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Financial liberalization and the middle-income trap What can China learn from the cross-country experience?☆

Huang YIPING [a,*], Gou QIN [b], Wang XUN [c]

[a] National School of Development, Peking University, China
[b] School of Finance, Central University of Finance and Economics, China
[c] China Economic Research Center, Stockholm School of Economics, Sweden

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ABSTRACT

Should China accelerate financial liberalization in order to avoid the middle-income trap? And, if the answer is yes, which specific reform steps should the government undertake? In this study we attempt to shed light on these questions by examining experiences of 80 countries during the period 1980–2010. Empirical analyses reveal that the growth effect of financial repression is insignificant among low-income economies, significantly negative among middle-income economies and significantly positive among high-income economies. Furthermore, for the middle-income group, repressive policies on credit, bank entry, securities market and the capital account significantly inhibit economic growth. In the meantime, law and order promotes growth among all income groups, while democracy has no impact whatsoever. We also validate these findings through a range of robustness checks. These findings offer important policy implications for China.

1. Introduction

China's rapid economic growth during the reform period lifted its GDP per capita from US$220 in 1980 to US$6600 in 2013. It now faces the challenge of middle-income trap, which was originally coined by World Bank economists to describe the situation in which a middle-income economy fails to graduate to high-income status (Gill & Kharas, 2007).[1] The comprehensive reform program approved by the Chinese leaders at the Third Plenum of the 18th Party Congress may be viewed as the authorities' efforts trying to sustain economic growth and to avoid the middle-income trap. It covers a wide range of economic reform measures, including financial liberalization. It also emphasizes independence of the legal system and accountability of the bureaucratic system but has no mentioning of democracy (Central Committee, 2013).

Is this the right policy package? And what should the Chinese government do to avoid the middle-income trap? Our primary interest in this paper is to understand roles of financial liberalization. We also wish to assess growth effect of the combination of emphasizing law and order without western-style democracy. In order to shed light on these questions, we examine international experience by running growth regressions, using a data set of 80 economies over the period 1980–2007. Specification of the

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* Corresponding author at: No.5 Yiheyuan Road, Haidian District, National School of Development, Peking University, Beijing, 100871, P.R.China.
E-mail address: yhuang@nsd.pku.edu.cn (H. Yiping).

[1] Between 1960 and 2008, only 13 out of 88 middle-income economies successfully rose to the high-income group (World Bank, 2012).

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growth model follows the literature, such as Barro and Sala-I-Martin (1992) and Barro (1996), and covers a list of conventional explanatory variables, such as government size, education, openness, fertility rate and investment rate, in addition to the three variables mentioned above — financial repression, law and order, and democracy.

The literature is inconclusive on the relationship between financial liberalization and economic growth. Existing studies find that repressive financial policies could either inhibit economic growth by dampening financial deepening (McKinnon, 1973; Shaw, 1973), or promote growth by better dealing with market failure (Hellmann, Murdock, & Stiglitz, 1997). Empirical results for the Chinese case study are also mixed (Huang & Wang, 2011; Li, 1994). We are also interested in the other two institutional variables, law and order and democracy, not only because they are parts of the current policy package but also due to lack of consensus views on their impacts on economic growth. For example, some empirical exercises find no significant correlation between democracy and economic growth (Barro, 1996). Others established clear causation between political institution and economic growth (Acemoglu & Johnson, 2005).

The main contribution of the paper is examination of growth effects of various policy and institutional variables for different income groups, although our focus is on middle-income economies. Most interestingly, we find that impact of financial repression on economic growth is insignificant for low-income economies, significantly negative for middle-income economies and significantly positive for high-income economies. These provide a unique angle for understanding of inconclusive results in the literature. Examination of repressive financial policies also reveals that policy restrictions on credit, bank entry, securities market and the capital account inhibit economic growth significantly among middle-income economies. In the meantime, the paper finds positive effect of law and order on growth for but no significant impact of democracy, for all income groups.

These findings have direct policy implications for China in its dealing with the middle-income trap challenge, subject to some important qualifications. While financial repression did not derail China's economic growth in the past, financial liberalization should be a key element of the policy strategy to sustain economic growth. Despite disagreement among academics and policymakers, the government should now move to realize capital account convertibility, at least for growth purpose. Furthermore, empirical analyses imply that strengthening law and order is critical, while democratization is not. They also suggest that, in order to sustain economic growth, the Chinese government should reduce government consumption, continue trade and investment liberalization, improve education, and maintain high investment rate.

The rest of the paper is organized as follows. The next section raises the research questions while reviewing the literature. Section 3 introduces the data set, model specification and estimation results. It then goes into the detail in analyzing the impacts of individual repressive financial policies. Section 4 conducts various robustness checks to deal with potential problems of endogeneity, alternative variable definition, multicollinearity and model uncertainty. And the final section draws important policy implications for China but also discusses some key qualifications.

2. Research questions and the literature

Should financial liberalization be a key focus for the Chinese government in its effort avoiding the middle-income trap and, if yes, which specific reform steps should the authorities undertake? These are the central research questions for this study. In addition we are also interested in the importance of some other policy and institutional variables, such as law and order, democracy, size of the government, economic openness, investment rate, education and fertility rate, for supporting economic growth at the current stage of development.

Financial liberalization is a key part of the reform program adopted by the leaders in November 2013. It contains reforms in 11 specific areas, including opening to both foreign and private financial institutions, establishing market-based interest rates, exchange rates and the official yield curve, developing multi-layer capital markets, achieving capital account convertibility and improving financial regulation (Central Committee, 2013). Financial liberalization was also an important part of the policy packages recommended, respectively, by the World Bank and the Asian Development Bank studies for China to avoid the middle-income trap (World Bank, 2012; Zhuang, Vandenberg, & Huang, 2012).

The relationship between financial liberalization and economic growth, however, is inconclusive in the literature. McKinnon (1973) first coined the term 'financial repression', referring to strict regulation of interest rates and mandatory allocation of resources. Such repressive policies would impede financial deepening and hinder financial efficiency and, therefore, should dampen economic growth (Pagano, 1993; Roubini & Sala-i-Martin, 1992; Shaw, 1973). However, some economists argued that conventional financial liberalization hypothesis is based on important prerequisite conditions and assumptions, such as prudent regulation, fiscal discipline, perfect competition and complete information (Arestis & Demetraides, 1999; Fry, 1997; Stiglitz & Weiss, 1981). Without these preconditions, developing countries might be able to better deal with market failures under financial repression (Hellmann et al., 1997; Stiglitz, 1994).

Empirical results are also mixed. For instance, Prasad, Rogoff, Wei, and Ayan Kose (2003) pointed out that an objective reading of the results of the vast research effort suggesting no strong, robust, and uniform support for the theoretical argument that financial globalization per se delivers a higher rate of economic growth. In a meta-analysis based on 66 empirical studies, Bumann, Hermes, and Lensink (2013) concluded that, on average, there is positive effect of financial liberalization on economic growth, but the significance of this effect is weak.

In the case of China, most economists argued that financial repression reduces efficiency and slows growth (Naughton, 1999; Park & Sehrt, 2001). Li (1994) argued that repressed interest rate had detrimental impacts, such as encouraging inefficient investment and distorting financial efficiency. Liu and Li (2001) confirmed positive contributions of financial liberalization to economic growth during China's reform period. In the meantime, Li (2001) argued that mild financial repression helped China