

FINANCIAL LIBERALIZATION IN CHINA

Limitations and lessons of the Japanese regime

Thomas F. Cargill and Elliott Parker

Abstract China has reformed old socialist banking institutions, using the Japanese financial regime as a model. We explain why this regime can perform well in the short run but will ultimately lead to serious economic problems, as exemplified by the recent Asian financial crisis, and we explain the problems and consequences of financial liberalization. We conclude with a summary of lessons China's reformers should learn from the recent financial experiences of their Asian neighbors.

Keywords China, East Asia, financial crisis, financial liberalization, Japanese financial regime.

INTRODUCTION

The People's Republic of China has managed to avoid much of the economic and financial distress experienced by many Asian economies since 1997 and Japan since 1991. For three years, China has been able to resist devaluing the yuan to regain its lost competitiveness in exports, enabled partly by accumulated foreign exchange reserves and limited exposure to short-term foreign debt, but more importantly, because China continues to impose economic and financial repression. Financial repression, however, masks long-standing problems, and China's reduced ability to continue its export-driven expansion due to the Asian situation has required expansionary monetary and fiscal policies to keep growth from declining significantly. Expansionary aggregate demand policy in the context of a 'weak' financial structure ensures serious future problems.

This paper explores a few of the implications of the Asian financial crisis for China. Asian financial structures in their most basic form are derivatives of the type of financial regime that supported Japan's impressive post-war growth through the late 1980s. Much of the financial distress experienced by Asian countries can be traced to the continued reliance on a self-reinforcing system of state intervention in the financial sector



intended to maximize capital formation in favored sectors. Though differing forces are at work in each Asian economy, they have all structured their financial systems around the Japanese model, either intentionally, in the case of South Korea, or inadvertently, in the case of China. For countries without well-developed financial markets, this state-controlled and bank-centered financial strategy has been a tempting alternative.

China adopted the Japanese style of finance due to shared cultural and historical reasons, as did other Asian economies, but mostly because the Chinese Communist Party had political reasons for continuing state control following the transition from the Stalinist 'monobank' approach. Furthermore, Japan had exhibited impressive growth through the 1980s, as did other Asian economies that adopted the Japanese approach, so the adoption of the Japanese regime was easy to rationalize. However, the Japanese financial regime began to unravel in the 1980s and 1990s as market forces increasingly came to dominate domestic and international flows of funds. This should serve as a warning call to China.

In the next section, we discuss the basic elements of the Japanese financial regime and explain how the regime became increasingly incompatible with the new environment of the 1980s. In the third section, we discuss the Chinese financial regime from several perspectives, especially how the Chinese financial system reflects the basic elements of the Japanese financial regime. Financial reforms that have occurred in China are evaluated as to how they have moved China away from the old regime. In the fourth section, we draw lessons for China from the experiences of Korea, Japan, and other countries regarding the old financial regime. Then we conclude the paper.

THE JAPANESE FINANCIAL REGIME

The financial systems of Asia are largely based on a financial structure that first evolved in Japan after the 1868 Meiji Restoration and reached maturity in the post-war period. Korea probably duplicated the Japanese regime to the greatest extent of the Asian economies, but the basic elements of the regime can be found throughout Asia.¹

In the Japanese financial regime, the state views the financial system as an instrument of industrial policy designed to transfer the majority of funds from surplus to deficit units through intermediation markets, especially bank finance. Large and highly-leveraged business groups are the primary recipients of this intermediation finance, and participation in the financial system by outside institutions is restricted to limit competition. Explicit and implicit government credit allocation policies play a major role in allocating funds, while the state's framework for supervision and regulation is intentionally opaque and non-transparent, so that political favors and concessions can easily be arranged between politicians, government bureaucrats, and

the business sector. Central banking institutions lack independence and instead serve as agents of the government. The regulatory system incorporates pervasive deposit guarantees, limits on portfolio diversification, and the central bank's lender of last resort services to support a policy of 'no failures of financial institutions or markets.'

This financial regime reduced the risk and the cost of private investment, limited financial instability, and supported an export orientation that both encouraged competition for foreign buyers and provided access to foreign capital without having to relax constraints over capital inflows or limits on the presence of foreign financial institutions.

Asian countries adopted the Japanese regime in different ways,² while maintaining the essential elements of financial repression, bank finance, and non-transparency (World Bank 1993). Japan and Korea, however, were the clearest examples of a bank-centered corporate governance model, in which large banks play a significant role in the management of large firms. The 'bank control' model has been credited with providing effective financial monitoring, not only in Japan and Korea, but also in post-war Germany.³

Japan's post-war industrial organization was centered on the *keiretsu* conglomerates, made up of firms connected to a main bank through cross-holding of shares. Korea's version of this was the *chaebol*, a smaller, more concentrated set of family-owned but government-partnered firms with special access to the state-owned banking system.

China in particular has found the bank-centered financial model appealing. China's economic reform has reduced the administrative power of the government and party bureaucracy over state enterprises. Under reform, the state has turned away from using direct budgetary allocations and toward using household deposits as the primary source of funds for propping up the state sector; state firms have been pushed towards relying on bank credit in the hopes this will improve monitoring and incentive effects. In its attempts to reform the management of state firms, China's leadership envisions state-owned enterprises under joint-stock ownership, with firm governance exercised by state-owned banks and other state agencies, rather than by individuals. Beijing has voiced admiration for the South Korean *chaebol*, and has encouraged the merger of its largest enterprises into similar trusts and conglomerates.⁴

The effects of state financial intervention

The Japanese financial regime was part of a development strategy that must, in hindsight, be considered successful. Lesser-developed economies are often victims of vicious cycles, in which low income levels lead to low savings rates, and thin markets lead to excessive investment risk. Many of the Asian 'miracle' economies essentially created a *virtuous* cycle, in which government

intervention helped to encourage lending towards productive uses and opened up available markets.⁵ This virtuous cycle reduced the investment risk for the private sector, which in turn led to rapid capital formation (both in physical and human terms), high rates of GDP growth, rising savings rates, and an inflow of foreign savings. Explicit or implicit guarantees that firms in good standing with the state would not be allowed to fail led to more private risk-taking, more willingness to invest, and a greater willingness to move into new markets. These economies also chose to rely on fixed exchange rate systems that helped reduce (particularly in lieu of adequate forward and options markets in the currency) the apparent risk of exporting goods overseas, borrowing from foreign lenders, and, for foreigners, investing directly.

However, many of the same policies which helped these economies grow rapidly have also had adverse consequences. Banks protected by implicit government guarantees are likely to exhibit moral hazard in their lending behavior. Financial repression, which makes funds available at low rates of interest, leads to investment in low-return projects and requires credit rationing, often to those whose political standing is better than their economic standing and thus misallocating savings away from the most productive use. Reducing the effects of risk may encourage excessive risk-taking by the firm, and reduce the incentive to invest wisely and manage well. These policies limit the growth of human capital to evaluate and monitor risk in both the financial and real sector.

Policies that reduce the likelihood of bankruptcy also lead to a greater disparity in economic efficiency over time. If less efficient firms are not shut down, then a greater proportion of the capital stock remains tied up in relatively unproductive uses. Capital formation becomes less important as an economy develops due to diminishing marginal returns and a diminishing 'catch-up' effect; thus, the very policy that helped an economy grow also helps to slow it down (Parker 1995a).

State intervention in the financial sector further encourages closer ties between the state, the firm, and the bank. Not only did this increase the opportunity for corruption and other diversions of funds in the Asian economies, it also reduced the need for transparency. This limited transparency increases the probability of speculative bubbles in asset prices as capital markets expanded and constraints on inflows and outflows of capital are relaxed.

Finally, fixed exchange rate policies, which in the short run appear to make international finance less risky to exporters, borrowers, and foreign investors, may actually be more risky in the long run. Fixed or pegged exchange rate regimes prevent the central bank from conducting independent monetary policy, but few governments (Hong Kong is a rare exception) are willing to forego attempts to sterilize intervention to insulate the domestic economy. Fixed exchange rate regimes further discourage the development of derivative markets to allow trading in currency risk,

so economic agents are forced to rely on government guarantees. The risk of devaluation becomes one-sided when the fixed exchange rate is one-sided (Friedman 1998), so that speculators can bet on devaluation without significant adverse risk.

The push towards financial liberalization

In the past decade, most Asian economies, including Japan, have initiated economic policies to gradually dismantle the Japanese financial regime. In most cases the reforms were forced on the government by conflicts between the rigidly regulated financial systems and the new economic, political, and technological environment that began to emerge in the 1970s. The new economic environment was characterized by variable and uncertain rates of inflation and changing patterns in the flow of funds. The new political environment stressed the benefits of the market system and the failures of socialism. Advances in computer and telecommunications technology provided a new technological environment that increased the efficiency and availability of financial services and assets.

There has been a significant liberalization in the domestic financial systems of almost every developed and developing economy since the 1970s. By the 1990s, financial systems in most countries permitted greater portfolio diversification and allowed interest rates and credit allocation to respond more to market forces, giving the consumer of financial services a larger, more competitive choice set. Financial liberalization, however, has not progressed in a smooth fashion in many countries. By the 1980s, many countries experienced significant banking problems manifested by increasing numbers of insolvent, or close-to-insolvent, institutions and increasing amounts of non-performing loans (*Economist* 1997; Lindgren *et al.* 1996).

The correlation between banking problems and financial liberalization has led some to suggest that recent financial liberalization is the primary cause of these financial crises.⁶ In the context of recent problems in Asia, Russia, and Latin America, some have argued either for a slower liberalization process or for a return to government-managed financial systems. For example, Malaysia has imposed exchange controls and some of the recent policy responses in Japan to their continuing banking problems clearly represent a return to the old style of finance.

These arguments are at best misleading since they fail to distinguish between the process of liberalization and liberalization *per se*. We suggest that liberalization itself is not the problem; instead, the problem is the political economy of liberalization (Cargill 1998b, 1998d). Three particular manifestations can be identified.

First, the mutual system of support between financial institutions, finance ministries, and politicians in the majority of developing economies allows

them to resist the exposure of their protected and non-transparent financial structures to the rigors of market forces. Market methodology (which places emphasis on transparency, limited government-directed credit allocation, direct money and capital markets, financial disclosure, and the willingness to accept business failures as a normal part of the market process) clashes with the Asian financial regime. As a result, liberalization progressed slowly in countries such as Japan and South Korea, and only after considerable political and economic pressure was brought to bear on the regulatory authorities.

Second, even economies that possess a more general acceptance of market forces have an incentive to pursue unbalanced liberalization, especially with regard to government deposit guarantees. The self-interest of the regulatory authorities and politicians provide incentives to pursue liberalization policies that increase portfolio diversification powers without significantly modifying the risk incentives embedded in, and the administration of, government deposit guarantees. An unbalanced liberalization process can also be created by attempts to maintain certain sectors of the financial system: for example, the mortgage or consumer finance sectors in the US economy, in a relatively privileged position.

Third, the old financial regime, with its emphasis on non-transparency and the belief that government can manage market forces, biases any regulatory response to a shock toward delay, forgiveness, and forbearance. The first reaction in this regime is to deny the problem and, once denial is no longer credible, to adopt accounting gimmicks clouded in non-transparency to understate the problem and give troubled institutions time to 'work their way out of the problem.' The prior release of market forces from past regulatory and market changes ensures that policies of delay will fail.

These manifestations of the old regulatory framework have adverse outcomes, as witnessed in the United States in the 1980s, Japan in the 1990s, and Korea in the late 1990s.⁷ The disruptions caused by market forces are primarily the outcome of market forces responding to government failure to modernize the financial sector. Thus state intervention, not market failure, is the key element of Asian financial crisis, and addressing this is the key to developing an approach to structural change that will ensure a return to a stable financial and monetary environment.

CHINA'S FINANCIAL REGIME

As the Chinese authorities have tried to restructure the incentives and institutions of both farm and firm, so too have they radically changed the financial landscape. In doing so, however, they have increasingly moved towards the Japanese financial regime.

At the end of the Maoist era, China's financial sector was essentially limited to a Soviet-style monobank which primarily managed the deposits

of state-owned enterprises (SOEs), and secondarily took deposits from consumers who were unable to spend the whole of their meager incomes on desired goods, channeling these funds towards investments in state production of heavy industry according to the dictates of the authorities. The People's Bank of China (PBC) did not need to compete for borrowers or depositors, did not need to evaluate creditworthiness of SOEs or their investment projects, and did not need to monitor firm performance except to verify that the firm's transactions matched the state's intentions; in essence, it acted as an extension of the state plan. Like many less developed nations, China's economy before reform was not very monetized, a fact exacerbated by Mao's emphasis on self-reliance: currency balances were 6.5 per cent of national income in 1952 but still only 7.1 per cent in 1978; urban and rural savings combined only grew from 1.5 to 7.0 per cent of national income in the same period (CSSB 1996).

Economic reform and financial restructuring

Mao died in 1976, and economic reform began in December 1978 with the political ascendancy of Deng Xiaoping and his policies. Within a decade after reform began, the stock of currency balances plus household savings deposits jumped to 50 per cent of annual national income. Meanwhile, China's official investment rate (as a share of GDP) grew to a high of 43 per cent by 1993, with household savings more than making up for a significant decrease in government savings.⁸ Economic reform not only gave farmers and workers more income, it gave them more reason to save, since it brought security from political attacks and more items to purchase.

This rapid growth in money demand made it possible for the government to finance its deficits with seigniorage without causing hyperinflation, and also encouraged some diversification of financial institutions and instruments. The government sold bonds to foreign and domestic buyers beginning in the mid-1980s, and by the beginning of the 1990s had begun to sell stock in its best-performing state enterprises and created two stock exchanges for trading. Still, by the mid-1990s banks still accounted for 90 per cent of China's financial intermediation, much more than in other Asian economies (Lardy 1998a).

For the past two decades China has been one of the world's fastest growing economies. Lardy (1998a) argues that China's growth has largely been a result of credit expansion, which has been primarily directed towards SOEs, and of the movement of rural workers from low-productivity agriculture into rural industry.⁹ China's open-door policy led to a rapid expansion of exports, but most of the growth in trade has come from non-state firms (Lardy 1992); some growth also came simply from China's recovery from the political turbulence of the Maoist period. Certainly China has become a more consumer-oriented, market-driven, and competitive

economy, but unfortunately productivity improvements in China's state-owned sector have contributed little to China's economic growth.

Reform of the financial system has moved in tandem with SOE reform. In 1978 SOEs employed only 19 per cent of the entire workforce but they dominated the urban economy, and by the early stages of reform it was apparent to policy-makers that the state-managed economy had created extremely inefficient state firms. Reform gave state managers greater autonomy and allowed the firm to keep a large share of its profits for bonuses and self-investment. Under a dual-track pricing system, state firms that fulfilled their existing quotas under the plan were able to market any surplus without fear of their quota ratcheting up. Eventually, as the above-quota and marketed share became dominant, the central plan was gradually dismantled. The state allowed competition from other state firms and then from non-state sectors: first urban collectives, then rural township and village enterprises, foreign joint-ventures, small rural and urban individually-owned firms, wholly-owned foreign firms, and finally larger domestically-owned private firms. Under the old system, profits of the state firm were government revenues, while the firm's investment was an unrelated, direct government expenditure. State firms exhibited investment hunger, to use Kornai's (1992) term, and planners faced with scarce savings were forced to ration investment. Reform attempted to rationalize investment by decentralizing decision-making and improving accountability, and direct state subsidies were increasingly replaced by bank loans and self-financing.

Unfortunately, SOEs have been very difficult to reform. SOEs initially improved productivity rapidly in response to the improved political and economic climate, but their capital stock grew much faster than their output due to increased firm autonomy without sufficient responsibility, combined with a banking sector responsible to state bureaucrats instead of private owners. A number of studies have shown the gradual stagnation of productivity growth in SOEs, especially relative to other types of firms, with worsening input price efficiency, wages increasing faster than inflation, and rapidly declining profitability (Parker 1999). State enterprises still employed 113 million workers in 1995, up from 75 million in 1978, though most of this increase was outside of industry and an increasing number of those employed in state-owned industry were staying home with partial pay under the so-called *Xia Gang* system.

China economists are now in general agreement that the state sector is in serious trouble, and there are many explanations for the state sector's poor performance.¹⁰ Of course some state firms have done quite well, but the variance of performance indicators is high, and large numbers are losing money and require subsidies to stay open. Because the fiscal budget has been a subject of government concern, direct subsidies have declined; instead, state banks have continued to be subject to political pressures to lend to state firms in dire straits, regardless of the inadequate return of

many of their investments. For the better performers, joint-stock corporatization has improved transparency somewhat and attempted to replace public funds with private capital, but these reforms have yet to address the fundamental problems of state ownership and bureaucratic control.

Changes in the banking sector

Banking reform began in 1984, when the PBC was split into several different entities. The PBC itself became the new central bank, while its more specialized functions were spun off into four state-owned commercial banks which still dominate China's financial sector (Pei 1998),¹¹ along with the China International Trust and Investment Corporation (CITIC) to manage foreign borrowing. A couple of new state banks have emerged – in the mid-1980s, CITIC was allowed to create the CITIC Industrial Bank, and the Communications Bank was established as a joint-stock bank (with 50 per cent of the shares owned by the PBC, and most of the rest owned by various state agencies and enterprises).¹²

In 1993, China announced a further acceleration in its financial sector reforms under the auspices of its new 'Socialist Market Economy' policy (Parker 1995b). Banks were to be separated into commercial banks, responsible for their own bottom line, and 'policy banks' which would carry out the government's lending priorities regardless of project profitability. These reforms proposed a more level playing field for all firms, both state and non-state, with better state regulation but less intervention, and a long-run goal of more competition in banking, including a role for foreign banks. However, China has been slow to allow further competition in the financial sector, and has done so primarily when circumstances dictated.

Only three additional national banks have been created since these reforms, including the Everbright Bank in 1992 (initially owned by the China Everbright Group), and the Huaxia Bank in 1992 (initially owned by Capital Iron and Steel, or *Shougang*, a major state-owned enterprise); both were reorganized into joint-stock banks in 1995 due to lending irregularities.¹³ A third bank, the Minsheng Bank created in 1995, is China's first non-state-owned bank; it was also the first bank to hire an internationally-recognized accounting firm to audit its books (Lardy 1998a), perhaps because it needed to reassure its depositors that their funds were secure in spite of the lack of the state's deposit guarantee.

Though there are other recently created financial institutions, including various policy banks, development banks, regional commercial banks, urban cooperative banks, and rural credit cooperatives, their access to financial markets is severely limited. China's government has also acted to prevent the creation of more private banks: for example, shutting down eighteen private banks in Wenzhou in 1995, and closing over a hundred small banks in Shanxi province in 1996; though the lack of oversight makes

closing unlicensed banks necessary, this is also consistent with Chinese concerns over bank privatization and competition. Foreign banks have been limited to doing business in foreign currency to restrict them from competing for Chinese depositors.¹⁴

Banks have slowly become somewhat more consumer-oriented than in the old regime. One of China's big four commercial banks, for example, recently experimented with consumer loans for automobiles;¹⁵ other banks in Shanghai and elsewhere are now offering mortgages, supporting a new state policy to privatize state-owned housing provided through the enterprise. However, both deposit rates and loan rates are strictly regulated by the PBC, leaving some banks to compete for depositors by providing more personal service, such as coming to the depositor's home to conduct transactions.

State banks respond to state pressure by exhibiting a clear bias in lending to state firms (Wei and Wang 1997), and many money-losing firms continue to turnover their old loans into larger loans without having to acknowledge their inability to meet even their interest payments. China's four major commercial banks are essentially insolvent, with 22 per cent of loans reported as non-performing in 1995, an amount over four times their net worth but still likely understated. Under the leadership of China's 'economic czar' and then vice-premier (now the current premier), Zhu Rongji, China implemented an austerity program in 1993 that slowed its rate of credit expansion and temporarily eliminated inflationary pressures. This engineered a 'soft landing' at the time in what was feared to be an overheated economy. Policy-makers have until recently been putting increasing pressure on banks to reduce their bad debts and to exercise more caution in future lending, but by most reports unrecoverable debt problems continue to worsen, rising by approximately 2 per cent per year in the late 1990s.

The effects of the Asian financial crisis

Owing to the high degree of government control and intervention, China's reform of its banking sector has led to a financial system that resembles the Japanese financial system rather than the more liberalized US system. However, there are a number of reasons why China's use of the Japanese financial regime did not lead it to suffer the same fate as its neighbors in 1997. First, China's foreign exchange regime is an 'airlock system', to use the phrase of the World Bank (1985: 97). Because of this vestige of China's socialist planned economy, the yuan is not easily convertible, particularly for capital account transactions, though capital flight still occurs through illegal practices such as under-invoicing of exports (Gunter 1996).¹⁶ China's equity market is still relatively small, and foreign investors are segmented off in the US and Hong Kong dollar-denominated 'B shares'

market. China also relied relatively more on long-term lending and foreign direct investment than Korea, so a short-term decrease in foreign exchange earnings does not threaten its ability to repay its loans. Thus, even though the devaluations throughout Asia have eroded China's advantage as a low-cost producer (particularly now that these economies are stabilizing and are re-establishing their ability to purchase inputs), China is not susceptible in the short run to financial panics in its currency markets.

The Asian financial crisis has probably set back China's plans for transitioning to full exchange convertibility by several years, but it has encouraged the government to take several confidence-building steps. Among these, the government recently announced plans to restructure the central bank along the lines of the US Federal Reserve Bank, and the banking sector's official capital adequacy rates are increasing to meet the Basel Agreement's standard for international banking. Simultaneously, plans to privatize, merge, or shut down money-losing state enterprises have accelerated. Regulators in Beijing have surprised critics by shutting down the Guangdong International Trust and Investment Corporation (GITIC), albeit with full compensation for its investors, along with Guangzhou's GZITIC.¹⁷

However, Lardy (1998b) stresses that the rapid escalation of bank credit in China, together with the significant rise in the share of non-performing loans, will likely make China's current rapid growth rates unsustainable. Chinese banks have been heavily exposed in an increasingly overbuilt real estate sector. In Shanghai/Pudong, Beijing, Shenzhen, and elsewhere, vacancy rates for office space have risen, and rents have fallen by as much as 50 per cent. At a time when export growth is necessary to employ those expected to be laid off by the state's new policy shift towards privatization of state enterprises, competitive devaluations from other Asian countries may begin to further slow China's speculative bubble in construction and other investments. So far, implicit deposit guarantees have kept depositors from fleeing the insolvent banking system, and the lack of significant banking competition gives households few alternatives except domestic and foreign currency. However, neither China's government nor its banks currently have the financial resources to cover bad debts; if households begin to become concerned about their deposits, there may be few alternatives to either a large-scale confiscation of deposits or a significant acceleration of inflation, both of which would seriously undermine China's continued growth prospects.

China's government is very concerned with the appearance of stability, and has committed itself to a stable yuan, in part to maintain economic confidence and partly because of the dangers of a devaluation to Hong Kong's economy, but also because China has gained a great deal of regional status from helping to stabilize the Asian economic situation. However, evidence of a current economic slowdown is leading to a loosening of monetary

policy and a reversal of past directives that banks reduce their lending to money-losing SOEs, and required reserve ratios are expected to decline in the near future. Combined with an unprecedented \$12 billion fiscal acceleration in public spending (Lu 1998), primarily directed towards more SOE capital investment, China's financial problems appear only likely to worsen.

LESSONS FROM ASIA'S FINANCIAL EXPERIENCE

Having abandoned the Maoist vision of building socialism, China's leaders now base their legitimacy on being able to deliver rapid growth rates with low unemployment and inflation rates (Parker 1995b). Thus, China's currently slowing economy causes the government serious concern, and financial liberalization may be pushed aside in favor of short-term expedients. However, there are a number of lessons that China should learn from the experience of Japan, South Korea, and other Asian economies.

First, China's leaders should understand that the interventionist approach characterized by the Japanese financial regime has a limited life. In Asia, financial repression was correlated with economic growth, though it is not certain whether it was causal, whether financial repression caused more rapid capital accumulation or whether economic growth merely made financial repression affordable. Clearly, however, when it does work this interventionist model requires certain conditions to succeed, including:

- 1 a high household savings rate;
- 2 a political consensus that the benefits of financial repression (favored firms receiving low-cost loans) exceed the costs to consumers or those investors who must use informal or 'curb' capital markets;
- 3 rapid GDP growth, both to build political support for the model and to mask its inefficiencies;
- 4 continued trade surpluses in order to build foreign exchange reserves; and
- 5 an early stage of economic expansion, when raw capital accumulation matters more to growth than technological progress.

Like the Stalinist model of forced savings for rapid industrialization, trade surpluses and financial repression both act to encourage domestic investment at the expense of consumption; the political support for this approach may not continue forever. Once economic growth begins to slow due to accumulating inefficiencies and a diminishing marginal product for capital, the inefficiencies become harder to hide, investor optimism begins to fall, and political support erodes. The model carries with it the seeds of its own destruction, and world integration makes it no longer viable in the long term except for hermit kingdoms.

As China liberalizes its financial sector, one of its most difficult problems

will be the design of a new system of deposit guarantees. In order to prevent contagion and maintain public confidence in the financial system, deposit guarantees are increasingly being institutionalized in many countries, often based on the US model. China's government, however, should be aware that deposit guarantees create a moral hazard problem in any economy, and may lead to 'too big to fail' policies. Deposit guarantees reduce deposit discipline and encourage risk-taking on the part of both depositors and depository institutions.

To limit the moral hazard, penalties for failure need to be clear to all participants; when an institution is to be closed or merged, the penalties must be consistently and predictably imposed according to the law. Departures from the penalty function have serious consequences for the liberalization process. In the United States the 'too big to fail' policy was inefficient, inequitable, and inconsistently applied. Japan until recently imposed few or no penalties on large depositors, shareholders, or even management in a number of failed institutions. Korea has also been reluctant to impose penalties for failure, though this policy toward financial institutions was changed in 1998. Unwillingness to impose real penalties on bank management, shareholders, and large depositors delays reaction and enhances the moral hazard problem.

Failure to modify the deposit guarantee system in the face of financial liberalization creates a fundamental flaw that renders the financial system inefficient and unstable. Moral hazard becomes an important element in portfolio management as liberalization enhances the ability of financial institutions to assume and manage risk. Deposit guarantees at a minimum need to be reduced if liberalization is to proceed smoothly. However limited, it is also important that any such deposit guarantees be explicitly and adequately funded, rather than backed up only by the government's full faith and credit. The reason is simple: If the funds are not easily available, regulatory agents will be slow to use them, and so will delay closing insolvent financial institutions.¹⁸

Deposit guarantees have been pervasive in Japan and Korea, and formed an important component of the mutual support system between financial institutions, politicians, and the Ministry of Finance; it was further complicated by the large postal savings system (Cargill and Yoshino 1998). Cargill *et al.* (1997, 2001) show how these guarantees contributed to Japan's bubble economy in the second half of the 1980s and persist to misallocate financial resources in the 1990s. Cargill (1999) discusses many of the same issues with respect to Korea.

Like the issue of deposit guarantees, effective bankruptcy policies are an essential characteristic of financial liberalization, and one that China's leadership has been forced to address. China's legislature passed a bankruptcy law in 1988, though the first bankruptcy of an SOE actually occurred two years earlier. However, until recently relatively few SOEs have been

closed, though the rate is now accelerating and the prospects of increasing shutdowns have caused great concern among the urban public. Most SOEs that have been closed are relatively small, and many poor performers have been eliminated through government pressure on better performers to take them over without closing them down, thus disguising the problem by injuring the balance sheet of the better firm. Many insolvent firms still continue to operate and have used bank loans to turnover past loans and pay current expenses; as a result, savings, which might have been used to finance capital expansion, have instead been used to prevent urban unrest. Bankruptcy must be implemented, not only for financial institutions but also for borrowers, state-owned or otherwise.

Parker (1995a) argues that systems which effectively reduce bankruptcies may aid capital formation in the short run, but will reduce technological progress in the long run as a result of increased performance heterogeneity. Even if the threat of bankruptcy were not necessary to improve managerial and worker incentive, firms get locked into inefficient technologies through circumstance and choices for which the outcomes are not *a priori* knowable. When resources do not flow from low-productivity to high-productivity firms overall growth performance declines. Bankruptcy, in essence, selects out the least efficient firms.

Can China delay the implementation of financial liberalization? Japan and South Korea are good examples of the costs of delay. As Japanese regulators avoided addressing the *jusen* problem, their bad debts continued to grow. Japanese politicians have recently admitted that their failure to address their banking crisis, rationalized by the hope that their economy would grow out of it, only made the costs skyrocket. Similarly, the Korean *chaebol* continued to borrow for the expansion of over-capacity, while weak banks continued to have access to short-term foreign credit. Banks continue to pour good money after bad, while insolvent firms continue to borrow while stripping their assets. Avoiding financial liberalization provides the illusion of stability while problems grow worse.

Delaying the solution only makes the ultimate crisis more catastrophic. If China had begun to close down money-losing state firms in 1985, when by official reckoning fewer than 10 per cent of those SOEs with independent accounting systems were losing money, the social costs would have been much less than in 1995, when this proportion had risen to 44 per cent. Similarly, unless China begins to act against insolvent banks, the bad debt problem will continue to escalate. Until recently, however, China has acted on the presumption that delay would allow it to outgrow the problem.

An important roadblock to financial liberalization lies in the government agencies themselves. The subsidy inherent in deposit guarantees, the political relationships between regulatory authorities and those institutions benefiting from deposit guarantees, and the time-inconsistency of short-run discretionary decision-making, combine to provide incentives for regulatory

authorities to adopt policies in dealing with troubled financial institutions that are a mixture of delay, forgiveness, and forbearance. The failure to deal decisively with troubled financial institutions by adopting policies that rely on a return to favorable economic conditions (lower interest rates, increased interest rate spreads between cost of funds and return on assets, and/or recovered asset prices) increases the moral hazard problem, reduces the efficiency of the financial sector, reduces the credibility of the regulatory authority, and ultimately increases the amount of funds that will be required to deal with the troubled financial institutions.

Agency problems were and continue to be pervasive in both Japan and Korea. The Ministry of Finance in Japan first denied and then understated the problem, and this approach was followed by a series of policies that were firmly based on forgiveness and forbearance. The same situation persisted in Korea, after its non-performing loan problem started in the 1970s.

Financial liberalization requires transparency, but a high degree of agency involvement makes transparency unpalatable. The Bank of Japan, for example, in late 1998 found itself in sharp disagreement with the Ministry of Finance over how much information to provide the public on bank holdings of non-performing loans. The lack of transparency makes it difficult to assess the condition of financial institutions and large non-financial corporations, both by the public and by the regulatory authorities. Just as important, it enhances the potential for regulatory authorities, financial institutions, and businesses to engage in mutual support, restrain competition, perpetuate insularity, and conceal the real cost of government failure in the financial system.

Lack of transparency in all dimensions is a major characteristic of Korean and Japanese financial regimes. Cultural and political institutional differences between different Asian economies and the United States contribute to differing attitudes about financial disclosure, but other more objective factors are also important. The depth and breadth of money and capital markets in the United States would not have been possible without the availability of meaningful financial information. The absence of significant money and capital markets in Korea and Japan reduced the need for financial disclosure, as did limits on the role of foreign capital. This elevated the role of banks to monitor credit risk through a system of long-term 'customer relationships' that relied on institutional knowledge rather than open public disclosure.

Financial liberalization is a slow process, in part because it takes time to develop appropriate human capital in the banking sector, to effectively evaluate credit and monitor performance in a more impersonal, competitive, and transparent environment, and also in the government agencies where the entire nature of regulation must change. As the financial sector liberalizes, state agents must relinquish control over the flow of funds at the same they increase prudential supervision and regulation.

In the interim, financial liberalization may increase the danger of crises until the liberalization process is complete, particularly since many existing firms may bear bad debts from government intervention under the prior regime. International financial liberalization is important for several reasons, but domestic liberalization should come first. Foreign banks, like foreign direct investors, are key to financial liberalization for several reasons: they provide a new source of foreign savings for domestic investment, and they may further help bail out insolvent institutions; they provide a model of best-practice in banking technology for domestic banks to follow; and finally, competition with domestic banks provides market discipline to make domestic banks more efficient, forcing them to reduce their spreads and lower their risk to keep their domestic depositors. Encouraging foreign capital to enter requires that it also be allowed to exit, so financial liberalization in international capital markets is a fundamental part of financial liberalization.

Bhagwati (1998) argues, however, that countries such as China and India should wait to drop their capital controls until their internal reforms are complete. He first advocates privatization, freer trade in goods, and 'targeted' convertibility for foreign direct investors. However, Bhagwati does not advocate the re-imposition of capital controls in those countries that have already dropped them, since he argues that it seriously undermines the confidence of both foreign and domestic investors.

Japan was not as vulnerable as Korea to panicked capital flight during the 1997 Asian Crisis, in large part because it had financed its past growth with its own savings, and also because it had been able to run continued current account surpluses to accumulate foreign exchange reserves. South Korea, on the other hand, was an externally-financed economy heavily reliant on foreign debt, with current account deficits and no significant foreign exchange reserves. Korea liberalized access to international capital too soon, before they liberalized their domestic financial sectors.

Also important to this is the exchange rate regime. The Japanese yen floats against the dollar and other major currencies, though this float has been characterized by significant intervention by the Bank of Japan. The Korean won was effectively pegged against the dollar until the mid-1990s, but even afterwards it was managed by excessive intervention by the Bank of Korea. Because Korea lacked Japan's foreign exchange reserves, its attempts to keep the won stable were doomed once it became apparent that problems in its financial sector would make foreign debt repayment difficult.

One major Asian country that also managed to avoid the worst effects of the financial crisis is India. According to Sachs, there were several reasons for this. Like China, India's ratio of short-term debt to foreign exchange reserves was low, so there was little reason for creditors to panic. Like China, India was cautious on banking sector liberalization; India also went slow on

the expansion of domestic credit and short-term foreign borrowing, and India also did a 'pretty good job' of banking supervision. Unlike China and those countries damaged by the financial crisis, India maintained a flexible exchange rate, so that when the rupee came under pressure in 1997 the central bank did not run out of reserves. Finally, India had already experienced a lesser crisis in 1991, an experience which led them to follow policies that adequately prepared them for the crisis of 1997.¹⁹

When China does liberalize capital account convertibility to encourage international capital flows, this will make it possible for foreign markets to signal inefficiencies in the domestic economy. Market discipline makes the financial sector (and the real sector) more efficient, though it is painful at times. To avoid a pattern of excessive investor optimism followed by panic, however, China should make sure that it has already made its domestic financial sector transparent and efficient. Finally, once China liberalizes, it should avoid the trap of fixed exchange rates, and instead float the yuan.

CONCLUSION

Financial liberalization cannot be avoided if China wants to become a modern and developed market economy, but liberalization requires several features. Financial activities and government involvement must be transparent to interested observers, effectively tying the hands of government agencies and reducing the susceptibility of the financial system to confidence shocks. Deposit guarantees must be limited, with explicit and real penalty functions for those who take advantage of them. Human capital must be developed both in the banking sector's evaluation and monitoring of risk, and in the government agencies' regulation and prudential supervision of banking activities; such development is a slow learning process. In the short run, for example, banks must probably be kept out of equity markets, in part to guard against fraud and reduce the likelihood of needing deposit guarantees, but also because banks have insider knowledge of firm creditworthiness that may discriminate against private owners. Finally, non-performing loans which resulted from past government policies of subsidizing inefficient state firms must be removed from the balance sheets of banks held responsible for their own decisions, and this will require a substantial commitment of state funds to maintain the integrity of the financial system. Delays in liberalization hide financial problems rather than solve them, and like the problems of inefficient firms, delay also raises the cost of the ultimate solution.

Financial liberalization is critical, but care should be taken to distinguish the goal of liberalization from the process. The transition at best is not smooth. Financial liberalization should follow a sequence. Korea made the mistake of increasing its vulnerability, not only by excessive short-term borrowing but also by wooing foreign capital through exchange convertibility,

without addressing its fundamental and long-standing financial problems in a timely manner. Japan was well ahead of Korea in its liberalization and was not vulnerable to foreign capital flight and debt repayment; however, the regulatory response to the collapse of asset prices generated economic and financial distress that has persisted throughout the 1990s.

China should get its financial house in order as soon as possible, and not depend on economic growth to solve its growing banking crisis, but care should be exercised to prevent sudden vulnerability. Capital account convertibility and bank privatization should not come until the fundamental problems are addressed. Because its reliance on continued government control and intervention disguises its banking problems while they continue to accumulate, China's apparent success in avoiding the more transparent manifestations of financial distress affecting other Asian countries should be no comfort to Chinese regulatory authorities.

University of Nevada, Reno

NOTES

- 1 The Japanese financial regime is summarized in Cargill (1998a). Korea's version of the regime is discussed in Cargill (1993, 1998a, 1998c). Huh and Kim (1994) discuss the evolution of non-performing loans in Korea and Japan and stress structural differences between the two financial systems. Lee (1992) provides a general presentation of Asian finance and argues that under certain conditions it provides a better base for economic development than more liberalized Western financial regimes.
- 2 These include differing arrangements of non-financial businesses, differing degrees of credit allocation, differing degrees of financial repression, and differing degrees of independence of central bank policy.
- 3 Cantillo Simon (1998) argues that it also provided effective financial oversight in the US prior to the passage of the Clayton Act in 1914, which outlawed interlocking directorates.
- 4 In a well-timed caution, Miller spoke at a 1995 conference in Shanghai and argued that the bank-centered corporate governance model used by Japan and South Korea was a poor choice for China, both because it encourages inefficient over-investment and because it tended to create a 'closed-loop' system where neither bankers nor managers were subject to market discipline (Miller 1997).
- 5 The concept of the virtuous cycle has been used in recent years to describe the increasing returns from government-market interaction. Naughton (1994), for example, used the term to describe the interaction between improvements in the performance of the state sector and the growing role of the non-state sector. Posner (1998) used it to make the point that modest legal reform can generate economic growth to finance further legal reform.
- 6 Borio *et al.* (1994), for example, argue that liberalization and financial disruptions are causally related. Nakajima and Taguchi (1995) suggest that deregulation in Japan encouraged banks to adopt risky loan and investment strategies.
- 7 Kane (1985) and White (1991) show how the political economy of liberalization generated the financial disruptions in the United States. Cargill (2000) and

- Cargill *et al.* (1997, 2001) discuss the same issues with regard to Japan and Cargill (1999) with regard to Korea.
- 8 Much of the national savings in 1979 was channeled through the government's budget, bypassing the banking system.
 - 9 This argument is similar to Krugman's (1994) argument that Asia's miracle was largely a myth, since growth in the region was not due to rapid improvements in technology or productivity across sectors, but instead could be explained almost entirely by higher savings rates and a reallocation of resources from existing low-productivity sectors (agriculture) to high-productivity sectors (industry, exports). Of course, this begs the question of why Asian economies did this while other less-developed economies did not.
 - 10 Some of the main reasons include: the erosion of the state's traditional industrial monopoly and labor monopsony power, which previously provided economic rents accounting for a significant portion of the state budget (Naughton 1995); a high social overhead because the state's agents have been unwilling to relinquish other goals in place of profit maximization (Parker and Wendel 1997); accumulation of inefficient technologies and institutional arrangements because of a lack of bankruptcy (Parker 1995a); and finally serious problems of managerial and worker motivation. See Parker (1995b) for a more detailed discussion.
 - 11 These include the Bank of China for international transactions, the Agricultural Bank of China, the Construction Bank of China, and the Industrial and Commercial Bank of China. Also created in the initial reform was the People's Insurance Corporation of China.
 - 12 The Communications Bank is particularly notable because it pioneered the use of modern banking methods in China (Pei 1998).
 - 13 Huaxia Bank, in particular, was being used as the 'private fiefdom' of *Shougang's* top managers (Lardy 1998a).
 - 14 Shanghai's Pudong special economic development zone has recently been the exception for Citibank and a handful of other foreign banks.
 - 15 This bank soon discontinued the practice, in spite of requiring borrowers to maintain time deposits at the bank in excess of the loan amount.
 - 16 Gunter estimates that illicit capital flight rose from an annual average of \$16 billion in 1989–91 to \$33 billion in 1992–4.
 - 17 Similarly, the government has begun to shut down some of the many insolvent urban credit cooperatives (*Singapore Business Times*, 30 October 1998).
 - 18 Though it has not followed that Japanese financial regime, the United States provides a transparent example of how deposit guarantees generate financial distress (Kane 1985; White 1991).
 - 19 This information comes from personal communication (e-mail) with Professor Jeffrey Sachs of Harvard University, on 2 February 2000.

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