


# Financial Liberalization in China

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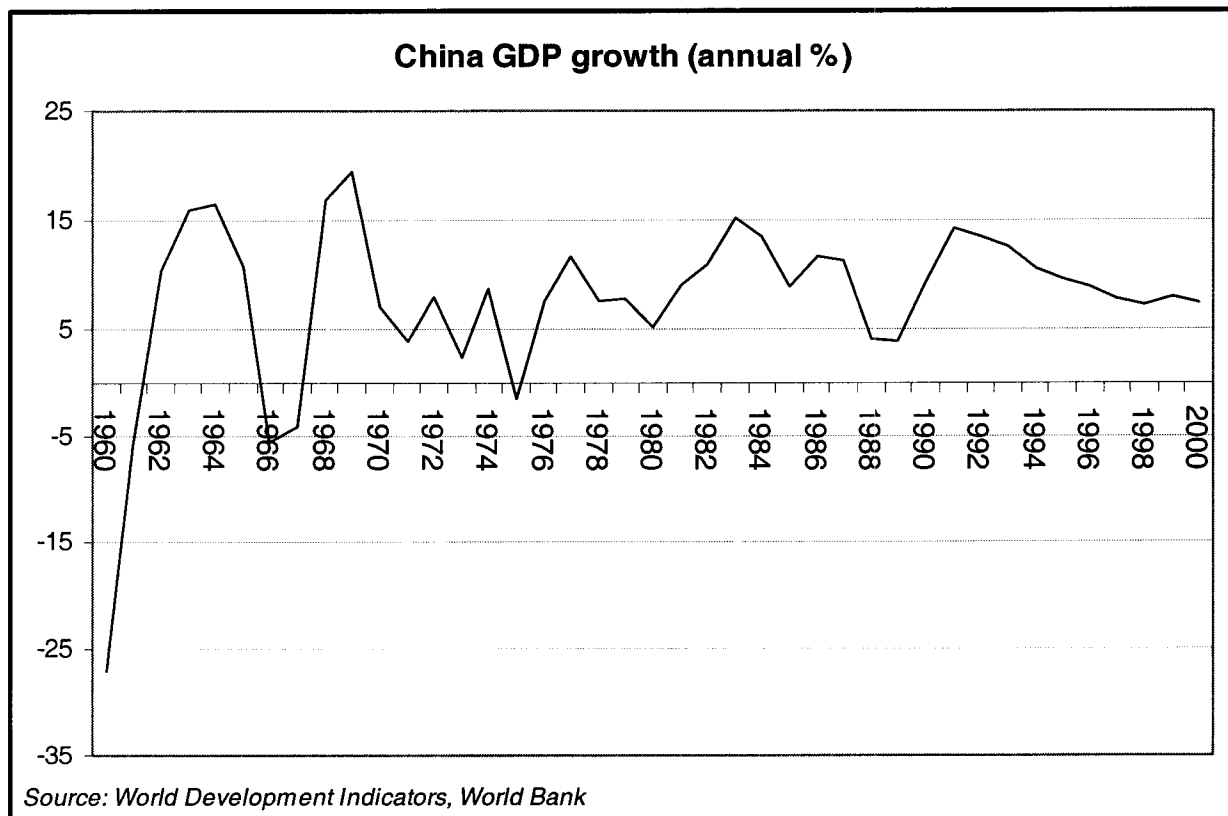
## Introduction

This paper argues that China should continue its pursuit of a gradual process of financial liberalization through the use of capital controls. Due to the underdevelopment of its macroeconomic policy, financial structure and institutions, and legal system, China's economy would be seriously vulnerable to financial crisis if it were to remove controls on capital movements. A financial crisis could undermine the progress China has achieved toward market-oriented systems and possibly impair its long-term economic growth.

In order to develop an understanding of the role of capital controls in economic growth, I examine China's financial system in the context of the experiences of other developing countries who have attempted to liberalize their capital accounts under similar economic distortions. In particular, I consider the experiences of the post-communist countries of Central and Eastern Europe who began economic reforms under similar economic regimes. In addition to theory on capital controls, I consider empirical work as well in order to form economic growth implications for China.

China has experienced unprecedented growth during the last 20 years, with annual GDP growth between six and twelve percent. This extraordinary economic growth is the result of reforms started in 1978. These economic reforms, which began in the agricultural sector, were intended to strengthen China's overall economic growth and focused on increasing productivity, modernizing the financial system, and improving monetary policy. China's international trade activities have increased to about 36 percent of GDP from about ten percent in 1978, evidence of the success China is having in certain sectors of their economy. Unfortunately, China's attempts to modernize its financial system have progressed with less enthusiasm. The financial sector has

not been successful in overcoming traditional roles or political ties. In China's centrally-planned economy, the financial sector consisted primarily of the state-owned banking system, which was established to serve the state-owned enterprises (SOEs). While China has restructured the banking system, it continues to be more than 90 percent state-controlled and therefore many lending decisions are still vulnerable to political influence.<sup>1</sup> As a result, the banking system continues to pour virtually unlimited support into SOEs, the majority of which are unprofitable. Under these circumstances, China's banking system has become overrun with bad debt. China's reluctance to open their capital account to international markets is largely due to the inherent weaknesses of their financial system.



<sup>1</sup> See Sharma (2002, p. 42)

Controls on Capital Transactions	Chile	China	Poland	Russia	Ukraine	United Kingdom	United States
Capital market securities		•	•	•	•		•
Money market instruments		•	•	•	•		•
Collective investment securities		•		•	•		•
Derivatives and other instruments	•	•		•	•		
Commercial credits		•	•	•	•		
Financial credits	•	•	•	•	•		
Guarantees, sureties, and financial backup facilities	•	•	•		•		
Direct investment		•	•	•	•	•	•
Liquidation of direct investment	•	•					
Real estate transactions		•	•	•	•		
Personal capital transactions		•	•	•	•		

*Source: 2003 IMF Annual report of exchange arrangements and exchange restrictions*

In order to protect their capital account, China has imposed some of the strictest capital controls in effect today. Critics of China's capital controls argue that capital controls are hurting China's long term economic and financial growth. According to economic theory, competition is a crucial factor in developing productive, efficient and mature markets. Critics argue that because of capital controls, China is losing out on this. To contrast, it is often cited that capital controls saved China's growth during the Asian Financial Crisis.<sup>2</sup> It could also be argued that capital controls continue to save China's growth. If China's economic growth is being slowed, it is most likely due to their overall lack of true financial system development rather than their use of capital controls. Due to the structural weaknesses of their economy, opening up their capital account could actually hurt their short and long term economic growth. Until China undergoes increased financial deepening, it may well be harmful to expose their capital account to the volatile international financial markets.

An examination of other country's experiences may indicate policy implications for China's progression. The Latin American crisis in the 1980s and the Asian financial crisis in the

<sup>2</sup> Examples of this can be found in Fernald and Babson (1999), Ahearne, Fernald and Loungani (2001) and Sharma (2002).

1990s both demonstrate the experiences of countries that attempted to liberalize their capital accounts before their economies were ready to withstand the influx of inflows and sudden flight of outflows that characterize international financial markets. Additionally, the experiences of Central and Eastern European countries attempting to transition from a communist, centrally planned economy to a market driven economy offer potential lessons for China.

### **Financial Liberalization Before Due Time**

During the past two and a half decades, the world has seen a concentrated shift among many countries to pursue more market-driven economic systems. These market-seeking countries have not arisen from only one part of the world, but from nearly all parts. As expected, the road to a free market system has not been without its challenges. One of the greatest tasks faced by each of these countries is the development of their financial sector. In almost every case the lack of financial depth has resulted in slowed economic growth. In extreme cases it has resulted in financial crises which setback economic growth. Despite its importance, there is no formal definition of or formula for financial deepening. Further, it is agreed that each country must find its own path to financial market maturity.<sup>3</sup> However, there are a few characteristics imperative to achieving financial depth. First, the development of a strong banking sector that is able to channel inflows to efficient and creditable investments is needed. Second, a country requires a restructured and efficient corporate sector that can use inflows effectively. Third, a strong regulatory and legal system must restrict monopolistic practices, ensure prudential banking practices and regulate bankruptcy of debt-burdened corporations. Fourth, a sound

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<sup>3</sup> Feltenstein and Nsouli (1998, p. 3)

macroeconomic environment that avoids large fiscal deficits is needed. Fifth, implicit government guarantees that encourage excessive inflows of short term capital must be avoided.<sup>4</sup>

Countries use capital controls to restrict capital mobility of all types of financial assets. Controls can take the form of a complete restriction on inflows or outflows, a tax on transactions, or a reserve requirement. Controls are used to restrict both domestic and foreign activity.

Capital controls affect the capital account of the balance of payments. The current account of the balance of payments, which includes trade transactions, is usually liberalized during the initial stages of reform. The theory of free trade suggests that countries with fewer restrictions to trade will tend to perform better than countries with regulations and distortions that impede the function and timing of markets has at times carried over to capital account liberalization.<sup>5</sup> However, Jagdish Bagwati, a prominent trade economists and free trade advocate, acknowledges the high risks of opening capital accounts in developing countries. He points out that evidence in favor of capital account liberalization is unclear and that the benefits that might come from free movement of capital can be negated by financial crisis.<sup>6</sup> Financial crisis in these circumstances typically takes the form of a currency or debt crisis. Newly liberalized countries that experience large inflows from foreign sources can face debt crisis if they are unable to service foreign debt when a large number of foreign investors remove investments from the country simultaneously. This is particularly acute if a country has overextended borrowing for risky projects. A currency crisis accompanies if the country cannot maintain their pegged currency rate. The currency is pressured to depreciate, making it even more difficult to service foreign debt. I will now discuss the experience of several countries to illustrate the usefulness of capital controls.

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<sup>4</sup> See [http://www-1.gsb.columbia.edu/ipd/j\\_capitalcontrols\\_bk.html](http://www-1.gsb.columbia.edu/ipd/j_capitalcontrols_bk.html)

<sup>5</sup> See Edwards (2002)

<sup>6</sup> See Schiffrin at [http://www-1.gsb.columbia.edu/ipd/j\\_capitalcontrols\\_bk.html](http://www-1.gsb.columbia.edu/ipd/j_capitalcontrols_bk.html)

## Swift Approach to Financial Liberalization and Crises

### *Chile*

Chile began reforms and economic liberalization in 1974. Trade barriers were dismantled immediately.<sup>7</sup> On the financial side, banking privatization and reform were high priorities. Domestically, the interest rate ceiling was lifted, the reserve requirement was lowered, and permission to establish non-bank financial institutions was granted. In 1979, the central bank pegged the dollar exchange rate.<sup>8</sup> Additionally, the public sector was prohibited from investing in the banking sector.<sup>9</sup> Chile also began lifting restrictions on foreign capital flows. By 1979, three restrictions remained: foreign debt was subject to a capital-asset ratio of five percent, a bank's capital inflows was not allowed to exceed five percent of the bank's capital in any month, and inflows of short-term capital were restricted.<sup>10</sup> However, these restrictions were eased during the subsequent years.

Leading up to 1982, capital inflows reached approximately 25 percent of GDP, the domestic interest rate soared and the Chilean peso was expected to devalue. However, when the peso instead appreciated Chile lost competitiveness in the trade sector. The trade balance turned negative and the balance of payments turned to deficit.<sup>11</sup> Due to Chile's poor performance, capital inflows came to a halt in 1982 and authorities could not maintain the pegged exchange rate.<sup>12</sup> This marked the beginning of Chile's two-year financial crisis.

Chile's financial crisis is sometimes referred to as its "banking crisis." Banking system weakness is often cited as the major cause of Chile's financial crisis. The flaws in the banking

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<sup>7</sup> See Hermes and Lensink (1996, p. 288)

<sup>8</sup> See Ibid. (p. 280)

<sup>9</sup> See Ibid. (p. 290)

<sup>10</sup> See Ibid.

<sup>11</sup> See Ibid. (p. 289)

<sup>12</sup> See Ibid.

system were due to poor supervision and regulations. When privatizing certain conglomerates purchased not only state-owned enterprises but commercial banks as well. The state tried to regulate ownership of banks, but the rules were circumvented.<sup>13</sup> It was not long before the banks were overrun with bad debt. By the time the government implemented a bailout program, the bad loans sold to the Central Bank were equivalent to eighteen percent of GDP—over three times the Bank's capital. The State was forced to take over or close 20 banks and finance houses, which was almost the whole of the Chilean private financial system.<sup>14</sup> The Central Bank estimated overall financial losses to be about 40 percent of GDP.

According to Edwards (2000), Chile utilized identical capital controls during the crisis of 1981-82 and again after 1991. Capital controls did not help to deter crisis in 1981-82, but Chile was able to avoid crisis in the 1990s. Edwards notes that the main difference in Chile in the 1980s and in the 1990s was not capital controls, but banking sector regulations. Chile implemented a major banking reform in 1986 that improved regulations and supervision.

### *Commonwealth of Independent States*

Like Chile, many Commonwealth of Independent States (CIS) such as Russia and the Ukraine liberalized their financial market very early in the transition process. Liberalization was completed with relatively few restrictions on capital flows. For example, Russia allowed the unregulated entry of banks and the development of domestic debt markets.<sup>15</sup> While rather complex financial markets developed due to the involvement of banks, foreign investment banks, and a few large firms, most of the economy continued to work on the widespread use of barter

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<sup>13</sup> See Ibid. (p. 292)

<sup>14</sup> See The World Bank (2000, p. 187)

<sup>15</sup> See Caprio, Honohan and Stiglitz (2001, p. 210)



transactions. As a result, well-functioning private markets failed to emerge.<sup>16</sup> Additionally, the lack of attention to major macroeconomic flaws increased the vulnerability of CIS countries to financial crisis. In August 1998, financial crisis began in Russia after the government failed to service its debt.

CIS countries developed differently than many Central and Eastern European (CEE) countries. One of the differences is the CIS countries' continuation of nonmonetary exchanges. For instance, barter accounted for more than 50 percent of industrial sales in Russia and the Ukraine.<sup>17</sup> Another difference is the timing of financial liberalization. CEE countries, such as Poland and Hungary that have had relative success in financial sector development, opened their capital accounts much slower than CIS countries.

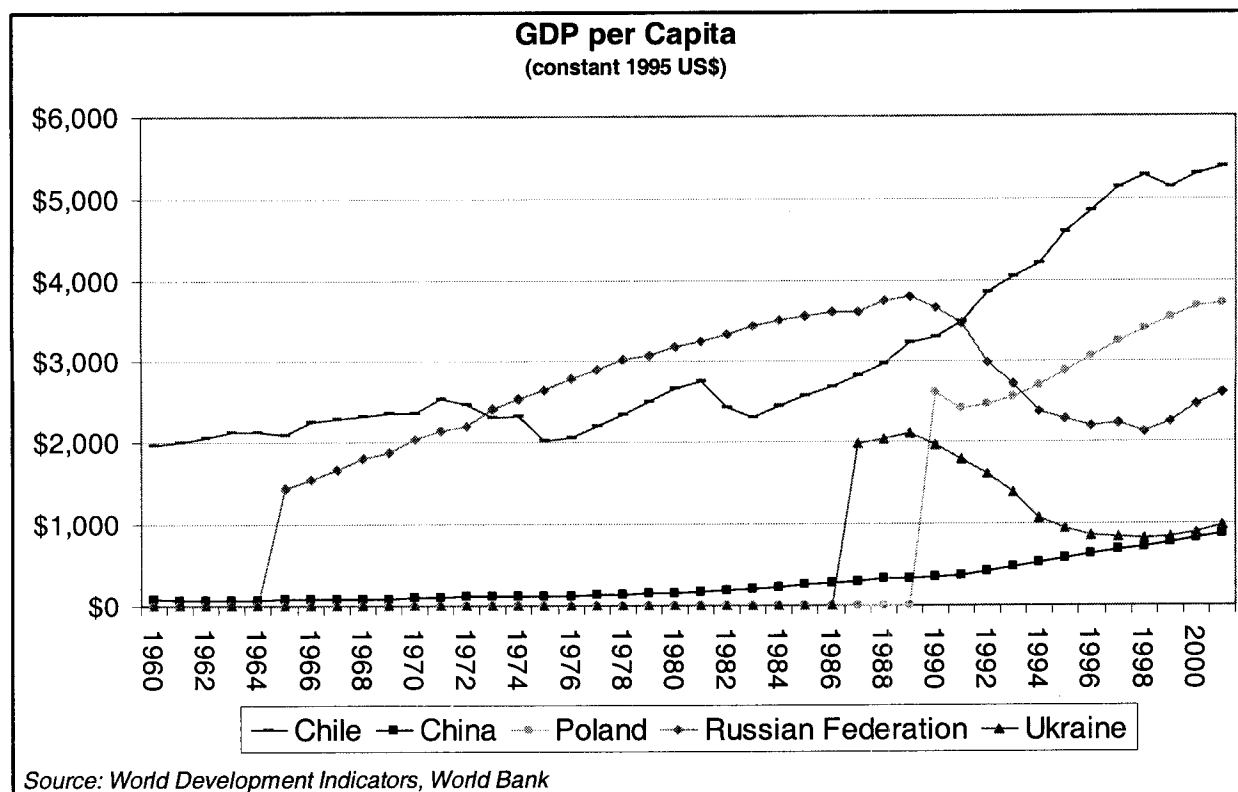
Developing and transitional crisis countries have had certain conditions in common prior to crisis. The first major factor was loosely regulated and unsupervised banks. These banks tended to over borrow and make poor lending decisions. The banking problems were accompanied by relatively liberal policies toward foreign currency deposits, which increased foreign exchange risk. The entry of foreign investors into domestic debt markets increased financial instability. These countries were also typically characterized as having overall macroeconomic instability and legal system weakness.<sup>18</sup> However, the most important factor that increased their vulnerability to crisis was the liberalization of financial markets before fiscal and macroeconomic stability was achieved. This more than any other aspect is what differentiates countries that experienced financial crisis from countries that were able to avoid financial crisis.

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<sup>16</sup> See Ibid.

<sup>17</sup> See Ibid. (p. 216)

<sup>18</sup> See Ibid. (p. 230)



### The Gradual Approach to Financial Liberalization

The Asian crisis of the late 1990s defined a consensus among economists that countries should liberalize the capital account slowly depending on the development of key economic factors. Prior to the crisis the International Monetary Fund (IMF) encouraged countries to liberalize quickly so that they would be able to reap the benefits of an open financial market. Directly after the Asian crisis, the IMF backed off slightly and began emphasizing the need to liberalize only after a certain level of reforms had been completed.<sup>19</sup> Along the same lines, De Grauwe (2000) notes that while he is otherwise critical of capital controls, if countries are unable or unwilling to remove “distortions in their domestic markets, it is probably better to keep some control on capital movements.”<sup>20</sup>

<sup>19</sup> See Financial Times (1997) and (1998)

<sup>20</sup> See De Grauwe (2000, p. 400)

An important difference between countries who have experienced financial crisis and those who have avoided it has been the timing of reforms. Certain CEE countries—Poland, Hungary and the Czech Republic—opted for a more gradual approach to liberalization. They faced many of the same problems as Chile or Russia including large amounts of bad debt and macroeconomic distortions. However, they chose to keep their capital accounts relatively closed to foreigners while tackling these problems. I now discuss how this aided their transition.

### *Poland*

Poland began reforms in 1998 with the restructuring of the National Bank of Poland (NBP). Up until 1998, the NBP acted as a traditional communist monobank. With the banking reform the NBP was limited to the primary functions of the central bank of the state, a note-issuing bank, and a banker to the banking system.<sup>21</sup> Additionally, nine commercial banks were established to take over the former regional branches of the NBP, and 49 licenses were granted to the private sector for the establishment of commercial banks. In 1989-90, the government established regulatory instruments, including requiring commercial banks to deposit reserves at the NBP.

In 1990, Poland began implementing an economic program recommended by the IMF. The objectives of the program included decreasing inflation, restoring macroeconomic balance, strengthening the role of the national currency, allowing the Polish zloty to be convertible for foreign trade, and initiating the process of privatization and economic restructuring.<sup>22</sup> Also in 1990, Polish authorities established a positive real interest rate (which protected deposits and savings against inflation), they abandoned preferential interest rates, they devalued the exchange

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<sup>21</sup> See Gowland (1992, p. 92)

<sup>22</sup> See Ibid. (pp. 93-4)

rate, and they prohibited the NBP from lending to the government.<sup>23</sup> By 1991, Poland began developing their capital market by opening the stock exchange and establishing the Securities and Exchange Commission.<sup>24</sup>

Private inflows increased substantially after 1994, particularly in the form of foreign direct investment (FDI), when Poland reached a debt service reduction agreement. Poland soon became the largest recipient of FDI in the region on a cumulative basis over 1992-96.<sup>25</sup> Inflows of FDI were driven by structural reforms, zloty convertibility since 1991, moderate fiscal deficits, overall good macroeconomic performance, and favorable prospects for European Union (EU) membership.<sup>26</sup> As of 2004, Poland was granted membership to the EU.

In 1994-95 as well as in 1996-97, Poland faced concerns due to the influx of foreign capital inflows. In both instances, the government responded with a more flexible exchange rate regime and sterilized interventions.<sup>27</sup> Thus due to Poland's successful reforms, they were able to control both situations with monetary and fiscal policy.

### **Investment and Economic Growth**

This section summarizes empirical work regarding the effects of open capital accounts on economic growth. This discussion is important to China's policies and progression because it is critical to establish a positive effect of investment on economic growth if one is to recommend that China continue on a path toward financial liberalization. If there is no evidence of a positive effect, China should perhaps rethink its pursuit of open market operations.

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<sup>23</sup> See *Ibid.* (p. 94)

<sup>24</sup> See The World Bank (2000, p. 244)

<sup>25</sup> See Claessens, Oks and Polastri in Edwards (2000, p. 322)

<sup>26</sup> *Ibid.*

<sup>27</sup> *Ibid.* (pp. 322-3)

Most empirical studies on this topic have found a positive correlation between an open capital account and economic growth. However, one influential exception should be noted. Rodrik (1998)<sup>28</sup> found no correlation between capital account liberalization and growth. Using a sample of 100 developed and developing countries during the period 1975 to 1989, Rodrik regressed the growth of GDP per capita on the share of years when the capital account was free of restrictions. Because Rodrik found no correlation between capital account liberalization and growth, he questioned whether capital flows enhance economic efficiency. Some later studies, including Edwards (2001) criticized Rodrik's results due to limitations of his capital account openness indicator. Rodrik used the IMF Annual Report on Exchange Arrangements and Exchange Restrictions data which indicate whether a country utilizes capital controls, but the indicators do not measure the extent of the controls.

A study completed by Gruben and McLeod (1998) found a positive correlation between capital inflows and GDP. The study included eighteen developing countries from Latin America, Europe, Africa and Asia and tested both FDI and portfolio equity capital inflows separately during the period 1971 to 1994. Their findings suggest a positive effect of both FDI and portfolio investment on GDP growth, although FDI showed a stronger positive impact.<sup>29</sup>

Edwards (2001) found a positive correlation between open capital accounts and economic growth, however this correlation is only apparent in countries that have reached a certain level of development. His results indicate that capital flows behave differently across categories, regions, and periods. Capital flows appear to be more volatile in the emerging economies.<sup>30</sup> According to

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<sup>28</sup> This section draws on Asiedu and Lien (2004)

<sup>29</sup> Countries typically prefer FDI due to its long-term nature. Companies who have invested in a country through FDI will typically not quickly remove operations from the country because of the sunk costs involved. Portfolio investment, on the other hand, can be quickly invested and quickly removed. Because of this, portfolio investment can have volatile effects on a country's capital account balance. In most cases, FDI will have a higher positive effect on growth because it not only generates capital and income, but can have other positive spillover effects.

<sup>30</sup> See Edwards (2001, p. 3)

Edwards, his results support the view that open capital markets are favorable for financially developed countries, but at very low levels of financial development an open capital account may have a negative effect on performance.<sup>31</sup>

In a study that compares the results of a number of empirical results, including Rodrik (1998) and Edwards (2001), Arteta, Eichengreen, and Wyplosz (2001) found additional evidence of correlation between capital account liberalization and growth. The results of their study support the interpretation that a country needs to eliminate major macroeconomic imbalances before opening the capital account. The evidence that economic growth, in the event of capital account liberalization, is contingent on the absence of macroeconomic imbalances suggests that in the presence of such imbalances, capital account liberalization is as likely to hurt as to help. The authors also tested whether the sequencing of the current and capital account liberalization had a significant effect on how liberalization effected growth. They found that while current account liberalization had a positive impact on growth, capital account liberalization is not contingent upon current account liberalization in order to also achieve a positive impact. They found cross-country evidence that the sequencing of reforms shapes the effects of capital account liberalization, but the results may be period specific as the evidence that sequencing matters was more robust in the 1980s than in the 1970s or 1990s.<sup>32</sup>

Klein and Olivei (1999) found correlation between open capital accounts and financial depth and economic growth. Klein and Olivei show a positive effect of capital account liberalization indirectly by first suggesting a positive link between capital account liberalization and financial depth. They then proceed to indicate a positive effect of financial development on economic growth. According to the study, countries with open capital accounts had a

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<sup>31</sup> See Arteta, Eichengreen and Wyplosz (2001, p. 16)

<sup>32</sup> See Ibid. (p. 27)

significantly greater increase in financial depth and experienced greater economic growth than countries with capital account restrictions. However, the results of the study are largely driven by the developed countries in the sample.<sup>33</sup> The results suggest that there is a failure of capital account liberalization to promote financial depth among developing countries. One interpretation of Klein and Olivei's findings is countries that liberalize their capital account require the establishment of stable economic, legal, and social institutions in order to gain the benefit of increased financial depth.<sup>34</sup> Notably, the industrial countries that influenced the positive effect of the study have strong and stable institutions. For these reasons capital account liberalization may not provide the same benefits to all. Klein and Olivei's study suggests that policy reforms in developing countries should require capital account liberalization to come at a later stage, when adequate institutions and sound macroeconomic policies are in place.<sup>35</sup> An important study by King and Levine (1993) showed strong positive correlation between financial sector development and economic growth. King and Levine used data on over 80 countries during the period 1960 to 1989. They found that indicators of the level of financial development are positively correlated with growth, the rate of physical capital accumulation, and improvements in the efficiency of capital allocation.<sup>36</sup>

While all these studies found positive effects of an open capital account on growth, they also emphasized stipulations of the positive effect. According to Edwards (2001) a certain level of economic development must be reached. According to Arteta, Eichengreen, and Wyplosz (2001), the elimination of macroeconomic imbalances must precede an open capital account.

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<sup>33</sup> See Klein and Olivei (1999)

<sup>34</sup> See Ibid. (p. 2)

<sup>35</sup> See Ibid. (p. 22)

<sup>36</sup> See King and Levine (1993, pp. 734-5)

According to Klein and Olivei (2001), the financial depth of a country will influence how positively or negatively the opening the capital account will effect economic growth.

Essentially, a country can expect capital account liberalization to positively effect economic growth once they have established effective and sound macroeconomic policies and a mature level of financial depth.

## **Capital Controls and Investment**

### *Background of Capital Controls*

It is widely accepted that the welfare benefits of an open financial market can follow those of free trade. However, as many countries have learned the hard way, the opening of an emerging economy's financial markets requires far more caution than that of free trade in order to gain the economic benefits. Extensive research on capital controls has been the result of the financial crises over the last two decades. In the midst of crisis, some countries employed capital controls in order regain control of their fragile economies.

Most capital control policies are aimed at curbing short-term speculative portfolio investment or bank deposits. In general, countries attempt to curb these short-term flows while encouraging long-term investment, such as FDI. Countries have typically used controls on capital inflows and/or controls on capital outflows. Controls on inflows usually take the form of a tax on the inflow or a reserve requirement. The goal of these instrument is to "slow down" the amount of capital flowing into the country and "tilt its composition" towards longer-term investments.<sup>37</sup> The controls on outflows either prohibit or liberalize capital outflows. The prohibition of capital leaving the country targets foreign short-term speculative investors and is usually temporary to give the country a chance to stabilize their money supply. Liberalization of

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<sup>37</sup> See Edwards (1999)



capital outflows targets domestic investors. Liberalizing outflows allows domestic investors to invest in foreign assets with the objective of reducing net inflows.<sup>38</sup>

Most economists agree that if capital controls are used, they should only be used as a temporary policy tool and dismantled as soon as possible. In addition, controls on capital inflows are considered to be more effective than controls on capital outflows. In some cases, controls on inflows have been shown to change the composition of inflows from shorter-term flows to longer-term flows.<sup>39</sup> The capital controls utilized by Chile after the Latin American financial crisis exhibit an example of “effective” controls on inflows. Chile used a reserve requirement that importers of capital had to deposit in the central bank. In theory, this approach reduces a country’s vulnerability to speculative attacks. Joseph Stiglitz, the World Bank’s chief economist, has been quoted by the New York Times (1 Feb 1998) as saying: “You want to look for policies that discourage hot money but facilitate the flow of long-term loans, and there is evidence that the Chilean approach or some version of it, does this.”<sup>40</sup> Moreover, there is evidence that inflow controls have allowed countries to take a more independent monetary policy.<sup>41</sup>

Some outflow controls have been considered effective in certain circumstances. An IMF staff report concluded that the prohibition of capital outflows used by Malaysia in the 1990s was effective in “eliminating the offshore ringgit market and choking off speculative activity against the ringgit despite the easing of monetary and fiscal policies.”<sup>42</sup> According to Edwards and Frankel (2002), Malaysian controls allowed the economy to recover faster: employment and real wages did not suffer as much as they could have, the stock market performed well, interest rates

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<sup>38</sup> See Reinhard and Dunaway (1996, p. 18)

<sup>39</sup> See Edwards (1999, p. 71)

<sup>40</sup> See Edwards (2000, p. 223)

<sup>41</sup> See Edwards (1999, p. 77)

<sup>42</sup> See Edwards and Frankel (2002, p. 394)

decreased, and inflation lowered.<sup>43</sup> In general, though, the prohibition of capital outflows is considered ineffective as they are easily circumvented, encourage corruption, and generally have not helped the economic adjustment process.<sup>44</sup> If outflow controls show any effectiveness it is only in the very short run. The second type of outflow control—the removal of controls on capital outflows—is generally agreed to be ineffective. For example, if the domestic market offers high returns, domestic investors do not have an incentive to invest in foreign markets. The control will have no effect in balancing on the capital account.<sup>45</sup> Lastly, it is widely known that both inflow and outflow capital controls are effectively evaded. If capital flight was high before the removal of outflow controls, the country may see little or no effect from the policy tool.<sup>46</sup>

Capital control evasion is a problem with any policy tool in the long run. The effectiveness of a given set of capital controls are expected to diminish over time.<sup>47</sup> “In country after country, the private sector has found ways of getting around controls. The simplest mechanisms are overinvoicing of imports, the underinvoicing of exports, and the mislabeling of the nature of the capital movement.”<sup>48</sup>

While there are few cases where capital controls show evidence of being effective temporarily, most economists agree, that in general, capital controls are harmful to economic development if not gradually phased out.

## China

### *History of Reforms*

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<sup>43</sup> See Ibid. (p. 397)

<sup>44</sup> See Edwards (1999, p. 82)

<sup>45</sup> See Reinhart and Dunaway (1996, p. 18)

<sup>46</sup> See Ibid.

<sup>47</sup> See De Grauwe (2000, p. 400)

<sup>48</sup> See Edwards (1999, p. 67)

China began economic reforms in 1978 with partial liberalization of the rural agricultural sector and reforms in the banking sector. The People's Bank of China (PBC) was established as the central bank and new specialized banks and nonbank financial institutions were established to take over functions formerly belonging to the PBC. For instance, the Agriculture Bank of China (ABC) was reestablished as a commercial bank in 1979 to serve the rural sector, which was responding positively to economic reforms. All financial institutions remained state-owned, but were allowed to compete with each other for domestic business.<sup>49</sup> Additionally, two stock exchanges were created in Shanghai and Shenzhen and in the late 1980s a small number of foreign banks were allowed to establish their subsidiaries in China.<sup>50</sup>

In 1984, China launched a next round of reforms in the industrial sector.<sup>51</sup> As part of these reforms the state leased out many SOEs to private enterprises. The "factory director's responsibility system" was established to reduce unwanted political interference by party secretaries, thereby expanding enterprise autonomy. Local governments were given considerable authority over budgetary revenues and expenditures. An experimental shareholding system was introduced to allow the state and enterprise workers to own assets through the purchase of shares. A contract labor system was introduced in an attempt to break the "iron rice bowl" (life-long secure jobs) in SOEs.

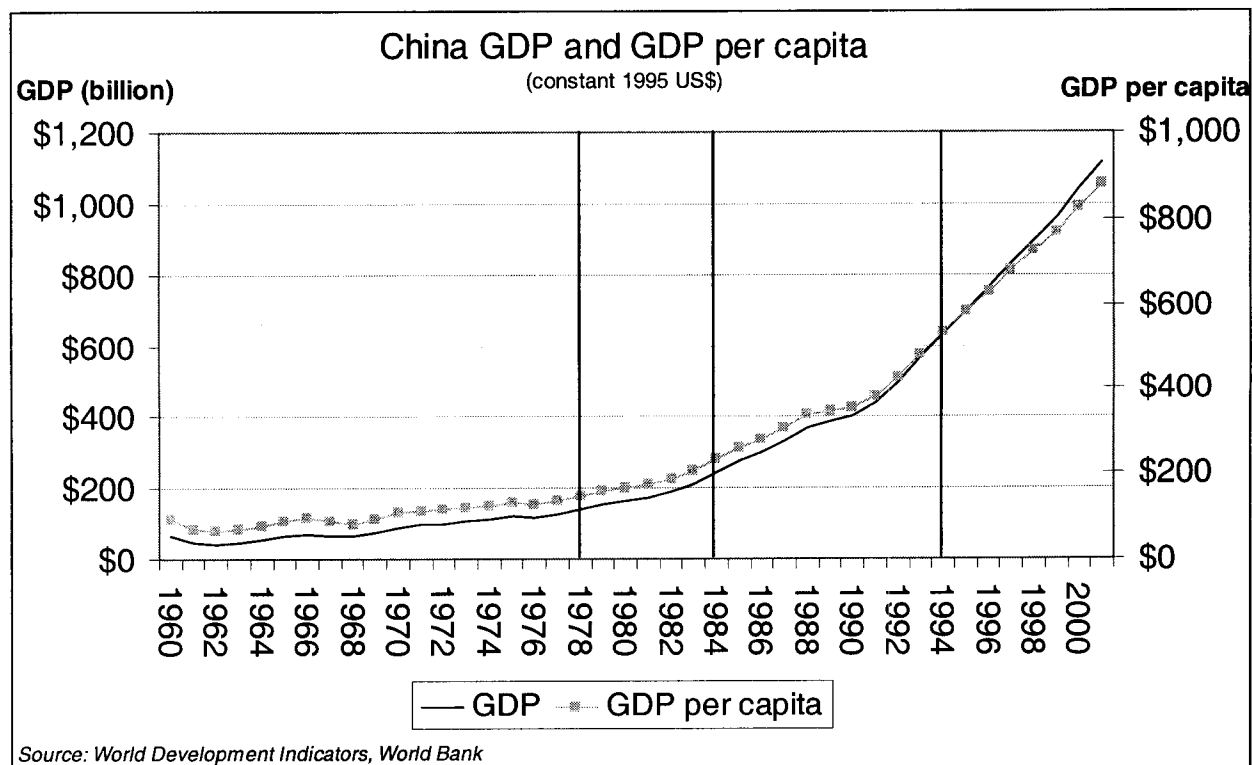
Additional banking reforms were implemented in 1994 aimed at defining the role of the PBC. The government issued the Commercial Bank Law of 1995 and the Central Bank Law to strengthen regulatory structure. According to the Central Bank Law the PBC is responsible for

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<sup>49</sup> See Ibid. (p. 18)

<sup>50</sup> See Zhang and Yao (2002, p. 63)

<sup>51</sup> This section draws from Zhang and Yao (2002, p. 63)



formulating and implementing monetary policy, as well as supervising the operations of commercial banks.<sup>52</sup>

### Financial System Concerns

A number of studies have questioned how China not only survived the Asian financial crisis, but continued to maintain relatively strong GDP growth throughout the crisis.<sup>53</sup> The topic is of interest because China's economy suffered from many of the same ailments as Thailand, Malaysia and South Korea did. In some cases, China's ailments were worse.<sup>54</sup> China's avoidance of crisis is attributed to two factors. First, China had strong external accounts. For example, China was running a current account surplus (about three percent in 1998-99) and its total debt to reserve ratio was lower than other Asian countries. Additionally, approximately 90 percent of

<sup>52</sup> See Lo (2001, pp. 21-2)

<sup>53</sup> See Fernald and Babson (1999), Sharma (2002), Ahearne, Fernald and Loungani (2001) and Depaulis in Agosin et al (1998)

<sup>54</sup> See Ahearne, Fernald and Loungani (2001, p. 38)

China's external debt was medium to long term.<sup>55</sup> Second, China's capital controls were kept intact while Malaysia, Thailand, and others eased or removed their controls. Two studies have analyzed how China's capital controls protected the economy from crisis. The first study, by Anne Depaulis (1998), concluded that China was insulated from speculative attacks from foreign investors because its currency was not convertible for capital account transactions.<sup>56</sup> The second study, by Fernald and Babson (1999), posits that because China did not permit domestic investment in foreign assets, which prevented Chinese institutions from borrowing excessively abroad.<sup>57</sup> The latter theory may come into question due to an estimated high level of capital flight from China. The errors and omissions line of China's balance of payments is unusually large. It was -4.1 billion in 2001, which was down from -11.7 billion in 2000 and -17.6 billion in 1999.<sup>58</sup>

The Asian financial crisis was born out of weak external and internal fundamentals in the Asian countries involved. Externally, Asian economies had large amounts of short-term external borrowing, frequently used to finance current account deficits. Internally, domestic banks made excessively risky loans to poorly governed firms.<sup>59</sup> When foreign investors began pulling their investments out of Asian economies, the region could not support its debt. Many countries could not maintain their pegged currencies and banks became insolvent.

China shares many of the weak internal fundamentals of the Asian countries who experienced crisis. In 1998, the *Economist* named China as having "the worst banking system in Asia".<sup>60</sup> Banking problems present China's most serious threat to macroeconomic stability.<sup>61</sup> As

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<sup>55</sup> See Sharma (2002, p. 51)

<sup>56</sup> See Sharma (2002, pp. 50-51) and Depaulis in Agosin et al (1998, p. 42)

<sup>57</sup> See Fernald and Babson (1999, p. 2)

<sup>58</sup> Data from World Development Indicators, World Bank

<sup>59</sup> See Ahearne, Fernald and Loungani (2001, pp. 39-40)

<sup>60</sup> See *Economist* (1998)

<sup>61</sup> See *Ibid.* (p. 48)

mentioned above, China's banking system is almost wholly state-owned. "Currently, state banks account for approximately nine-tenths of all financial intermediation between savers and investors, a ratio that exceeds that found in almost all other Asian countries. The banks near total monopoly and the lack of competition in the financial sector have stunted the development of capital markets resulting in systematic underpricing of loans by banks, not to mention inefficient financial intermediation, almost non-existent credit risk-assessment and diminishing rates of return for savers who have no real alternative to bank deposits."<sup>62</sup> The primary concern of China's banking system is its bad debt. The banking system is burdened with non-performing loans estimated at about 20 to 50 percent of total GDP.<sup>63</sup> The 20 percent estimate of bad debts tends to cover only nonperforming loans and loan losses, while the higher estimate usually includes overdue loans.<sup>64</sup> Based on the internationally recognized eight percent capital adequacy standard, all four of China's state-owned commercial banks are insolvent.<sup>65</sup> In August 1998, the government injected 27 billion renminbi (U.S. \$33 billion) into a bank recapitalization program to bring the banks up to the international adequacy standards.<sup>66</sup>

China's banking problems are not an independent phenomenon. On the contrary, the PBC's bad debt problem is directly related to the growth in SOE losses over the past two decades. The banking sector was originally established to serve the state-owned sector of the economy. Accordingly, in 1978, 91.1 percent of all loans disbursed by banks went SOEs. By 1998, SOEs still received as much as 82.8 percent. Therefore, banks' performance largely depends on the performance of SOEs. Unfortunately, at least one third of SOEs are losing

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<sup>62</sup> See Sharma (2002, 42)

<sup>63</sup> See Ibid.

<sup>64</sup> See Holz and Zhu (2000, p. 75)

<sup>65</sup> See Ibid.

<sup>66</sup> See Sharma (2002, pp. 47-8)

money, and one third barely break even.<sup>67</sup> Accordingly, a majority of SOEs have zero or negative net worth.<sup>68</sup>

It seems that the bad debt problem and SOEs' inefficiency are interdependent. If the banks had autonomy and incentives to make sound lending decisions, they would not have made risky lending decisions to unprofitable SOEs. And if SOEs did not have such easy access to loans, they would either have to become more efficient or go bankrupt.<sup>69</sup>

Establishing a modern financial system has been particularly difficult because it has not been accompanied by economic decentralization. Specifically, provincial and local governments were given broad discretionary authority regarding economic investment and allocation without simultaneously enhancing the banking sectors regulatory and supervisory capabilities.<sup>70</sup> As a result, "local government departments frequently try to influence bank lending decisions to favor the SOEs under their jurisdiction. They exert pressure on banks to lend for capital investment purposes, so as to increase production and accelerate economic growth."<sup>71</sup>

Despite positive growth trends, there is wide consensus that the problems in China's banking system and within SOEs are not sustainable. The international position of China still hinges on the future of the banking system and on the prospects of further financial market liberalization. The central dilemma facing the Chinese leadership is how to phase out loss-making SOEs without precipitating massive unemployment. Ultimately the SOEs must be restructured either through hard-budget constraints, downsizing, or outright closure.<sup>72</sup>

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<sup>67</sup> See Holz and Zhu (2000, p.77)

<sup>68</sup> See Ibid.

<sup>69</sup> See Ibid. (p. 78)

<sup>70</sup> See Sharma (2002, pp. 42-3)

<sup>71</sup> See Ibid. (p. 79)

<sup>72</sup> See Sharma (2002, p. 53)

China has made some progress in reforming the state enterprise sector. Many small firms have been privatized or shut down, while larger firms have shed some surplus labor. However, reform has been hindered by concerns about possible social unrest. The development of a functioning social welfare system to provide laid-off workers with unemployment benefits, pensions, and health insurance is still in its early stages.<sup>73</sup>

### *International Pressure*

China is receiving increased pressure from the international community to ease their capital controls and to revalue their currency. Currently, China's yuan is pegged to the U.S. dollar. The U.S., for instance, recently complained that the yuan is undervalued and is costing U.S. jobs.<sup>74</sup> According to the *Economist's* Big Mac index, China has the most undervalued currency in the world.<sup>75</sup> China's currency rate is criticized because China has a large foreign currency reserve, and its balance of payments is in surplus.<sup>76</sup> These are both typical indicators of a currency that should be appreciating.

Given the complexities and interdependence of the problems China currently faces, the short-run costs of further rapid reforms may be unacceptably high to the Chinese leadership. If China were to enforce strict banking rules such as insisting on commercial lending decisions or imposing hard budget constraints, banks would stop lending to SOEs. Many SOEs would in turn go bankrupt causing huge ripple effects through China's economy. Government budgets would

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<sup>73</sup> See Ahearne, Fernald and Loungani (2001, pp. 47-48)

<sup>74</sup> See Taipei Times (2003)

<sup>75</sup> See Economist (2003)

<sup>76</sup> See Ibid.



be so overwhelmed by the increase in social security tasks, government officials may contemplate a general retreat from reform activities.<sup>77</sup>

## Conclusion

Most economists agree that the gradual approach to financial liberalization is recommended for developing countries. Capital account liberalization should occur after a certain level financial depth is achieved. Namely, a strongly regulated and supervised banking sector, an effective legal system, firm and tested macroeconomic policy, and a competitive corporate sector must be in place before capital account liberalization. In the absence of financial depth, it is necessary to use capital controls to protect the domestic economy from international financial markets. Controls on inflows may be a preferred policy tool as they tend to be more effective. If the capital account is opened before financial depth is achieved, a country is greatly vulnerable to financial crisis, as can be seen by experiences of many developing countries over the last thirty years. It is also recognized that there is no formulated path to achieving financial depth. It is a path each country must pioneer itself according to the condition of their economy.

Since 1978, China has been on the road to reform. The government is strongly committed to gradually opening their economy to international markets. Although they have been opening their economy to trade, the sector is still strongly protected. Moreover, China has yet to fully open their capital account. The government is allowing certain forms of FDI, but virtually all other capital account transactions are prohibited. Despite reform, serious concerns remain. The financial and banking sectors remain highly underdeveloped. The state sector continues to hinder the economy due to inefficiency and insolvency. Clearly, China faces a difficult dilemma. With the unprofitable state sector dragging down reform in the banking sector,

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<sup>77</sup> See Holz and Zhu (2003, p. 101)

any attempt to change bank lending policies may cause the bankruptcy of a large number of SOEs.<sup>78</sup> This could lead to an influx of unemployment and the government budget would not be able to hold up under the increased pressure on social security.<sup>79</sup>

Although China's capital account protectionism is criticized by some developed countries, their gradual approach is likely necessary at this stage in their development. Underdevelopment of the banking and state sectors, an ineffective legal system and widespread corruption are serious concerns that must be dealt with before China could become a strong player in international financial markets. Although it may benefit China to be more aggressive in pursuing reforms, any premature move toward capital account liberalization could leave China wide open to financial crisis. A financial crisis in China would not only harm China's long run economic growth, but have serious implications for numerous world economies.

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<sup>78</sup> See Zhang and Yao (2002, p. 64)

<sup>79</sup> See Holz and Zhu (2002)

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