

Financial System in India and China – A Comparative Study

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Both India and China have introduced significant financial sector reforms with a view to improving efficiency and enhancing stability of their financial systems. This paper attempts a comparative study of financial systems in India and China, especially in the context of the financial sector reforms and identifies the challenges ahead. The study finds that although the financial systems in both the countries continue to be dominated by the public sector banks, there were significant differences in the initial conditions. At the time of initiation of reforms, while India had a reasonably well developed financial system, China had to start virtually from nothing. Not surprisingly, the nature of financial sector reforms undertaken in the two countries have been different in many respects. Initiation of various financial sector reforms has helped over the years in making the Indian financial system quite robust. The financial system of China has also witnessed some improvement, although several challenges remain. The future challenge for the Chinese authorities is to strengthen the banking system and further reform the capital market. The major challenge for the Indian financial system is to bring down the intermediation cost of the banking system.

Keywords : Financial system, capital market, financial sector reforms

JEL Classification: G20, G21, P34

* Views expressed in this paper are authors' personal views and not necessarily of the institution to which they belong.

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The financial system plays an important role in promoting economic growth not only by channeling savings into investments but also by improving allocative efficiency of resources. The recent empirical evidence, in fact, suggests that financial system contributes to economic growth more by improving the allocative efficiency of resources than by channeling of resources from savers to investors. An efficient financial system is now regarded as a necessary pre-condition for growth. This shift in the emphasis along with opening up of domestic economies to international competition has encouraged emerging market economies (EMEs) such as India and China to introduce financial sector reforms. In the wake of the financial crises of the 1990s however, the role of the financial system in growth has been subjected to a critical reassessment. Increased financial integration has exposed the countries to the risk of contagion. It is now widely recognised that stability of the financial system is critical for a sustainable growth.

China has been growing rapidly ever since it introduced structural reforms in 1978. Its GDP has grown at an average rate of about 9 per cent per annum since 1978. With the real per capita income rising over five fold, China has been able to get over 200 million people out of poverty (Tseng, 2003). This is indeed a remarkable achievement. China could also successfully weather the East Asian crisis in 1997 and the synchronised global slowdown in 2001. While China's macroeconomic performance has been quite robust, its financial system has accumulated non-performing loans (NPLs) to a considerable extent.

The macroeconomic performance of India has also improved significantly in the post-reform period, *i.e.*, 1992 onwards. The Indian economy has become quite resilient over the years and like China, it emerged almost unscathed from the East Asian crisis in the second half of the 1990s. Importantly, India's improved macroeconomic performance has been associated with a significant improvement in its financial system.

Incidentally, both India and China initiated wide-ranging financial sector reforms in the 1990s. It would, therefore, be of interest to know as to (i) what has been the nature of financial sector reforms undertaken in China and India, (ii) what has marked the difference in the performance of financial sectors in two countries, and (iii) what challenges lie ahead for these two of the largest EMEs.

The paper, after dealing with the broad features of financial systems in both India and China, delineates various initiatives undertaken to reform the financial systems and the challenges that the authorities are facing in these two countries. The remaining paper is organised into five sections. Sections II and III deal with the main features of financial systems in China and India, respectively, offering an overview of various reforms introduced in the financial sectors. Section IV presents a synoptic view of the current

financial systems in India and China. Section V deals with the major issues and challenges faced by the authorities in India and China. Concluding observations are set out in the last section.

Section II: Structure and Size of Financial System in China

Until introduction of reforms in 1978, China's financial sector was essentially a monobank with the People's Bank of China (PBC) as the only bank. The PBC managed the deposits of state-owned enterprises (SOEs) and mobilised household savings. The current structure of the Chinese financial system reflects the significant institutional changes that have taken place over the last decade or so. The Chinese financial system, as it exists today, comprises commercial banks, co-operative banks, non-bank financial institutions and the capital market.

As at end-September 2004, the Chinese commercial banking system consisted of four wholly owned state-owned commercial banks (SOCBs), 12 nation-wide joint stock commercial banks (JSCBs), 112 city commercial banks (with business restricted to home city) and 162 foreign banks' branches and 14 subsidiaries or joint venture entities. The four state-owned commercial banks were originally established in the 1980s to serve different economic sectors and to extend loans for policy objectives. In 1994, they were reestablished as commercial banks and officially absolved of their policy lending responsibilities. Since then they have expanded their operations beyond their original sectors and have come into competition with one another (Wong and Wong, 2000). JSCBs, which were initially created to provide specialised products, now offer a full range of financial services. They are partially owned by local government and state owned enterprises (SOEs) and in some cases by the corporate sector. Since 1994, China has set up three policy related banks under the State Council to assume the policy lending roles previously performed by the SOCBs. Policy banks operate on a no-profit no-loss basis and they do not compete with commercial banks. Unlike the SOCBs and other commercial banks, policy banks fund themselves through central bank loans, government deposits and issuance of government guaranteed bonds held by commercial banks. Policy banks primarily extend long-term loans for infrastructure projects. China also has four rural commercial banks.

The co-operative banking structure in China comprises 709 urban credit co-operatives and nearly 34,000 rural credit co-operatives. Chinese non-banking financial institutions consist of four asset management companies, 59 trust and investment companies, 74 finance companies, 12 financial leasing companies, four auto financing companies and several postal saving institutions.

Of various types of financial intermediaries, state-owned commercial banks constitute the largest category, followed by joint stock commercial banks, co-operative banks, policy banks and non-bank financial companies in that order (Table 1).

Table 1: Financial Intermediaries in China

(As at end-December 2003)

(RMB billion)

Category	Assets	% of Total Assets
1. Commercial Banks (i to iv)	20,511	74.2
i) State-owned commercial banks	15,194	55.0
ii) Joint-stock commercial banks	3,817	13.8
iii) City commercial banks	1,462	5.3
iv) Rural commercial banks	38	0.1
2. Co-operative Banks (v+vi)	2,798	10.1
v) Urban credit cooperatives	147	0.5
vi) Rural credit cooperatives	2,651	9.6
3. Policy Banks	2,125	7.7
4. Other institutions (vii to ix)	2,205	8.0
vii) NBFIs	910	3.3
viii) Postal Savings	898	3.3
ix) Foreign funded FIs	397	1.4
Total (1 to 4)	27,639	100.0

Source : China Banking Regulatory Commission (www.cbrc.gov.cn) .

China's banking system is quite large both in absolute and relative terms. This reflects the predominant role of banks in financial intermediation, the size of the economy and the high savings rate (Table 2).

Table 2 : Size of the Banking System in relation to GDP

(as at end-August 2004)

(RMB billion)

Indicator	Amount	% of GDP
Credit	18,220	257.9
Deposits	24,530	155.9
Total Assets	30,150*	209.8

*As at end-September.

Note: Based on GDP for 2003.

The capital market in China is of recent origin. There are two stock exchanges, *viz.*, Shanghai Securities Exchange (SHSE) and Shenzhen Securities Exchange (SZSE). Until the establishment of SHSE, there was no capital market in China because the financial system was highly centralised.

Initially, Chinese firms issued four different classes of shares, *viz.*, State Shares, Legal Person Shares, 'A' Shares and Employees Shares. State and Legal Person Shares are non-tradable. Employees Shares are not tradable for a certain period after the issuance. Only 'A' shares are tradable upon issuing. In 1992, the Chinese stock markets were opened to international investors with the aim of helping companies to obtain foreign financing and introduce a level of sophistication into the stock markets. For foreign investors, 'B' shares were created. 'B' shares can be owned only by

foreign investors and have the same rights as 'A' shares which are owned only by the Chinese citizens. The recent data indicate that on an average State Shares, Legal Person Shares and A-Shares account for 30 per cent each of the total shares, with the remaining shares being accounted for by the 'B' shares and employees shares.

In addition to the above, around 70 Chinese firms have dual listing overseas, mainly in Hong Kong ('H' Shares) and New York ('N' Shares). The 'H' shares were introduced to facilitate the direct listings of Chinese companies on the Stock Exchange of Hong Kong, while 'N' shares were introduced for listing at New York Stock Exchange.

Listing on either SHSE or SZSE is through government consent. The State Planning Commission and the Securities Regulatory Commission set the quota for the total number of shares to be issued over the year after which is subsequently allocated among provinces (Kwok and Sun,1998). The number of listed firms on the two national stock exchanges increased to 1,378 as at end-October 2004 with the combined market capitalisation of two stock exchanges being at RMB 3,874 billion (US \$ 468 billion) or 29.2 per cent of GDP.

Reforms in the Chinese Financial Sector

Financial sector reforms in China have been based on the following five broad tenets: First, a central bank was created and developed which has resulted in more effective conduct of monetary policy. Second, a diverse network of government financial intermediaries has been established. Third, measures have been initiated to develop the financial markets. Fourth, a system of financial regulation and supervision has been put in place. Finally, the financial sector is gradually and cautiously being opened up (Ruogu, Li, 2001).

Following Shuangning (2004), various reforms introduced could be broadly divided into three phases.

Phase I (1978-1994): In 1978, the People's Bank of China (PBC) became independent of the Ministry of Finance. Until then, the PBC was responsible for a wide range of activities such as the conduct of monetary policy, exchange policy, foreign reserve management, deposit taking, commercial lending activities and the financing of development projects. During the Phase I, a two-tier banking system was created in which the PBC emerged as the central bank, while the Bank of China (BOC), the China Construction Bank (CCB), the Agricultural Bank of China (ABC) and the Industrial and Commercial Bank of China (ICBC) emerged as the specialised banks. The ABC specialised in rural credit; the CCB in fixed asset management, while the BOC in the foreign exchange business. With the restructuring of the PBC as the central bank, the ICBC was set up to serve a target client base consisting of industrial and commercial enterprises. In 1984, the PBC was specifically designated as the central bank of China. In 1992, the securities business supervision was transferred

from the PBC to the newly established China Securities Regulatory Commission (CSRC) to supervise stock listing and trading activities.

Phase II (1994-1998): During Phase II, three policy banks, *viz.*, the China Development Bank, the Agricultural Development Bank of China and the Export-Import Bank of China were set up in 1994 to undertake the policy driven financing earlier assigned to specialised banks. Specialised banks, in turn, became commercial banks engaging in commercial financial business only. In 1994, the Company Law containing provisions on issuance, transacting and listing of public securities became effective.

Phase III (1998 onwards): This phase witnessed several significant reform initiatives, as set out below:

- As part of its WTO accession, China has committed to open the banking sector to foreign institutions by December 2006. Accordingly, China has been gradually opening its financial sector to foreign competition. 13 cities have been opened for foreign banks to conduct renminbi business. 100 eligible foreign banks were permitted to conduct renminbi business and 55 of them were allowed to provide renminbi services to the Chinese enterprises. Foreign banks have so far been allowed to provide 12 categories of services in China. The permitted equity holding in Chinese financial institutions by a single foreign investor has been raised from 15 per cent to 20 per cent, while the maximum foreign equity holding remains at 25 per cent.
- In 1998, the China Insurance Regulatory Commission (CIRC) was set up to take over the function of insurance business supervision from the central bank, *i.e.*, PBC. In 1999, the securities laws became operational, aimed at standardising the issuing and trading of securities, protecting investors and promoting the development of the socialist market economy. The Government's intention in developing the equity market was to improve the performance of relatively promising SOEs, regulating problematic ones through mergers and acquisition and raising funds to finance companies and budget (Shirai, 2002).
- In 1999-2000, China set up three asset management companies (AMCs) for offloading RMB 1.4 billion of NPLs representing about 40 per cent of the estimated total NPLs of the big four banks. NPL transfers represented 'policy based' loans; the government took responsibility for bank losses related to policy lending prior to 1996 but not for loans made after 1996 (Ma and Fung, 2002).
- In March 2003, the Chinese government made another big move in reforming the financial supervisory regime by creating the China Banking Regulatory Commission (CBRC) to assume the responsibility of supervising all banking institutions. The PBC is now expected to concentrate only on monetary policy matters. The Bank of Communications has further diversified its ownership to include a foreign strategic investor.

- A joint mechanism has been developed among the CBRC, the CSRC and the CIRC for co-operation among themselves.
- Among the specialised banks-turned commercial banks, the Bank of China (BOC) and the China Construction Bank (CCB) have completed the corporatisation process, *viz.*, corporate restructuring into shareholding banks. The BOC and the CCB were chosen to launch joint-stock restructuring on a pilot basis. The Chinese government invested US \$ 45 billion from the official foreign exchange reserves at the end of 2003 into the BOC and the CCB to boost their capital aimed at building good corporate governance. The two banks are required to write off or dispose of their asset losses *via* market means. The CBRC promulgated Guidelines on Corporate Governance Reforms and Supervision of these two banks setting ten requirements for them to reform their management regime and systems, improve their corporate governance and operating mechanisms and thereby boost their profit-earning capacity. The CBRC also set seven benchmarks to assess the operational performance of the BOC and the CCB, requiring them to reach or surpass the average performance of the world's top 100 banks by the year 2007. The CBRC has asked the other two state-owned banks, *i.e.*, the ICBC and the ABC to follow the corporate governance guidelines to speed up the internal reforms and get ready for ownership restructuring.

China has introduced several monetary policy reforms as well moving from direct instruments of monetary control towards indirect system of monetary management.

Impact of Reforms in China

Wide ranging reforms introduced in China have had a distinct positive impact. Average return on assets and average return on equity, however, declined significantly between 1996 and 2002, reflecting perhaps the impact of increased competition. Net interest margin, especially in respect of SOCBs declined significantly and is now at reasonable level by international standards, reflecting improvement in the cost of intermediation. A disconcerting feature, however, has been the overall deterioration in the ratio of equity to total asset and capital funds to liabilities ratio in respect of JSCBs; the ratios in respect of SOCBs have improved significantly (Table 3).

Table 3 : Selected Indicators of Performance of Chinese Banks

(Per cent)

Item/year (Jan. - Dec.)	1996	2000	2001	2002
<i>Return on average assets</i>	0.48	0.26	0.22	0.22
SOCBs	0.27	0.22	0.16	0.18
JSCBs	1.01	0.40	0.37	0.33
<i>Return on average equity</i>	10.68	4.67	4.20	4.45
SOCBs	8.57	4.07	3.16	3.78
JSCBs	17.62	9.26	9.31	9.23
<i>Net interest margin</i>	3.10	2.23	1.91	1.93
SOCBs	2.59	2.35	1.98	2.02
JSCBs	2.33	2.32	2.18	2.07
<i>Cost to income ratio</i>	80.02	58.61	56.84	58.07
SOCBs	63.82	56.47	56.37	53.79
JSCBs	52.93	57.82	54.45	53.98
<i>Equity to total assets</i>	4.33	5.51	5.16	4.53
SOCBs	3.11	5.32	5.04	4.59
JSCBs	5.75	4.10	3.79	3.49
<i>Capital funds/ liabilities</i>	4.53	5.83	5.44	4.75
SOCBs	3.21	5.62	5.31	4.81
JSCBs	6.10	4.28	3.94	3.62
<i>Loan loss reserves/ gross loans</i>	1.13	1.51	1.81	1.81
SOCBs	1.16	1.24	1.66	1.82
JSCBs	0.88	4.30	3.56	2.73

SOCBs: State-owned Commercial Banks. JSCBs: Joint Stock Commercial Banks.

Source: Herrero, Alicia Garcia and Daniel Santabarbara, 2004.

There has also been a significant decline in the recent period in the non-performing assets, although the stock of NPLs continues to be large (Table 4).

Table 4 : NPLs of Major Commercial Banks

As at end of	Outstanding Balance (RMB billion)	Share in Total Loans (Per cent)
March 31, 2004		
Total	2,078	16.61
SOCBs	1,890	19.15
JSCBs	188	7.12
September 30, 2004		
Total	1,700	13.37
SOCBs	1,560	15.71
JSCBs	140	5.03

Source: Chinese Banking Regulatory Commission (<http://www.cbrc.gov.cn>).

There has been a steady increase in the number of companies listed on the stock exchanges in China. However, the size of the capital market measured both in absolute terms (market capitalisation) and in relation to the size of the economy has shrunk quite significantly in recent years. Liquidity in the stock market measured in terms of traded value ratio (turnover as percentage of GDP) has declined significantly during the last three years. The turnover ratio (turnover as percentage of market

capitalization), after declining in 2002 and 2003 however, improved in 2004 (Table 5).

Table 5 : Stock Market Indicators – China*

Year (As at End- December)	No. of Listed Companies	Size		Liquidity		
		Market Capitalisation (RMB billion)	% of GDP	Turnover ** (RMB billion)	Traded value ratio	Turnover ratio
2001	1,160	4,352	44.7	3,831	39.4	88.0
2002	1,224	3,833	36.4	2,799	26.6	73.0
2003	1,287	4,246	36.3	3,212	27.5	75.6
2004 @	1,378	3,874	29.2	3,725	28.1	96.1

* : 'A' or 'B' listed companies. ** Total turnover during the year. @ : Up to October 2004.

Note: GDP for 2004 is based on IMF projections (World Economic Outlook, September 2004).

Source: China Securities Regulatory Commission (<http://www.csrc.gov.cn>).

Section III: Structure and Size of the Indian Financial System

The Indian financial system comprises scheduled commercial banks, co-operative banks (urban co-operative banks and rural co-operative credit institutions), development financial institutions and non-banking financial companies.

Scheduled commercial banks which consist of public sector banks, old private sector banks, new private sector banks constitute the largest segments of the Indian banking system (Table 6).

Table 6 : Assets of the Indian Financial System

Category	Outstanding as at end-March 2004 (Rs. crore)	% to total assets
A. Scheduled Commercial Banks#	19,75,020	70.64
<i>of which:</i>		
i) Public Sector Banks	14,71,428	52.63
ii) Private Sector Banks (a+b)	3,67,276	13.14
a) Old Private Sector Banks	1,20,700	4.32
b) New Private Sector Banks	2,46,576	8.83
(iii) Foreign Banks	1,36,316	4.88
B. Co-operative Banks (i to iii)	2,28,851	8.19
i) Scheduled Urban Co-operative Banks	56,256	2.01
ii) State Co-operative Banks	57,762@	2.07
iii) District Central Co-operative Banks	1,14,833@	4.11
C. Financial Institutions*	5,70,797	20.42
D. Non-banking Financial Companies++	21,083	0.75
TOTAL (A+B+C+D)	27,95,751	100.0

* Financial assets relating to term-lending all India financial institutions, state-level institutions, investment institutions (UTI, LIC and GIC, etc.).

Excluding Regional Rural Banks. @ As at end-March 2003.

++ Relating to companies holding public deposits of Rs. 20 crore and above.

Source: Report on Trend and Progress of Banking in India (Reserve Bank of India), 2003-04.

Major Financial Sector Reforms in India

Wide-ranging reforms have been introduced in India covering both the financial intermediaries and capital market. The Indian banking sector reforms could be broadly grouped into three main areas, *viz.*, enabling measures, strengthening measures and institutional measures. Enabling measures were designed to create an environment where financial intermediaries could respond optimally to market signals on the basis of commercial considerations. Some of the major initiatives taken in this regard were significant reduction in the statutory pre-emptions, rationalisation of sector-specific directed lending programme, deregulation of interest rates (barring savings deposits), allowing new banks in the private sector. Strengthening measures were introduced to reduce the vulnerability of financial institutions in the face of fluctuations in the economic environment. These, *inter alia*, included introduction of prudential norms, recapitalisation of weak banks and several initiatives to enable banks to cleanse the balance sheets of banks. Institutional measures, which were initiated to create an appropriate institutional framework conducive to development of markets and functioning of financial institutions, included introduction of risk-based supervision, consolidated accounting and prompt corrective action (PCA) based on early warning triggers. India has encouraged state-run banks to diversify ownership by inducting private share capital through public offerings rather than by strategic sales and still absorb the overhang problems. The process has helped reduce the burden on the Government, enhance transparency, encourage market discipline and improve efficiency as reflected in stock market valuation, promote efficient new private sector banks, while drastically reducing the share of the wholly government owned public sector banks in a rapidly growing industry. The successful reform of public sector banks is a good example of a dynamic mix of public and private ownership in banks (Reddy, 2004).

Several initiatives were also taken to reform the Indian capital markets. These, among others, included setting up of a statutory regulatory body in the form of Securities and Exchange Board of India (SEBI), introduction of free pricing, shortening of trading settlement period, strengthening of risk management measures, dematerialization of securities, modernization of trading infrastructure, strengthening of corporate governance practices, integration of domestic capital market with the international capital market and introduction of derivative products.

Efforts were also made towards development of the Government securities market, which focused on three areas *viz.*, institutional measures, innovations through instruments and enabling measures.

Besides reforms in the banking sector and the securities market, some reforms have also been introduced in the insurance sector. The insurance sector has been opened to the private sector. Foreign participation up to 26 per cent has also been allowed. Separate regulatory authorities called Insurance Regulatory and Development Authority

(IRDA) and Pension Fund Regulatory and Development Authority (PFRDA) have also been set up for regulating and developing the insurance sector and the pension funds, respectively.

Financial Sector in India – Impact of Reforms

Profitability and soundness parameters of the Indian banking system improved significantly over the years. Net profits of the scheduled commercial banks improved from 0.8 per cent to 1.1 per cent between 1997-98 and 2003-04. Capital adequacy of scheduled commercial banks at 13 per cent as at end-March 2004 stood significantly higher than the minimum stipulated ratio of nine per cent. The non-performing assets (NPAs) declined from 7.3 per cent as at end-March 1998 to 2.9 per cent as at end-March 2004. The net interest margin, however, continues to be at high levels (Table 7).

Table 7: Select Performance Indicators - Indian Commercial Banks

Item/Year (April-March)	1997-98	2000-01	2003-04
(Per cent)			
I. Net NPAs *			
Scheduled Commercial Banks	7.3	6.2	2.9
Public Sector Banks	8.2	6.7	3.0
Private Sector Banks #	5.3	5.2	3.1
II. CRAR			
Scheduled Commercial Banks	11.5	11.4	12.9
Public Sector Banks	11.6	11.2	13.2
Private Sector Banks #	12.8	11.7	12.0
III. Net Profit/Loss to Total Assets			
Scheduled Commercial Banks	0.8	0.5	1.1
Public Sector Banks	0.8	0.4	1.1
Private Sector Banks #	1.0	0.7	1.0
IV. Net Interest Income (Spread) to Total Assets			
Scheduled Commercial Banks	3.0	2.9	2.9
Public Sector Banks	2.9	2.9	3.0
Private Sector Banks #	2.5	2.3	2.2
V. Operating Expenses to Total Assets			
Scheduled Commercial Banks	2.6	2.6	2.2
Public Sector Banks	2.7	2.7	2.2
Private Sector Banks #	2.1	1.9	2.0

* Non-performing assets as per cent to net advances.

Including both old and new private sector banks.

Source: Report on Trend and Progress of Banking in India.

As a result of reforms, the performance of capital market has improved significantly measured in terms of size of the secondary market and liquidity. The capital raised from the primary market, however, declined over the years as also the savings of the household sector in the form of shares/debentures/units of mutual funds (Table 8).

Table 8 : Select Indicators of the Indian Stock Market**(Rs. billion)**

Year (April - March)	Savings in capital market instru- ments#	Capital Raised	No. of Listed Cos.\$	Size		Liquidity		
				Market Capital- isation	% of GDP	Turnover*	Traded value ratio (%)	Turnover ratio (%)
1992-93	138(17.2)	198	NA	1,881	25.1	457	6.1	24.3
1995-96	91(7.3)	160	NA	5,265	44.3	1,182	9.9	22.5
1999-00	181(7.7)	52	5,889	9,128	47.1	15,241	78.7	167.0
2000-01	102(4.1)	49	5,955	5,716	27.4	23,395	112.0	409.3
2001-02	78(2.7)	57	5,782	6,122	26.8	8,205	36.0	134.0
2002-03	55(1.6)	19	5,650	5,722	23.2	9,321	37.7	162.9
2003-04	57(1.4)	32	5,528	12,012\$	43.3	16,022	57.8	133.4

*Relating to the Stock Exchange, Mumbai (BSE) and the National Stock Exchange of India (NSE).

\$ Relating to the BSE only. NA – Not available.

Relating to the household sector. Figures within parentheses are percentages to total savings in financial assets.

Source: Annual Report and Handbook of Statistics on the Indian Economy (Reserve Bank of India).

Section IV : India and China - A Comparison of Financial Systems

A comparative analysis of financial systems in India and China based on data as at end-March 2004 brings out some interesting features as detailed below:

- In both the countries, commercial banks dominate the financial system. The relative significance of commercial banks in the financial system in both India and China is more or less same. Also, in both the countries, public sector banks dominate the banking system, followed by joint stock/private sector banks. Foreign banks in India are relatively more significant than they are in China.
- The relative share of cooperative banks in the banking system is more or less same in both the countries.
- Asset quality of commercial banks in India has improved significantly. Profitability of Indian banks has also improved discernibly.
- The cost of intermediation by banks in India is significantly higher than that of China.
- The size of the banking system in China in relation to the size of the economy (measured as ratios of total assets/credit/deposits to GDP) was also significantly higher than that of the Indian banking system.
- On the whole, the financial system in China is much larger than that of India. The size of the commercial banking system of China is about eight times the size of the Indian commercial banking system.

Table 9 : Financial System in India and China : A Comparative Picture

(As at end-March 2004)

Item	China		India	
	Absolute (US \$ bn)	Per cent to Total	Absolute (US \$ bn)	Per cent to Total
A. Financial Intermediaries				
1. Size (assets)	3338	100.0	644	100.0
(i) Commercial Banks	2525*	75.6	455	70.6
<i>of which:</i>				
(a) State-owned Commercial Banks	1835*	55.0	339	52.6
(b) Joint Stock/ Private Banks	461*	13.8	85	13.1
(c) Foreign Banks	48*@	1.4	31	4.9
(ii) Urban & Rural Co-operative Banks	338*	10.1	53	8.2
(iii) Policy Banks	257*	7.7	-	-
(iv) Non-Banking Financial Institutions	110*	3.3	136	20.4
(v) Others	108*	3.2	-	-
2. Some Ratios (Banking System)				
(i) Total Assets as percentage of GDP	246.7		100.8	
(ii) Credit as percentage of GDP	181.7		30.3	
(iii) Deposits as percentage of GDP	191.7		54.3	
3. Health Parameters (per cent)				
(i) Asset quality (Net NPAs)				
(a) Commercial Banks	19.2		2.9	
(b) State-owned Commercial Banks	7.1		3.0	
(c) Foreign Banks	-		1.5	
(ii) Profitability (Net Profit to Assets)				
(a) Commercial Banks	0.2#		1.1	
(b) State-owned Commercial Banks	0.3#		1.1	
(c) Foreign Banks	-		1.7	
(iii) Net Interest Margin				
(a) Commercial Banks	2.0#		2.9	
(b) State-owned Commercial Banks	2.1#		3.0	
(c) Foreign Banks	-		3.5	
B. Capital Market				
(i) No. of Stock Exchanges	2		23	
(ii) No. of Listed Companies	1302		5042	
(iii) Market Capitalisation (US \$ bn)	609		369	
(iv) Market Capitalisation as percentage of GDP	43.1		43.3	
(v) Turnover as percentage of GDP Ratio	35.8		57.8	
(vi) Turnover to Market Capitalisation Ratio (%)	83.0		133.4	
(vii) Price – Earning Ratio** (%)	42.5		16.2	

* As at end-December 2003. # As at December 2002. @Relating to foreign-funded FIs.

** Relating to 'A' shares at Shanghai Stock Exchange.

- The number of stock exchanges and the companies listed on the stock exchanges are significantly larger in India in comparison with those in China.
- Notwithstanding fewer number of listed companies and the recent origin of capital market, the size of the capital market in China in absolute

terms was about one and half times the size of the Indian capital market. In relation to the size of the economy, however, the size of capital market in two countries was more or less same.

- The liquidity in the Indian stock exchanges was significantly higher than in the Chinese stock exchanges.
- Valuations in the Chinese equity markets turn out to be far higher than those in the Indian markets (Table 9).

Section V: An Assessment of Reforms in India and China and Challenges Ahead

The analysis in the preceding sections brings out that there are significant differences in the financial system of India and China. The Indian financial system is reasonably well developed with both the banking system and the capital market playing important roles, even as the financial system is dominated by the banking system. There has been significant improvement in the profitability and health parameters of the banking system as a result of which the financial system, on the whole, has become relatively safe, sound and efficient. The capital market in India has also undergone metamorphic changes in the recent past and is now comparable to the best in the world.

Several improvements have also taken place in the financial system of China. The level of NPAs over the years has declined significantly, even as it continues to be large by international standards. The intermediation cost in China has also declined quite significantly. The capital market in China has grown rapidly. Empirical evidence also suggests that firms' stock prices do reflect their fundamentals to a significant extent indicating that stock prices play a role in signaling information about issuers' fundamentals (Shirai, 2002).

Notwithstanding several initiatives by the Chinese authorities to reform the financial system, there are several areas which merit attention.

- The banking system continues to be characterised by large non-performing loans.
- Financial intermediation in China continues to be largely bank-based with the capital market playing only a peripheral role in the financial system. The share of capital market funding remains small in comparison with that in developed economies. In the first half of 2004, bank deposits constituted the largest source of funding (83 per cent) for non-financial sector (including households, enterprises and government), followed by treasury bonds (12 per cent), stocks (4.6 per cent) and company bonds (0.4 per cent)(Li Wei, 2004).
- There is evidence to suggest the prevalence of excess capacity build-up in several manufacturing industries and real estate. One of the major reasons for this has been the large proportion of lending to the SOEs (Tseng, 2003).

- The Chinese financial market is still lacking in product varieties. Financial deepening is still inadequate and there are hardly any innovations (Xiaochuan, 2004a).
- China's monetary system is still dominated by direct control measures in the form of credit and interest rate ceiling and reserve requirements.
- The size of the primary capital market is small with limited number of new issuances of debt and equity. Also, the majority of shares (accounting for about two-third of stock market capitalisation) are not traded.
- The Chinese capital market continues to remain fragmented. Apart from segmentation between 'A' and 'B' shares, there is also no fungibility between 'A' and 'H' shares, which impedes arbitrage and efficient pricing in two markets.

It needs to be noted that unlike in India, reforms in the real sector in China preceded reforms in the financial sector. In comparison with the agricultural and industrial reforms, the reforms in the financial sector in China moved at a slow pace. It was perhaps due to this reason that the financial sector remains vulnerable. In India, on the other hand, financial sector reforms started early in the reform cycle which imparted in a significant way efficiency and stability to the financial sector (Reddy, 2003). The faster reforms in the other sectors of the economy call for quick reforms in the financial sector in China.

Major Challenges faced by the Financial Sector in China

As part of its accession to the WTO, China has promised to open banking business in all places and in all currencies to foreign banks by 2006. After December 2006, foreign and domestic banks should be able to provide products to all customers in China throughout the country. With this, the banking system in China will face serious challenges; First, there is a large stock of NPLs in comparison with the international standards. Secondly, there is still a gap between the management and operational capacity of the wholly state-owned commercial banks and that of the world's leading banks. Third, the regulatory and supervisory system is not yet prepared for the complexities of the new situation (Li Ruogu, 2001).

The key focus of further reforms in the Chinese financial system is on resolution of NPLs problem. This requires concrete action plan on two fronts, *i.e.*, to resolve the existing stock of NPLs and to avoid accumulation of further NPLs. The flow problem perhaps could be tackled by further enhancing commercial orientation of the lending operations of banks. Ceiling on interest rates as and when removed could also allow banks to price their products based on their risk-return perception. To overcome the stock problem, the authorities need to keep in view the experience of the four AMC's set up, which has not been satisfactory as their losses are expected to surpass the current financial contributions to the AMC's from both the Ministry of Finance and the PBC (Ma and Fung, 2002). Further

improvements in bankruptcy and foreclosures would also enable banks to recover NPLs.

The further development of financial markets apart from imparting market discipline into the system, would have several other advantages. A balanced financial system, where both banks and financial markets play important roles, not only helps in averting crises, but also creates competitive conditions which would benefit both savers and investors. The capital market could help in improving allocative efficiency of resources by putting competitive pressures on the banking system. The financing needs of the Chinese economy appear to be far more than the lending capacity of banks. Those enterprises, which are not able to raise funds from the banking system could finance their requirements from the capital market. The capital market could, thus, help in spurring the growth of the private sector.

In China, ownership of shares is based on the status of the investor as well as of that of the company. There is no transferability between 'A' and 'B' shares, even as they are identical in respect of shareholder rights. Because of segmentation, the Chinese capital market is also not much integrated with other capital markets. Further integration with the international capital market could help China in reaping the benefits. The convertibility of state and legal person shares into 'A' class shares and making them tradable along with 'B' shares could also help in integrating its market further.

Administrative controls over raising of capital perhaps could be phased out in favour of well defined and objective entry and disclosure norms. Reforms of the capital market in China could also include the development of the private debt market, which could provide the financing choices to the borrowers and the opportunity to diversify risk to the savers.

Challenges Faced by the Financial Sector in India

Financial sector reforms in India have undoubtedly brought about significant improvements in the profitability and health parameters of the banking system. However, some issues in the Indian financial system would have to be addressed in the near future. Furthermore, as a result of deregulation, financial integration and advances in information technology, several new challenges have emerged which merit attention in India.

Notwithstanding some improvements, the intermediation cost in India continues to be high in comparison with the international standards. In fact, intermediation cost of scheduled commercial banks changed only marginally from 3.0 per cent as at end-March 1998 to 2.9 per cent by end-March 2004. In contrast, intermediation cost in China declined significantly from 2.6 per cent in 1998 to 2.0 per cent in 2002. The high intermediation cost in India is a cause of concern and it needs to be brought down. Banks are now exposed to increased market risk. With the increasing financial integration, banks are also exposed to serious asset-liability mismatch with serious implications for interest rate risk, liquidity risk, foreign exchange risk. These risks need to be managed in a proactive

manner as they pose a serious challenge for the banks and the regulatory authority.

Distinctions among providers of various financial services are getting increasingly blurred which have the potential to lead regulatory gaps/overlaps. This, along with the emergence of large and complex financial institutions as a result of consolidation could pose a supervisory challenge and call for quick and coordinated responses on the part of all the regulatory authorities.

Although the capital market in India has become modern, safer and more transparent, the lack of interest by the retail investor in the market is a cause for concern. The new capital being raised from the market for the last several years has remained insignificant both in absolute and relative terms. As a result, the relative significance of the primary capital market in the financial system has declined. Although sizeable funds have been raised from the capital market in the current year, it would have to be seen as to whether this trend would be sustained in the coming years. In the secondary market, although there are about 9000 companies listed in the stock exchanges, bulk of the trading is confined to a few large companies. It is estimated that about 50 stocks make up for as much as 75 per cent of the total turnover in the Indian stock exchanges as against 15 each in the case of the US and the UK and 25 per cent in the case of Japan. There has also not been any significant progress in the private corporate debt market. With the major DFIs disappearing from the scene and banks having difficulties to undertake project finance in a big way, a gap has emerged in financing the long-term requirements of funds, especially for the infrastructure sector. This could have serious implications for the real sector in the future.

Section VI: Concluding Observations

Financial sector reforms in India and China were introduced more or less at the same time. However, there were significant differences in the level of development in two systems at the time of introduction of reforms. Whereas, the structure of the financial system in India was already reasonably well developed and market-based with private sector and foreign banks operating along with the public sector banks, China, on the other hand, had to migrate from a totally command economy to a market oriented economy. As a result, the financial system in China continues to face a number of challenges, especially poor asset quality of the banking system. Future reforms in China need to focus on strengthening the financial system and further reforming the capital market. It is significant to note that in terms of size, the Chinese banking system has emerged significantly larger than that of India. In a globalised world, the size can matter a lot. In order to take advantage of its size, China could focus on quick qualitative improvements, especially in the asset quality of the banking system. The strengthening of the banking system would also enable China to pursue further reforms in area of external sector and monetary policy.

Financial sector reforms in India have resulted in significant improvement, especially in the asset quality of the banking system. On the whole, the Indian financial system has emerged much stronger in the post-reform period. However, the major challenge for the Indian authorities lies in bringing down the intermediation cost of the banking system, while at the same time maintaining its profitability.

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