Law, Finance, and Economic Growth in China: An Introduction

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Summary. — China has experienced remarkable economic growth for three decades despite having a weak legal system and under-developed financial markets thought to be crucial for economic development. An assessment of the relationship among the legal and financial systems and economic growth reveals a complex set of institutional factors that have underpinned China’s marketization, and which is not premised on the establishment of a legal or financial system before development takes off. China’s experience holds lessons for other developing countries struggling with imperfect legal systems and nascent financial markets, which are not uncommon features of economies at an early stage of development.

Key words — China, law and finance, economic growth and transition

1. INTRODUCTION

One of the enduring puzzles surrounding China’s rapid economic growth for three decades is how it was achieved within an incomplete legal system and under-developed financial markets—both of which are thought to be crucial in enabling the workings of an efficient market economy. By contrast, China, a developing country transitioning from a centrally planned system with communal property ownership, did not have a well-established legal regime or recognition of private ownership. Its financial sector was in its nascent stages as state-owned banks dominated lending and other financial transactions until market-oriented reforms began to commercialize the sector in the mid to late 1980s. Allen, Qian, and Qian (2005) document the various ways in which China’s legal and financial systems are under-developed, including the lack of financial depth, which raise doubts about the stability of sustained economic growth.

This paradox arises at a time when the economic literature has increasingly emphasized the importance of laws and market-supporting institutions in explaining disparate economic performance (see e.g., Acemoglu, Johnson, & Robinson, 2005; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Levine (1998) and Beck, Demirgüç-Kunt, and Levine (2003) further argue that legal development can underpin a well-functioning banking and financial sector which in turn contributes to successful overall economic development. The emphasis on the rule of law in many ways stems from the Coasian view of a market economy in that secure property rights and low costs of transaction made possible by a quality legal system enable efficient exchange to take place. For developing countries which have fledgling legal systems and transition economies which often start from scratch in terms of market foundations after abandoning Communism, this is a notable challenge in their growth agendas. Some have adopted transplanted laws without significant success (see e.g., Berkowitz, Pistor, & Richard, 2003; Pistor, 2002; Pistor, Martin, & Geller, 2000) regarding findings for transition economies in Eastern Europe) while others such as China have experienced strong growth despite the lack of such formal legal institutions (Jefferson & Rawski, 2002). Thus, the argument subsequently put forward is that the existence of the legal system alone is insufficient, but the effectiveness of the law is the relevant factor that promotes economic and financial development in transition and developing countries.

In turn, financial sector development is viewed as a key factor in promoting economic growth even though financial repression (whereby legal restrictions hamper the development of the financial sector) exists in many developing and transition economies (McKinnon, 1973; McKinnon, 1993; Shaw, 1973). A burgeoning financial sector, by contrast, can translate savings into investment and therefore facilitate capital accumulation that increases the income level of an economy. Efficient capital markets also allocate resources efficiently so that an economy gains productivity and full factor utilization which can drive long-run growth. Finally, a healthy banking and financial sector can insulate an economy against short-term macroeconomic instability by providing a cushion against slowdowns and external crises if sufficient financial depth exists.

The pioneers McKinnon and Shaw in this field view financial repression in terms of legal restrictions on financial intermediaries that deprives an economy of financial depth. Nowhere is this more apparent than in transition economies where the privileged (sometimes former) state sector disproportionately obtains financing and distorts the efficient allocation of capital (Denizer, Desai, & Gueorguiev, 1998). In developing countries, the lack of financial intermediation hampers the transfer of what limited savings exist into useful investment that dampens economic development (Stern, 2002). Both transition and developing countries have been prone to currency and financial crises related to their lack of sufficient financial depth (see e.g., Krugman, 2000). For these reasons, financial sector development—premised on effective
legal systems—is viewed as essential in successful economic growth.

Doubtless there are other institutional factors such as political stability which are relevant in fostering economic growth. The focus on market-supporting institutions, including law and financial systems, in explaining long-run economic performance has come to the fore as a key factor for developing and transition economies—and an area where China has become a puzzle worthy of investigation to shed light on its own growth prospects and any potential lessons for other emerging economies.

The rest of the article proceeds in the following manner. Section 2 examines China’s particular path to marketization and the evolutionary nature of the formation of its legal and regulatory structures. Section 3 traces the relationship among law, finance, and growth in China with a critical analysis of the small but growing literature assessing that relation. Section 4 concludes with an evaluation of the evidence concerning China’s economic growth since market-oriented reforms began in 1978 and traces out policy implications for other developing countries struggling with imperfect legal and financial systems.

2. MARKETS AND LAWS IN CHINA

The growth of China is all the more remarkable given its lack of either a well-developed legal or financial system. The trajectory of China’s economic transition and reform is fairly well established (see e.g., Lin (1992) for the effectiveness of agricultural reforms; Naughton (1995) for industrial reforms). Market-oriented reforms were undertaken at the end of 1978, which were multi-phased starting in rural areas and highly decentralized. Reforms began in the rural economy followed by urban state-owned sector reforms and greater opening to the global economy. They were also characterized by provinces having a great deal of autonomy in experimenting with policies that altered the incentive structures of an administered economy to those that are oriented toward profit and efficiency. This was initially in a “dual track” system which created a market segment of the economy that co-existed with another part of the economy which stems from its under-developed legal system and a system which crested a market segment of the economy that co-existed with another part of the economy that was administered a market segment of the economy that co-existed with another part of the economy that was administered.

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Despite not having a well-defined set of property rights which stems from its under-developed legal system and a system of communal property existent from the pre-reform era, China has managed to grow via a complex set of institutional reforms that have altered the expectations and incentives of its populace and managed to achieve a significant extent of market development. China’s growth has been prompted by the so-called “institutional innovations” which provided incentives that would normally be generated through well-defined property rights. This allowed China to reform without change in ownership from public to private or undertaking privatization in the early stages. These were notably the Household Responsibility System (HRS) for rural residents in the late 1970s and early 1980s, the Budgetary Contracting System (BCS) allowing decentralization of state-owned banks and local authorities in the early 1980s, and the Contract Responsibility System (CRS) instigated in the mid 1980s for state-owned enterprises (SOEs). A more formal set of legal property rights was created for foreign investors in the mid 1980s in the form of joint venture laws.

The operation of China’s “dual track” transition, in which one part of the market was liberalized while the other was kept under administrative control, depended on generating growth from the marketized part of the economy which could then subsidize the faltering state-owned sector with the outcome of maintaining economic stability (Lau, Qian, & Roland, 2001). Prior to the “institutional innovations,” collectivization meant that there was little incentive for farmers to produce output as their work points were allocated on the basis of a day’s labor irrespective of effort. Adopted by households gradually in the early 1980s amidst a move to de-collectivize agriculture, the incentives generated from receiving some returns from own labor caused agricultural output to increase substantially (Riskin, 1987). A significant part of China’s growth in agricultural productivity and the overall rural economy can be traced to both the HRS and de-collectivization (Huang & Rozelle, 1996; Lin, 1992).

Whereas the HRS refined the incentives facing households, the creation of township and village enterprises (TVEs) is a striking example of how China created a new institutional form whose parameters were defined by policy and not by private ownership or outright transfer of the ownership to individuals. Yet, the reliance of the Chinese rural workers on this newly recognized institutional form of enterprise was sufficient to instill market-driven incentives to fuel rural industrialization, whereby TVEs grew rapidly and accounted for an impressive one-third of China’s total output in the mid 1990s (National Bureau of Statistics (NBS) of China, various years). The evidence of growth stemming from these reforms is notable, as rural industrialization helped remove surplus labor from the farms and contributed significantly to the remarkable poverty reduction witnessed in China in the reform period (see Ravallion & Chen, 2007).

With respect to the urban economy, the CRS in 1981 permitted state-owned enterprises to pay a fixed amount of taxes and profits to the state and retain the remainder (Koo, 1990). In principle, so long as the SOEs delivered the tax and profit remittances specified in the contracts, they were free to operate. This resulted in increased production of SOEs in the 1980s through the re-orientation of incentives of managers (Groves, Hong, McMillan, & Naughton, 1995). However, the decline of SOEs in the 1990s illustrated the limits of relying on the so-called institutional innovations as “soft budget constraints,” whereby the enterprises are not bound by the constraints of profit and cost due to the support of the state, continued to plague SOEs. This is in spite of the positive incentive effects of the CRS and eventually led to the transformation of many SOEs into joint stock companies in the 1990s with ownership changing into private hands (Choo & Yin, 2000).

This system of market-gearied incentives was extended to China’s treatment of multinational corporations, albeit under more clearly defined laws. Since the “open door” policy reforms of China’s external sector was adopted in the late 1970s and sped up in the early 1990s, China has rapidly become one of the world’s top destinations for foreign direct investment (FDI). For most of the reform period especially prior to WTO accession in 2001, the predominant form of FDI was Chinese–foreign joint ventures, where the Chinese and foreign partners set up either equity or cooperative joint ventures. Both forms of joint ventures were vested in contracts that legally specified the rights and obligations of both parties and subject to judicial enforcement. The uncertainty that might have been generated by the lack of adequate protection of private property due to
a weak legal system, though, did not seem to serve as a deterrent to FDI, which is another puzzle in China’s growth narrative. Indeed, China is a competitive destination for foreign direct investment even measured against developed economies, such as the United States and the United Kingdom, despite its under-developed legal and institutional system (see e.g., United Nations Conference on Trade, 2006).

Reform of the state administrative sector was also important. Decentralization has occurred in nearly all areas of decision-making in production, pricing, investment, trade, expenditure, income distribution, taxation, and credit allocation through the BCS (Riskin, 1984). Since 1980, under the BCS, the central government shares revenues (taxes and profit remittances) with local governments. For local governments which incur budget deficits, the contract sets the subsidies to be transferred to the local governments. Fiscal decentralization further gave scope for regional experimentation by local governments, a key element to China’s gradualist path, because it permitted market-oriented activity while limiting the possibility of instability through enabling the fairly autonomous development of the state’s component parts relatively independently. This was instead of a top–down approach whereby a mistaken national policy could reverberate throughout the country (see Qian & Xu, 1993).

Since 1985, state grants for operating funds and fixed asset investments were also replaced by bank loans. Local governments and SOEs are allowed to borrow directly from banks. Six years later, local governments and SOEs were permitted to borrow from household and other institutions. Rapid changes in the banking and financial system followed. The sole bank, People’s Bank of China, was shifted toward becoming a central bank and shed its retail banking functions by reforming it to focus on monetary policy formulation in the mid-1980s. Its banking functions were in turn divided into four state-owned commercial banks (SCBs), each initially with a specialized remit that was reflected in their names: Industrial and Commercial Bank of China, China Construction Bank, Bank of China, and the Agricultural Bank of China. Three further policy banks were also formed in 1994 to take over the developmental aims of the state banking system: China Development Bank, Export-Import Bank of China, and the Agricultural Development Bank of China. There is also a second tier of state-owned banks, which have shares owned by the government or private entities. There are approximately a dozen or so of these joint stock commercial banks, which were largely set up in the 1990s. They include the Bank of Communications, China Everbright Bank, CITIC Industrial Bank, Shenzhen Development Bank, Pudong Development Bank, China Merchant Bank, Fujian Industrial Bank, and Guangdong Development Bank. Several are listed on the domestic stock market, including the Shanghai Pudong Development Bank, the Shenzhen Development Bank, and the China Merchants Bank. A number of these banks have foreign banks as minority shareholders as part of China’s opening of the sector in accordance with the terms of its accession to the World Trade Organization in 2001. At the local level, there were originally some 3,000 urban and 50,000 rural credit cooperatives that have gradually merged. For example, the Shenzhen cooperative bank was created from 16 urban cooperatives and the Shanghai City United Bank from 99 urban cooperatives (see e.g., Lardy, 1998). It is worth mentioning that a private bank, Minsheng Bank, was established in 1996. It is unique in having mostly private owners and is listed on the domestic stock market. In addition, private participation has begun to be allowed in transforming urban and rural credit cooperatives.

Other financial institutions, such as investment banks and other financial intermediaries, made little headway until liberalization sped up in the 1990s with anticipation of accession to the WTO. There was only one investment bank in China, the China International Capital Corporation (CICC), prior to WTO accession. CICC was established in 1995 as a joint venture among China Construction Bank, Morgan Stanley Dean Witter, and several other smaller shareholders. Its remit included underwriting domestic equities, taking equity stakes in foreign investments in China, undertaking mergers and acquisitions, organizing project finance, and handling foreign exchange transactions. Bank of China was the only other bank which provided investment banking services, although the other SCBs and one of the policy banks (China Development Bank) have moved in this direction. Finally, with the opening of the sector after WTO accession, foreign banks are increasing their presence, though it remains dominated by the state-owned commercial banks.

Capital markets also developed starting in the early 1990s with the creation of two stock exchanges in Shanghai and Shenzhen. Within a decade, China had one of the largest stock markets in terms of market capitalization (over $500 billion in 2004) in Asia. However, this measurement has been plagued with problems as 69% of all shares in the 1,400 listed companies on these exchanges were non-tradable, so their value was prescribed rather than market determined. The stock markets are also estimated to provide only a small fraction of corporate financing in China, so their reach is limited despite the market capitalization (Riedel, Jin, & Gao, 2007). The numerous designations of shares as individual, government, legal persons, A, B, and H each with its own restrictions with respect to trading are problematic. Not surprisingly, returns to Chinese equities have been volatile. The under-development of the stock market is symptomatic of the state of the financial system. This is not atypical of emerging economies; however, for China, it is exacerbated by a stock market with a significant portion of non-tradable shares belying the large capitalization of the Shanghai and Shenzhen stock exchanges. It was not until the early 2000s that the government began a serious set of reforms to reduce the amount of non-tradable shares. The potential of these shares to flood the market, however, created market turbulence as existing shareholders feared the dilution of their holdings. The reforms were halted, but resumed in 2005 and is pushing ahead with greater emphasis on the benefits of increasing the tradability and liquidity of the bourses. A bond market and small foreign exchange market have also been formed; although they remain small scale with a number of restrictions in place, including limits on the role of foreign investors (see Riedel et al., 2007).

Therefore, across all sectors of the economy, marketization, though imperfect, has gradually taken hold in China (see e.g., Young, 2000). Given the gradual reform of three decades, whereby the market developed over time, the legal system supporting the market economy was likewise under-developed for most of this period.

(b) The evolutionary nature of laws and regulation

Given the dominance of the state in the banking and nascent financial sector, the legal and regulatory framework supporting the sector was understandably under-developed, and serves as an example of the evolutionary nature of the adoption and implementation of laws and regulations. For instance, the banking regulator (China Banking Regulatory Commission or CBRC) was created to oversee banking sector reforms in 2003, including the corporatization of the formerly
state-owned or cooperatively-owned banks whereby they were transformed into corporations or shareholding companies, and to govern the incursion of foreign banks after China’s post-WTO opening. Another ministerial level body, the China Insurance Regulatory Commission (CIRC), was established in 1998 to govern competition and foreign investment in China’s liberalized insurance sector.

A similar pattern can be seen in the legal/regulatory framework of capital markets. Until China set up its two stock exchanges in Shanghai and Shenzhen in 1990 and 1991, respectively, there was no corresponding need for securities regulation. With the inception of the bourses, the third of the trio of financial sector regulators—the securities regulator (China Securities Regulatory Commission or CSRC)—was established shortly thereafter in 1992. The trading of stocks and increased financial liberalization also led to the growth of brokerages and fund management companies as financial intermediaries, which were similarly in need of regulation. Corporatization and issuances of stocks creating shareholding or joint stock companies further led to the passage of the Company Law in 1994 which provided the legal foundations for share ownership. With mergers and acquisitions possible among privately owned companies that grew rapidly after the Company Law promulgation, an M&A law was passed in 2002.

The creation of the regulatory agencies and the adoption of corporate and related laws as the need arises are an illustration of the reason for the lagging nature of legal reforms in China, which follows an evolutionary path that is not unfamiliar in other industrialized economies (see e.g., Chen, 2003 who describes China’s adoption of laws as following a “crash and adopt” path). For instance, in the United States, the Securities and Exchange Commission or SEC was created after the banking crisis of the Great Depression in the 1930s (see also, Franks, Mayer, & Rossi (in press) for the development of UK securities laws following the advent of dispersed shareholding of publicly traded companies). In other areas, a similar pattern where laws are promulgated to govern the evolving economic circumstances can be seen in the passage of the Property Law in 2007. For instance, privatization of housing in the early 2000s, where housing that had previously been allocated by SOEs to their workers was replaced by private purchase of the units and thus ownership, raised the need for protection and recognition of the rights of property owners (see e.g., Ho, 2006).

The progress of legal and institutional reforms is made more challenging, though, by the nature of China’s transition. The economic transactions for which these institutional reforms are intended to support are often themselves gradually reformed and in a manner that preserves elements of state ownership, evidenced by the dominance of non-tradable shares in the stock market that are owned by the state either directly or via legal persons which are state-owned institutions, which reduces transparency and the information necessary for regulators and efficient markets. Moreover, even where there are de jure laws on the books, there is much evidence of weak enforcement and poorly implemented regulatory structures such that the de facto effectiveness of the legal system is a significant issue in China as it is elsewhere (see e.g., Pistor et al. (2000) find in a sample of 19 transition countries that the effectiveness of laws is more important than the completeness of the written formal law for economic growth).

Against this backdrop of marketization and legal and regulatory developments, the relationship among the legal system, financial sector, and China’s growth can be assessed. The next section does so.

3. LAW, FINANCE, AND CHINA’S ECONOMIC DEVELOPMENT

There is a small but rapidly expanding literature on the relationship between law and financial and economic development in China (see e.g., Alford, 2000; Allen et al., 2005; Clarke, 2003; Pei, 2001; Pistor & Xu, 2005). These studies find that China’s legal system falls short in terms of the absence of an effective court system, the lack of an independent judiciary, and inadequate regulation when compared against a cross-section of other countries (Allen et al., 2005; Pistor & Xu, 2005) and with respect to the enforcement of commercial contracts (Pei, 2001). They tend to emphasize the role that informal enforcement mechanisms play in commercial transactions and thus lean toward the view that formally prescribed laws alone do not provide a comprehensive picture but the effectiveness of laws and informal institutional arrangements, such as use of social networks and membership of the Communist Party, are necessary to be considered (see e.g., Alford, 2000; Knight & Yueh, 2008). For instance, Clarke (2003) argues that formally defined property rights and enforcement of the same are not as important in China as the security of the property is held often on a less formal premise.

The nexus of legal reform, financial sector development, and economic growth is not easily to generalize. These elements influence each other in complex, causal, and sequential ways. As discussed earlier, cross-country studies of the relationship between law and economic growth see China as an outlier for its successful growth within a weak legal and financial system (see e.g., Allen et al., 2005). In the studies of legal origin, attempts have been made to argue that a particular type of legal system (such as common law versus civil law systems) which predates modern economic development can establish the causal influence of law on financial sector and economic growth (see, e.g., La Porta et al., 1998; Acemoglu et al., 2005). However, China remains a paradox for its weak legal system and remarkable growth experience, and its experience instead suggests that more nuanced measures of laws, institutions, and development be considered within the context of the particular circumstances of a country. This approach could be fruitful and reconcile an undoubtedly large and significant outlier in cross-country studies (see e.g., Fan, Morck, Xu, & Yeung, 2009).

Disentangling the influence of law on financial sector development and economic growth as well as the reverse causal effects therefore requires more detailed studies of the likely channels in China. Rapid growth can foster financial sector development and is likely to produce more legal reforms in the process (see Chen, 2003). In turn, better financial sector development will improve economic growth and induce more effective regulatory structures (see Tobin & Sun, 2009). Strengthening the legal system in the absence of considering the institutional context of China can impede financial development (see Lu & Yao, 2009). A better structured regulatory system can support more robust economic growth and the development of the banking and financial sectors (see Shen, Shen, Xu, & Bai, 2009), to name a few possibilities. It is also likely that the channels of influence are simultaneous in that strong economic growth accompanies financial sector development which reinforce each other and lead to laws which produce more effective market-supporting institutions, particularly as China’s burgeoning private sector requires such improvements in order to sustain the activities that drive China’s economic growth (see Yueh, 2009; Zheng, Bigsten, & Hu, 2009; Zhou, 2009). By any of these channels, the effects are
more complicated than a simple relationship between growth and law.

This section will examine two growing areas of research regarding the influence of the legal system on the banking sector, viewed through the lens of financial repression and the impact of a weak regulatory system on financial sector development, notably with respect to the crucial process of privatizing SOEs through initial public offerings and incorporation. The development of the banking and financial sector, in turn, will inform the success or failure of the transition process. The next section will investigate the effects of such market imperfections stemming from the incomplete legal and financial systems on the drivers of economic growth. Doubtless, much more research is needed on these and other channels, but the evolving research has already begun to shed some light on the relationship between law, finance, and economic growth in China.

(a) Financial repression and the banking sector

Lu and Yao (2009) document the extent of financial repression in China which has been a persistent trait of the economy since the centrally planned period. Interest rate policies biased toward state-led development and preferential treatment of the state-owned banking sector are the main factors contributing to financial repression. Dating back to the pre-reform period, China’s industrialization was achieved in part due to low interest rates keeping down the cost of financing the development of heavy industry at that time (Naughton, 1995). During the reform period, the official market interest rate remained lower than the rates found in the informal credit market by an estimated 50–100%, continuing the bias toward state financing (Garnaut, Song, Yao, & Wang, 2001). By the 1990s when lending restrictions were loosened, banks were allowed to lend to non-state enterprises within a band of 10% below and 50% above the official benchmark rate. However, the unofficial market rate remained some 50% higher than the upper band (Garnaut et al., 2001; Riedel et al., 2007).

The dominance of the four SCBs forms the other major aspect of the financial repression. In the early 1990s, they accounted for more than 90% of the total amount of formal bank credit and still dominated the credit market in 2007 where they control some 60% of lending (see e.g., Bai, Li, Qian, & Wang, 1999). This creates a situation of credit rationing and funneling of credit to inefficient state-owned enterprises that are the main beneficiaries of lending by state-owned banks. In the 1990s, an estimated 80% of bank credit went to the state sector even though it accounted for less than half of GDP as compared with the contribution of the non-state sector which accounted for a greater portion of GDP but received less than 20% of formal bank credit (Garnaut et al., 2001). A resultant effect is the accumulation of non-performing loans in the state-owned banks, which has been estimated to be a significant 40% of GDP by the early 2000s (Fan, 2003).

One of the most notable manifestations of credit rationing in China is seen in the small and medium-sized enterprises (SMEs) sector which comprise the most important and dynamic source of economic growth. According to China’s National Bureau of Statistics (NBS), by 2005, 99.6% of enterprises in China were SMEs that accounted for nearly 60% of GDP and three-quarters of total employment in urban areas, as well as nearly 70% of international trade and approximately 80% of outward investment (see Shen et al., 2009). However, over 98% of SMEs had no access to formal financing in 2006 (Lin, 2007). According to The World Bank Investment Climate Survey, Chinese SMEs obtained only 12% of their capital from bank loans in 2003, which lags behind its Asian neighbors.

Shen et al. (2009), using a detailed panel data set on bank lending and SMEs from the 2000s, investigate how bank characteristics, such as bank size, discretion over credit, incentive schemes, competition, and the institutional environment, affect lending to small- and medium-sized enterprises in China. They find that bank size alone is not an important factor in determining SME lending. However, factors affecting the bank manager’s incentives, such as linking wages with loan quality, tend to have a significant impact on SME loans. Competition and institutional arrangements can also significantly affect loan decisions to SMEs. The conclusion from this study reinforces the view that the institutional framework and incentives facing banks will influence the development of the banking sector.

Despite the extent of the financial repression in China, Li (2001) argues that China has managed to grow well because financial repression helps to maintain financial stability and thus muster political support for economic reform. In a similar vein, Bai et al. (1999) view financial repression as a mechanism for the state to collect quasi-fiscal revenues from the state banking system generated by the increased private incentives in the economy, further fuelling the impetus for reform. Lu and Yao (2009) empirically test the effects of financial repression on financial sector development and provincial growth rates using a panel of provinces from the 1990s. They investigate the effect of enhancing one key element of the effectiveness of law—the enforcement of court rulings—on economic growth as well as four key indicators of financial development in the economy, that is, share of private investment, share of private bank credit, financial depth, and the degree of bank competition. They find that enhancing the legal system reduces private investment and has no effect on increasing financial depth, although the private sector’s share of bank credit increases and there is greater bank competition. An enhanced legal system also does not have a significant effect on GDP growth at the provincial level.

Their central argument is that there is a “leakage effect” whereby financial resources in the privileged state sector are channeled to the private sector. This movement circumvents the rationing imposed on the private sector and allows for informal financing arrangements to support the growth of that sector. A lax legal system in effect allows for risk sharing between the bank and the state sector when it comes to risks associated with diverted investment to the private sector. Strengthening enforcement shifts more risk to the managers in the state sector who will then reduce such diversions. As a result, private investment will fall and the state sector’s demand for credit may also fall as revenues plateau. Therefore, enhancing the legal system may hurt financial development and economic growth when the private sector’s access to credit is rationed.

This informal mechanism occurs through three channels, all of which arise in response to China’s repressed financial system. The first channel is trade credit, that is, firms owe trade credits to each other and delay their repayments. By 2001, they observe that such debts reached 1.5 trillion Yuan. However, in China, trade credit is a means for firms to obtain working capital given the existence of credit rationing. The second channel of leakage is the diversion of assets and bank credits from the state sector to the private sector. The third is “tunneling,” whereby managers appropriate firm assets for personal gain. This practice is widely observed in China, particularly in the process of gaizhi—a Chinese expression for firm restructuring whose scope ranges from incorporation to sale through...
auction of SOEs. A common mean of restructuring is “spinning off,” where the old SOE becomes a new private firm that takes most of the productive assets of the SOE, leaving it with debts, obsolete equipment, and workers (Garnaut, Song, Tenev, & Yao, 2003). Therefore, Lu and Yao (2009) conclude that the “leakage” effect that moves financial resources from the privileged state sector to the rationed private sector is hampered when the legal system is strengthened. They prescribe that the effectiveness of the legal system requires other complementary institutions to improve financial sector depth and performance, such as understanding the mechanisms which relate the formal system and the informal practices that have arisen in response to financial repression, before enhancement of the formal legal system can result in improved economic development.

(b) Financial sector development

Turning to the financial sector, the same paradox exists as to how China has been able to develop a significant capital market in the absence of legal institutions supporting such a market when the standard predictions of law and economic studies suggest that markets will be retarded in the face of a weak legal framework. Contrary to these predictions, China’s stock markets performed better than comparable bourses launched also in the early 1990s in other transition economies, some of which adopted transplanted complete legal systems unlike China. In terms of the most important aspect of financial market development, the ability of listed firms to raise funds, China’s ratio of market capitalization to GDP in 2002 was 0.4, which is double the average ratio of the East European and former Soviet Union transition economies (Pistor & Xu, 2005). When measured in terms of liquidity and number of initial public offerings (IPOs), China again fares comparatively well. Pistor and Xu (2005) show that China had the most liquid of all stock markets in transition economies with a turnover ratio (defined as the ratio of the total stock value traded to the market capitalization of stocks traded) of 67.6, while the average ratio of transition economies in Central and Eastern Europe was 24.7 in 2002. The same conclusion is drawn from IPOs. Companies in the former Soviet bloc have only rarely issued IPOs to raise capital, with the exception of Poland with 47 IPOs during 1994–2001, while there were 873 IPOs in China during that same period. During 1998–2001 alone, China had issued some 414 IPOs raising a total of 508.6 billion RMB (or $61.6 billion), far exceeding any other transition economy (Pistor & Xu, 2005).

Du and Xu (2009) put forth an explanation that China was able to defy expectations and develop its capital markets through regulatory decentralization in the absence of adequate market-supporting legal institutions. In their view, China developed an alternative governance system characterized by regulatory decentralization based on regional governments being responsible for selecting state-owned enterprises to go public. Du and Xu (2009) demonstrate that regional governments tended to choose better-performing SOEs in the pre-listing stage to become publicly listed companies, although this system has come under criticism for the under-pricing of IPOs and the post-listing under-performance of IPO shares (see e.g., Chan, Wei, & Wang, 2004; Su & Fleisher, 1998, 1999; Tian & Megginson, 2007). Nevertheless, China’s substantial savings have been channelled into stock market investments and found their way into potentially productive companies. They conclude that administrative governance of capital markets can take the place of market-supporting legal institutions, fortifying the contention that the lack of effective laws can be supplemented with institutional arrangements that effectively underpin markets in China. Du and Xu (2006) further show that enforcement failures were also addressed in such a system. Regional governments that had previously selected better-performing firms for stock share issuance were rewarded with more stock issuance quotas (associated with financial injections into their state-owned enterprises) in subsequent periods, and vice versa, which mitigated the problems of enforcement in an incomplete legal system.

Extending the analysis to internationally listed firms, Tobin and Sun (2009) find evidence that innovative firms are able to overcome domestic institutional constraints and manage overseas listing which allows them to secure international capital and learn from operating in global capital markets. Likewise, Nolan (2001) suggests that although China’s large enterprises still lag behind in terms of managerial competencies, they are quickly learning to compete in international product markets. Again, against the usual predictions, Tobin and Sun (2009) argue that Chinese firms, through being innovative, can benefit from financial globalization despite their weak starting point of operating in an institutionally underdeveloped financial system in China. In turn, they posit that these firms induce legal and regulatory reform through demands for a more standardized system of economic regulation.

Johansson and Ljungwall (2009) examine the evidence concerning the institutional development and the international linkages of China’s stock markets. The level of integration, or how much a certain movement in one market tends to affect other markets, is influenced by institutional factors, such as direct regulatory impediments (capital controls, etc.), and changes in political and economic relations among countries. They explore the linkages among the different stock markets in the Greater China region (China, Hong Kong, and Taiwan) and find no indications of long-run relationships among the markets. There are, however, short-run spillover effects in both returns and volatility in the region, for example, both China and Hong Kong are affected by spillover effects from Taiwan, and volatility in the Hong Kong market spills over into Taiwan which in turn affects the volatility in the Mainland China market. The Mainland China market is related to other markets, even though the possibilities for outside investments have been quite limited until recently. The linkages further suggest that the global dimension of China’s capital and financial market development must be considered in further market-oriented reforms.

4. MARKET IMPERFECTIONS AND THE DRIVERS OF GROWTH

A weak legal system and under-developed financial market lead to significant market imperfections which affects the growth of the real economy. Importantly, it influences the strategies and prospects of foreign investors, domestic state-owned enterprises as well as the all important private firms which enable economic growth. Undoubtedly, informal mechanisms play a notable role here as well. Understanding how foreign and domestic firms and entrepreneurs alike cope and innovate within a challenging institutional context will shed light on the paradox of China’s extraordinary record of economic growth despite having such an imperfect formal, legal, and regulatory framework. The following assesses the influence of the legal and financial systems on the drivers of economic growth.
(a) Foreign direct investment and growth

Foreign investors were granted legal protection early on in China’s reform period in recognition of the importance of FDI in transferring more advanced know-how into China’s developing economy. However, China’s incomplete legal system, opaque regulatory structure, and problematic judicial enforcement of largely poorly defined property rights should have been expected to deter FDI. Instead, China has become the leading destination for FDI globally, albeit with some measurement issues due to the porous borders among the Greater China region. Huang (2006) proposes that because of the lack of private property rights in the rest of the Chinese economy, the joint venture laws provided more protection to foreign-invested enterprises than that accorded to Chinese non-state firms, such as private getihu (sole proprietorships) and other non-state-owned enterprises. The clamor for better legal protection by Chinese firms is in part a reaction to the greater security granted to foreign capital, which has resulted in the phenomenon of “round-tripping” whereby Chinese capital leaves its shores to return as FDI in order to gain the privileges accorded to international investors. Fan et al. (2009) explore this puzzle systematically by estimating cross-country regressions that control for institutional quality and a country’s economic growth track record. They measure three aspects: (1) the general quality of government, proxied by respect for property rights; (2) constraints on executive power, such as an independent judiciary; and (3) the government’s track record, which is measured by its history of delivering economic growth since countries with a history of attractiveness to FDI due to growth could build upon that record. They conclude that the standard “good government”/institutional quality variables poorly track rapid transformations such as China’s institutional changes, whereas an economy’s track record can serve as a useful additional indicator. Taking the measures together, they conclude that China’s FDI inflow has been unexceptional and quite similar to that of Eastern Europe once the institutional variables are appropriately considered.

(b) Innovation and “catching up”

The legal insecurities, particularly around proprietary information and intellectual property, are further posited to have an effect on the type of foreign capital invested in China. It may well be that foreign investors utilize China as a low cost manufacturing base, while withholding more advanced technology for fear of expropriation due to imperfect protection of intellectual property rights in particular. This would reduce the potential for imitation of existing technology that fuels “catch up” growth for China. The evidence on innovation and FDI is mixed and limited. For instance, using data from the period 1995–99, Hu, Jefferson, and Qian (2005) find that large and medium-sized domestic firms’ R&D activities complement technology transfers from both domestic and foreign capital, but FDI does not contribute to innovation which is driven solely by in-house R&D. Examining a later period from 1999 to 2005 and focusing only on SOEs, Girma, Gong, and Gorg (2009) find that FDI increases the innovativeness of these enterprises, but FDI in their industrial sector negatively influences innovative activity except for those SOEs that export, invest in human capital, or have prior innovation or R&D experience. The findings attest to the rapid changes in China’s economy and to research still needed to discern the effects of FDI on China’s technological progress. However, they suggest that despite two decades of FDI inflows, the purported benefits from foreign capital are influenced by China’s institutional framework and the strategic calculus of multinational corporations.

(c) Entrepreneurs and the private sector

The same legal and institutional insecurities influence the development of China’s de novo private sector, which comprises of entrepreneurs and private firms, key drivers of China’s transition and growth. Entrepreneurs in China are likely to be hampered by under-developed formal, legal institutions in the areas of property rights and other traits thought to be crucial for private sector development, such as complete credit markets, certainty in contracting, and investment protection. Studies of entrepreneurship have consistently found that entrepreneurs are wealth constrained and need to obtain external financing, making financing central to the process of entrepreneurship and the reliance on social networks common (see e.g., Evans & Lastovicka, 1987; and Evans & Chin, 1998). China has also traditionally had a strong cultural and historical emphasis on inter-personal relationships or guanxi, which informs business dealings both within and outside of China, and helps to explain how entrepreneurs cope in an imperfect legal system and still manage to become an engine of economic growth (see e.g., Knight & Yueh, 2008). Financial repression in China thus impedes entrepreneurship, though entrepreneurial and private sector activities have been on the rise in spite of the context and likely due to informal institutional mechanisms such as guanxi.

In this challenging legal and institutional environment, those who have certain characteristics, such as having inter-personal relationships manifested in social networks, possessing strong motivation and personal drive, and carrying a robust attitude toward risk, are more likely to overcome the institutional challenges and become entrepreneurs. Yueh (2009) uncovers the traits of entrepreneurs and first of all finds that self-belief is the main driver of entrepreneurship. In a national household survey conducted in 2000, when asked the reason why the respondent started his or her own business, 37% said that it was because he or she had the requisite skills and experience, 17% started a business by joining in with relatives, 11% had real estate, and 7% had funds.1 The first reason is found to be common among entrepreneurs across countries (see e.g., Blanchflower & Oswald, 1998). The second reason reflects utilization of Kinship-based social networks, which can help overcome credit and supply constraints. For instance, entrepreneurs were found to have arranged for inventory to be issued without advance payment. Anything which is sold is then split between the entrepreneur and the supplier of the inventory, such as peddlers receiving their goods in advance without paying a deposit. Access to suppliers and distributors is a significant challenge in a partially marketized economy in any event, and having a social network and the appropriate attitude to overcome these constraints would facilitate starting a business.

The final reasons reflect the difficulty that small and medium-sized enterprises have in obtaining credit and instead often rely on family and friends, including remittances from migrated family members, to start a business (Oi, 1999). Those with an asset such as real estate or funds would be better placed to become entrepreneurs given the wealth constraints mentioned earlier. Finally, in an opaque regulatory environment, having the contacts and know-how to obtain a license that enables the business to operate would be important. Licenses and permissions are needed not only for the set up of
the business, but also for the transport of goods across locales, such as crossing city or provincial borders.

A social network as well as possessing drive and having a healthy appetite for risk would help in this context, and these traits were indeed found to be significant determinants of entrepreneurship by Yueh (2009). Therefore, Yueh (2009) concludes that although entrepreneurs share similar educational and socio-economic background characteristics as non-entrepreneurs, they differ in having larger social networks, are more driven, and willing to embrace risk. These are traits that would help them overcome the institutional barriers to entrepreneurship in China’s under-developed legal/regulatory and financial systems and achieve greater rewards (they earned on average between 20% and 35% more per annum) that have the ultimate effect of fuelling China’s economic growth.

Zhou (2009) also explores the manner in which entrepreneurs operate in China’s credit constrained and imperfect institutional environment and concludes that political capital, a particular form of social capital/networks, is the informal mechanism relied upon. He argues that entrepreneurs actively invest in political capital to overcome bank financing obstacles by pursuing membership in the legislative or semi-legislative organs of the Chinese government. It corresponds to a growing literature which suggests that Communist Party membership is growing in importance even as China increasingly marketizes (see e.g., Appleton, Knight, Song, & Xia, 2009). Empirically, he finds that legislative membership helps entrepreneurs to obtain access to bank loans and perhaps more so for small and medium-sized enterprises.

The effects of China’s imperfect legal and financial systems are found in SOEs as well as in the de novo private sector and with some influence over the decisions of foreign firms. By so affecting the drivers of China’s growth, the implications lead naturally to assessing the evidence of China’s growth thus far and its future prospects in such an institutional context.

5. CHINA’S GROWTH PROSPECTS AND WIDER POLICY IMPLICATIONS

Despite the challenges of an under-developed legal system, China achieved remarkable rates of economic growth exceeding 9% on average for three decades. However, when this growth is analyzed, it appears to be driven more by factor accumulation than by technological progress—the former of which increases the level of growth, while the latter drives the long-run rate of growth. Most of the studies conclude that China’s growth is related to the underlying institutional arrangements in an economy that is particular to its social and economic context. Second, a nascent banking and financial sector is influenced by international economic norms and laws, as need more effective legal institutions. However, the crucial role of informal institutional mechanisms must be recognized and reconciled for legal reforms to be effective, as they have been a key aspect of China’s success.

China’s context as a transition economy and developing country perhaps allows the roles of informal and formal mechanisms to be more clearly visible since it evidently had no recognition of private property under Communism and its transition was premised on individuals and firms coping with the vagaries of market imperfections created by financial repression and an under-developed legal system. The potential lessons from China’s growth experience for other countries struggling with imperfect laws and regulations are also discernible. First, more often than not, laws tend to follow market developments, and the effectiveness of laws in fostering growth is related to the underlying institutional arrangements in an economy that is particular to its social and economic context. Second, a nascent banking and financial sector is not uncommon among developing countries, but informal lending mechanisms will influence the flow of funds and help determine the overall impact on the real economy. Third, the effects of a weak legal system on foreign investors and domestic firms will also distort the drivers of growth, but again, informal institutional structures can help entrepreneurs and innovative firms overcome the obstacles and will likely continue as a way of doing business and become intertwined with the evolving legal changes. Finally, perhaps the most damaging aspect of a weak legal system is in preventing innovation and entrepreneurship—key drivers of economic growth. China’s experience suggests that more effective legal protection will be needed as the market matures and a growing private sector in turn will generate the impetus for better laws and more stable financial development. Overall, China provides an interesting case for other developing countries faced with the challenge of adopting laws and reforming their economies in an increasingly open global context.

NOTES

1. The responses do not sum to 100% due to lack of responses (see Yueh, 2009).
REFERENCES


