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Economic policy uncertainty, credit risks and banks' lending decisions: Evidence from Chinese commercial banks

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ABSTRACT

Using data for Chinese commercial banks from 2000 to 2014, this paper examines the effects of economic policy uncertainty (EPU) on banks' credit risks and lending decisions. The results reveal significantly positive connections among EPU and non-performing loan ratios, loan concentrations and the normal loan migration rate. This indicates that EPU increases banks' credit risks and negatively influences loan size, especially for joint-equity banks. Given the increasing credit risks generated by EPU, banks can improve operational performance by reducing loan sizes. Further research indicates that the effects of EPU on banks' credit risks and lending decisions are moderated by the marketization level, with financial depth moderating the effect on banks' credit risks and strengthening it on lending decisions.

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Contents

1. Introduction	00
2. Literature and hypotheses.	00
2.1. Institutional background	00
2.2. Literature review	00
2.2.1. Effects of EPU	00
2.2.2. Credit risks and lending decisions of commercial banks	00
2.2.3. Brief summary of related literature.	00

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2.3. Theoretical analysis and hypotheses development	00
3. Research design	00
3.1. Sample	00
3.2. Key variables	00
3.2.1. Credit risks	00
3.2.2. Loan sizes	00
3.2.3. EPU	00
3.3. Model	00
3.4. Descriptive statistics	00
4. Empirical results	00
4.1. EPU and credit risks	00
4.2. EPU and adjustment of loan sizes	00
4.3. EPU, adjustment of loan sizes and performance	00
5. Additional analyses	00
6. Conclusion and implications	00
References	00

1. Introduction

As an emerging and transforming economic power, China's government plays an important role in business activities. To realize the goal of social governance, governments use economic policies (e.g., fiscal, monetary, industrial and administrative) to adjust and control the economic operation and behavioral patterns of market participants. Following the 2008 financial crisis, the Chinese government proposed and implemented a set of intensive policies to stimulate the economy and alleviate the pressure generated by the economic downturn. These policies efficiently addressed the economic decline, but they also objectively aroused tremendous economic policy uncertainty (hereinafter referred to as EPU). [Fan and Xu \(2015\)](#) survey 1041 CEOs in domestic and foreign enterprises operating in China, and find that 57% and 66% of CEOs in domestic and foreign enterprises, respectively, explicitly treat the condition that laws and regulations are ambiguous, changeful and selectively executed as their biggest concern. Facing a high level of EPU in China, market participants must dynamically rectify their operational strategies and actions.

As important participants in the Chinese market, commercial banks possess the same essential attributes as general corporations, but one of their special functions is channeling the effects of governmental macroeconomic control. Specifically, given advancing marketization, commercial banks are becoming more similar to general enterprises, exhibiting more market-orientated behavioral modes and operating goals. Governments also intensively adjust deposit rates and reserve requirement ratios to indirectly achieve economic regulation and control. This suggests that commercial banks are a key loop in the transmission mechanism of official macroeconomic policies. The operating businesses of commercial banks are at enormous risk and inherently possess great influence. Given these characteristics, we assume that the effects of EPU on commercial banks are particularly complex. Therefore, there is an urgent need to investigate whether EPU affects commercial banks. In particular, it is important to uncover the mechanism by which EPU operates, and the solutions for mitigating its effect on commercial banks. To answer these issues, we pursue an understanding of commercial banks' behavioral patterns in dealing with the shock generated by EPU within emerging economies.

Using unbalanced panel data for Chinese commercial banks between 2000 and 2014, we investigate how EPU influences commercial banks' credit risks and lending decisions, and how commercial banks respond to these effects. We find that an increase in EPU increases bank non-performing loans, single borrower concentration and the normal loan migration rate. That is, EPU increases the credit risks of Chinese commercial banks. We also reveal that the level of EPU significantly and negatively correlates with the loan-to-deposit ratio and the loan growth rate, and this negative relationship is more pronounced in joint-equity commercial banks with fewer state-owned shares. This empirical finding indicates that commercial banks, particularly

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