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# Ending Financial Repression in China

by James A. Dorn

China has made significant progress since 1978 in opening its economy to the outside world, but economic liberalization largely stopped at the gates of the financial sector. Investment funds are channeled through state-owned banks to state-owned enterprises (SOEs), there are few investment alternatives, stock markets are dominated by SOEs, interest rates are set primarily by government fiat, the capital account is closed, and the exchange rate is tightly managed.

The consequences of China's financial repression are easy to see: a sea of nonperforming loans; misallocation of capital, with overinvestment in the state sector and underinvestment in the private sector; politicization of investment decisions and widespread corruption; poor performance of stock markets even though economic growth has been robust; an undervalued real exchange rate; and stop-go monetary policy.

By suppressing two key macroeconomic prices—the interest rate and the exchange rate—and by failing to privatize financial markets and allow capital freedom, China's leaders have given up flexibility and efficiency to ensure that the Chinese Communist Party (CCP) retains its grip on power.

Controls on the free convertibility of currencies and on capital transactions violate private property rights and attenuate both economic and personal freedom. Indeed, as F. A. Hayek warned in his classic book *The Road to Serfdom* (1944):

> The extent of the control over all life that economic control confers is nowhere better illustrated than in the field of foreign exchanges. Nothing would at first seem to affect private life less than a state control of the dealings in foreign exchange, and most people will regard its introduction with complete indifference. Yet the experience of most Continental countries has taught thoughtful people to regard this step as the decisive advance on the path to totalitarianism and the suppression of individual liberty.[1]

Once exchange and capital controls are imposed, they are difficult to remove. Government officials and special interest groups will profit at the expense of the public and use the force of law to plunder rather than protect property rights. That has been the experience in China and was clearly the case in Europe after convertibility was suspended in 1931. When convertibility was restored in 1958, Ludwig Erhard, vice-chancellor and minister for economic affairs of the German Federal Republic, stated, "Of all the many possible forms which integration of the free world can take, free convertibility of currencies is the most fruitful."[2]

Although China has made its currency convertible for current-account transactions, the capital account is still largely closed. Moreover, residents are often discriminated against in favor of foreigners. Making the transition to capital freedom in China would greatly increase economic and personal freedom and help bring about political reform. The best way to achieve that goal is to stick to a policy of engagement rather than succumb to what Alan Greenspan has called "creeping protectionism."[3] President Bush is correct to remind the world, "As the people of China grow in prosperity, their demands for political freedom will grow as well."[4]

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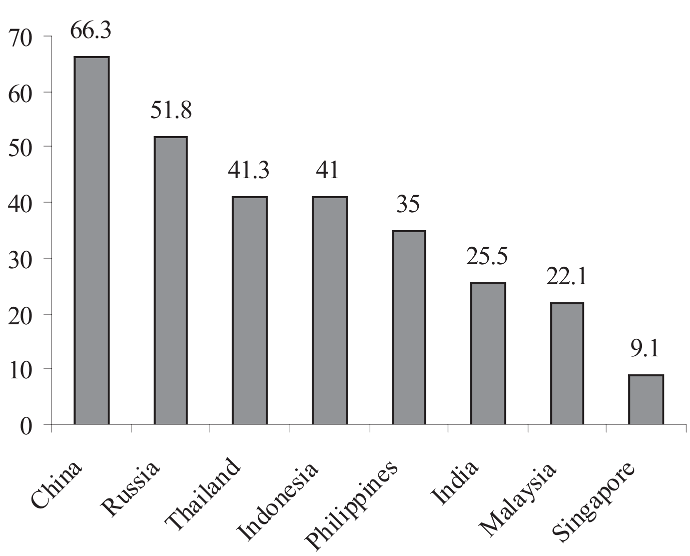
**Financial Repression and Its Consequences**

In a market-liberal order, in which private property rights are transparent and effectively enforced, people have the right to acquire, use, and sell their assets—the prices of which reflect the capitalized or present values of expected net income streams over the life of the assets. Those future income streams can be capitalized precisely because private capital markets exist and interest rates are competitively determined. In China, most financial capital is still state owned and interest rates are not free to fluctuate with demand and supply. Government agencies at various levels hold majority ownership in joint-stock companies and many shares are nontradable. Exchange controls limit the ability of residents to freely convert renminbi (RMB) into foreign currencies, and capital controls narrowly limit investment options. With few alternatives, the bulk of household savings is in the form of low-yielding deposits at state-owned banks, which channel funds to politically favored investment projects with low returns.[5] Meanwhile, private-sector firms must rely on the informal market.

Yasheng Huang, an economist at MIT, has shown that China's financial market repression is substantial and got worse in the 1990s relative to the 1980s. Using the World Bank's "World Business Environment Survey (WBES) 2000" and other indicators, he finds "a systematic, pervasive, persistent bias in financial policies in favor of the least efficient firms in the Chinese economy—SOEs—at the expense of the most efficient firms," namely, "China's small, entrepreneurial and private enterprises."[6] In response to a survey question, which assessed the extent of the "general financing constraint" (GFC) in selected countries as perceived by a sample of entrepreneurial firms in the nonstate sector in 1999–2000, the WBES found that 66.3 percent of the Chinese firms considered the GFC a "major obstacle." That proportion is the highest among Asian countries and exceeds the proportion in most transitional economies, including Russia (Figure 1).[7]

**Figure 1**
**Percentage of Nonstate Firms Subject to Major Financing Constraints, Selected Countries, 1999–2000**




Source: Yasheng Huang, "Do Financing Biases Matter?" Table 1, p. 19, based on World Bank, "World Business Environment Survey (WBES) 2000."

While the state sector produces less than one-third of industrial output value, it receives two-thirds of the commercial credit flowing through state-owned banks. The lack of transparency and the politicization of the lending process have led to considerable waste as seen in the high proportion of nonperforming loans, estimated at 25 percent or more.[8] Beijing has injected billions of dollars into the large state-owned banks and is slowly transforming them into joint-stock companies, but privatization is taboo.

The People's Bank of China (PBC) continues to peg the nominal exchange rate at a disequilibrium level, as indicated by the rapid accumulation of foreign exchange reserves that now exceed $800 billion. To prevent inflation, the PBC sells securities to drain off the RMB that are created when the bank buys foreign currencies. That "sterilization" process, however, becomes more difficult as the size of China's current-account surplus grows.

Although China moved to a new exchange rate regime on July 21, 2005, in which the RMB is officially pegged to a basket of currencies, there has been relatively little movement in the RMB/dollar exchange rate. After an initial 2.1 percent appreciation on July 21, the RMB has risen by less than 1 percent against the dollar. The daily trading band for the RMB/dollar rate remains fixed at 0.3 percent. However, institutional changes are occurring to deepen the foreign exchange market and widen the range of choice for traders.[9]

China has the most restricted capital markets in Asia. Portfolio investments are heavily controlled, as are most other capital-account transactions. Changes are occurring, such as more lenient treatment of qualified foreign institutional investors, but at a snail's pace.[10] A ranking of Asian countries based on the UBS capital restrictiveness index indicates that China has a long way to go before it reaches the degree of capital freedom enjoyed by top-rated Hong Kong.[11]

Capital and exchange controls clash with trade liberalization and are a heavy burden on China's economy. Of the top 10 global trading nations, only China has extensive capital controls. In addition to restricting individual freedom, those controls impose high administrative costs, distort investment decisions, misallocate capital, and corrupt what would naturally be mutually beneficial free-market exchanges.[12]

**Capital Freedom and Development**

Trade liberalization must be accompanied by financial reform if China is to continue to develop. It makes no sense for a capital-poor country like China to run persistent current-account surpluses that lead to net capital outflows—particularly, the massive accumulation of official foreign exchange reserves used primarily to purchase U.S. government securities. Ending draconian capital controls and allowing widespread privatization would transform China's socialist capital markets into genuine markets with real owners who would be responsible for their decisions and who would steer capital to its highest valued uses—as determined by free markets, not state planners.

John Greenwood, chief economist at Invesco Asia, Ltd., has advocated that China abolish capital controls, float the RMB, and privatize state-owned banks and firms. In his view, "If China's capital markets and its industries were normalized (through deregulation, proper implementation of the rule of law, the encouragement of private markets, and extensive private ownership), then China's balance of payments would no doubt undergo a major transformation."[13]

The transition to capital freedom will be smoother, says Greenwood, if the central bank pursues a policy of monetary stability—that is, provides a framework for long-run price stability. To do so, however, requires that the PBC let market demand and supply determine the equilibrium value of the exchange rate and focus primarily on controlling domestic money and credit growth, which means interest rates must also be liberalized. On the other hand, "under a fixed nominal rate framework, external capital controls are much more likely to be maintained and the adjustments to the trade and current account are therefore much less likely to occur."[14]

To those who argue that capital-account liberalization would destabilize China, just as it did other emerging market countries during the 1997–98 Asian financial crisis, Greenwood says that the root cause of that crisis was not capital freedom but rather the pegged exchange rate system combined with excessive growth of money and credit beginning as early as 1993. "The general lesson is that to control money and credit growth within reasonable ranges that are compatible with low inflation in the longer run, the external value of the currency must be free to adjust—especially upwards."[15]

If China chooses to keep the RMB/dollar rate undervalued and maintains capital controls, it will continue to experience stop-go monetary policy as the domestic money supply responds to the balance of payments and the PBC attempts to sterilize capital inflows. This schizophrenic monetary policy—trying to use monetary policy to manage both the exchange rate and the price level—is untenable in the long run if China wants to become a world-class financial center.

The CCP faces a dilemma: it can either maintain the status quo by suppressing capital freedom to retain its grip on power, or it can normalize China's capital markets and risk losing power. If it chooses the later path, China is likely to become the world's largest economy—and possibly one of the freest—in the second half of this century, and political reform would become a reality.

With stronger private property rights and long-run price stability, China would attract and retain capital—including human capital. People would be free to choose in international capital markets and free to trade. A fully convertible RMB, a flexible exchange rate, and a stable domestic price level would enhance both economic and personal freedom.

**The Question of Sequencing**

There has been much discussion of how China should sequence its economic reforms and make the transition from financial repression to capital freedom. It is clear that opening capital markets without reforming state-owned banks and without maintaining monetary stability could lead to substantial capital flight and exacerbate the problem of nonperforming loans. Moreover, there must be an effective legal system to protect newly acquired private property rights.

In a recent interview, Zhou Xiaochuan, the head of the PBC, emphasized that China is committed to create an institutional framework for a more flexible exchange rate regime "based on market demand and supply," and "gradually realize RMB convertibility . . . by lifting the restrictions on cross-border capital movements in a selective and step-by-step manner." In sequencing the financial sector reforms, the first priority is to put the banking system on a sound footing by recapitalizing the large state-owned banks and turning them into joint-stock companies with the participation of foreign strategic investors. Further progress must also be achieved in widening the scope of foreign exchange transactions, including liberalizing the capital account. Zhou recognizes that institutional change cannot occur overnight because "people need some time to learn and adapt to change." A new "mindset" must be developed. Moreover, he understands that China "cannot wait to start reforming the exchange rate regime until all banking reform measures have been completed."[16] Reform measures must move along a broad front.

Financial restructuring is occurring and the new exchange rate regime should allow for more flexibility, but one should not think that the CCP will easily give up its control over the financial sector or allow the exchange rate to be set by market forces. Political change must accompany economic reform if capital freedom is to be fully realized.

**Policy Recommendations**

Economic development—properly understood as "an increase in the range of effective alternatives open to people"[17] —requires the protection of both economic and other liberties. Without secure private property rights and economic freedom, personal freedom will suffer. Economic liberalization, privatization, and free-market competition are the only effective means to expand individual choices and, hence, to develop.

The United States and China need to continue the policy of engagement and recognize that it is more important to focus on the issue of capital freedom than on the narrow question of the proper exchange rate. China should continue to liberalize its exchange rate regime, open its capital markets, allow full convertibility of the RMB, liberalize interest rates, and use domestic monetary policy to achieve long-run price stability. Most important, China needs to privatize its stock markets, its banks, and its firms.

Many of those recommendations have already been accepted in principle as long-run policy goals. Indeed, the PBC's Monetary Policy Committee, at its third quarterly meeting in 2005, concluded:

- "The market itself should be allowed to play its role in economic restructuring."
- "Market-based interest rate reform policies should be continuously carried out."
- "Measures should be taken to further improve the managed floating exchange rate regime and maintain the exchange rate . . . at an adaptive and equilibrium level."
- "Efforts should be made to advance financial reform"

and “to enhance the effectiveness of monetary policy transmission.”[18]

Those pro-market policy recommendations are a positive sign and a clear signal that China’s top policymakers are aware of what needs to be done to improve the financial architecture.

In addition to internal pressures for financial reform, China is facing external pressures from the U.S. Congress and the World Trade Organization to end exchange and capital controls. China has promised to allow full participation by foreigners in its banking sector by 2007 and to further open to foreign portfolio investment. However, China is intent on moving at its own pace, especially regarding the transition to a floating exchange rate regime. According to Zhou, the “noises” being made on Capitol Hill (e.g., by Democratic Sen. Charles Schumer and Republican Sen. Lindsey Graham) for protectionist measures—if China does not significantly revalue the RMB/dollar exchange rate—“will not change the basic conditions and sequence of China’s exchange rate reform.” Such measures, however, could “disturb the normal course of the reform.”[19]

## Conclusion

President Hu Jintao’s “big idea” is to create a “harmonious and prosperous society” via “peaceful development.” To achieve that goal, however, requires *institutional change*—namely, a genuine rule of law that protects persons and property, and a change in thinking to accept the idea of spontaneous order and the principle of nonintervention (*wu wei*).

Long before Adam Smith, Lao Tzu argued that when the ruler takes “no action,” “the people of themselves become prosperous.”[20] China’s growing middle class and prosperity have come from increased economic freedom, not from top-down planning. Trade liberalization and the growth of the nonstate sector have been the hallmarks of China’s new economy. It is now time to get rid of the last legacy of central planning—state-directed investment and capital/exchange controls—and to end financial repression.

Congress would be wise to focus on capital freedom rather than bash China for its large trade surplus with the United States and blame that imbalance on an undervalued RMB/dollar exchange rate. Protectionist measures to force China to revalue would place a large tax on U.S. consumers and not advance capital freedom.

For its part, China needs to follow the Tao of the market if it is to fulfill its promise of “peaceful development.” Ending financial repression by liberalization, privatization, and competition would increase the chances for political reform. The United States and other free countries can help China move in the right direction by adhering to a policy of engagement rather than reverting to destructive protectionism.

## Notes

This article is an expanded version of an article that appeared in *Japan Economic Currents* (Tokyo, Keizai Koho Center), no. 59 (November/December 2005).

1. F. A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944), p. 92, n. 2.
2. Ludwig Erhard, *The Economics of Success* (New York: Van Nostrand, 1963), p. 247.
3. Alan Greenspan, “The Evolving U.S. Payments Imbalance and Its Impact on Europe and the Rest of the World,” *Cato Journal* 24, nos. 1–2 (Spring/Summer 2004): 11.
4. George W. Bush, quoted in “Bush’s Asia Strategy,” *Wall Street Journal*, November 19–20, 2005, p. A6.
5. In a study of China’s financial sector, Genevieve Boyreau-Debray and Shang-Jin Wei found that funds allocated through the government budget and through state-owned banks were negatively correlated with the marginal efficiency of capital. They also found that “the strongest determinant of capital allocation . . . appears to be the prominence of SOEs in local economies.” Genevieve Boyreau-Debray and Shang-Jin Wei, “Can China Grow Faster? A Diagnosis of the Fragmentation of Its Domestic Capital Market,” IMF Working Paper WP/04/76, 2004, pp. 22–23. China’s incremental capital output ratio, which measures the amount of investment required to generate an extra dollar’s worth of output, is very high (about 5) relative to Western market economies, indicating a very inefficient use of capital. “A Great Big Banking Gamble,” *The Economist*, October 29, 2005, p. 71.
6. Yasheng Huang, “Do Financing Biases Matter for the Chinese Economy?” Paper presented at the Cato Institute’s 23rd Annual Monetary Conference, Washington, November 3, 2005, p. 4.
7. Ibid., Table 1, p. 19. This table is based on the World Bank’s “World Business Environment Survey (WBES) 2000.”
8. Jonathan Anderson, “How to Think about China (Part 3): Which Way Out for the Banking System?” *Asian Economic Perspectives* (UBS Securities Asia Ltd.), May 9, 2005, pp. 7–8.
9. See Zhang Dingmin, “Forex Rate Forming Mechanism Reformed,” *China Daily*, January 4, 2006, p. 1; and Steve Johnson, “Traders Price in Surging Renminbi,” *Financial Times*, January 6, 2006.
10. On recent reforms, see Fred Hu, “Capital Flows, Overheating, and the Nominal Exchange Rate Regime in China,” *Cato Journal* 25, no. 2 (Spring/Summer 2005).
11. The UBS capital restrictiveness index is based on a score of 10 (closed capital account) to 1 (open capital account). In calculating this index, UBS takes account of “the number of legal impediments to capital account transactions” and “the size and variability of actual ex post capital flows.” Jonathan Anderson, “How to Think about China (Part 6): Seven Ways China Won’t Change the World,” *Asian Economic Perspectives*, November 28, 2005, p. 23, n. 3.
12. See Hu, p. 359.
13. John Greenwood, “The Impact of China’s WTO Accession on Capital Freedom,” *Cato Journal* 21, no. 1 (Spring/Summer 2001): 93.
14. Ibid., pp. 93–94.
15. John Greenwood, “The Real Issues in Asia,” *Cato Journal* 20, no. 2 (Fall 2000): 146.
16. “Governor Zhou Xiaochuan Speaks on Issues Related to the Reform of the Exchange Rate Regime,” *People’s Bank of China News*, September 10, 2005, pp. 1–2, 13, www.pbc.gov.cn/english//detail.asp?col=6400&id=572.
17. Peter Bauer, *Economic Analysis and Policy in Underdeveloped Countries* (Durham, N.C.: Duke University Press, 1957), p. 113.
18. “Monetary Policy Committee of the PBC Held the 3rd Quarterly Meeting of 2005,” *People’s Bank of China News*, September 26, 2005, www.pbc.gov.cn/english//detail.asp?col=6400&id=593.
19. “Governor Zhou Xiaochuan,” p. 3.
20. See James A. Dorn, “China’s Future: Market Socialism or Market Taoism?” in *China in the New Millennium*, ed. James A. Dorn (Washington: Cato Institute, 1998), pp. 104–6.