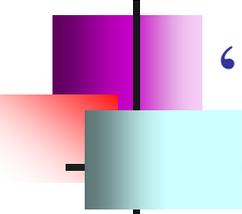




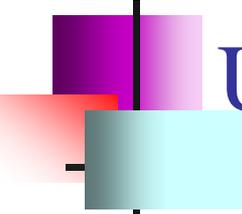
Understanding the “China Puzzle”

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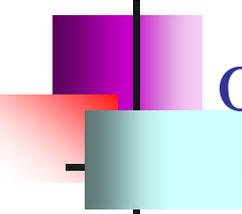
“China Miracle” and “China Puzzle”

- The Chinese economy has grown at double digits on average for the past 30 years. – a “China Miracle”
- However, this economic growth is achieved without good institution.
- How to understand this “China Puzzle”?
 - Is it a puzzle?
 - How did Chinese firms grow in such an institutional environment?



Understanding the “China Puzzle”

- How puzzling is this?
 - ✓ Not much a puzzle
 - ✓ Together with the rapid economic growth, the institution of China has also improved
 - ✓ Evidence that good institutional development promotes economic growth in China
 - ✓ e.g., Du, Lu, and Tao (JCE forthcoming) find that good institutions promote regional economic development in China by attracting more FDIs;
 - ✓ Zhang, Wang, and Qu (2012, CER)

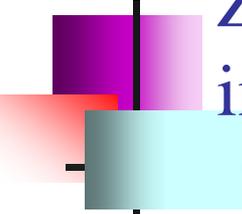


Zhang, Wang, and Qu (2012)'s Research on Banking in China

A B S T R A C T

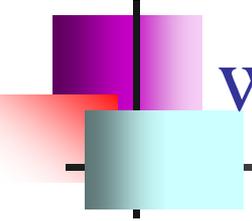
We investigate bank risk taking, efficiency and their relation to law enforcement using a unique sample of 133 Chinese city commercial banks across 31 regions for the 1999–2008 period. We find that stronger law enforcement tends to promote greater bank risk taking in the region. Furthermore, employing a stochastic distance function approach, our analysis shows that the performance of Chinese city commercial banks, as measured by bank efficiency, is heavily influenced by the effectiveness of law enforcement in the region. Better legal environment, higher efficiency in the legal system, and stronger protection of intellectual property right are associated with a higher level of efficiency among these banks.

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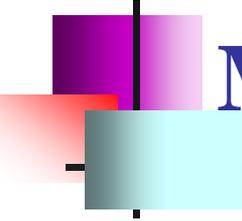
Zhang, Wang, and Qu (2012)'s Research on Banking in China

- Legal environment may affect the operation and performance of banks (Cole and Turk-Ariss, 2008; Houston et al. 2010; Berger and Udell, 2006; Qian and Strahan, 2007; Demirguc-Kunt et al., 2003)
- Variation in institutional and legal environments within a particular country may be important in affecting economic outcomes (Berkowitz and Clay, 2006; Laeven and Woodruff, 2007; Acemoglu and Dell, 2009)



Regional Variation in Law Enforcement within China

- China is a big country with great regional variation
- Although China is a centralized country so that the laws on book are highly uniform across regions, the quality of law enforcement varies significantly across provinces
- Such difference in law enforcement could affect economic outcome in the region both directly and indirectly

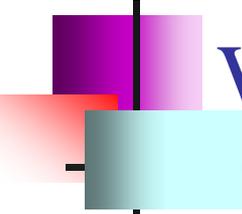


Measure of Legal Environment

- Data from *Market Development Report* of Fan, Wang and Zhu (2000, 2004, 2006, 2010):
 - An index that measures the development of market intermediaries and legal environment
 - the efficiency of law enforcement
 - the protection of intellectual property rights

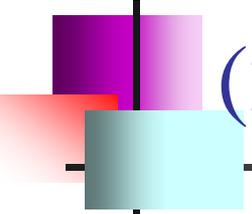
Table 3
Legal environment of different regions in China (1998–2007).

Regions	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Beijing	9.20	4.52	5.12	7.37	7.62	7.63	8.10	7.78	7.87	8.41
Tianjin	3.97	4.05	4.35	5.86	6.50	6.95	7.49	8.51	8.98	9.92
Hebei	1.59	2.95	3.15	3.26	3.39	3.48	3.90	5.11	5.13	5.27
Shanxi	3.11	3.24	3.94	2.91	3.08	3.20	3.61	4.38	4.51	4.78
Inner Mongolia	2.30	2.87	3.42	3.30	3.38	3.56	3.96	4.47	4.43	4.50
Liaoning	3.24	3.16	3.54	4.28	4.51	5.15	5.46	6.35	6.55	7.23
Jilin	2.79	3.35	3.36	3.65	3.69	3.83	3.89	4.79	4.84	5.37
Heilongjiang	2.65	3.13	3.51	4.07	4.24	4.44	4.56	5.30	5.15	5.46
Shanghai	5.32	3.92	5.51	9.42	10.52	12.15	11.06	12.84	13.87	16.61
Jiangsu	2.17	3.66	3.76	5.20	5.69	6.18	6.61	8.18	9.07	11.50
Zhejiang	2.32	3.49	3.99	6.19	7.16	8.09	8.39	10.59	11.97	13.89
Anhui	1.34	3.15	3.05	2.53	2.67	2.63	3.15	4.99	5.53	5.99
Fujian	2.36	3.66	4.31	4.68	5.05	5.23	5.30	6.41	6.61	6.92
Jiangxi	1.55	2.76	2.59	2.23	2.61	3.01	3.38	4.32	4.28	4.75
Shandong	2.22	3.15	3.11	3.80	4.18	4.67	5.13	6.14	6.71	7.37
Henan	1.50	2.85	3.00	3.06	3.12	3.07	3.38	4.52	4.66	4.99
Hubei	2.04	2.87	3.04	2.96	3.24	3.74	3.81	4.87	5.02	5.79
Hunan	1.68	1.35	1.50	2.29	2.64	3.13	3.75	4.29	4.20	4.32
Guangdong	3.85	4.17	6.02	7.11	7.69	8.45	8.86	10.64	11.47	12.59
Guangxi	1.90	2.89	2.99	2.92	3.10	3.20	3.17	3.80	3.70	4.23
Hainan	2.09	3.73	3.93	3.86	3.80	3.64	3.57	3.63	3.74	3.87
Chongqing	2.19	2.13	1.72	2.37	2.74	3.29	3.95	4.89	5.20	5.61
Sichuan	1.96	2.65	2.43	3.49	3.81	4.03	4.11	5.04	5.24	5.96
Guizhou	1.27	2.47	2.32	1.82	1.88	1.96	2.16	3.12	3.20	3.76
Yunnan	1.85	2.26	2.74	2.17	2.33	2.41	2.75	3.91	4.15	4.63
Tibet	NA	NA	0.00	1.90	1.91	2.25	2.63	3.60	3.78	3.89
Shannxi	2.93	1.73	1.92	1.78	2.29	2.47	2.88	3.96	4.29	4.99
Gansu	1.45	2.27	1.89	1.15	1.36	1.52	2.11	3.34	3.57	3.79
Qinghai	1.88	2.75	3.02	1.47	1.58	1.49	1.53	1.85	2.06	2.79
Ningxia	2.37	2.92	2.58	1.67	1.86	2.24	2.83	3.47	3.52	3.80
Xinjiang	2.83	2.17	2.12	3.28	3.85	4.37	4.48	4.83	4.64	4.56
Country average	2.60	3.01	3.16	3.61	3.92	4.24	4.51	5.48	5.74	6.37



Within-country Studies

Questions related to the importance of legal institutions “will be almost impossible to answer with cross-country data alone, and micro data investigations, for example, exploiting differences in regulations across markets and regions appear to be a most promising avenue” (Acemoglu, 2005, p. 1045)



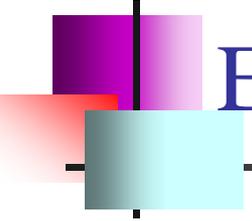
Main Findings of Zhang, Wang, and Qu (2012)

- The performance of Chinese banks, as measured by bank efficiency, is heavily influenced by the legal environment in the region.
 - More developed market intermediaries, higher efficiency in the legal system, and better protection of intellectual property right are associated with a higher level of efficiency among these banks.

Table 6
Inefficiency analysis: results of the income-based model.

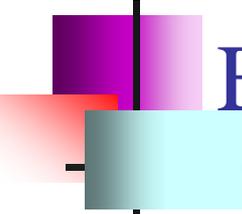
	(1)	(2)	(3)	(4)	(5)	(6)
Legal environment	-0.074*** [-3.27]	-0.082*** [-4.66]	-	-	-	-
Efficiency of the legal system	-	-	-0.189*** [-6.05]	-0.149*** [-8.69]	-	-
Protection of intellectual property right	-	-	-	-	-0.023** [-2.14]	-0.032*** [-3.32]
Loans/GDP	0.003 [0.02]	-	-0.402** [-2.40]	-	-0.466*** [-2.60]	-
Ln (GDP)	0.424*** [5.79]	0.529*** [6.55]	0.697*** [8.18]	0.601*** [10.51]	0.427*** [6.51]	0.538*** [12.48]
GDP growth rate	-	-0.025** [-2.20]	-	-0.031*** [-3.15]	-	-0.039*** [-3.42]
Selection governance	-1.628*** [-8.00]	-1.434*** [-10.19]	-1.062*** [-3.46]	-1.534*** [-8.11]	-1.221*** [-8.17]	-1.435*** [-8.98]
Dynamic governance	0.326 [0.94]	0.418* [1.65]	0.517*** [4.21]	0.365 [1.22]	0.467** [2.12]	0.467*** [2.62]
Equity/assets	-7.149*** [-8.83]	-7.716*** [-9.40]	-8.292*** [-9.78]	-6.786*** [-10.31]	-7.968*** [-9.85]	-8.022*** [-7.73]
NPL ratio	4.734*** [10.41]	5.237*** [12.36]	5.255*** [12.68]	3.968*** [12.80]	5.283*** [11.92]	5.289*** [12.40]
Loans/deposits	-2.917*** [-10.83]	-3.198*** [-12.10]	-3.114*** [-10.08]	-2.465*** [-11.27]	-3.268*** [-9.48]	-3.199*** [-9.93]
Interbank funds/ (interbank funds + deposits)	1.246*** [5.15]	1.117*** [3.94]	1.052*** [3.52]	0.869*** [3.98]	1.180*** [3.67]	1.147*** [3.46]
Long-term loans/loans	0.153 [1.11]	-0.007 [-0.05]	-0.287* [-1.95]	0.023 [0.23]	-0.083 [-0.50]	0.038 [0.22]
Securities/earning assets	-3.732*** [-11.18]	-3.985*** [-11.38]	-4.436*** [-10.87]	-3.637*** [-12.86]	-4.001*** [-10.42]	-3.972*** [-8.47]
Constant	-5.396*** [-5.24]	-4.095*** [-3.59]	-8.117*** [-7.46]	-3.606*** [-3.33]	-5.248*** [-5.48]	-2.884** [-2.29]
Gamma	0.911*** [71.42]	0.923*** [78.17]	0.924*** [94.29]	0.898*** [70.57]	0.919*** [66.50]	0.924*** [95.37]
Log likelihood	-100.59	-98.52	-92.70	-96.58	-98.63	-98.83
LR test	567.18	571.32	582.94	575.19	571.10	570.68
Observations	1083	1083	1083	1083	1083	1083

Note: ***, ** and * indicate significance at the 1%, 5% and 10% levels, respectively; t-values are in square brackets.



Firm Growth in Chinese Institutional Environment

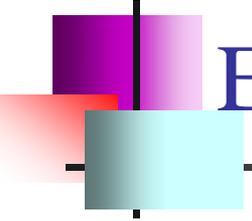
- Despite the improvement in recent years, the Chinese institution is still relatively poorly developed when compared to advanced economies and some developing countries.
- How did Chinese firms grow in such an environment?



Firm Growth in Chinese Institutional Environment

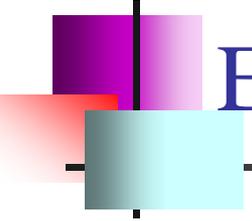
1. International trade

- Taking advantage of the trade liberalization and promotion policies of China (e.g., tax benefits, more efficient processing of financing request and custom clearance)
- Trade with foreign countries with good institutions such as US and Europe
- Some firms specialize on foreign markets rather than the vast domestic market (poor protection of intellectual property rights, poor contract protection, regional bias of local courts, etc.)



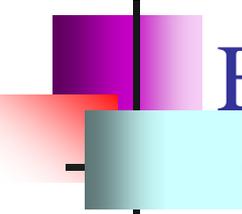
Firm Growth in Chinese Institutional Environment

2. Informal institution and culture
 - Social trust: E.g., the Wenzhou model
 - Traditional Chinese culture
 - Other informal institutions



Firm Growth in Chinese Institutional Environment

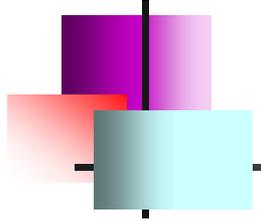
3. Setting up special relations with the government
 - Participating in the social project of the region
 - Lobbying, etc.



Firm Growth in Chinese Institutional Environment

4. The role of SOEs

- Internalizing transactions by vertical integrations and other M&As (rapid expansion of the largest SOEs in recent years, e.g., CMG) with the support of state-owned banks and government
- The ability to affect local institutions
- The ranking system of SOEs has important implications on its relation with the government and determines how much government support it can obtain, especially when there is a legal dispute



Thank you!