



# IDSS COMMENTARIES (102/2006)

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## **Ignoring Doctors' Orders: Political Impediments to China's Financial Liberalization**

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AT THE opening seminar on the sidelines of the IMF/World Bank meetings in Singapore recently, reforming China's financial system can under scrutiny. Two academics on the panel – Larry Summers and Barry Eichengreen – emphasized the need for liberalizing reforms that would strengthen capital markets and thereby assist long-term economic growth. However, neither scholar spoke about the likelihood that China would actually implement these needed reforms. To be sure, there are political impediments to acting on their advice.

### **Financial System Woes**

The critical weakness in China's financial system is the heavy reliance on bank loans being directed to state-owned enterprises. The first reason for this is largely to prevent massive layoffs. Another reason is that the equity and bond markets are incapable of offering a financing alternative. Because most of the banks' capital is lent to large, often state-owned companies, smaller firms and consumers get crowded out. This leads to a misallocation of capital, which, if corrected, could boost GDP by US\$62 billion a year according to a McKinsey study released in May this year on financial reform in China. The same study says reforms that enable a larger share of funding to go to more productive enterprises would raise GDP by up to \$259 billion, or 13 percent a year, and bring higher returns for Chinese savers, thus enabling them to raise their living standards and consumption.

### **Actors' Views on Liberalizing Reforms**

The McKinsey study offers ten recommendations to improve the financial system, many of which involve deregulating banking and capital markets and follow the basic liberalizing advice of Summers and Eichengreen. But how are important actors in China's political economy -- such as farmers and small firms, labour, and large firms -- likely to view the proposed reforms?

*Farmers and Small Firms:* China's decentralized political structure grants considerable political power to local politicians. They have the ability to direct state funds (through policy banks) to local projects of their choosing. China's political and economic structure is so decentralized, that, in some ways, it can be best understood as a collection of independent provinces. Local leaders have significant influence both on companies and on the banking system that serves them. This decentralization has limited the effectiveness of China's

financial system so far, and it also makes reform more difficult. Agriculture and small local firms are important actors in this regard. The best country example to compare China to, in this regard, is the United States.

American states did not begin permitting interstate bank branching until the 1970s, and have a far larger number of unit banks (local independently-owned banks, not branches of larger national banks) than any other OECD country. Japan has a more central political authority, but with its political system granting considerable power to local politicians and to farmers and small firms in particular. Japan has also witnessed a considerable bias towards the countryside in terms of subsidized lending rates, and redistribution of capital to rural areas. As long as Chinese politicians rely on local groups to remain politically powerful, farmers and small firms will continue to play an important role in assuring that money gets diverted away from the cities. To be sure, money will go to urban areas more than before since the growth of new firms will attract financing. However, the level of financing to urban areas will not achieve its market-determined potential. In this way, farmers and small firms will attempt to block many of the efficiency enhancing reforms of the banking system.

*Labour:* Although workers and farmers lack political representation in China's government, they exercise unusual political influence because of Chinese leaders' fears of popular upheaval. That is, Chinese officials placate these groups while at the same time slowly shifting the economy in a market-oriented direction, and integrating it into the global economy. Doing this necessarily means moving the economy away from agriculture towards industry, and allowing unsuccessful businesses to fail, and for their workers to lose their jobs. Because of the large numbers of non-competitive state-owned enterprises, and the potentially huge job losses, Chinese leaders have good reasons to fear a political firestorm from such manoeuvres.

*Local politics reinforces this political pressure:* According to the McKinsey study, branch managers sometimes face political pressure from local government leaders to continue to supply [state-owned enterprise] funding. This keeps the largest employers in the area afloat, and "it is in the interest of both the local government and the bank itself to protect local jobs". At present, China's strategy seems to be to allow the economy to grow its way out of the problem, by creating enough jobs in competitive firms so that most workers do not oppose government efforts to wean companies off of state subsidized lending over time. But this strategy could be problematic since it crucially depends on maintaining high and stable levels of economic growth over a long period of time.

*Firms:* Competitive private-sector business (*not* state-owned enterprises) would largely favour liberalising reforms. Reducing the transactions costs of obtaining financing and improving consumers' purchasing power is certainly in their interest. The present relationship of the Chinese government to the private sector is reminiscent of 1880s Japan, when securities markets became heavily relied upon as state-run industries were privatized. However, a critical difference is the existing volume of non-performing loans and the heavy dependence on non-competitive state-owned enterprises to maintain employment stability. Indeed, China's present market-oriented trajectory resembles that of many countries during the late nineteenth century, before true democratic reforms were instituted. However, because the Chinese people can easily see the political power that people have in other countries, democratic reforms are likely to be pursued more aggressively in contemporary times than in late nineteenth and early twentieth centuries.

To keep China on its liberalizing trajectory, it must overcome the close linkages between politics and business, which leads to corruption. This has led to political reforms in other East Asian countries in the wake of economic crises – such as South Korea after 1997 -- and is a serious worry for Chinese politicians. Making a smooth transition away from corruption could be difficult as long as non-democratic institutions dominate, and local politicians continue to wield political influence over lending decisions.

### **Political Impediments to Reform**

Thus, there are two key impediments to financial liberalization in China: The first is the decentralized political structure; and the second is Chinese leaders' fears of popular upheaval should workers lose their jobs. The decentralized political structure creates several additional hurdles for liberalizing reforms by: (a) preserving corruption at the local level; (b) undermining nationwide efficiency-enhancing reforms to the banking sector; and (c) creating additional incentives to keep workers employed at noncompetitive SOEs, and the continuance of directed lending to them.

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