

# **The Impact of Foreign Bank Entry on Domestic Firm Performance: The Case of China**

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## **Abstract**

We study the relationship between foreign bank entry and productivity growth of manufacturing firms in China. After China's accession to the World Trade Organization (WTO) in 2001, foreign banks can enter China's local currency market in phases and compete with local banks.

The existing theoretical literature suggests a non-trivial relationship between banking market structure and growth. For example, Pagano (1993) argues that banking competition can improve allocative efficiency and promote growth; but Petersen and Rajan (1995) argue that, due to information asymmetry, banks with market power can internalize the benefits of helping financially constrained firms. Empirically, studies using industry-level data also show mixed results: firm growth can not only be positively or negatively related to banking competition, but also depend on the firm's reliance on external finance. For example, Cetorelli and Gambera (2001) find that bank concentration has a negative impact on growth but promotes the growth of more financially dependent industries; Claessens and Laeven (2005) find that bank competition has positive impact on growth especially those financially dependent industries.

One main limitation of existing studies using industry-level data is that such data do not capture firm dynamics such as firm entry and exit decisions. In this paper, we use firm-level data from Annual Survey of Industrial Production from the National Bureau of Statistics of China for empirical analysis. This data set covers all state-owned and non-state-owned manufacturing firms having sales over 5 millions RMB. The sample period is between 1998 and 2007 with number of firm observations ranging from about 160,000 (in 1998) to about 330,000 (in 2007). We use these firm-level data to examine the following two questions: (1) Does foreign bank entry after China's accession to WTO affect the growth of manufacturing firms? (2) Do industries with different reliance on external finance benefit (or suffer) differently from foreign bank entry?

In the empirical analysis, we use the value-added production function estimation method developed by Levinsohn and Petrin (2003) to compute total factor productivity (TFP). To measure foreign bank entry, we use a binary variable indicating whether foreign banks are allowed to do local-currency business with domestic firms. For example, by end of 2001, foreign banks are allowed to enter Shanghai, Shenzhen, Tianjin, and Dalian; and the foreign bank dummy equals to 1 for these regions from 2002 onwards. We regress TFP growth on the foreign bank dummy as well as its interaction with the industry's financial dependence proxied by the fraction of capital investment that cannot be financed by internal cash (Rajan and Zingales, 1998).

Our preliminary results suggest that (1) foreign bank entry is negatively related to TFP growth, and (2) industries with higher dependence on external finance grow relatively faster with foreign bank entry. These results provide further firm-level evidence on the relationship between banking market structure and growth.