Volume Title: Capitalizing China

Volume Author/Editor: Joseph P. H. Fan and Randall Morck, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-23724-9; 978-0-226-23724-4 (cloth)

Volume URL: http://www.nber.org/books/morc10-1

Conference Date: December 15-16, 2009

Publication Date: November 2012

Chapter Title: Comment on "China's Financial System: Opportunities and Challenges"

Chapter Author(s): Chenggang Xu

Chapter URL: http://www.nber.org/chapters/c12460

Chapter pages in book: (p. 143 - 145)

Communication Costs on Information Production: Evidence from Bank Lending." Working Paper. Boston College.
Qiu, Yuemin, Bing Li, and Youcai Cai. 2000. "Losses of State-Owned Commercial Banks: Reasons and Policy Response." *Jingji gongzuozhe xuexi ziliao* [Study Materials for Economic Workers], no. 44.
Rajan, Raghuram, and Luigi Zingales. 2003a. "The Great Reversals: The Politics of Financial Development in the Twentieth Century." *Journal of Financial Economics* 69:5–50.
———. 2003b. *Saving Capitalism from Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity.* New York: Random House.
Ranciere, Romain, Aaron Tornell, and Frank Westermann. 2003. "Crises and Growth: A Re-evaluation." NBER Working Paper no. 10073. Cambridge, MA: National Bureau of Economic Research, November.
Stein, Jeremy. 2002. "Information Production and Capital Allocation: Decentralized vs. Hierarchical Firms." *Journal of Finance* 57:1891–921.
Stulz, René, and Rohan Williamson. 2003. "Culture, Openness, and Finance." *Journal of Financial Economics* 70:261–300.
Tsai, Kellee. 2002. *Back-Alley Banking.* Ithaca: Cornell University Press.
Xu, Chenggang. 2011. "The Institutional Foundations of China's Reforms and Development." *Journal of Economic Literature,* 49:1076–1151.
World Bank. 2001. "Bankruptcy of State Enterprises in China—A Case and Agenda for Reforming the Insolvency System." Working Paper no. 33267.
Wu, Jing, Joseph Gyourko, and Yongsheng Deng. 2011. "Evaluating Conditions in Major Chinese Housing Markets." *Regional Science and Urban Economics,* forthcoming.

Comment Chenggang Xu

This chapter provides an excellent overview of China's financial system from a cross-country comparative perspective. It is very insightful and informative that I have learned a lot from this chapter. But my job is to provide critical comments, which are in the following.

One of the most distinctive features of Chinese economy and China's financial system is regional heterogeneity and importance of regional governments. Although this can be quite consistent with the arguments made by the chapter, this is its weak point. National aggregate or average figures miss the feature. At the national level, the Chinese economy is larger than the whole of Latin America (China's total GDP is $3.4 trillion vs. Latin America GDP of $2.4 trillion, 2007). However, China's regional heterogeneity in development and so forth is a lot larger than that of Latin America. The per

Chenggang Xu is the Quoin Professor in Economic Development at the University of Hong Kong and the World Class University visiting professor at Seoul National University (WCU-SNU).

For acknowledgments, sources of research support, and disclosure of the author's material financial relationships, if any, please see http://www.nber.org/chapters/c12460.ack.

capita GDP in China's richest region, Shanghai, is 9.6 times of that of the poorest region, Guizhou. As a comparison, the per capita GDP of Chile, the richest country in Latin America, is 7.3 times of Bolivia, the poorest country in Latin America. Most Latin American countries are about the average size of a Chinese prefecture. At that level, the regional disparity in China will be ten times higher than in Latin America.

This chapter is almost silent on the basic governance structure of China's financial system. The Chinese economy is featured by centralized personnel control and decentralized regional operations (Xu 2011). Although China's banking and financial markets are more centralized than other sectors, they still share the same basic feature. The central-local games determine the operation of the financial system. These games deeply affect the finance of most projects. Subnational governments' influences were prevalent and are not negligible in lending decisions of local branches of major banks; and they are important players of financial market regulation.

A central theme of this chapter is to find out whether China's financial system "will stimulate or hamper its economic growth." But the question is yet to be addressed by systematic empirical evidence. Concerning the formal financial sector, by using nationwide firm-level census data and provincial bank lending data, Demetriades et al. (2008) find huge regional variations in regional financial development, measured by total loans to private sector over GDP ratio. They find everything else being equal, firms located in provinces with better financial development have significantly higher total factor productivity (TFP) growth rates and vice versa. And in general, China's banking system contributes to Chinese firms' TFP growth. This discovery is consistent with the market performance of the major Chinese commercial banks. But one has to be very careful on these observations since these are based on an upside of the cycle in the Chinese real sector since the year 1999. During this period of time, the interest rate has been very low. What will happen in the downside of the cycle when the interest rate goes up substantially is yet to be known.

Concerning the informal sector, intrigued by the township-village enterprise (TVE) development, major alternative mechanisms beyond the formal legal system have been discussed since long ago (e.g., Weitzman and Xu 1994). There are huge cross region variations in culture and on the level of trust in doing business that some distinctive local business culture (without formal law) can be traced back to one thousand years ago; that is, the Song Dynasty. These coincide well with local TVE development in the 1980s and the 1990s, and also coincide well with today's development of hundreds of town-based world factories (i.e., local industrial cluster developments [Xu 2011]). Here, the key point is that alternative mechanisms are local and most Chinese towns are not well developed. Thus, it could be misleading to speak of China as one phenomenon.

When discussing financial crisis, the chapter ignores an important fact: China is the only major economy which has largely escaped from the 1997

East Asia and the 2008 global financial crises. This luck is not accidental and is worth exploring. A key mechanism for escaping from the 1997 crisis is the capital account control. In addition to this, another key mechanism that allowed China to escape from the 2008 crisis is that asset-backed securities have never been allowed to be originated or to be traded in China. Should China keep controlling capital account? Should China keep banning financial innovations? These are critically important issues for China's forthcoming financial reforms.

The chapter points out the importance of venture capital (VC). However, it does not discuss the extraordinary development of China's VC sector and the serious problems the sector faces. Since the late 1990s, with a rapid development in VC, China has become the second-most active economy in the world in attracting VCs (after the United States). China has the second-largest VC investment in the world since 2008; in that year, the VC investment in China is equivalent to the 1994 level of the United States; China's VC/GDP ratio is about half of that of the United States; and 62 percent of VC investments are in high-tech sectors. Nevertheless, the VC sector development in China faces serious institutional problems. About two-thirds of VC investments in China are from foreign VCs, mostly from the United States. Although they face no serious governance problems, the foreign VCs are not allowed to raise funds in China, whereas the Chinese domestic VCs face much worse institutional constraints in determining their corporate governance structure (Guo 2009).

My last comment is about the claim of the chapter that "[t]he role of deposits from government agencies and organizations has steadily decreased over time." However, many research papers and reports by the World Bank and the Chinese government document the opposite: that the share of government and enterprise deposits in total deposits has increased, and the share of household in total deposits has decreased (e.g., Bai 2009). In fact, this has been a major concern for Chinese policymakers and there are many policy debates regarding how to deal with this trend.

References

Bai, Chong-en. 2009. "Chinese National Income Distribution and Economic Growth Pattern: Facts, Reasons and Policies." "(国民收入分配格局与经济增长模式: 事实、原因和对策)." Working Paper. Tsinghua University.

Demetriades, Panicos O., Jun Du, Sourafel Girma, and Chenggang Xu. 2008. "Does the Chinese Banking System Promote the Growth of Firms?" World Economy and Finance Research Programme Working Paper No. 0036.

Guo, Di. 2009. "Do Institutions Matter? An Empirical Examination on VCs' Project Screening in China." Working Paper. University of Hong Kong.

Weitzman, M. L., and C. Xu. 1994. "Chinese Township Village Enterprises As Vaguely Defined Cooperatives." *Journal of Comparative Economics* 18 (2): 121–45.

Xu, C. 2011. "The Fundamental Institutions of China's Reforms and Development." *Journal of Economic Literature* 49 (4): 1076–1151.