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How will financial liberalization change the Chinese economy? Lessons from middle-income countries

Yiping Huang, Yang Ji*

National School of Development, Peking University, China

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ABSTRACT

This study projects the impact of financial liberalization in China by drawing on the experiences of 60 middle-income economies over a period of four decades. Our results suggest that comprehensive financial reform could increase GDP growth per capita by up to 1.4% points and raise the real bank lending rate by up to 5.1% points. Perhaps the most unexpected result is a massive increase in net capital inflows by up to 20.1% of GDP, which could plant seeds for financial risks later. The probability of a currency crisis could increase by up to 21.7% points, but the probability of a banking crisis may rise or fall, depending on the quality of bank supervision. We also find different policy impacts of different financial reform measures. Bank ownership reform and regulatory reform are critical in supporting economic growth and financial stability. These findings offer important policy implications on how to derive maximum benefit from financial reforms while effectively mitigating potential risks.

1. Introduction

China's financial policy remains heavily repressive, as evidenced by restrictions on interest rates, the exchange rate, credit allocation, and capital movements, despite the country's rapid economic growth during the reform period. In November 2013, Chinese leaders proposed an ambitious financial reform program, as a part of a more comprehensive policy agenda, covering three broad areas: opening up to foreign and private financial institutions; liberalizing the market mechanism for pricing and allocation of capital; and improving financial regulation and infrastructure (CCP, 2013). If these reforms are rigorously implemented, by 2020 according to the plan, they could significantly transform China's financial and economic landscape.

However, economists and officials are still divided on how financial reform should be carried out, particularly with respect to its pace and sequencing. Disagreement among policymakers is partly attributable to problems inherent in the current structure of the regulatory system, such as difficulties of coordination among four ministerial-level financial regulators. An even greater hurdle is a lack of consensus on likely consequences of such reform. Like any policy program, financial reform has its costs and benefits. Quality policy decisions should be based on careful risk-reward analyses.

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* Corresponding author.
E-mail address: jiyangpku@163.com (Y. Ji).

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However, if all parties participating in a policy debate make their cases based on subjective and qualitative judgments, it would not be possible to build consensus. The current debate about capital account liberalization in China offers a good example – while proponents highlight potential improvement in efficiency of capital allocation, opponents warn about risks of financial crisis. Quantitative analyses should be the first step of good policymaking.

There are three broad approaches for quantitative assessment of financial liberalization. The first is to apply numerical models to run policy simulations. For example, Meza and Urrutia (2011) used a DSGE model to study the impact of financial liberalization on the exchange rate. Porter, Takáts, and Feyzioglu (2009) applied a partial equilibrium model to analyze interest rate liberalization in China. The second is to conduct case studies. Maudos and Solís (2011) examined the experience of the Mexican banking system after its opening up to foreign capital. Galbis (1998) summarized lessons of interest rate liberalization in 26 developing countries and two developed countries. Finally the third, which is adopted by this study, is to draw implications from the experiences of a group of countries. In this spirit, He, Cheung, Zhang, and Wu (2012) predicted China's future cross-border capital flows by examining data for other countries.

In this study, we assess likely effects of financial liberalization in China by examining the experiences of 60 middle-income economies during the past four decades. The purpose is to provide projections for key indicators such as economic growth, interest rates, cross-border capital flows, and financial risk. The analysis involves three steps. First, we estimate regressions of key economic and financial indicators on important policy and other explanatory variables using data for middle-income economies. Second, we input baseline and target levels of Chinese policy variables into estimated equations to derive changes in the key indicators. And, third, we interpret projections based on the above quantitative results, taking into account China's unique conditions.

We recognize that this approach may not produce accurate predictions of reform consequences given obvious difficulties analyzing financial behavior. However, it should add value even by simply looking at previous experiences of a large number of middle-income countries. The risk-reward framework should enable analysts to think about reform issues in a more balanced fashion. It may be worthwhile to accept some short-run costs and risks in order to claim longer-term benefits. The analysis may also help alert policymakers to potential economic and financial risks. While the numerical findings of such an approach will likely be controversial, they may nevertheless provide a good starting point for thoughtful policy deliberation.

This study points to a number of likely effects of further financial liberalization in China. First, the GDP growth rate promises to be lifted by the reform. Second, real bank lending rates should rise, but the interest rate spread may narrow or widen depending on the extent of financial liberalization and the quality of bank supervision. Third, capital inflows would rise more than outflows after liberalization. Fourth, the probability of a currency crisis would increase, while the probability of a banking crisis could rise or fall, depending on the quality of bank supervision. Of note, however, particular financial liberalization measures may have different effects on economic growth and financial risks. Specifically, bank ownership reform generally plays a positive role in supporting economic growth and financial stability. Like any empirical findings, these results need to be interpreted carefully. For instance, GDP growth may accelerate if financial liberalization leads to more efficient capital allocation even if the immediate effect is a dip in growth as financial liberalization forces the closure of inefficient enterprises. And, while the formal bank lending rate will undoubtedly rise, interest rates in informal markets could fall.

Our findings point to a number of policy implications. Implementation of systemic financial reforms may be a better strategy than stimulus policy for raising the growth rate. However, the government should take steps to ease the pain in sectors that rely heavily on bank loans following expected increases in real bank lending rates. Policymakers may also wish to consider special measures, such as reserve requirements adjustments or a Tobin tax, to slow capital inflows, which could create a source of financial instability later. Although we don't expect banking or currency crises in China in the foreseeable future, the authorities should deal with incipient banking problems early to avoid more devastating consequences later. The government may also consider a broader array of reform measures involving regulation and ownership to smooth the transition process.

The rest of this paper is organized as follows. Section 2 briefly reviews financial reforms in China during recent decades. Section 3 presents the research questions and hypotheses and summarizes the literature. Section 4 specifies the model and introduces the dataset. Section 5 presents the empirical estimation results. Section 6 projects and discusses the likely changes in the Chinese economy following further financial liberalization. The final section offers policy implications and concluding remarks.

2. Financial reform and development in China

China started its financial reform when the leaders decided to shift policy focus from class struggle to economic development at the Third Plenum of the 11th National Party Congress in late 1978. In pre-reform China, there was a monobank financial system in which the People's Bank of China (PBC) served as both central bank and commercial bank. At that time, there was little demand for financial services as fund allocation was executed by the central plans, not the financial system.

In 1978, the government established three specialized state-owned commercial banks (SOCBs) – the Bank of China (BOC), the People's Construction Bank of China (CCB) and the Agricultural Bank of China (ABC). At the start of 1984, the PBC was split into two parts, one becoming the Industrial and Commercial Bank of China (ICBC) and the remainder forming the new central bank. In the meantime, the government made efforts to create a wide range of new financial institutions, including policy