

China's Financial Repression: Symptoms, Consequences and Causes

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Abstract

China's financial system conforms to the stereotype described by the theory of financial repression. The banking sector is dominated by state ownership, interest rates are controlled by the government and credit allocation is heavily influenced by political factors rather than by commercial motives. The severity of repression in China's financial sector increased to an unprecedented level after 2008, when the Chinese government poured enormous financial resources into the economy as a response to the financial crisis. Financial repression has seriously damaged the sustainability of China's economy by decreasing economic efficiency. However, financial repression may be maintained in the future despite its harmful effects because for the Chinese Communist Party control over financial resources is a powerful weapon that can be used when necessary to address certain economic, political or social problems that may endanger its rule. Given the importance of financial resources to the rule of the Party, it is difficult to imagine that it will eventually adopt a liberalization strategy and relinquish its control over the financial system.

Keywords: financial repression, China, economic growth, financial risk, politics

Introduction

Financial repression theory has its origins in the work of McKinnon (1973) and Shaw (1973). McKinnon and Shaw argue that numerous countries, including developed nations,¹ but particularly those that are in the process of developing, have historically restricted competition in the financial sector through government intervention and regulation. According to their argument, a repressed financial sector discourages both saving and investment because the rates of return are lower than what could be obtained in a competitive market. In such a system, financial intermediaries do not function at their full capacity and fail to efficiently channel savings into investment, thereby impeding the development of the overall economic system.

The influence of financial repression has been tested by numerous empirical studies, many of which identified a negative association

between financial repression and certain economic variables, such as savings rates, investment and economic growth.² Given its harmful effects, a liberalization-oriented policy that attempts to relax or abolish financial repression has gained momentum among policymakers in developing countries. As a result, since the 1980s a gradual removal of financial restraints has been witnessed worldwide (Abiad, Detragiache and Tressel 2010).

However, China appears to be going against the tide of financial liberalization. After 40 years of economic reform (particularly some significant liberalization-oriented reforms in other markets), China's financial markets remain heavily repressed. According to Huang and Ji (2017: 29), 'China's financial liberalization is among the lowest in the world'. The banking sector continues to be dominated by state ownership; in addition, interest rates are still controlled by the government and credit allocation is heavily influenced by political factors rather than commercial motives. All these features will, as suggested by the financial repression theory, contribute to the misallocation of financial resources, social welfare loss and, finally, a slowdown of growth or even economic recession. However, China has experienced remarkable economic growth over the past four decades and has surpassed Japan as the world's second-largest economy.

China's case raises interesting and important questions. How serious is China's financial repression? How has China been able to achieve remarkable success in terms of economic development despite its repressed financial system? And why does the Chinese government liberalize other markets, such as product and labour markets, but fail to liberalize its financial system? We attempt to answer these questions in this study. More specifically, we describe the status quo of China's financial system, with special attention to its repressed nature, explore the connection between financial repression and China's economic growth, and, finally and most importantly, reveal the role of the domestic political environment, particularly the survival strategy of the Chinese Communist Party (hereafter the Party), in shaping China's financial landscape.

The remainder of the paper is organized as follows. The following section describes the landscape of China's financial sector, with particular attention to its repressed nature. We then discuss the connection between financial repression and China's economic growth, and the influence of the fiscal stimulus programme adopted by the Chinese government in 2008 on China's financial system. The article next explores the political

factors that may contribute to the distortion of China's financial sector, before drawing out conclusions in the final section.

Financial Repression in China

Dominance of State Ownership in the Banking Sector

China has an extremely high level of state ownership in the banking sector. For example, Naughton (2017a) reports that by 2014 the Chinese government controlled at least 85 per cent of banking sector assets. Government ownership tends to politicize resource allocation. Therefore, the top executives in Chinese state-owned banks are confronted with two different and often conflicting missions: to advance the government's political objectives and to optimize the bank's financial performance. When these two missions contradict each other, the former always dominates.

State ownership also creates a moral hazard problem for bank managers because they are ultimately not accountable for losses that result from the loans they have extended and therefore have little incentive to develop skills and expertise in credit evaluation. As a result, state-owned banks are shown to suffer from inefficiency, low profitability and a lack of caution in credit issuance, particularly when they are compared with joint-stock banks and city commercial banks (Berger, Hasan and Zhou 2009; Jiang, Yao and Feng 2013; Jiang, Yao and Zhang 2009; Lin and Zhang 2009).

However, there are also studies showing that the performance of state-owned banks has improved after China's financial reform. For example, Firth et al. (2009) find that banks tend to allocate loans to firms with higher profitability, more experienced and incentive-compatible CEOs and more independent corporate boards, which implies that the banks use commercial judgements in loan-extension decisions. Hsiao, Shen and Bian (2015) show that the operating efficiency of Chinese domestic banks (including the state-owned banks) is catching up with that of foreign banks.

Misallocation of Credit

After several decades of economic reform, China's non-state sector has replaced state-owned enterprises (SOEs) as the key driver of China's economic growth. However, the non-state sector, particularly private enterprises, has been discriminated against in terms of credit access

and availability. For example, Li, Yue and Zhao (2009) report that for unlisted manufacturing firms in China, state ownership is significantly and positively associated with a firm's likelihood of having long-term debt (but not short-term debt) and a higher leverage ratio. Based on a data set including more than 20,000 Chinese firms from 1998 to 2005, Poncet, Steingress and Vandenbussche (2010) find that private firms significantly relied on their cash flow to finance investments, which is evidence of credit constraints, whereas SOEs did not. Financial discrimination against private enterprises appears to have continued or even worsened after 2008, when the Chinese government adopted a gigantic stimulus plan (Herrala and Jia 2015; Johansson and Feng 2016; Roberts and Zurawski 2016).

Internal and informal financing, such as retained earnings, trade credit and private loans, have thus played a more important role in financing the growth of private firms. Cull, Xu and Zhu (2009) find that (poorly performing) SOEs were more likely to redistribute credit to firms with less privileged access to loans via trade credit, which could be considered a substitute for loans that these target firms were unable to obtain from formal credit markets. In addition, credit discrimination may force private firms to seek foreign investors; by establishing cross-border relationships with foreign firms, private domestic firms can bypass the financial and legal obstacles that they face at home (Héricourt and Poncet 2009; Poncet, Steingress and Vandenbussche 2010).

Interest Rate Controls

The liberalization of interest rates in China came relatively late in the sequence of economic reform and has followed a gradual approach. What deserves more attention in this study is that China's central bank appears to adjust the benchmark interest rates in an asymmetric manner in response to inflation (Liu, Margaritis and Tourani-Rad 2009). More specifically, the central bank adjusts deposit and lending rates downward more quickly than it adjusts them upward. When inflation increases, the rigidity of interest rates leads to lower or even negative real interest rates. This trend is more obvious after 2004 (Lardy 2012). The direct result of the central bank's approach to setting nominal interest rates is that, on average, household interest earnings have been far less than they would have been in a more liberalized financial environment.³ Lardy (2012) reports that whereas from 1997 to 2003 the real return on a one-year bank deposit was consistently positive and averaged 3 per cent, since the beginning of 2004 the real return on a

one-year deposit has been negative for approximately half the time and averaged -0.5 per cent. In contrast, the corporate sector benefits greatly from such a monetary policy. There was a marked decline in real lending rates after 2003. Whereas from 1997 to 2003 the real rate on a one-year loan averaged 6.8 per cent, since the beginning of 2004 the real interest rate on a one-year loan has averaged only 1.7 per cent, thus artificially lowering the cost of capital and encouraging investment in projects that have much lower returns (Lardy 2012). The low cost of capital in China has made the country an anomaly when compared with other countries, both developed and developing. For example, based on data for 30,000 firms across 53 economies, Geng and N'Diaye (2012) show that the real cost of capital—defined as a weighted average of the real cost of bank loans, bonds and equity—faced by Chinese listed firms is below the global average. The authors further argue that China's capital appears to be particularly cheap compared with its productivity. An estimate of the marginal product of reproducible capital (i.e., capital adjusted for land) shows that China's return to capital is well above its real loan rate, which makes China an outlier on the international scene.

Recent Reforms

The Chinese government appears to have attempted to liberalize its financial system in recent years. For example, since 2012 interest rate liberalization advanced at an accelerated pace. The lending rate floor, which was expanded to 0.7 times the benchmark rate in 2012, was removed in July 2013. In theory, this allowed financial institutions to independently determine lending rates based on market forces. From November 2014 to October 2015, the deposit rate ceiling was increased three times and was finally removed in October 2015. Therefore, the International Monetary Fund (IMF) (2016: 5) announced that 'interest rate liberalization was formally completed ... these reforms help move China towards an independent, market-based, monetary policy'.

However, the practical effects of the reform are limited. Tan, Ji and Huang (2016: 2) claim that

the de jure completion of interest rate liberalization has generated little impact on the Chinese financial system ... commercial banks still stick to the official benchmark rates set by the PBOC, although they are not required to do so anymore, at least in theory. Both deposit rates and loan rates have stayed nearly the same as those before reform. Without any real change in the pattern of financial institutions' behaviour, the recent reforms have not

yet put an end to financial repression ... there is no sign of diminishing distortion of capital allocation.

Similarly, in the area of financial openness, reform also leads to mixed outcomes. The Chinese government has indeed taken measures to reduce foreign exchange interventions, loosen capital account controls and encourage the internationalization of the Chinese currency (renminbi). For example, China has gradually widened the band around which the currency could trade relative to the fixing rate set by the central bank, loosened capital account controls by partially relaxing restrictions on portfolio investment and cross-border lending and borrowing, and pursued internationalization of renminbi along two interrelated tracks – that is, the trade track and the finance track (Cohen 2017; Goldman Sachs 2016; IMF 2017b). A milestone of China's financial openness was reached in October 2016, when renminbi was included in the IMF's special drawing rights basket.

However, the improvements in China's financial openness are limited. Despite recent reforms, China still has one of the strictest systems of capital control in the world. As a response to the intensification of capital outflows (US\$648 billion in 2015 and US\$640 billion in 2016, triggered by worries regarding China's serious debt problem and gloomy economic prospects), the Chinese government has tightened its control over capital flow since mid-2016. Should economic growth continue to slow and confidence in the stability of renminbi erode, it is unlikely that the capital account will be meaningfully opened beyond current levels in the near future. This in turn means that the process of renminbi's internationalization will soon reach a dead end. Slowing down the pace of financial openness, despite its efficiency losses, is understandable, as further financial openness will expose China's flawed financial system to international capital flows and endanger the nation's financial and economic stability. Financial openness needs a solid foundation, such as an efficient and robust banking sector, which China lacks.

In general, progress towards financial liberalization after the Third Plenum of the 18th Party Congress, which was held in November 2013 and aimed to bring about new momentum for China's economic reform, has been limited. A recent estimation of reform performance after 2013 concludes that 'it is impossible to resist the conclusion that the reform process overall has stumbled and is in serious trouble' (Naughton 2017b: 3).

More specifically, Naughton argues that

the prospect of a large package of interrelated reforms achieving success together has disappeared, and many complex multi-stage reforms are

in limbo... A number of individual reforms have been watered down... Most tellingly, financial reforms of the stock market and capital account liberalization have been spectacular failures. (2017b: 3)

Economic Consequences of Financial Repression

Effects on Efficiency and GDP Growth

China's repressed financial policies have severely undermined its prospects of economic growth by misallocating financial resources. For example, Bas and Causa (2013) find that aligning financial policies in China to the average level observed in Organisation for Economic Co-operation and Development (OECD) countries would result in labour productivity gains of 6.5 per cent in the manufacturing sector. Brandt, Tombe and Zhu (2013) find that between 1985 and 2007 capital and labour misallocation lowered aggregate non-agricultural total factor productivity (TFP) by an average of 20 per cent, with capital misallocation accounting for more than half of the total loss. Wu (2015) reports a higher estimation and shows that policy distortions in financial markets caused an aggregate TFP loss of 19.2 per cent.

Therefore, financial repression has significant implications for China's gross domestic product (GDP). Several empirical studies show that financial repression has been harmful to China's economic growth. For example, Guariglia and Poncet (2008) report that the indicators measuring the level of state intervention in China's finance sector – such as the share of state-owned banks in total bank credit and the ratio of total state-owned bank credit to GDP – are negatively associated with GDP growth, physical capital accumulation and productivity growth. By contrast, Peng et al. (2014) construct an index of financial liberalization that combines eight aspects of China's financial reform process between 1978 and 2004 and report that liberalization has a significant positive effect on growth in the short run and on accumulated growth in the long run. Similarly, Anzoategui, Chivakul and Maliszewski (2015) show that China's GDP could be boosted by approximately 5 per cent by liberalizing interest rates and removing credit discrimination.

Thus, how did China achieve such miraculous economic performance despite its inefficient financial system? Chinese financial repression has in fact caused economic inefficiency. However, such inefficiency may be counterbalanced by other forces and, therefore, the detrimental effects of financial repression are limited. For example, Xu and Gui (2013,

2014) demonstrate that China's repressed financial system acts as a double-edged sword: on the one hand, credit misallocation and state ownership in the banking sector retard economic growth by damaging economic efficiency; on the other hand, interest rate controls contribute to economic growth by lowering the cost of capital, and exchange rate distortion promotes economic growth by stimulating exports. In other words, although the private sector, which is the key driver of China's economy, is hurt by credit discrimination, it can still benefit from other financial repression policies, such as a low interest rate environment and exchange rate undervaluation. China's financial repression policies, therefore, appear to subsidize the entire corporate sector (including both SOEs and private enterprises) at the cost of household sectors, even though SOEs benefit disproportionately from such a subsidy. In general, it may be argued that before 2008 China adopted a modest financial repression policy which, as suggested by Hellmann, Murdock and Stiglitz (1998), may not have been very harmful (and may even have been helpful) for China's economy.

Effects on Debt Accumulation, Financial Stability and Financial Risks

China's economy was severely impaired by the global financial crisis of 2008. In response, on 5 November 2008 the Chinese government announced a massive fiscal stimulus programme (the 'CNY 4 trillion stimulus programme'). The stimulus package appears to have effectively boosted China's economic growth, at least in the short term. Unfortunately, this success was achieved at the cost of intensifying China's financial repression. The basic logic of the programme is to stimulate China's economy by mobilizing SOEs, particularly local government financing vehicles (LGFVs), which, with the (almost unlimited and unconditional) help of the banking sector, primarily invest in certain low-yielding projects, such as infrastructure. Therefore, China's growth pattern has become much more credit driven, SOE-favoured and state led than before 2008.

On the asset side of the programme, investments made by both LGFVs and traditional SOEs have played a key role in reinvigorating China's economy after the shock of the financial crisis (Deng et al. 2015; Shi and Huang 2014; Wen and Wu 2014). Unfortunately, the efficiency of these investment projects is doubted (Cong and Ponticelli 2017; Shi, Guo and Sun 2017; Shi and Huang 2014). In addition, as a result of China's stimulus programme, total industrial production in China

nearly doubled between 2007 and 2013 (Wen and Wu 2014). Because of the rapid expansion of production, capacity utilization in key sectors of the economy has declined significantly, which suggests that there is substantial excess capacity in the economy (IMF 2012; Nie et al. 2016). Therefore, the ratio of 'zombie firms' has increased significantly, which leads to serious solvency problems in certain industries, and exposes Chinese banks to the increasing risk of non-performing loans (EIU 2017; IMF 2016; Prasad 2016).

On the liability side, bank loans played a dominant role in financing LGFVs and other SOEs before 2012. Bai, Hsieh and Song (2016) report that 90 per cent of local government off-balance-sheet spending (through LGFVs) in 2009 was funded by bank loans. Similarly, Zhang and Barnett (2014) show that bank loans accounted for approximately 80 per cent of total local government debt by 2010, which is equivalent to CNY 12.7 trillion.

Because of the surge of bank credit in 2009, the Chinese government realized that the policy-driven credit boom could grow out of control and therefore, after 2012, tightened monetary policy and discouraged bank lending to LGFVs and certain industries. As a result, LGFVs and other firms were forced to turn to other financing vehicles, particularly to the shadow banking system.

China's shadow banking has developed at an astonishing speed since 2008.⁴ It is beyond the scope of this study to discuss the details of these activities. Rather, we outline just three important features of the sector. First, the prosperity of China's shadow banking system is the direct result of the stimulus programme (Acharya, Qian and Yang 2016; Chen, He and Liu 2017; Chen, Ren and Zha 2016). Second, the shadow banking system is closely intertwined with the formal banking sector (Elliott, Kroeber and Qiao 2015). Third, the development of China's shadow banking system may sow the seeds of financial risk, or even crisis, in view of its operating pattern, which has been characterized by 'less stringent regulation, lower safety margins, riskier business models, and opaque business methods' (Elliott and Qiao 2015: 18).

Perhaps more importantly, because of the credit boom before 2012 and the subsequent rise of the shadow banking sector, China's debt accumulation has reached a stunning level. Total debt held by the non-financial corporate sector doubled from 68 per cent of GDP to 136 per cent in 2015 (McKinsey Global Institute 2016). Altogether, China's total debt (including the debt of the financial sector) has nearly quadrupled since 2007, increasing from US\$7.4 trillion to US\$28.2 trillion by the

second quarter of 2014, and increasing from 158 per cent of GDP to 282 per cent (McKinsey Global Institute 2015). This ratio is higher than the aggregate ratio for advanced economies (279.2 per cent) and far above the average of emerging markets (excluding China) (186.5 per cent) (EIU, 2017).

The rapid growth in credit and accumulation of debt in China has generated concern about its financial stability and prospects of economic growth. For example, based on the credit-to-GDP gap, which is defined by the Bank for International Settlements as the difference between the credit-to-GDP ratio and its long-run trend, and is generally used to predict the probability of a financial crisis, the IMF has warned several times that China's financial stability may face a serious threat in the near future (IMF 2015, 2016, 2017a).

In fact, even the Chinese authorities themselves expressed a similar concern. On 9 May 2016, an article was published in the *People's Daily*, which is known as the mouthpiece of the party-state. The article cited an 'authoritative person' (who is believed to be Liu He, the right-hand man of Chinese president Xi Jinping), who claimed that 'it is neither possible nor necessary to force economic growth by leveraging up' and warned that there might be a possibility of systemic financial crisis if the process of leveraging up finally gets out of control.⁵ President Xi Jinping also urged others to 'prevent financial risk' and 'maintain financial security' at several public events.⁶

Accordingly, the Chinese government has taken certain measures to address potential financial and economic risks. So far, the most important policy framework is the so-called 'supply-side structural reform' (SSSR), which was first mapped out in December 2015 at the Central Economic Work Conference, a high-level annual meeting of policymakers and senior Party leaders, including Xi Jinping himself. This conference identified five areas of focus under SSSR, including cutting (industrial) overcapacity, destocking (property inventory), (corporate) deleveraging, lowering corporate costs and improving 'weak links'. While there has been progress in implementing SSSR in certain areas, such as reducing overcapacity in the steel and coal sectors, overall performance is not encouraging. Naughton (2017c: 8) concludes that 'SSSR and reforms in general have faced unprecedented opposition that has stalled their implementation'. The most serious problem with the implementation of SSSR, as a report issued by the Economist Intelligence Unit (EIU) states, is that 'rather than supporting the market-friendly reform agenda set out in 2013, SSSR

in many respects runs contrary to it ... the programme rests too much on political will for its enforcement. At present, political support for the programme is strong, but SSSR could quickly fall apart were it to ebb' (EIU 2017: 28).

A Political Economy Framework for Understanding China's Financial Repression

The (under)development of the financial sector cannot be fully understood without considering the broader political environment. Politics may determine financial development directly by influencing the direction of credit allocation and the access to equity finance on the micro level as well as the performance of the financial sector on the macro level, and indirectly by distorting the design and operation of financial regulatory institutions. Clearly, 'political choices deeply affect the development and operations of the financial system' (Haber and Perotti 2008: 48). Therefore, we explore the relationship between politics and financial repression in the Chinese context in the following section.

Financial Repression and the Party's 'Growth-oriented' Strategy

It is difficult to understand the emergence and continuation of financial repression in China without considering the survival strategy of the Party, particularly its 'pro-growth' or 'growth-oriented' strategy which has been in effect since the reform era began at the end of the 1970s. Economic growth has been a top priority because of the simple fact that the Party lacks legitimacy in the democratic sense; therefore, it has been forced to seek performance-based legitimacy by continuously improving the living standards of Chinese citizens (Xu 2011). To clarify, it can be argued that there is an implicit social contract between the Party and the Chinese population that the latter will not press vigorously for more democratic forms of government if the former delivers high levels of economic growth and prosperity.

Economic growth may help to maintain the Party's dominance not only by improving its legitimacy but also by strengthening its capacity for repression and addressing certain challenges to political stability, such as unemployment. Repression has been identified as one of the key aspects of the Party's survival (Dickson 2016; Pei 2012). With the

help of economic growth, China's spending on public security rose by 93 per cent between 2008 and 2013 (Dickson 2016). It was reported that China's spending on internal public security (CNY 549 billion) overtook national defence (CNY 533.4 billion) in 2010.⁷ Clearly, economic growth is the most effective tool that can be used to address the unemployment problem (Lam, Liu and Schipke 2015). Workers, particularly migrant workers who lack access to China's welfare system, must rely on their job-related incomes to support themselves (and their family members); an economic recession that wipes out millions or even tens of millions of jobs will place these individuals in a desperate situation and, subsequently, they would become a threat to social stability. Therefore, it is understandable that the Chinese government responded to the financial crisis of 2008 at such speed and scale.

Whereas empirical evidence regarding the connection between financial repression and China's economic growth has mixed implications (see our discussion in the previous section), it is understandable that the Party attempted to boost economic growth through a policy of financial repression. The impact of financial repression on economic growth can be illustrated by referring to the production function, $Y = AF(K, L)$, where Y is the output, K is capital, L is labour and A is a productivity parameter. Indubitably, *ceteris paribus*, the lower the cost of capital, the stronger the incentive to accumulate it (investment, $I = \Delta K$), and as more capital is accumulated, the potential for economic growth increases. Therefore, financial repression arguably may promote economic growth by lowering the cost of capital (for example through interest rate control) and therefore encourage investments by the corporate sector.

Indeed, our previous studies find that, generally, financial repression (measured by interest rate control, credit misallocation, dominance of state-owned banks and exchange rate manipulation) is beneficial to China's economic growth. Xu and Gui (2013, 2014) find that a decrease in the real interest rate and an increase in credit extended to SOEs will stimulate investment. Moreover, Xu and Gui (2013, 2014) report that although the effects of credit misallocation and dominance of state-owned banks on economic growth are harmful, other dimensions of financial repression—such as a low interest rates and devaluation—actually promote economic growth. Therefore, 'when the pro-growth effects of financial repression outweigh its anti-growth effects, the overall influence of financial repression may be beneficial, rather than harmful, to economic growth' (Xu and Gui 2014: 92).

Financial Repression and the Party's Patronage System

Pursuing legitimacy through economic growth is certainly not the Party's only survival strategy; it also adopts other strategies, such as establishing a patronage system through which loyalty and support can be bought by material and non-material benefits and co-opting new social groups (such as private entrepreneurs) whose economic power and social influence may ultimately become a threat to the dominance of the Party if they are free from its control. Both strategies demand an economic system in which economic rents (subsidies) can be created continually, distributed selectively and protected effectively. Financial repression policies are a part of this narrative.

State-related institutions, particularly SOEs, are perhaps the most important mechanism through which economic rents and loyalty can be exchanged (Pei 2012). On the management level, the CEOs of SOEs, particularly of SOEs controlled by the central government, are rewarded for their loyalty and support with high incomes and elite positions inside the party-state (Brødsgaard 2012; Lin and Milhaupt 2013). Employees of SOEs, compared with their counterparts in the private sector, have an average wage level that is much higher (CNY 23,565 versus CNY 14,096 in 2007), and the growth rate of their average wage is faster (259.8 per cent between 1992 and 2007 versus 178.2 per cent over the same period) (Ge and Yang 2014). Therefore, it is not surprising to find that employees in the state sector show more support for the party-state than their counterparts in the private sector (Chen and Lu 2011).

Motivated by the economic and political benefits (and constrained by the control and discipline of the Party), SOEs serve the interests of the Party enthusiastically and effectively. For example, studies have shown that SOEs help to achieve social stability by maintaining employment (Huang, Li and Lotspeich 2010; Ljungqvist et al. 2015) and rehabilitate the economy by carrying out massive investment projects (Deng et al. 2015).

Given their inherent inefficiency and heavy policy burden (such as needing to maintain employment), it is difficult for SOEs to survive—much less make a profit—without governmental support. Indeed, China's SOEs were so inefficient that almost half reported losses in the 1990s. The situation has changed drastically during the past decade, and the profitability of the SOEs has increased by an impressive amount. However, the major driving force behind the profitability of China's SOEs consists of certain distorted economic policies that favour SOEs

at the expense of private enterprise development and greater social welfare. Financial repression policies are part of the explanation.

According to a report issued by a Beijing-based independent think tank, from 2001 to 2009, SOEs paid CNY 305.98 billion less annual interest, on average, than they should have done (Unirule Institute of Economics 2011). For those nine years, CNY 2,753.85 billion that should have been paid as interest was instead appropriated by SOEs and included in their nominal profits. Our own study finds that the rents from financial repression were greater than the profits earned by SOEs in most years from 1978 to 2012 if we assume that the real market interest rate is 10 per cent; even if we follow Caprio, Atiyas and Hanson (1996) and use 2 per cent as the interest rate spread in most years, the financial repression rents remain greater than 30 per cent of the profits earned by SOEs (Xu and Gui 2016).

Financial Repression and the Party's Co-optation Strategy

As argued by Dickson (2001), when Leninist parties such as the Chinese Communist Party abandon the class struggle for the sake of economic modernization, they typically switch from an exclusionary to an inclusionary, or co-optive, strategy. In the post-Mao period, the intelligentsia, technocrats and private entrepreneurs were brought into the party-state system because they have the skills and resources desired by the Party to accomplish its new policy agenda (economic growth, technological improvement, etc.). In addition, it is safer for the Party to place these newly emerging classes under its direct oversight rather than leaving them to grow into independent powers that might ultimately become a threat to the dominance of the Party.

Private entrepreneurs can be incorporated into the party-state system through several channels. The first is to recruit certain private entrepreneurs into the Party, who then become so-called 'red capitalists' (Dickson 2007; He and Ma 2016). The second channel is to elect private entrepreneurs to the People's Congress (PC) and the People's Political Consultative Conference at different levels (Dickson 2007; Jin 2015; Zhou 2016). Finally, private entrepreneurs may join government-sponsored associations, such as the Private Enterprises' Association and the All-China Industrial and Commercial Federation (McNally and Wright 2010).

Co-opted entrepreneurs are rewarded with valuable financial resources for their loyalty to and cooperation with the party-state. Numerous empirical studies confirm that political connections, particularly membership in the PC,⁸ help private entrepreneurs to access bank credit

more easily and at a better price. For example, Bai, Lu and Tao (2006: 623) find that 'access to bank loans is significantly easier for entrepreneurs who are members of the Chinese People's Congress, but membership of the Chinese People's Political Consultative Conference has a limited effect'. This conclusion is further supported by subsequent studies, such as Zhou (2009), Sun, Zhu and Wu (2014), Yang, Lu and Luo (2014), Feng, Johansson and Zhang (2015) and Zhao and Lu (2016). In addition to bank loan accessibility, studies show that political connections are important for private enterprises' access to China's stock markets (Francis, Hasan and Sun 2009; Liu, Tang and Tian 2013; Li and Zhou 2015).

With the help of financial repression policies, the Party's co-optation strategy appears to work well because co-opted entrepreneurs show strong support for the status quo, in which the Party enjoys monopolized political power. For example, Chen and Dickson (2008) report that private entrepreneurs that are members of the Party (and those who have applied to join the Party, those who were formerly cadres and those who were formerly SOE managers) express significantly higher levels of regime support than entrepreneurs who have no political affiliations with the party-state. Similarly, Dickson (2007) finds that private entrepreneurs, particularly co-opted entrepreneurs, share similar viewpoints with communist officials on a range of political, economic and social issues. He and Ma (2016) also note that private entrepreneurs who are members of the Party show a much higher evaluation of the Party's policies than entrepreneurs without such status.

Conclusion

China's financial repression has seriously damaged the sustainability of the country's economy by lowering economic efficiency. The severity of repression in China's financial sector increased to an unprecedented level after 2008, when the Chinese government poured enormous financial resources into the economy as a response to the financial crisis. China's economy was rescued, but only for the short term, and with tremendous costs. The response of the party-state to the financial crisis provides persuasive evidence that in China finance is not a purely economic affair that can be left to the market but rather is a powerful weapon that can be used when necessary to address certain economic, political or social problems that may endanger the rule of the Party.

Stimulating the economy is certainly not the only reason for the party-state to create and maintain financial repression. The party-state also

needs a repressed financial system to enable it to create and distribute rents to reward its core constituency (such as managers and employees of SOEs) and buy support from new emerging forces (such as private entrepreneurs). Whether and to what extent the Party can control the financial system and subsequently direct the flow of financial resources is a life or death issue. Given the importance of financial resources to the rule of the Party, it is difficult to imagine that it will eventually adopt a liberalization strategy and relinquish its control over the financial system. From this perspective, as long as the Party can retain power, China may never have the chance to be free from financial repression.

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NOTES:

1. Reinhart and Sbrancia (2015) report that for advanced economies, real interest rates were negative in approximately half of the years during the 1945–1980 period; as a result of this repression policy, the average annual interest expense savings for their 12-country sample ranged from 1 to 5 per cent of GDP. They also show that after the 2008 financial crisis, financial repression has resurfaced in its many forms among the advanced economies through a variety of regulatory changes.
2. For a more general survey on the role of financial repression (as opposed to financial liberalization) in economic development, see Loizos (2017).
3. It may seem puzzling that China has maintained an extremely high level of saving (46 per cent of GDP in 2016) despite its repressed interest rate policy. There are two explanations for this phenomenon. First, given China's less developed and less diversified financial markets, there are limited choices for Chinese households to address their wealth management needs. Depositing their funds in the banking sector (which is implicitly guaranteed by the Chinese government) seems to be the most convenient and the most secure arrangement. Second, and perhaps more importantly, there are certain structural factors that contribute to China's high saving rate, including the demographic changes caused by the one-child policy, the breakdown of the social safety net and increasing income inequality (IMF 2017b).
4. Estimates of the size and exposure of China's shadow banking sector vary considerably. They range from approximately CNY 5 trillion to 46 trillion or approximately 8 to 80 per cent of China's GDP. For more detailed discussions, see Elliott, Kroeber

- and Qiao (2015) and Sharma (2014).
5. See 'kaiju shouji wen dashi: quanwei renshi tan dangqian zhongguo jingji (Inquiring into the trend at the first year of China's 13th Five-Year Plan: authoritative person on China's current economic situation'. Available at: http://paper.people.com.cn/rmrb/html/2016-05/09/nw.D110000renmrb_20160509_6-01.htm.
 6. See 'Xi stresses financial security'. Available at: http://news.xinhuanet.com/english/2017-04/26/c_136238375.htm (accessed 3 June 2017); and 'Preventing financial risks vital to economy'. Available at: http://www.chinadaily.com.cn/opinion/////////2017-08/15/content_30622475.htm.
 7. See 'Beijing raises spending on internal security'. Available at: <https://www.ft.com/content/f70936b0-4811-11e0-b323-00144feab49a>.
 8. Studies that use different proxies for political connections, such as the Party membership of entrepreneurs (Guo et al. 2014; Li et al. 2008), government intervention in CEO appointments (Cull et al. 2015) and top managers (or board members) as officials at certain levels (Su and Fung 2013), also confirm the importance of political connections in helping private entrepreneurs address financial constraints.

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