other services (Rajan, 1996). Banks also enjoy economies of scope from the production of financial services. They can spread the fixed costs in terms of physical and human capital needed for managing a client relationship over a wider set of products (Steinherr and Huveneers, 1990). Economies of scope can be exploited by using their branch networks and all their other existing delivery channels to distribute additional products at low marginal cost (Llewellyn, 1996). Also, banks can better handle the shifts in demand for the products they offer by quickly transferring resources within organizations.

These advantages, however, can be offset by the following disadvantages. First, public sector banks' engagement in securities business may promote a concentration of power in the banking sector. This is partly because banks become too large and partly because banks have a natural tendency to promote lending over securities, thereby indirectly deterring the development of capital markets. Further, the reputation and informational advantages enjoyed by public sector banks put them in an even more advantageous position, preventing other banks and investment firms from competing on a level playing field.

Second, banks' engagement in underwriting services may lead to conflicts of interest between banks and investors. Banks may decide to underwrite securities for troubled borrowers so that proceeds from the issue of securities can be used to pay off these banks' own claims to the companies. Banks may dump into the trust accounts they manage the unsold part of the securities they underwrite. Further, banks may impose tie-in deals on customers by using their lending relationships with firms to pressure them to purchase their underwriting services (e.g., using the threat of increased credit costs or non-renewal of credit lines). Banks may also use the confidential internal information that they possess when they underwrite firms' securities in a way that the firms do not contemplate, such as disclosing the information directly or indirectly to the firms' competitors.

Third, diversification may expose banks to various new risks. For example, banks may end up buying the securities they underwrite. They may also face greater market risks as they increase their share of securities holdings and market making activities. Further, derivatives involve higher speed and greater complexity, which may reduce the solvency and transparency of banking operations.

Given this background, Shirai (2002a) has found that Indian banks' engagement in non-traditional activities and an increase in profits from these activities have contributed to improved banks' performance based on profitability and cost-efficiency as well as the earnings-efficiency of the banking sector. In India, banks have been allowed to engage in diverse activities including securities and foreign exchange transactions, brokerage and dealing activities and other fee-based business even before the 1991 reform programmes have been launched. At the same time, the RBI is aware of problems arising from banks' engagement in non-traditional business and has tried to cope with them by encouraging banks to engage in this through subsidiaries, thereby putting in place firewalls between traditional banking and securities services to some extent. The expansion of the scope of banks' business has certainly helped offset a decline in net interest income from advances, driven by interest rate deregulation. This has an important policy implication for the sequencing of financial liberalization. Namely, regulators should introduce policy measures that would supplement an expected decline in net interest income caused by interest rate liberalization, in order to prevent banks from taking excessive risks in an attempt to maintain profitability.

In China, the Commercial Bank Law prohibited banks from engaging in securities and related business activities in 1994 after the occurrence of the 1992-93 chaos. In 1992, the Government permitted banks to transact some non-traditional banking business in 1992. Consequently, all the specialized banks and most of their major branches were encouraged to establish finance companies, which engaged in imprudent or fraudulent operations and led to financial chaos in 1992-1993. Also, many of these banks divested funds earmarked for agriculture and other key projects into stock market and real estate market speculation. When monetary policy was tightened in late 1993, many banks and branches lost money from these securities activities, causing instability in the banking system (Ma, 1997). Since then, the Government has required all banks to divest themselves of investment banking affiliates and prohibited commercial banks from engaging in securities trading and underwriting, investment in non-bank financial enterprises and productive enterprises and investment trust business under the Commercial Bank Law.

Since 1998, WSCBs have begun to provide money-managing services, including personal investment to individual clients. These banks have since established money-management offices in major cities. In July 2001, the PBC issued a provisional regulation on commercial banks' intermediate business to promote business innovation, improve bank services and competitiveness, and reduce financial risks. The PBC has defined intermediate businesses as those that do not constitute scheduled assets and liabilities, and produce non-interest income for banks including settlement, warranty, acceptance and trading. Thus, with PBC's ratification, commercial banks can engage in financial derivatives business, agency security business, investment bank business, information consultation and financial advisory services. Diversification of banks' business is likely to become an important component of the reform agenda in China, especially when the Government begins to promote further interest rate deregulation. However, it is important that regulators should implement necessary regulatory and legal systems that are able to cope with problems arising from banks' engagement in non-traditional business.

Connected lending

The RBI prohibits cross-holdings with industrial groups to minimize "connected lending" – one of the causes of the East Asian crisis. The Banking Regulation Act prohibits loans and advances to directors or to any firm or company in which directors are interested or individuals in respect of whom any of its directors is a partner or guarantor. In addition, banks are required to provide loans to their own subsidiaries or joint ventures on an arms-length basis. Banks' investments in subsidiaries are deducted from their Tier I capital. Considering that connected lending was one of the major problems causing excessive risk-taking by banks in Asian crisis-affected countries, it is appropriate for bank regulators in China to impose

this restriction from the beginning when entry deregulation has occurred. Once such practices are implemented, it is difficult to remove them later due to strong resistance, as is the case in a few East Asian countries.

IV. REMAINING AGENDA FOR CHINA

In China, the biggest constraint holding back drastic financial reforms arises clearly from the problems of borrowers – namely, the poor and deteriorating performance of SOEs. Growing numbers of SOEs have experienced a substantial decline in profits in the 1990s in spite of overall economic growth. This has not only caused a rapid deterioration of WSCBs' loan assets, but has also limited credit available to non-state firms by absorbing more than 75 per cent of bank loans, deterring investment and output growth of non-state firms. About half of the SOEs incur net losses nowadays, compared with only 30 per cent just a few years ago. Factory capacity utilization rates for major industrial products of SOEs have been at a level below 60 per cent.

The poor performance of SOEs is attributable to growing competition, slackening efficiency due to the slow adoption of technological advancement and large accumulated debt. Also, SOEs are obliged to provide social services to workers and maintain their employment and, in some cases, continue to pay a salary to retirees. These practices make it difficult for the SOEs to become commercially oriented (Broadman, 1999). Moreover, the absence of clear identification of owners of the SOEs and inadequate property rights undermine corporate governance since it is not clear who should monitor managers. Also, the introduction of non-state shareholders through public listings has not resulted in a clear separation of ownership and management, since few outside shareholders exercise discipline on the management of the SOEs. In response to the rapidly deteriorating performance of SOEs, the Government attempted various experiments in the 1990s, including management contracting, providing greater autonomy to managers, corporatization and ownership diversification. Moreover, the supervisory capacity over most industrial SOEs (about 110,000 firms) has been transferred from the central Government to local governments (Broadman, 1999). Also, a multilayered organizational network has emerged by including State asset management bureaus, State asset operating companies and State asset supervisory committees. Nevertheless, only a few SOEs have been divested to the non-state sector and almost all of such firms have been small. It has also become increasingly apparent that the SOE reform strategy has produced problems unanticipated by the reform's framers, including asset stripping, decapitalization, wage manipulation and tax evasion. These problems have severely undermined banking sector performance.

By contrast, such SOEs' problems have been less pronounced in India, which makes it relatively easier for the Government to cope with banking sector restructuring.

In India, there are only about 300 SOEs at the central Government level, as compared with China with a few hundred thousand SOEs. Many of these firms have been already partially privatized since the early 1990s. Even during the planned economic development regime, there were already many private firms that operated across sectors. Thus, SOEs are not major borrowers of banks in India and, therefore, not the major cause of NPA.

China's second constraint acting against a smooth implementation of financial reforms is that the ownership of WSCBs has not changed and the intervention by the central Government in banks' resource allocation remains. Aware that privatization of the WSCBs (as well as SOEs) is a key to successful financial reforms, the Government recently announced that these banks would be gradually restructured by allowing them to become joint-stock companies listed on the stock exchanges. Immediately after the announcement, however, the stock prices of listed banks (and SOEs) plunged in the expectation that a massive disposal of stocks would lead to a decline in prices and thus investors would experience a capital loss. In response, the Government reversed its decision by suspending state share sales. The PBC Governor, Mr Die Xianglong, announced in November 2001 that WSCBs restructuring would be carried out in several steps: (1) an improvement of management skills with a rationalization of staff and organizations; (2) allowing WSCBs to become joint-stock companies with central Government holding more than 50 per cent of stock; and (3) encouraging them to list on the stock exchange. In addition, the Governor said that WSCBs would be allowed to sell shares to foreign investors.

In the case of India, public sector banks have been gradually and partially privatized in the 1990s. Even though there is no significant impact of partial privatization on the performance of public sector banks based on regression analysis, it has certainly increased pressure on the management of these banks. Moreover, all public sector banks used to be private sector banks prior to the nationalization and hence used to operate on a commercial basis. This makes it easier for public sector banks to improve their risk management skills and performance – a sharp contrast to China, where there were no such private banks prior to the reforms.

The third constraint is that entry of private sector banks is limited. Moreover, other commercial banks need to be restructured through listing shares in stock exchanges and improving their corporate governance. So far, there are only four publicly listed commercial banks. Shirai (2002b) has reported that these listed banks have not necessarily performed better than other banks. These banks have been less profitable (in terms of ROA) and less well capitalized than city banks. This suggests that the Government policy of approving listings is not necessarily based on the performance of the bank and the approval process is not transparent.

In India, allowing the entry of private sector and foreign banks that are well capitalized and high technology-oriented has certainly increased competitive pressures on public sector banks. Also, all private sector banks are listed on stock exchanges

and managers of these banks are very conscious of their performance. The stock market in India has developed rapidly since the 1980s. There are about 10,000 listed companies and 22 stock exchanges. In 1992, the National Stock Exchange of India was established in order to offer screen-based trading. In 1992, the Securities and Exchange Board of India (SEBI) Act was introduced. Pror to 1992, the Controller of Capital Issues (CCI) used to approve equity issuance based on the requirment of a debt-equity ratio of 2 versus 1 (higher ratio for capital-intensive industries). Shares could be issued only once a year. Since 1992, the CCI was abolished and SEBI became a special Government entity with the aim to protect investors and develop the capital market. Foreign institutional investors were also allowed to enter primary and secondary markets. Thus, the listing requirement is transparent and participation is open to all private firms. Moreover, the accounting and disclosure standards have been strengthened in the 1990s.

The fourth constraint is that the balance sheets of WSCBs have remained weak despite recapitalization and transfer of NPA to the AMCs. The Government of China needs to clean up and restructure the balance sheets of WSCBs more drastically before they become public. Once NPA problems are resolved, the Government must consider how to strengthen the capital base of these banks. However, the absence of secondary markets for credit and collateral and inadequate property rights makes it difficult to transfer, sell, or securitize WSCBs' assets, since the market price of the assets can hardly be realized and the ratio of realized asset values to book values is low. Improving the legal and institutional environment is essential to fulfilling this goal. Moreover, the Government should ensure that AMCs are granted the authority to restructure SOEs and formulate asset resolution procedures. This might include a revision of the bankruptcy law that would provide AMCs with the skills and incentives to discharge their responsibilities and would ensure that their financial positions are sound (IMF, 2000). Similarly, the balance sheets of OCBs should be cleaned up and restructured.

At the same time, as a related measure, the Government needs to adopt global standards on accounting, auditing and disclosure requirements in order to reveal the true status of the NPA problems of WSCBs. The Government had already tightened prudential regulations in 1998 and 2000. However, existing accounting principles appear to be problematic, especially as to the calculation of maturities of interest receivable and the principle of provisioning for NPA. Also, reliable, transparent business records of financial institutions are scarce, making mergers, restructuring, or closure of any financial institutions difficult. Thus, promoting standardization of information regarding financial institutions as well as enterprises is a prerequisite not only for successful restructuring of WSCBs and other financial institutions, but also to foster sound capital markets.

While prudential norms are still not adequate in India, the strengthening of these norms has helped the Government to grasp the true status of NPA of nationalized

banks when recapitalization practices were launched. As a result, some nationalized banks have improved their balance sheets, thereby enabling them to sell shares in the stock exchanges. Also, strengthening of provisioning requirements has helped these banks cope with NPA problems.

Finally, there are three good lessons that could be learnt from the experience of India's banking sector reforms and could be applied to China. First, the entry of new banks should be promoted provided that they are sufficiently capitalized and are technology-oriented. Second, diversification of banks' business should accompany interest rate liberalization in order to supplement an expected decline in net interest income and prevent banks' from taking excessive risks in an attempt to maintain profitability. Third, banks should be prohibited from connected lending. Considering that connected lending was one of the major problems causing excessive risk-taking by banks in Asian crisis-affected countries, it is appropriate for bank regulators to impose this restriction from the beginning when entry deregulation has occurred.

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