Rise of Bank Competition: Evidence from Banking Deregulation in China

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Summary

Using comprehensive loan-level data in China, we investigate how the deregulation on bank entry barriers alters local banking industrial organisation and its economic consequences. In particular, we find that following deregulation in the form of geographically lowered bank entry barriers, banks entering into deregulated cities significantly increased lending amounts, as anticipated. However, the impact was filtered through and altered the local industrial organisation of banks, and the potential benefits were adversely mitigated by a preference for lending to state-owned enterprises (SOEs) over more productive private firms.

More specifically, the soft budget constraints of SOEs, with implicit government guarantees, make new entrant banks prefer inefficient SOEs to contemporaneously opaque local private

firms. For private firms that did receive bank loans, the entrant banks required more guarantees and higher internal loan ratings as indicators of quality. In the longer run, entrant banks learned the characteristics of local private firms and lent more to them, but a sizeable amount of money lent to SOEs in new markets was "lost" (approximately 0.25% of annual GDP). In addition to this loss, there were immediate beneficial impacts. The on-lending interest rates in deregulated cities decreased significantly following deregulation, and the private firms that received such credit achieve yet higher levels of growth and profitability. We describe this phenomenon as a novel trade-off of banking deregulation and in turn contribute to the ongoing debate.