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China's and India's financial systems: **A barrier to growth**

Reducing government interference in the financial sector and strengthening its market orientation are essential to make it allocate capital efficiently and meet the needs of savers.

Article at a glance

At first sight, the financial systems of China and India are quite different from each other: the relatively new institutions of the former, with its massive banking sector, seem to contrast sharply with the colonial roots and burgeoning equity market of the latter.

Yet these two economic giants share a common handicap: excessive government intervention that distorts the allocation of capital and thus dampens growth.

Reducing government involvement and increasing its responsiveness to the market are the keys to progress.

Addressing the deficiencies of these financial systems would increase GDP by up to $321 billion a year in China and $48 billion a year in India, sharply boosting growth in both countries.

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China's and India's financial systems: **A barrier to growth**

Diana Farrell and Susan Lund

On the surface, the financial systems of China and India appear to have little in common: China's—by far the larger—is dominated by a massive banking sector, while India has a strong equity market. The two systems have vastly different roots as well. The Bombay Stock Exchange along with many of India's venerable banks trace their ancestry to the era of British rule. China's current financial institutions are products of an economic liberalization that began only in 1978.

Yet the two countries' financial systems, different as they are, share a common handicap: excessive government intervention that distorts the allocation of capital and consequently holds back growth. In China, state-owned enterprises (SOEs), many with low productivity, receive most of the available funds for investment in order to maintain employment levels. In India, the government itself absorbs a good deal of the country's capital to finance its rural investment priorities and large fiscal deficit. In both countries, the results are wasteful investments that yield negligible returns, limited financing options for the private companies that drive growth, and limited investment options for consumers. To reach the next stage of development, both China and India must create a modern financial sector that allocates capital efficiently and meets the needs of savers.

Research by the McKinsey Global Institute[1] finds that reforms to create a modern financial sector would have immense value, boosting GDP by up to $321 billion a year in China and up to $48 billion a year in India. For both countries, reducing government involvement in the sector and increasing its responsiveness to the market are the keys to progress. A comparison of the two systems highlights the strengths and weaknesses of each and sheds light on the specific paths to reform that these economic powerhouses must take if they are to achieve their full potential.

[1] The two reports on which this article is based—*Putting China's capital to work: The value of financial system reform* and *Accelerating India's growth through financial system reform*—are available free of charge online at www.mckinsey.com/mgi.

Deeper in China

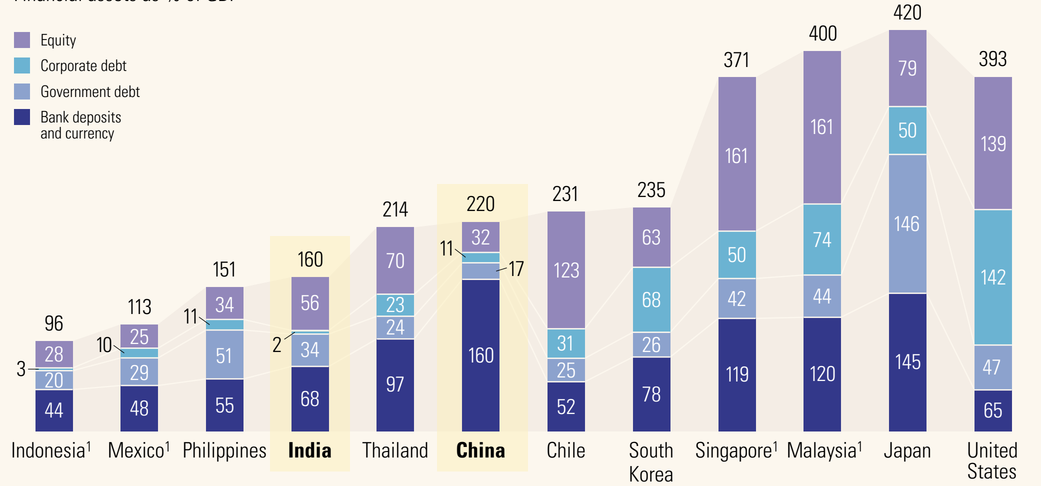
The most notable difference between the two financial systems is the greater financial depth of the Chinese one—that is, the ratio between the value of its financial assets and the size of the underlying economy. China's financial assets equal 220 percent of GDP, India's just 160 percent. These statistics reflect the fact that China's financial system intermediates a greater proportion of the country's savings and investment than does India's, and this is a clear advantage in generating economic growth. By contrast, much of India's savings and investment occur outside the formal financial system. We estimate that India's informal lending market (including underground institutions and money lent by families and friends) was worth $85 billion at the end of 2004, or some 30 percent of the value of the credit extended by the formal banking system. In China, the informal lending market is thought to be larger in absolute terms, at around $100 billion, but equals only 5 percent of the country's level of outstanding bank loans.

Exhibit 1

Depth of nations

Financial depth, 2004

Financial assets as % of GDP



[1] Figures do not sum to 100%, because of rounding.

Source: McKinsey Global Institute global-financial-stock database

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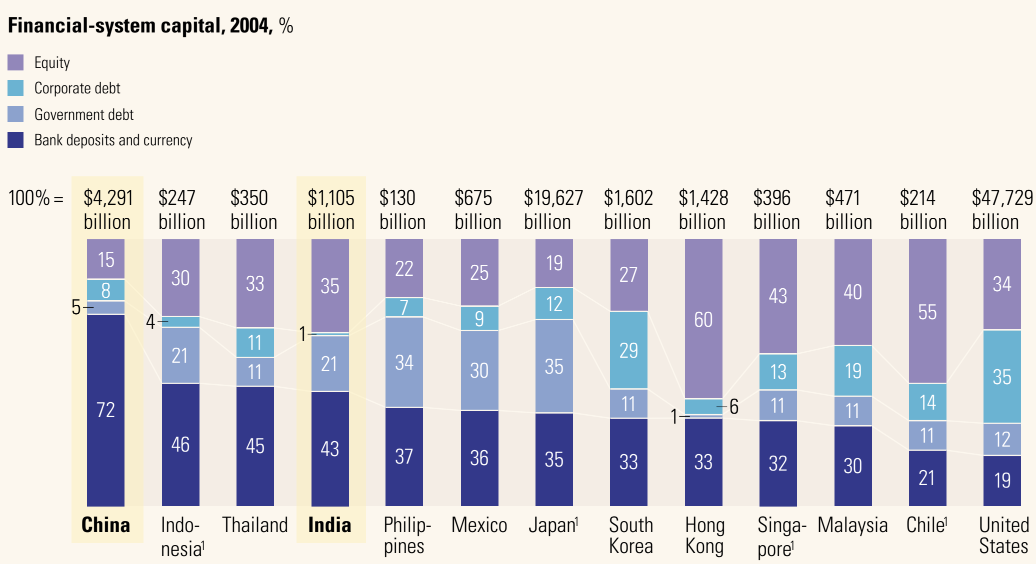
Banks rule in China

China's banks dominate its financial system, accounting for around 70 percent of its financial assets and providing more than 95 percent of new corporate financing last year. The fortunes of China's financial system thus hinge largely on the health of the banking sector, which is dominated by four huge commercial banks.[2] The largest has some $600 billion in assets—more than half the total value of all financial assets in India—and nearly 20,000 branches.

India's financial system, more balanced than China's, features a modest-sized banking sector, a large and growing equity market, and a sizable government bond market. Over the past decade, India's system has also expanded in a more balanced way: China's financial depth has come largely from increasing numbers of bank deposits, India's from growth in all asset classes. Both countries have underdeveloped corporate-bond markets, largely because cumbersome regulations (such as lengthy approval and issuance processes) raise the cost of such transactions. Corporate bonds represent just 2 percent of GDP in India and 1 percent in China—compared with 68 percent in South Korea, 73 percent in Malaysia, and 145 percent in the United States.

Exhibit 2

Wealth of nations



[1] Figures do not sum to 100%, because of rounding.

Source: McKinsey Global Institute global-financial-stock database

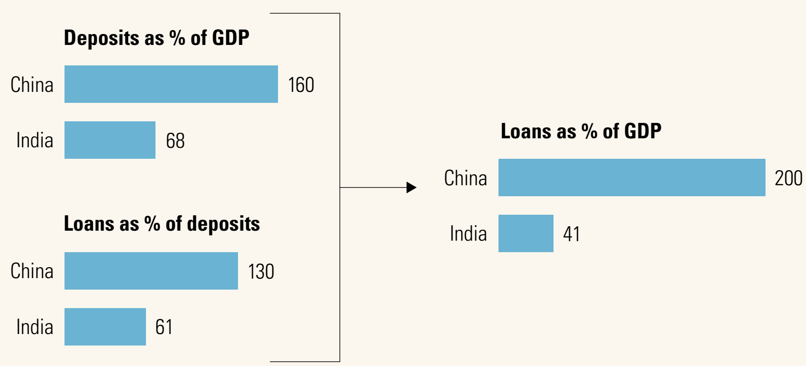
[2] Agricultural Bank of China, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China.

Extra credit in China . . .

The abundance of credit in China goes a long way toward explaining its higher levels of investment and growth. In addition to taking in far more in deposits, China's banks lend out a larger share of them than do India's. Banking regulations require Indian banks to invest one-quarter of their assets in government bonds; as a result, they lend just 61 percent of their deposits, compared with 130 percent for their Chinese counterparts. The total value of loans in China thus represents 200 percent of GDP, compared with only 41 percent in India. In both countries, the vast majority of loans go to large corporate borrowers; underdeveloped bond markets leave companies with few options for obtaining credit. This has the disadvantage of crowding out bank lending to consumers and small businesses—the natural customers of banks in countries with more highly developed financial systems.

Exhibit 3

Percentages



Source: McKinsey Global Institute analysis

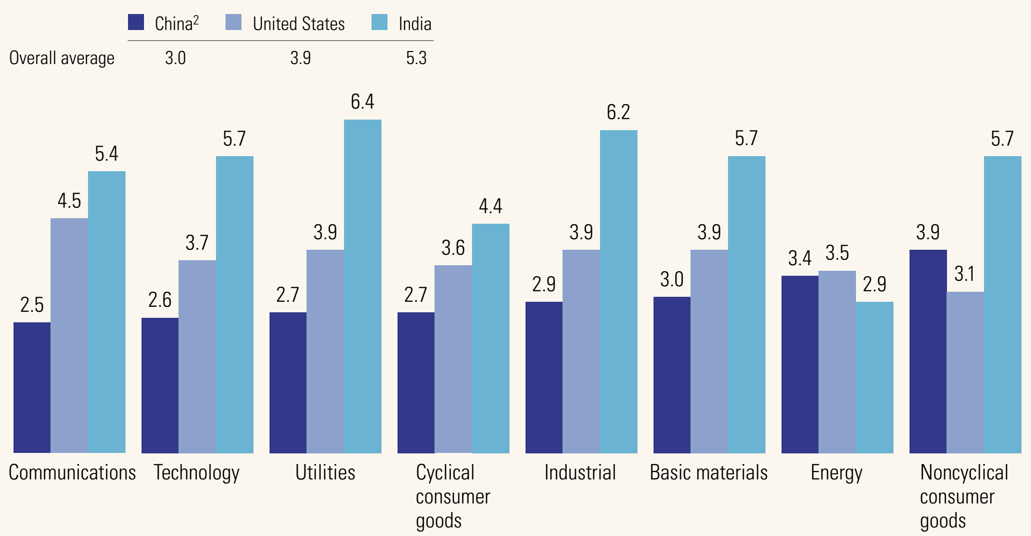
. . . and cheaper too

Corporate credit is much cheaper in China than in India—a difference partly reflecting the different credit totals available to their respective economies. Indeed, for many Chinese companies the average cost of debt is lower than it is even for US ones, despite China's smaller economy and riskier operating environment. However, the low cost of credit also reflects government intervention. To spur investment-led economic growth and protect jobs, China caps the rate depositors receive, so that banks can offer cheap credit to companies. The intervention of India's government, motivated largely by its need to finance a swelling budget deficit and to meet its investment priorities in rural areas, have the opposite effect: raising the cost of debt for companies.

Exhibit 4

Real interest rates: sector by sector

Average real interest rate on debt for listed companies,[1] 2002–04, %



[1] Figures for top 700–800 nonfinancial companies based on sales; cost of debt = interest expenses ÷ total debt; interest rates >50% were deleted; total debt not adjusted for pensions, leases.

[2] Interest rates in China are below those in United States because of regulatory restrictions.

Source: Bloomberg; McKinsey Global Institute analysis

Strong stocks in India

One of India's advantages over China is the comparative strength of India's equity markets and the world-class trading and regulatory infrastructure the country has developed over the past decade. From January 2003 to January 2006, the Bombay Stock Exchange index more than tripled in value; over the same period, the value of the shares on China's mainland equity markets dropped by 16 percent. During the period from 2001 to the Shanghai market's trough, in mid-2005, these shares lost no less than half of their value.

Is there a danger of an Indian equity bubble? Not necessarily: roughly half of the increase in market capitalization during this period stemmed from earnings growth in listed companies and just 30 percent from higher P/E ratios. Shares of private-sector companies account for some 70 percent of India's market cap, so the market's rise reflects India's strong private corporate sector. The poor performance of China's equity market is also directly linked to the state of its listed companies: until very recently, the only ones with share listings were SOEs, which mostly failed to earn their cost of capital. Moreover, the largest and best-performing Chinese companies list in Hong Kong—where mainland Chinese aren't permitted to invest—and their shares trade at a premium relative to the shares available to the mainland's investors.

Exhibit 5

Comparing the indexes

Source: Bloomberg; McKinsey Global Institute analysis

Wasted capital

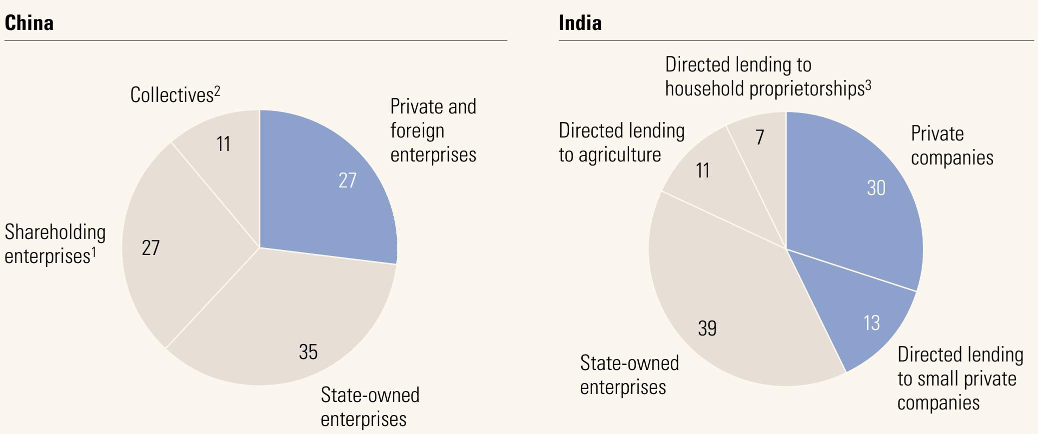
The two systems, despite their differences, share a significant problem: a majority of funding flows to the economy's less productive parts, thus making investments less efficient and productive and imposing huge economic costs. In China, private companies now produce more than half of GDP but account for just 27 percent of all loans, which mostly continue to finance SOEs. In India, the government itself absorbs the lion's share of the financial system's capital in order to finance a budget deficit that equals nearly 10 percent of GDP.[3] Much of what's left is directed to priority areas, including agriculture, tiny household businesses, and state-owned enterprises. Despite being far more productive than the public sector, India's private sector receives just 43 percent of total commercial credit.

In both countries, the main reason for these skewed patterns of capital allocation is the same: preserving jobs. China wants to maintain its SOEs because they continue to be large employers in many parts of the country; India directs lending to agriculture and rural enterprises because rural underemployment is arguably the country's most pressing social problem. Although the concern with unemployment is certainly understandable, distorting the financial system is not the remedy. Our research on Brazil, India, Russia, South Korea, and other countries[4] confirms the idea that the best way to create jobs is to encourage growth in the most productive parts of the economy.

Exhibit 6

Where the money went

Total commercial credit outstanding, 2004, %



[1] Most shareholding enterprises are partly state owned; some are controlled by the state, some are not.
[2] Collectives are owned by groups of people; some are run by local-government interests.
[3] These are known as 'small-scale industry,' but nearly all are tiny enterprises run by household labor.

Source: McKinsey Global Institute analysis

[3] This figure includes the deficits of both central and state governments, as well as the deficit of the central government's "capital account," used to finance physical investments in infrastructure and in state-owned enterprises.

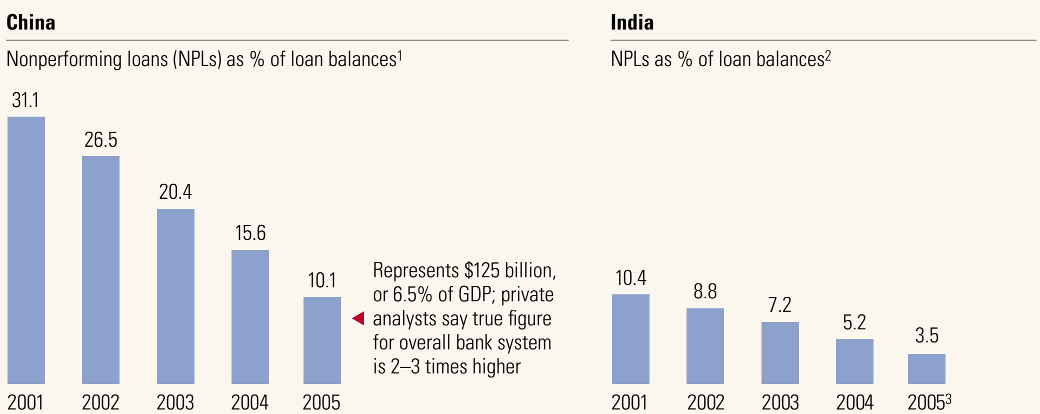
[4] See, for example, Heinz-Peter Elstrodt, Jorge A. Fergie, and Martha A. Laboissière, "How Brazil can grow," *The McKinsey Quarterly*, 2006 Number 2, pp. 12–15.

Dud loans

China's banks have a worse lending record than India's. Although government reports indicate that the level of nonperforming loans made by China's large commercial banks fell from 31.1 percent in 2001 to 10.1 percent at the end of 2005, roughly 60 percent of this reduction is attributable to the government's transfer of bad loans to state-owned asset-management companies. China's government has not yet corrected the underlying causes of the non-performing loans: poor information on borrowers, weak lending and risk-management skills, and a lack of incentives to make banks choose borrowers according to their risk and profitability. By contrast, more vigilant regulatory oversight and better lending decisions by bankers have helped India's ratio of nonperforming loans to decline from 10.4 percent in 2001 to 3.5 percent in 2005.

Exhibit 7

The nonperformers



[1] For large commercial banks; excludes credit cooperatives.
[2] For scheduled commercial banks; data represent fiscal year ending Mar of following year.
[3] Estimated.

Source: Reserve Bank of India; McKinsey Global Institute analysis

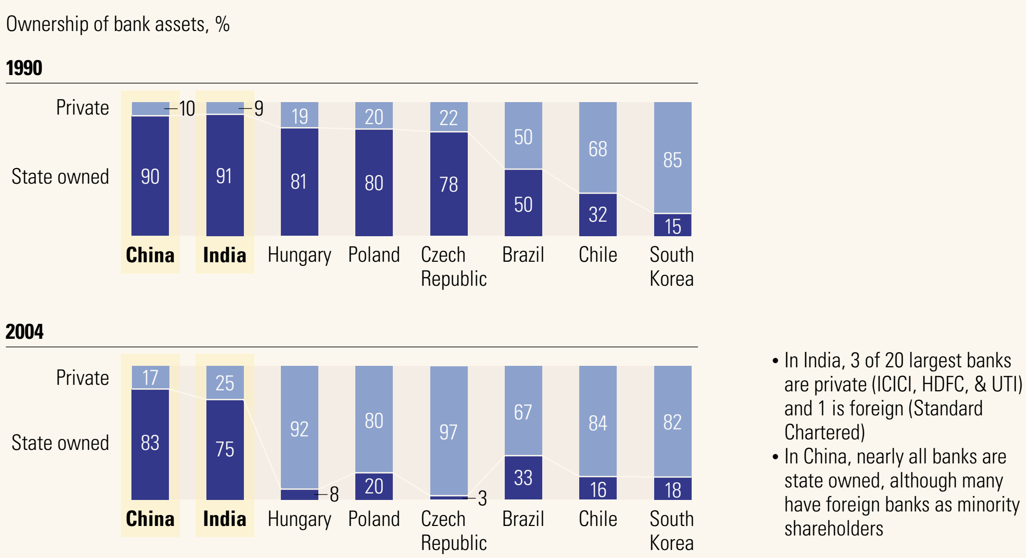
State ownership

In both China and India, state ownership of the banking sector remains extensive, hobbling competition and making banking less efficient than it could be. Despite successful recent IPOs, state ownership is higher in China's banking sector than in that of any other major economy. And although India has some high-performing private and foreign banks, there too the state owns fully 75 percent of total bank assets.

This pattern contrasts starkly with the experience of many emerging economies in Eastern Europe and Latin America, which have been busy privatizing their banks over the past ten years. Both China and India will probably retain their dubious distinctiveness, at least in the short term. To be sure, China's largest banks are now listing shares in Hong Kong and Shanghai and seeking foreign investors—but their partners are allowed to hold only minority stakes. And even though China's commitments to the World Trade Organization stipulate that foreign banks must gain access to the market for local-currency deposits and loans by the end of 2006, the ability of these banks to gain market share in the near term looks uncertain. Foreign banks not only have tiny networks of branches compared with their Chinese rivals but also face high costs in setting up additional ones. As for India, regulators there have tabled, until 2009, further consideration of new rules to ease the current restrictions on the expansion of foreign banks that now do business in the country or to allow foreign investment in its state banks.

Exhibit 8

Who owns the assets?



Source: Central banks of countries shown; McKinsey Global Institute analysis

A rupee saved

India's savers get a better deal than their counterparts in China because government-regulated deposit accounts and pension funds offer Indian consumers above-market rates in order to raise enough money to service the country's budget deficit. Along with roaring equity markets, these higher rates explain why India's households earn far higher rates of return on their financial assets than China's do. The downside is that India's financial system has a much smaller pool of capital to lend Indian companies and therefore charges them more for it. China's financial system, by contrast, can afford to lend out money at rock-bottom rates because the government maintains a low ceiling on those that banks can offer depositors. Despite this cap, Chinese households keep more than 80 percent of their financial assets in bank deposits, since equities are so volatile and there are few other investment opportunities.

Exhibit 9

Meet the players

%

	India		China		United States	
	Distribution,[1] %	Real return, 1995–2005, %	Distribution,[1] %	Real return, 1995–2005, %	Distribution,[1] %	Real return, 1995–2005, %
Other	0	N/A	0	N/A	9	N/A
Mutual funds	1	14.9	1	2.5	12	1.9
Equity	1	16.4	7	2.5	18	4.5
Fixed income	4	2.7	4	1.6	7	4.9
Pensions, life insurance[2]	42	5.1	2	1.6	35	4.5
Bank deposits and cash	52	–0.1	86	0.4	19	0.3
Weighted average real return, %		2.6		0.6		3.1

[1] Estimated.

[2] Many of these are regulated accounts with above-market returns.

Source: Prudential Financial; US Federal Reserve; People's Bank of China; Reserve Bank of India; National Stock Exchange of India (NSE); McKinsey Global Institute analysis

Size of the prize

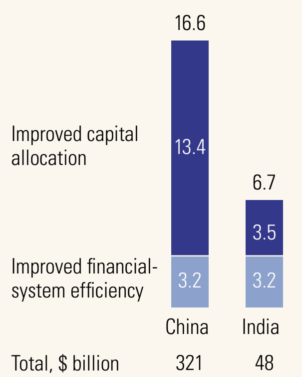
In the long run, the low incomes and underemployment that millions of Chinese and Indian consumers endure would be greatly alleviated if each country's government allowed the financial system to heed market signals. The potential value of such reforms is immense. We calculate that China could boost its GDP by up to $321 billion a year (17 percent) if it increased competition in the banking sector, deregulated interest rates, streamlined its payments system, developed a bond market, and improved the allocation of capital. Likewise, India could reap $48 billion a year by adopting similar reforms, which would boost the annual real growth rate of its GDP to 9.4 percent—matching China's—from the current forecast of 6.5 to 7.0 percent.

Getting there will take time, however. India's financial system must grow significantly in size and reach. Its government should step back and lift regulations on banks and other financial intermediaries so that they can base their allocation of capital on risks and returns rather than official mandates. India must also tame its fiscal deficit. Meanwhile, reform in China must not only transform the country's massive banks into market-oriented institutions but also create the institutional infrastructure (including an effective legal system) that is critical to the success of any financial system. Although a quick transformation isn't in the offing for either country, today's systemic shortcomings will only become a greater drag on sustainable growth in the future without continued progress.

Exhibit 10

The benefits of reform

Potential annual increase in real GDP through financial-system reform, % of GDP



Source: McKinsey Global Institute analysis

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Diana Farrell is director of the McKinsey Global Institute, where **Susan Lund** is a consultant.