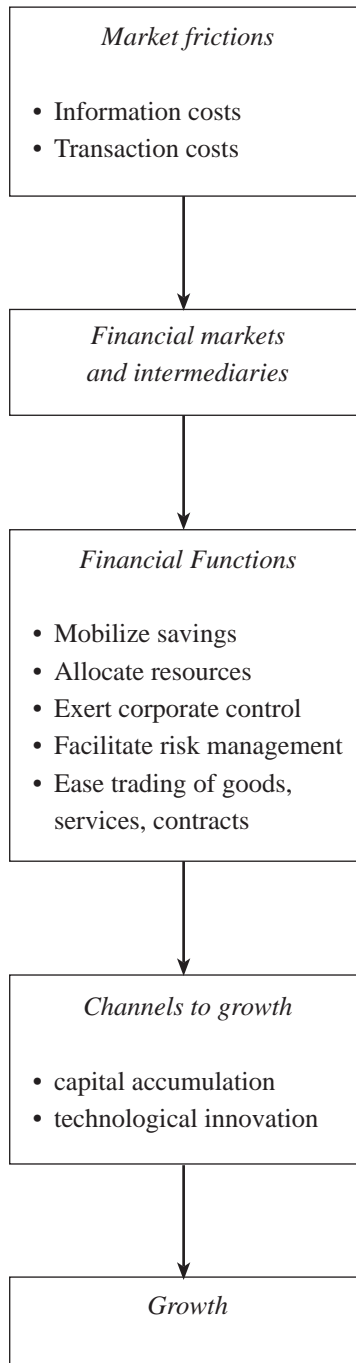


1. Introduction

The idea that the functioning of financial systems affects economic development has a long history in the economics literature, dating back at least to Schumpeter (1912). Following Schumpeter, numerous important contributions to this theme were made, most notably the work of Gurley and Shaw (1955) who provided a theoretical basis for a relationship between the functioning of a financial sector and economic development, and Goldsmith (1969) who was the first to empirically confirm the existence of such a relationship using international panel data. In a review of the more recent empirical literature, Levine (1997, pp. 689, 690) concluded that ‘...broad cross-country comparisons, individual country analyses, and firm-level investigations point in the same direction: the functioning of financial systems is vitally linked to economic growth’. Levine also set out a theoretical framework that illustrates the factors driving the formation of financial intermediaries and markets, and their impact on economic growth (Figure 1.1). The costs of acquiring information and making transactions create an incentive for the formation of financial intermediaries and markets. In ameliorating these costs, financial systems serve several functions including mobilizing savings, allocating resources and exerting corporate control. In performing these functions, the financial sector can contribute to capital accumulation and technological innovation, thus impacting upon the rate of economic growth.

Given that the financial sector provides such basic services necessary for sustainable economic growth, many economists have argued that financial reform has a particularly important role to play in economies undergoing the transition to a market economy (Griffith-Jones, 1995; World Bank, 1996; Hermes and Lensink, 2000). Mobilizing savings for investment, exerting effective corporate governance over reforming state-owned enterprises (SOEs) and selecting non-state firms to finance are all important elements of a successful transition. Financial reform in transitional economies is also more comprehensive than in most developing countries because it involves not only liberalization, but also shaping the structure and functions of the financial system (Long and Sagari, 1991, p. 431). While the functions of financial systems outlined in Figure 1.1 are provided as a matter of course in most market economies, this has not been the case in transitional economies.



Source: Levine, 1997, p. 690.

Figure 1.1 A theoretical approach to finance and growth

Historically, banks in such countries have been largely administrative units, passively facilitating the physical plans of the central government.

Given the apparent importance of financial reform in determining the economic performance of a developing, transitional economy such as China, it is surprising then that the role of finance has been downplayed in the literature examining China's rapid economic growth during the reform period (1978–present). With only a few exceptions (see, for example, Chai, 1981; Byrd, 1983; Tam, 1986), the study of China's financial sector was assigned a distinctly second-fiddle role to other engines of growth such as trade and foreign investment during the 1980s. Even as recently as the mid-1990s, Fry (1995, p. 53), in a review article on the state of the literature concerning financial development and reform in Asia, concluded that, 'Another major hole is the absence of any material on financial reform in China; this fascinating subject warrants a review article in its own right'. While several important works have emerged in recent years on the topic of financial reform (see, for example, Li, 1994; Tam, 1995; Lardy, 1998a), the balance has yet to be fully redressed. Furthermore, the link between financial reform and economic development continues to be poorly understood.

Perhaps the major reason finance has been so downplayed is because the standard view holds that China's financial sector, in contrast to most other areas of the economy, remains, 'essentially unreformed' (Cheng et al., 1997, p. 204). In particular, the central government continues to exercise considerable control over the financial sector. This control can be seen primarily through two stylized facts. First, the activities of state-owned banks (SOBs) have changed little in that most of their lending continues to be directed towards the state sector (see Table 2.1). Second, the interest rates that SOBs levy on loans and offer on deposits are still controlled by the central government connected central bank, the People's Bank of China (PBC). Largely on the basis of these stylized facts, several recent influential works have argued that the apparent lack of financial reform in China represents a drain on an otherwise successful program of economic reform. Li (1994, p. 3), for example, argues that, 'China has kept a low interest rate ceiling for many years, and it has detrimental impacts. Typically, it encourages inefficient investment and distorts financial efficiency'. This view is supported by Lardy (1998a, p. 127) who states, 'Setting lending rates at below market clearing levels ensures excess demand for loans. Political allocation of credit funds, including corruption inevitably results'. Declining rates of profitability in SOBs and SOEs are typically presented as evidence of the inefficiency of China's financial system.

The theoretical foundation of the standard view regarding the effects of China's apparent lack of financial reform is the well known McKinnon–Shaw hypothesis (McKinnon, 1973; Shaw, 1973). These authors contended that com-

mon government interventions in the financial sector, such as repressing interest rates at below market determined levels and directing credit, are fundamental stumbling blocks to economic growth in many developing countries. It was argued that interest rate repression has two primary negative effects. First, it reduces the incentive of economic agents to hold surplus in the form of financial assets. Thus, the quantity of financial savings forthcoming will be restricted with negative implications for the rate of investment and economic growth. Second, if interest rates are fixed at below market determined levels, there will be an excess demand for credit and the need for an administrative rationing process is created. As a result, McKinnon–Shaw proponents argue that low return investments may gain funding at the expense of high return investments. The policy implication of the McKinnon–Shaw model then, which has been advocated by several authors in the case of China (Li, 1994, p. 3; Lardy, 1998a, p. 127), is financial liberalization whereby the market prices and allocates financial resources.

There are, however, several deficiencies in the above standard view regarding the extent and impact of financial reform in China. As a result, any policy implications that flow from much of the existing literature could be misleading. First, the theoretical foundation of the standard view regarding the impact of the current state of financial reform in China is the subject of much debate in the wider literature. While the McKinnon–Shaw hypothesis was the dominant paradigm during the 1970s, it came increasingly under attack as numerous countries had disappointing, or even perverse, experiences with financial liberalization (Diaz-Alejandro, 1985). Fry (1997a, p. 758) states that the primary reason many experiments with financial liberalization failed was due to the perverse reaction to higher interest rates by insolvent and/or non-profit motivated firms. By definition, an insolvent firm is unable to repay its existing loans and hence is not deterred by a higher borrowing cost. It simply continues, if it can, to borrow whatever it needs to finance its losses. Such firms bid up the interest rate until normally solvent, profit-motivated firms cannot access credit or become insolvent due to the high cost of borrowing. This observation is particularly instructive in the case of China where the chief borrowers, the SOEs, are often insolvent and/or non-profit motivated. Even McKinnon himself (McKinnon, 1993), along with other long-time proponents of financial liberalization such as Fry (1997a), have more recently argued that international country experience has shown that there are prerequisite conditions that must first be met before successful financial liberalization can be conducted. Fry (1997a, p. 759) summarizes these as follows:

- a. Adequate prudential regulation and supervision of financial institutions and markets.
- b. A reasonable degree of price stability.

- c. Fiscal discipline taking the form of a sustainable government borrowing requirement that avoids inflationary expansion of reserve money by the central bank.
- d. Profit maximizing, competitive behavior by financial institutions.
- e. A tax system that does not impose discriminatory taxes on financial intermediation.

As many countries, including China, have yet to satisfy the above prerequisite conditions, a growing body of literature has emerged which argues that well designed government intervention can be preferable to a fully liberalized financial system in terms of promoting economic development (Stiglitz, 1994; Hellman et al., 1997). Therefore, government intervention in China's financial sector cannot be dismissed as being damaging to economic development *a priori*.

Second, the dominant methodology presented in the existing literature, which uses financial criteria such as profitability to evaluate the economic performance of China's SOBs and SOEs, is inadequate. The use of financial criteria to evaluate the internal efficiency of a firm or bank can be misleading because these variables can move in opposite directions. Whereas internal efficiency reflects the quantity of output attainable from a quantity of inputs, financial performance reflects revenues relative to costs. The declining financial performance of SOBs also need not reflect allocative inefficiency in their lending. This is because it has long been recognized that projects that have great development significance may only yield a marginal financial return, if at all (Kane, 1983, p. 16). That is, due to the existence of market failures, there is often a large divergence between social and private returns to lending. For this reason, Stiglitz (1994, p. 23) argues that there can be no presumption on the basis of economic theory that a liberalized financial sector will optimally allocate credit. The exclusive use of financial measures to gauge the performance of SOEs and SOBs is also inappropriate in that they are trying to satisfy a range of objectives (economic development objectives, social objectives, and so on) in contrast to firms and banks in a purely market economy that are solely attempting to maximize profits.

Third, the standard view regarding the extent of financial reform in China and its impact on economic development appears to be incongruent with several basic observed facts. For example, the fact that since 1978 China has experienced one of the fastest rates of economic development in modern history has been widely established (Chai, 2000). This is extremely difficult to reconcile with the standard view that China's financial system grossly distorts the optimal allocation of loanable funds. The standard view implies that China would have grown even faster without government intervention in the financial system, which is possible, but not very probable. Another exam-

ple is the fact that China has experienced rapid financial deepening during the reform period. This is extremely difficult to reconcile with the standard view that the financial sector remains unreformed and that the returns on financial assets have been seriously repressed at low levels by the government. If interest rates had been seriously repressed, surplus agents would have held little incentive to hold financial assets and hence financial depth should have remained low. The declining market share of SOBs and the vast institutional diversification that has taken place is also difficult to reconcile with the view that the financial sector has experienced little real reform. Largely as a result of this institutional diversification, it has been reported that 51 percent of new loans extended by China's financial system in the first half of 2001 went to non-state-owned enterprises (*Asia Times*, 26 September 2001).

In light of the fact that the standard evaluation of financial reform in China lacks a robust theoretical foundation, often uses a questionable methodology and appears at odds with basic observed facts, the objectives of this book are twofold. First, it aims to further the understanding of the nature and extent of financial reform in China. Second, it will examine the impact of financial reform on economic development in China during the reform period. This will enable a more accurate assessment of the Chinese approach to financial reform to be made, and therefore allow more informed policy choices to be made in the future for both China and other developing and transitional economies.

To tackle these issues, the book is divided into eight chapters. Following this introductory chapter, Chapter 2 examines the nature and extent of domestic financial liberalization (DFL) in China. It begins with a review of the reforms that have taken place in the three areas where the government has historically intervened in the financial sector, namely, interest rate controls, credit allocation controls and financial intermediation controls. Following this, a financial repression index is constructed to shed light on the overall trend in DFL and to determine whether in fact meaningful reform has taken place. The second part of Chapter 2 investigates the relationship between DFL and financial depth in China, which is currently an area of confusion in the existing literature.

Chapters 3 and 4 are devoted to investigating the efficiency of SOEs and SOBs. Chapter 3 considers this issue from the perspective of the SOEs. It first presents a theoretical framework that illustrates why financial performance measures such as profitability are deficient as measures of economic efficiency. An empirical exercise is then conducted which directly estimates the change in SOE total factor productivity over the period 1978–97. The chapter then concludes by discussing the various factors, apart from declining internal efficiency, which have contributed to low levels of SOE profitability.

Chapter 4 considers the issue from the perspective of the SOBs. It begins with a discussion concerning the behavior and objectives of the SOBs. This is necessary to determine the appropriate criteria by which to evaluate their performance. Following this, the impact of SOB lending on economic development is directly considered using econometric techniques. Various conceptual reasons why SOBs lending to SOEs should not automatically be taken as evidence of allocative inefficiency are then presented.

While the existing literature has devoted considerable attention to the study of SOEs, and to a lesser extent the SOBs, Chapter 5 examines China's non-bank financial institutions (NBFIs). It begins by chronicling their development during the reform period. Following this, the ownership, control and industrial structure of NBFIs is discussed. The impact NBFIs can have on economic development is then briefly reviewed from a theoretical perspective before the situation in China is evaluated using available data.

While the preceding chapters mainly focus on credit markets, Chapter 6 discusses China's rapidly developing stock markets. Although several studies have been completed on China's stock markets from a financial economics perspective, there have been few, if any, systematic attempts to gauge their impact on economic development. Chapter 6 begins with a review of the nature and extent of stock market development in China. The theoretical and empirical literature examining the relationship between stock markets and economic development is then briefly reviewed before the situation in China is evaluated using available data.

Chapters 2–6 primarily focus on issues pertaining to domestic financial sector reform in China. Chapter 7 switches the focus to the external financial liberalization (EFL) that has taken place during the reform period. This is a much under-studied aspect of China's reform program. The discussion begins by reviewing the nature and extent of EFL that has taken place. An interesting outcome of this discussion is that it is shown that China has not been a large net capital importer, despite economic theory suggesting that it should have been on the basis of its low capital–labor ratio. An empirical analysis is then conducted to establish whether this finding can be at least partly explained by the slow pace of EFL. The chapter then discusses from a theoretical perspective whether China can look upon EFL as a means to promote greater levels of economic development in its current state.

Chapter 8 first provides a summary of the key findings of the study. It then highlights the policy implications of the analysis for other developing, transitional economies, and for China's future financial reforms.