3. Financial Repression and China's Economic Imbalances

Anders C. Johansson

Introduction

China's impressive growth over the past three decades has come under scrutiny from both domestic and international economists. Most observers as well as the Chinese leaders themselves now agree that the economy needs to rebalance in order to sustain high levels of growth in the long run.¹ Economic imbalances such as high levels of investment and saving and low levels of consumption, external imbalances, high and increasing levels of inequality, and increasing environmental problems need to be addressed. This chapter argues that these imbalances and challenges, while pressing, are primarily symptoms rather than root causes. I propose that repressive financial policies constitute a central problem in the Chinese economic system and that comprehensive financial reforms should play an important part in any serious attempt to address current economic imbalances.

It is a well-known fact that the Chinese Government has applied severe policies of financial repression as part of its development strategy since the beginning of the reforms in the late 1970s (for example, Lardy 2008; Lu and Yao 2009). Financial repression is, however, relatively seldom tied to the increasing imbalances and challenges to continued economic development that the country is facing. One plausible reason for this is that research on financial repression has mainly focused on the direct relationship between repressive financial policies and economic development. A common finding in this research literature is that financial repression has a significant and negative effect on economic growth. To some extent, this relationship does not go hand-in-hand with the very repressive financial policies seen in China together with the strong and sustained level of China's economic development. Recent research, however, sheds new light on the relationship between financial repression and economic growth, suggesting that the relationship is nonlinear. Furthermore, and more importantly, new research on financial repression and economic imbalances highlights the fact that repressive financial policies often lead to both domestic

¹ During a speech at the 2011 Boao Forum, President, Hu Jintao, stated that 'population, resources and the environment have put great pressure on our economic and social development, and there is [a] lack of adequate balance, coordination or sustainability in our development' (Hu 2011). Examples of scholars and policymakers stating the need for restructuring include Huang and Wang (2010), Lardy (2012), World Bank (2012) and Yao (2011).

and external economic imbalances. Governments can use financial repression to allocate limited financial resources, skew relative prices and provide capital to preferred sectors. This is perhaps especially common in developing countries, where governments often want to attract foreign investment, increase the competitiveness of the traded sector and develop domestic industrial capability (Johansson and Wang 2011).

The connection between financial repression and economic imbalances in China and its importance for sustained economic development is seldom highlighted in the literature on China's imbalances.² The aim of this chapter is twofold. First, I want to shed light on the forms of repressive financial policies that have been used in China over the past three decades and provide an initial discussion on how reforms can be undertaken in order to address imbalances that are threatening the economy. Second, I highlight some of the specific imbalances that are likely to be at least partly due to repressive financial policies. To fulfil these two aims, I first introduce the concept of financial repression and briefly discuss individual repressive policies in China. I then draw on recent research that connects financial repression with economic imbalances to highlight the relationship between the two in the case of China. The main point of this chapter is not to argue that financial repression constitutes the single cause of China's economic imbalances. These policies should instead be seen as part of a complex economic system that is marked by significant imbalances.

The remainder of this chapter is organised as follows. The section immediately following introduces the concept of financial repression. Section three takes a closer look at repressive financial policies in China. The fourth section discusses the relationship between financial repression and economic imbalances and places this relationship in the Chinese context. Section five discusses potential financial reforms that are likely to have a positive impact on current imbalances and section six concludes the study.

Financial Repression

The term 'financial repression' was arguably first used about 40 years ago by McKinnon (1973). He defined financial repression as policies that regulate interest rates, set high reserve requirements on bank deposits and mandatorily allocate resources in the economy. Such policies are generally used more extensively in developing countries. It is often argued that repressive financial

2 One important exception is Lardy (2012), who emphasises the need for the Chinese Government to undertake financial liberalisation in order for the economy to continue to grow at high levels during the next decade. The World Bank's recent report on the Chinese economy that aims to bring forward a new development strategy for China also touches on the need for financial liberalisation (World Bank 2012).

policies hinder financial development and lower the overall efficiency of the financial system. For example, Pagano (1993) finds that policies such as interest rate controls and reserve requirements limit the financial resources available for financial intermediation. A natural extension of this is the argument that financial repression holds back economic development (McKinnon 1973; Shaw 1973).³ This is because repressive financial policies discourage saving and investment due to lower returns than in a competitive market. In an often-cited paper, Roubini and Sala-i-Martin (1992) present theoretical and empirical analyses of the negative relationship between repressive financial policies and long-term economic growth. In a related paper, King and Levine (1993) use an endogenous growth model to show that financial sector distortions reduce growth by way of limiting the rate of innovation in an economy.

It should be noted that even though there today exists a large number of theoretical and empirical studies that portray the negative link between repressive financial policies and economic growth, other studies have cast doubts on the relationship between the two. One proponent of this alternative view is Joseph Stiglitz, who argues that imperfect information might result in a need to impose financial restraints in order to uphold stability in the financial system. For example, Stiglitz (2000) attributes the increasing frequency of financial crises during the past decades to the process of financial liberalisation in developing countries. It can thus be argued that such countries are better able to manage their money supply and financial stability under policies that focus on financial restraints due to the existence of significant degrees of imperfect information (Hellmann et al. 1997, 2000; Stiglitz 1994; Stiglitz and Weiss 1981). These two seemingly opposite approaches to repressive financial policies do not, however, necessarily contradict each other. In a recent study, Huang and Wang (2011) examine the impact of financial repression on economic growth in China during the past three decades. Their findings confirm that repressive financial policies have indeed helped economic growth in China. The authors link this positive relationship to a prudent and gradual approach to liberalisation; however—and what is more important for the analysis in this chapter—their results also indicate that the impact turned from positive during the first two decades of reform to negative in the 2000s. At least in the case of China, these findings indicate that the effect of repressive financial policies on growth and its composition are dependent on the general level of development as well as the institutional setting. How repressive financial policies affect economic activity is thus dependent on the net effect of the positive and negative influences discussed here.

3 For a detailed and interesting review of the topic of financial development and economic growth, see Levine (2005).

Repressive Financial Policies in China

In this section, we discuss different forms of repressive financial policies in China. The repressive financial policies in China that are most often mentioned in the literature include interest rate controls, credit controls and reserve requirements; however, financial repression includes several additional policies that can be and often are used in countries around the world, including China. Here, the discussion is based on a list of different policies in an index of financial reforms developed by Abiad et al. (2008), who cover a range of potential ways to liberalise the financial sector: interest rate controls, credit controls and reserve requirements, barriers of entry and state ownership in the banking sector, capital account restrictions, regulations and supervision in the banking sector, and security market policies. The last two of these are usually not seen as typical repressive policies, but as they are directly connected to other policies of financial liberalisation or repression, we briefly discuss them as well.

Interest Rate Controls

Repressed interest rates constitute arguably the most-often cited repressive financial policy in China (for example, Lardy 2008; Lu and Yao 2009). During the period of the traditional planned economy, interest rates were deliberately kept low in order to stimulate the development of heavy industry in China. After economic reforms were initiated in 1978, artificially low interest rates remained. Basically, very low deposit rates and lending rates have resulted in an implicit tax on net lenders. As Lardy (2008) points out, since households are major net savers in China, the redistribution has to some extent been from households to corporations, but even more so to the state. Due to the fact that the state has full control over the domestic banking sector, the major beneficiaries of repressive interest rate policies have been the state-owned enterprises (SOEs); however, Chinese corporations are also large net savers. According to Lardy (2008), one of the most significant gains for the state has therefore been that the cost of sterilisation has been kept relatively low, thus allowing for a significantly undervalued renminbi during most of the past decade.

Figure 3.1 shows the real interest rate during the reform period. The very low general level of real rates of return to bank deposits is clearly visible. There are even several prolonged periods with negative real interest rates during this period.

Figure 3.1 Real Interest Rate, 1978–2011

Source: Data from National Bureau of Statistics of China.

Credit Controls and Reserve Requirements

It is still common for many countries to require that a minimum share of total bank lending be given to priority sectors or companies. This is especially so in the case of China, where the banking system is generally regarded as a channel for industrial policy. Research shows that state-owned banks in China tend to favour SOEs and generally do not focus primarily on enterprise profitability (for example, Podpiera 2006; Wei and Wang 1997). A typical example of credit control and direct lending in China is the difficulty faced by private enterprises looking to obtain credit.⁴ Walter and Howie (2011) argue that most of the bank lending in China goes to state-owned enterprises. Some observers are worried that this became worse during the global financial crisis, stating that much of the fiscal stimulus package introduced in 2008 resulted in an increase in directed lending. There are, however, those who take the opposite view. Lardy (2012) argues that the view that Chinese banks' main purpose is to provide funding for the Government and SOEs is 'outdated and wholly inaccurate'. Looking at lending during the global financial crisis, he shows that the growth of lending to small firms was more than twice the growth of lending to large firms and that the total amount of new lending to small firms actually surpassed that

4 Some solutions to this and other forms of discrimination for such firms have included disguising themselves as a state-owned or collectively owned entity ('wearing a red hat') or developing strong ties to political leaders (for example, Feng et al. 2011).

to large firms (Lardy 2012). While SOEs might be receiving less of the total lending than before, it is clear, however, that the banking system is still filled with preferential treatment to certain groups of enterprises. A growing literature on political connections shows that strong ties to leading politicians are very valuable for Chinese firms. One of the effects of political connections is preferential access to debt capital (Shih 2008). Supporting the view that the Government is still very much controlling credit, the International Monetary Fund (IMF) recently published a report claiming that the Chinese Government's role in credit allocation is partly responsible for causing a build-up of contingent liabilities and making the much needed reorientation of the financial system more difficult (IMF 2011).

Besides control over credit allocation, the Government can use reserve requirements to repress the financial system. Figure 3.2 shows the reserve requirements for Chinese banks imposed by the People's Bank of China during the reform period. While the level of required reserves was very high during the initial stage, it then came down to the 5–15 per cent interval, only to return to about 20 per cent during the past two years. Abiad et al. (2008) use 20 per cent as a threshold when determining whether reserve requirements are to be seen as excessive, suggesting that China's reserve requirement ratio is to be regarded as too high. Lardy (2012) also argues that China's reserve requirements are 'very high' and that they should be addressed in future financial reforms.

Figure 3.2 Reserve Requirements, 1978–2011

Source: Data from National Bureau of Statistics of China.

Entry Barriers and State Ownership in the Banking Sector

In China, most of the capital in the financial system is allocated through banks. As Walter and Howie (2011) point out, '[i]n China, the banks are the financial system'. Naturally, ownership of banks is the most direct way to control credit allocation in an economy. State ownership of banks is therefore an important indicator of how liberalised the financial system is. Here, it is clear that financial reforms in China have a long way to go. While China's banking sector has undergone significant reforms during the past two decades, the state still controls all the major banks. Table 3.1 shows the different banks in 2009, classified by ownership structure according to the People's Bank of China. Policy banks are fully owned by the state. The four major banks have all undergone initial public offerings, but still remain under majority state control.⁵ Of the other 13 major banks classified as joint-stock commercial banks, 11 are controlled by national or local government organs. This means that the state-controlled banks hold assets of close to RMB59 trillion, corresponding to approximately 73 per cent of total bank assets in 2009.

Table 3.1 China's Banking Institutions, 2009

	Number	Share (%)	Assets (RMB trillion)	
			Amount	Share (%)
Policy banks	3	0.05	6.95	8.63
State-owned commercial banks	4	0.07	39.04	48.47
Joint-stock commercial banks, state as largest shareholder	11	0.20	12.59	15.63
Others	2	0.04	2.01	2.50
Others				
City commercial banks and credit unions	158	2.80	5.71	7.09
Rural commercial banks and credit unions	5241	93.02	8.64	10.73
Postal savings bank	1	0.02	2.70	3.35
Foreign banks	32	0.57	1.35	1.68
Non-bank institutions	182	3.23	1.55	1.92
Total	5634	100.00	80.53	100.00

Source: Data from Deng et al. (2011).

⁵ The four large commercial banks (commonly called the 'Big Four') are: Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China and Bank of China.

Walter and Howie (2011) argue that banks are basically used as utilities providing unlimited capital, which is then mainly channelled to state-owned enterprises. In this sense, the Chinese economic model during the past three decades has been based on a developmental state that channels funds through the banking system. This has not been without cost. It has been argued that the financial system is quite fragile and that it will need to be recapitalised on a regular basis based on current business practice (for example, Walter and Howie 2011). Reforming the banking sector in China probably constitutes one of the most difficult challenges in the effort to reform the financial sector, as it would result in a significant loss of control over capital allocation in the economy. Nevertheless, it should be seen as a key priority in the effort to secure long-term financial stability. Showing that China's leadership is aware of this problem, Prime Minister, Wen Jiabao, recently stated that the large commercial banks are making profits far too easily due to their monopoly position (Barboza 2012).

Capital Account Restrictions

Capital account restrictions are imposed to obtain greater control over the exchange rate as well as domestic credit flows. A desire to limit competition for 'captive' bank deposits is a further motivation. Typical policies related to the capital account include restrictions or taxes on inflows or outflows as well as alternative exchange rates for different forms of transactions across country borders. Without tight capital account restrictions in place, repressive financial policies such as suppressed interest rates would be much less effective.

Ever since the beginning of the economic reforms in the late 1970s, the Chinese Government has taken gradual steps to liberalise the capital account in China. Foreign direct investment was allowed to flow in early and outward direct investment has been allowed for most of the past decade; however, besides small test cases (such as the qualified foreign institutional investor, QFII, and the qualified domestic institutional investor, QDII, schemes), private portfolio flows have been kept off limits. It is not unusual for developing countries to have relatively low levels of capital account convertibility. One could therefore argue that China's policies follow those of other emerging economies. Figure 3.3 shows Chinn and Ito's (2006) index for capital account openness for the United States and a number of emerging economies. Naturally, the United States has a much higher level of capital account openness; however, even when compared with other, larger emerging economies, China exhibits a relatively low level of capital account convertibility. It is only India that shows signs of a similar low level of liberalised capital account. At the same time, there seems to be a growing consensus among Chinese policymakers that continued capital account liberalisation is desired. A recent report published by the survey and statistics department of the People's Bank of China states that it is now time to open up

the capital account. The report even provides a three-step roadmap for such reform over the coming 10 years (*China Securities Journal* 2012). These signals are consistent with the trend towards internationalising the renminbi, which has gathered pace since 2010.

Figure 3.3 Capital Account Openness Index

Note: The Chinn–Ito index measures a country's degree of capital account openness. The higher the index is, the higher is the degree of openness.

Source: Data from Chinn and Ito (2006); Ito and Chinn (2010).

Regulations and Supervision in the Banking Sector

Prudential regulation and supervision of banks are important for financial reforms. Not only the formal regulative framework, but also, more importantly, the actual supervisory oversight is crucial in the development of a sound and stable banking system. In the case of China, significant steps have been taken to improve the regulatory framework and the supervision of the banks. Nevertheless, as pointed out in a recent assessment by the World Bank and the IMF, the autonomy of the China Banking Regulatory Commission (CBRC) is challenged due to the fact that the banking system is used so extensively by the Government to pursue its economic policy and to facilitate a high level of credit growth (World Bank 2011).

Security Market Policy

The development of the securities market constitutes an important part of financial development. It allows for investors to further diversify their portfolio holdings and provides alternative channels for funding. The Government can carry out a range of different policies to facilitate the development of domestic securities markets, including the auctioning out of government securities, establishing debt as well as stock markets, making use of different forms of encouragement such as tax incentives, and opening up domestic capital markets to foreign investors, albeit under a quota system (Abiad et al. 2008).

While China has taken steps to develop its securities markets, it is still far from having well-functioning capital markets. The bond market especially has yet to become an important part of the financial system. While the domestic stock market has grown significantly in size over the past decade, it is still far from developing into a mature and well-functioning market. Foreign investors' access to the Chinese stock market is also still very limited; most are allowed to trade only in B-shares, which constitute a very limited share of the overall market, with a relatively small number of QFII firms able to fill an A-share quota. Most trading activities by foreign investors instead take place in Hong Kong (as well as other markets), where a large number of companies from the Mainland have listed, especially during the past decade. Furthermore, supervision of the stock market is generally considered weak and it is commonly argued that the supervisory body, the China Securities Regulatory Commission (CSRC), is in need of considerably more resources in order to function well. Even the recently appointed chairman of the CSRC, Guo Shuqing, has stated that 'insider trading, market manipulation, fraudulent listings and other illegal activities have not only seriously distorted the normal path for investors seeking returns, but have also severely harmed investor confidence and critically affected normal market functions' (Lu et al. 2012). According to a recent joint report by the World Bank and the IMF, the CSRC needs greater operational autonomy. The report also states that the commercial court, enforcement of illegal investment activities and the detection and deterrence of unfair trading practices need to be improved (World Bank 2011). There is thus still much work to be done to facilitate the development of more market-driven and market-based intermediation in China.

Financial Repression and China's Imbalances

In this section, some of the imbalances in the Chinese economy are highlighted. Each of them is then discussed within the framework of repressive financial policies in an attempt to shed light on how such policies might have played a role in the emergence of such imbalances.

Structural Imbalances

Recent research has shown that repressive financial policies are associated with structural imbalances. Typically, countries follow a similar pattern of structural change as their economy develops. Economic growth is accompanied by the gross domestic product (GDP) share of the agricultural sector falling as the GDP share of the industry sector increases. Later, the industry share of GDP decreases as the service sector expands. In countries that make use of strict, repressive financial policies, however, such policies will slow structural transformation. Johansson and Wang (2011) develop a model in which financial repression affects the balance between the industry and the service sectors. The main implication of their model of non-balanced growth is a repressed service sector relative to the industry sector. Their empirical findings on a large set of countries strongly support the theoretical framework, indicating that institutional distortions can have important consequences for a country's economic structure.

This unbalanced pattern of development is quite apparent in the case of China. Figure 3.4 depicts structural change during the reform period. While the agricultural sector follows the typical pattern of structural change seen in many other countries, the industry sector's share of GDP has remained at very high levels throughout the three decades. Given the strong focus on industry during the period before 1978, industry's share of total GDP at the beginning of the reforms was at a very high level. The fact that it has remained at this level throughout such a long period of very high economic growth indicates that the economic structure has become heavily distorted.

Figure 3.4 Sectors' Share of GDP, 1978–2008

Source: Data from National Bureau of Statistics of China.

Structural imbalances similar to the ones found in China are arguably synonymous with the developmental state often found in East Asian countries. Strong state intervention combined with extensive planning and regulation in countries that are late to industrialise mean that it is the state itself that takes on different developmental functions and thus leads the industrialisation process (Amsden 1989; Johnson 1982; Wade 1990). China, perhaps more than any other country, portrays this development model and also shows how the success of state intervention during one phase might be followed by the state acting as an interest group and thus serving as an obstruction to ongoing adaptation. The empirical evidence found in Johansson and Wang (2011) and the fact that the developmental state most often is tied to a heavy reliance on the development of industry support the argument that less repressive financial policies would most likely help mitigate the disparities in China's economic structure. A rebalancing of the economic structure would in itself also have ramifications for a number of other areas of the Chinese economy, including its external balances, the labour market, and so on.

External Imbalances

China's large external imbalances have been a sensitive and heavily debated topic, especially since the beginning of the global financial crisis. While China has maintained what many have argued is a significantly undervalued currency during most of the past decade (Frankel 2006; Goldstein and Lardy 2006), the Chinese current account surplus has been persistent during this period. Figure 3.5 shows the current account and the trade balance during the past three decades. The trade balance widened dramatically from 2003 to 2007 from an already high level. It is only during the later stages of the global financial crisis that the trade surplus has decreased.

There are a number of plausible reasons for China's external imbalances. For example, the exchange rate has often been singled out as a main reason behind China's growing trade surplus. What has often been overlooked, however, is how repressive financial policies in general can affect a country's external balances. In a recent study, Johansson and Wang (2012a) use a panel of countries to analyse the relationship between financial repression and external balances. They suggested two hypotheses for how repressive financial policies could affect the current account. First, they build on the model developed in their earlier work (Johansson and Wang 2011) and argue that financial repression can cause external imbalances due to the imbalance in the basic economic structure. As in the case of China, if repressive financial policies are used to develop the industry sector at the expense of other sectors, the result is most likely a strong increase in exports, as manufacturing makes up a significant part of the industry sector. Second, financial repression can have an effect on external

balances by way of hindering financial development. Financial development is associated with a lower level of the current account, since financially developed economies are less anxious about their international financial resilience. While the empirical results in Johansson and Wang (2012a) mainly support the first of these hypotheses, the second one is plausible, perhaps especially in the case of China. Recent research thus highlights fundamental structural features in the financial sector as being at least partly responsible for external imbalances. In the case of China, a heavily repressed financial sector is likely to have helped the country's external imbalance become even more severe during the past decade.

Figure 3.5 China's Current Account and Trade Balance, 1981–2010

Note: The current account is on the left axis, the trade balance on the right.

Source: Data from National Bureau of Statistics of China.

Inequality

Rising inequality is one of the primary concerns of the Chinese Government. It fears that the growing divergence between rural and urban incomes and the general income inequality in the country could result in an increasing level of social instability. Figure 3.6 shows just how severe the level of inequality has become during the reform period. The Gini coefficient shows a steady increase during the whole period. Starting from a relatively modest level of 0.29 in 1978, it increased to close to 0.47 in 2005 (Fang and Yu 2012). The subject has become so sensitive that the Chinese Government will not even publish the

Gini coefficient and has not done so for the past decade.⁶ While the National Bureau of Statistics argues that this is due to the problem of incomplete data, the Government has been criticised for trying to downplay the large wealth gap in the country (Fang and Yu 2012). Figure 3.6 also shows the disparity between rural and urban incomes in China. The urban–rural income ratio follows the general inequality as measured by the Gini coefficient closely, indicating that the growing divide between rural and urban households makes up a significant part of the overall income inequality in the country.

Figure 3.6 Gini Coefficient and Urban–Rural Income Ratio, 1978–2005

Note: The urban–rural income ratio is on the left axis, the Gini coefficient on the right.

Source: Data from National Bureau of Statistics of China.

Repressive financial policies can result in higher levels of income inequality. As Johansson and Wang (2012b) point out, repressed interest rates can lead to uneven returns to savings in countries with fragmented financial markets. One of the reasons for this is that affluent people might have better access to alternative investment instruments. For rural households in China, the number of alternatives for where to invest savings is limited and the most common form of savings is a typical bank account. For more affluent people, there are alternative investment opportunities, including a range of financial instruments and the investor housing market, which is unaffordable for ordinary Chinese. Furthermore, and as noted earlier, repressive financial policies can cause

6 The Gini coefficient measures inequality on a scale from zero to one, where zero reflects complete equality and one represents complete inequality. It has been argued that, when taking hidden income into account, China's Gini coefficient is most likely significantly higher than 0.5 (Wang and Woo 2011).

severe disruptions to the process of financial development. Demirguc-Kunt and Levine (2009) note that, with large financial market imperfections, investment opportunities become a function of dynastic assets. This is because a producer's wealth has a large effect on problems with moral hazard and adverse selection that put constraints on opportunities. Furthermore, financial development is linked to equality through other mechanisms. For instance, efficient credit markets allow for people with high ability to access quality schooling regardless of parental wealth, thus decreasing the potential for permanent, or intergenerational, inequality (Demirguc-Kunt and Levine 2009).

Given the potentially important effect that repressive financial policies can have on income inequality over time, such policies are working against what the Chinese Government is trying to achieve. Inequality is one of the imbalances emphasised in the Twelfth Five-Year Plan; however, policy discussions so far have not focused on the relationship between severe repressive financial policies and inequality. It is likely that the high level of financial repression in China, especially the excessive use of repressed interest rates, has added to the growing disparities in household income. Thus, if the Government were to ease up on such policies, it might prove productive in the battle against inequality.

Moving Forward with Financial Reforms

Financial liberalisation poses difficult challenges to any country. One of the fundamental lessons learned from failed liberalisation processes around the world is that sequencing is imperative. In the case of China, although capital account liberalisation is regarded as important and is even included in the Twelfth Five-Year Plan, a complete opening up of the capital account would preferably come after other financial reforms have taken place. The key role interest rate restrictions play in fuelling the banking system with cheap capital means that a sudden and comprehensive liberalisation of the capital account without taking the restrictive interest rate controls into account could generate a massive outflow of capital if Chinese households and companies were able to place their capital in investments in foreign markets and if expected returns abroad were to be much higher than those at home (net of foreign currency risk perceptions). Comparing interest rates in different countries, this would not constitute a significant problem at the moment as the Chinese interest rate is now significantly higher than interest rates in the United States and Europe. Nevertheless, the existing interest rate differences are a result of economic crises in both the United States and Europe and this could change as time passes. Similarly, if significant weaknesses are found in the domestic banking system, especially during a time of crisis, an open capital account would accelerate bank runs. Thus, supervision and regulatory practice in the banking system

need to be in place before there is a complete reform of the capital account. Lardy and Douglass (2011) note that for capital account liberalisation to work well, there is also a need for sufficiently developed domestic capital markets, as they provide incentives for further commercialisation of domestic banks, enable absorption of large capital inflows and reduce the risk of currency mismatches. Lardy and Douglass also argue that there is a need for exchange rate flexibility, since a significantly under or overvalued currency would result in large capital inflows or outflows if the capital account is opened. A recent report by the People's Bank of China added macroeconomic stability and adequate foreign exchange reserves as important precursors for continued capital account reform (China Securities Journal 2012).

Besides interest rate liberalisation, continued efforts to strengthen the regulatory framework and supervision for both the banking sector and the securities markets are needed. The lack of independence for both the CBRC and the CSRC needs to be remedied so that both of these sectors will become more market driven.

Conclusions

Financial repression affects not only financial development and economic growth in general. It can also be the root cause of a number of different economic imbalances, some of which have been discussed in this chapter. Some of these economic imbalances have developed into difficult challenges for the Chinese Government. While the country's current account seems to have moved closer to a reasonable level of late, it is still too early to tell if this is temporary and due only to a significant fall in demand from its main trading partners due to the global financial crisis or if it is more permanent in nature. In addition to external imbalances, structural imbalances at home and a severe level of inequality constitute some of the primary difficulties that China's policymakers need to address. While financial repression is certainly not the only factor causing such imbalances in China, less repressive financial policies could help mitigate them. Financial liberalisation would decrease the heavy reliance on investment and heavy industrial development and free resources for the expansion of the service sector and consumption. Similarly, continued financial reforms would result in a significant increase in financial development, which would have multifarious benefits from higher returns to household savings and to better opportunities for individuals from less affluent households to access high-quality education. These potential changes are likely to help bring a stop to the negative trend of increasing inequality in China.

As noted in this chapter, recent research has brought the formerly disparate fields of financial repression and economic imbalances together. Additional research along these lines is important to fully understand the many ways in which repressive financial policies can affect an economy. Such research is also likely to help shed light on issues that have been overlooked in the debate on the positive and negative effects of financial liberalisation.

Looking at each of the dimensions of financial reform discussed in this chapter, it is clear that continued reforms are needed for China to develop a well-functioning financial system. It is also important, however, to identify a proper sequence for each of these reforms, as swift reforms in certain areas without taking related repressive policies into account could result in instability, which might discourage policymakers following through on the entire package, which would be a damaging outcome for both the Chinese and the global citizenry.

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