Statement of

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Mr. Chairman and Commissioners, thank you for inviting me to share with you my views on the growing presence of Chinese firms in the international capital markets, and Chinese use of the global capital markets for its economic development strategy.

The broad questions posed for us in the panel today involve assessing, in particular, the role of U.S. capital markets to the economic development strategy of China. I organize my statement in the following order. In Section (1) below, I first provide an assessment of the role of capital-raising in the global capital markets, including the U.S. markets, as part of the economic development strategy of China. I show that global capital markets and external financing via issuance of stocks and bonds is very marginal in funding Chinese enterprises today. I identify rather the marshalling of financial resources through an ***actively*** repressed domestic banking system as a dominant strategy for funding economic development in China. I expound, in Section (2), on the notion of financial repression and its general implications, characterizing the Chinese financial system as a prototype of severely repressed financial system. The report would then outline the potential implications of China's repressed financial system to the economic interests of the U.S., suggesting some policy prescriptions. In Section (3), I focus on the harmful effects on U.S.'s competitive position, and in Section (4), I explore the implications of the lack of governance mechanisms in Chinese financial system. Section (5) provides concluding remarks, underscoring some policy options available to U.S. policy makers.

(1) China's Strategy in Financing its Economic Development

What is the financing strategy of China to fund its economic development? What is the importance of capital-raising in global capital markets, particularly from the U.S. for the funding strategy? These are some of the questions posed to me in preparing for this testimony.

While Chinese firms are getting increasingly visible in international capital markets, at this point, the role of external capital-raising (including from Chinese domestic markets) to the Chinese economy is very negligible. In China, investments of non-financial enterprises are financed through four main sources: (i) self-fundraising including retained earnings, (ii) government capital transfer to State Owned Enterprises, (iii) bank loans channeled from the household sectors, and (iv) foreign direct investment. The predominant source of funding investment in the non-financial enterprise sector, as is common in other countries is internal funds. In year 1999, for example, the amount of enterprise investments that was funded through "self-fundraising and internal sources' amount to 67.6 % (Allen, Qian and Qian (2002)). This estimate is only for Chinese locally listed companies. However, the figure compares well with Chen (2003) who reports the share of self-fundraising to be 69.6 % in 2001 for the entire enterprise sector in China (see Figure 1 in the Appendix). Self-fundraising includes proceeds from capital raised from local government and communities and internal financing from retained earnings. External capital raised in stock and corporate bond markets was a mere 3.7 % in 1999 for listed companies. This figure is significantly lower for the enterprise sector as a whole. The total capital raised over the period 2000 through 2004 in international IPOs (including Hong Kong) amounts to approximately $30 billion which is a fraction of the yearly total investment needs of the enterprise sector. In contrast, the share of domestic bank loans was a significant 19.2% in 1999 that compares well with the 19.1 % for the entire enterprise sector in 2001 (Chen (2003)). **Bank loans,** hence, constitutes the **largest source** of **external** capital.

Domestic loans have also been increasingly substituting state budged appropriations as a primary external source of financing capital investments. State budget appropriations declined from 28% in 1981 to just 6.7 % of capital investment in 2001 while, in parallel, domestic loans jumped from 13% to 19% of capital investment during the period. In addition, Chen (2003) suggests that about half of the so called "self fundraising" could actually be forms of loans that are not authorized by regulations; thus **bank loans** that channel household savings could **account for as much as 50% of enterprise investment** in China.

Household savings is one of the highest with around 25 percent of disposable income since 2000, accounting for about 16% of GDP in 2001. The amount of household savings in excess of investments (i.e., the saving surplus) is between 10 and 14% of GDP. About ***90%*** of this **excess saving** is in the form of ***bank saving deposits***. This is because of the limited financial investment opportunities available to Chinese investors.

The role of capital-raising in global capital markets is expected to increase with China's integration into the global economy and the expected needed reforms, including the opening of its banking sector to competition. However, the relatively negligible role of cross-listing in the U.S. in the larger context of

funding economic development in China does not insulate U.S.'s economic interest from China's financial activities.

As I pointed out, the domestic banking system is the main source of external finance for enterprises in China. While what a nation's banking system does, to a large extent, is an internal affair, with China's increasing economic integration with the global economy, the *institutional arrangement* of the banking sector and the *manner* it channels from the household to enterprise sectors, has significant implications, some harmful, to other countries. The Chinese financial system is a severely repressed financial system, with the government strictly controlling the channeling of savings to government-connected enterprises through its ownership of banks, entry barriers, and restrictions of capital markets. Such institutional arrangement in the banking sector entails severe repercussions both to the country and its trading partners, and it will be the subject of my testimony in the rest of the statement.

(2) Financial Repression and China's Financial System

2.1 Financial Repression

Financial repression (or financial underdevelopment) refers to the prevalence of undue interference by governments in financial systems. A financially repressed system is a state-dominated financial system. In highly repressed financial systems, the financial sector is viewed as mere extension of the government treasury.

State interference in financial systems takes many forms. These include, in increasing order of scope, the following:

- Imposition of interest rate controls (such as deposit interest rate cap);
- Excessive bank reserve requirements;
- Government credits and government direction of bank credits;
- Restrictions on entry of foreign banks and domestic non-bank entities;
- Imposition of barriers to foreign capital inflows and *active underdevelopment* of competing domestic *capital markets*; and finally
- Outright government ownership and micromanagement of banks.

The consequences of financial repression are many, but the main ones are the following:

- Financial repression leads to gross misallocation of resources, resulting in economic inefficiency and retardation
- Financial repression transfers wealth from the citizenry to the state and its connected cronies. Regardless of the form of repression, **savers** and **private-sector borrowers** will be **worse off**, and the **government** and **government-connected borrowers** will be **better off**.

2.2 The Chinese Financial Sector as a severely repressed financial system

The current Chinese financial system is concentrated around the banking sector.

- The **dominant** source of funding for Chinese companies is **bank** loans.
    - as much as **80%** of funding is sourced in bank loans
- There is **no** real corporate **debt market**.
- Capital markets are very small, fragmented, and excessively controlled

China's **banking sector is dominated** by the big **4 State-Owned Banks (SOBs)**, among which they represent about **60 - 80% of the banking business**.

At the end of 2001, the 4 state-owned banks had a 62 % share of the savings and lending business and about 80 % of the payment business (see Figure 2 in the Appendix).

Other State Banks, Private credit agencies, and Community Banks such as the 40,000 Rural Credit Cooperatives, the 3500 Urban Credit Cooperatives, and the 80 or so City Commercial Banks account for the rest of the domestic banking business.

The Chinese **government owns 99.45%** of the 10 **largest commercial banks** in China in 1995 (La Porta, et al. (2002)).

Under the government's guidance, the **State-Owned Banks (SOBs) direct their funds to the State-Owned Enterprises (SOEs) and to other enterprises connected to the state via ownership, through 'policy loans'**, at interest rates far below market.

The **private sector's access** to bank loans is **extremely limited**. In 1999, private enterprises received only **0.62% of the loans from all banks**, and less than **0.5 % of all loans from state banks**.

Why should we worry about financial repression in **China**? What are the implications to the U.S.? Traditionally, the consequences of financial repression have been viewed solely as internal: financial repression distorts resource allocation and leads to economic retardation. With the severity of the repression in China, and its increasing involvement in the global economic relations, the state of Chinese financial system poses serious risks to the security and economic interests of other countries, including the U.S. The implications are numerous; I would, therefore, summarize the discussion under two organizing themes, namely (i) **the cost advantages financial repression endows the Chinese government**, and (ii) the **breakdown of basic governance mechanisms** financial repression entails.

(3) Implications of Chinese Financial System Repression to U.S.'s Competitive Position

a. China has been developing unfair advantages in costs of capital that was made possible through its ACTIVE financial repression.

- Through direct control of household savings via its state-owned-banks, the government has amassed massive amount of financial capital, at virtually no cost, at its disposal for the benefit of its SOEs and government-connected enterprises. 90 % of net household savings (e.g., one of the largest in the world with 10% of GDP in 2001) is in the form of bank saving deposits.

- The state is providing **subsidized** financing **through its state-owned** or directed financial institutions **to its state-owned companies** (in effect, agencies of the government), providing unfair cost advantage that can be utilized, for example, as is happening recently, **to acquire strategic assets** around the world

- This is very analogous to the UNFAIR trade practices countries commonly engage in international trade.

    - e.g., Agricultural products dumped in the international markets made possible through government subsidy of their farmers; China's dumping of steel products in international markets made possible through export rebates and tax subsidies to gain competitive advantage in the industry.

- In effect, therefore, **active financial repression can be utilized to develop unfair competitive advantage**, and China's actions are consistent with this practice.

- Countries have developed various mechanisms to retaliate or contain UNFAIR TRADE practices over time, including protectionism.

- The **U.S.** should **recognize financial repression** in partner countries as a potential **harm that can erode** its competitive position.

- It should look into ways to protect itself from the harmful effects of financial underdevelopment.
    - Over the long term, ***financial development should be considered a foreign/trade policy*** priority item.

    - In the short to medium term, the U.S. has to be aware of the harm it can cause U.S.'s interest, and devise ways to protect itself.

b. China's Financial repression as a New Challenge

- Traditionally, financial underdevelopment/repression was considered a domestic affair,
  - through misallocation of resources, it retards domestic economic growth
  - and, involves a transfer of wealth from the countries' citizens to the State
- Examples of regions with significant financial repression used to include much of the developing world, and the Soviet block of countries. Financial underdevelopment in the **developing world did not directly affect other countries**, simply because these are poor countries. Financial repression in the **Soviet bloc countries had the potential to harm others**, but **its effects were contained via the cold war**.

- China, however, is a different case:
  - Financial repression has endowed the government with cheap capital, redistributed from its citizenry,
  - Financial repression, combined with state control of its foreign exchange mechanisms, is providing China with a competitive advantage to undertake **cross-border acquisitions** of strategic assets.
  - If recent examples are good indicators, Chinese state-owned enterprises (in essence, arms of the government), with massive capital channeled through the state-owned banks, under the direction of the government, appear to be posed for high finance acquisitions.
  - In essence, China could be thought of as using financial repression as a ***strategic tool*** to build competitive advantages **in its real-sectors** at the expense of others, including the U.S.
  - The reluctance of policy makers to respond to such threats is partly because this represents a different type of challenge compared to the open and shut cases of unfair trade practices, and <u>also</u> because China is an ally.
- It is, therefore, **imperative**, to recognize the new threat emerging from financial repression. Financial underdevelopment is no longer a domestic malaise, which nations have to deal with in their own. It can be used as a ***strategic tool*** by rich, otherwise financially underdeveloped countries, to the detriment of others.
- The implication is that, **FINANCIAL DEVELOPMENT** (i.e., financial liberalization and the undoing of financial repression) **has to be pursued as a NATIONAL FOREIGN/TRADE POLICY** priority in engaging partner countries.

(4) Inadequate Governance Mechanisms in China's Financial System and their Implications

- Financial systems serve **two** broad **functions:** (a) channeling of capital from savers to enterprises and other users of capital (i.e., the **capital mobilization** function) and (b) provision of good **corporate governance** through facilitating information flows and monitoring of corporate insiders by external stakeholders (i.e., the **governance** function).

- As their governance function, banks screen potential borrowers, collect and generate information about financed projects, and continually monitor to ensure appropriate use of the funds. Similarly, financial markets provide venues (through, for example, facilitating corporate takeovers) for external shareholders to influence corporate policies.

- The financial system **accomplishes** these important **governance** functions through its various **institutions**, which include investor protection laws, regulations, legal enforcement mechanisms and a strong legal profession; as well as such institutions of information as accounting standards, company disclosure rules, a strong auditing profession, independent credit rating agencies, a financial analyst community, and a vibrant financial press.

- China's repressed financial system does **not have** the **institutional infrastructure** to provide **adequate governance** to the companies and businesses it supports.

    - China's financial system suffers from poor investor protection, lack of rule of law as evidenced by its pervasive corruption even by developing countries standard, and a highly underrepresented legal profession (with an estimate of 150,000 lawyers in the whole of China). Among the more than five million business enterprises in China, only 4 % of them have regular legal advisers. There is a complete lack of transparency with poor accounting standards and practices, and a critical shortage of independent auditors, analysts, other agents and institutions of information.

- As a result, such repressed financial systems **fail grossly** in providing appropriate governance. In such systems like that of China's, bank credits are, for example, channeled under government direction to connected borrowers without screening and further monitoring.

- **Inadequate governance** has **severe economic and social consequences** as was evident in the recent corporate scandals (e.g., the case of Enron) even in the most advanced countries. The consequences are doubly severe in emerging economies such as China.

- With the importance of China in the global economy, the **lack of governance mechanisms in China's financial system** has important **implications to** the **U.S. economy** and its other trading partners. These are:

    - With the increasing reliance on China in international trade, **systemic failure** of governance at Chinese companies could disrupt the provision of strategic products and services, endangering U.S.'s economic security.

    - To the extent that Chinese companies become global employers (via cross-border acquisitions), failure of governance endangers the welfare of employees from potential layoffs.

    - In the increasingly integrated world, system-wide failure of governance could adversely affect customers and U.S. firms interconnected to Chinese companies through the supply chain.

    - The potential failure of governance also raises significant financial risk and security-related concerns to U.S. investors in Chinese companies.

- An example of an immediate implication to U.S. policy makers is in the context of recent attempts by Chinese companies to acquire U.S. firms. Understandably, policy makers raise such governance issues of concern as the consequences to U.S. employees and the sustainability of service provision under the potential Chinese acquirers. The Chinese companies appear to be ready to provide assurances in all such areas of concern on governance.

- It is, however, **imperative** to realize that individual **company assurances** have **no significance** so long as the governance infrastructure is virtually lacking in the system. The potential **governance problem in China is system-wide**. Hence, policy makers should go beyond the case-by-case assurances and look into the system-wide lack of adequate corporate governance in China, which has **significant adverse implications** to the U.S. economy.

- Another implication has to do with the extent to which U.S. investors as well as regulators could **credibly rely** on Chinese company **financial representations** and **disclosures** made in the context of such a gross failure of corporate governance and a breakdown of information institutions as I outlined above. One of the main problems in Chinese corporate governance is a dearth of qualified independent accountants and auditors (Allen et al. (2003)). There has been a number of cases in the U.S. of financial misrepresentations by cross-listed Chinese companies, including the cases of China Life, and Sina. Data on disclosure malpractices is not widely available. It would not, however, be farfetched to speculate that the scope of the problem is much larger. China is a command economy where economic agents, including agents of information, operate under guidance from above. The lack of professional independent

accounting and poor transparency in general, combined with rampant corruption is a breading ground for disclosure impropriety.

- Furthermore, despite lower registration costs and less stringent disclosure rules in European stock exchanges, Chinese firms prefer to cross-list in the U.S. For example, more than 70 Chinese firms are cross-listed in the U.S., while only 6 firms from Mainland China are in the London Stock Exchange. With the poor disclosure environment in China, one would expect that the much stringent disclosure regulations in the U.S. may discourage Chinese firms from cross-listing in the U.S. This has been the reason for the success of the London stock exchange in attracting firms from many other emerging economies. It might be that the motive of Chinese firms to attract capital and increase their investor base in the deep U.S. capital markets is so strong to justify their presence. It is also possible that the disclosure adjustments to the higher standard may not be that costly to these companies for the reasons I outlined above.

- In this regard, U.S. regulators need to go beyond a checklist of required disclosure, and look into the manner in which financial disclosure has been produced. I should point also out that the Sarbanes-Oxley Act of 2002 appears to be of help along this line. Although the full implications of the Act remain to be seen in the years to come, it is interesting to note the dramatic decline in Chinese cross-listings in the U.S. after the passage of the Act.

(5) Concluding remarks

- China is an ally and a valuable economic partner. It should be noted that although, due to the focus of this testimony, I focus on the potential risks and threats of China's financial system to the economic interest of the U.S., the benefits of economic engagement with China can not be overemphasized. Thus, it is paramount to continue to engage China to reform its institutions, including its financial system, both to strengthen mutually beneficial economic partnerships and to protect U.S.'s national economic interest.

- As noted, financial repression provides the government with a source of cheap capital, which it can direct through central planning to SOEs and other government-connected cronies. Financial repression provides the basis for the government's power and unparalleled influence.

- As a result, the state has **no** incentive for financial development. It is better off with financial repression rather than without it. Hence, it is naïve to presume that governments will reform their financial sectors by their own.

- External pressure has to be exerted to effect financial development. These pressures may include:

    - The natural course of globalization and competition, and
    - Pressures by international organizations such as the IMF, the World Bank, and the WTO
        - e.g., via strategic adjustment packages (SAP), the IMF requires borrowing countries in the developing world to reform their financial sectors.

- China is, however, a different case. China is a rich and powerful country, and does not rely on IMF's conditionalities for its financing. International pressure of this type will not, therefore, be effective. The WTO agreements do not adequately cover areas of investments and financing, although China's commitment under its **WTO agreement** to open up its financial sector starting 2007 could be **a historic opportunity** for the desired reforms, and remains to be seen.

- Hence, **appropriate pressure has to be exerted from bilateral partners, such as the U.S.**

- It is also important to note that it is **to China's interest** to reform **and develop its financial system**. The severe misallocation of capital that breads in economic inefficiency would pose a serious threat to China's economy in the long run. Hence, **financial reform** should be viewed as **a win-win strategy** for **both China and the U.S.**

References

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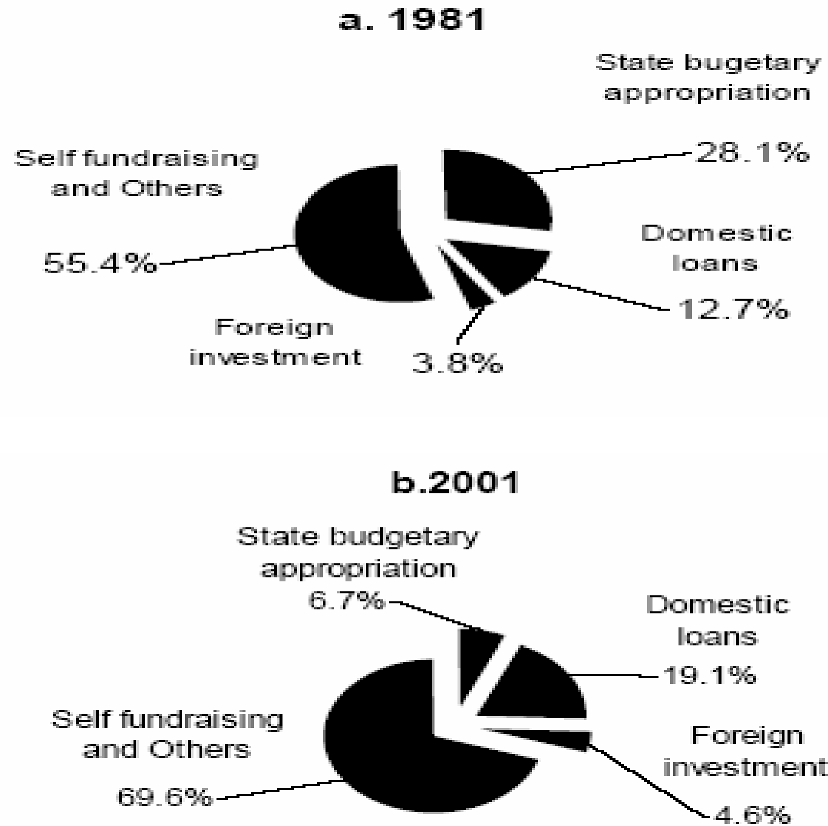
La Porta, Rafael, Lopez-d-Silanes, R., Shleifer, A. (2002), "Government Ownership of Banks," *Journal of Finance* 57, 265-302.

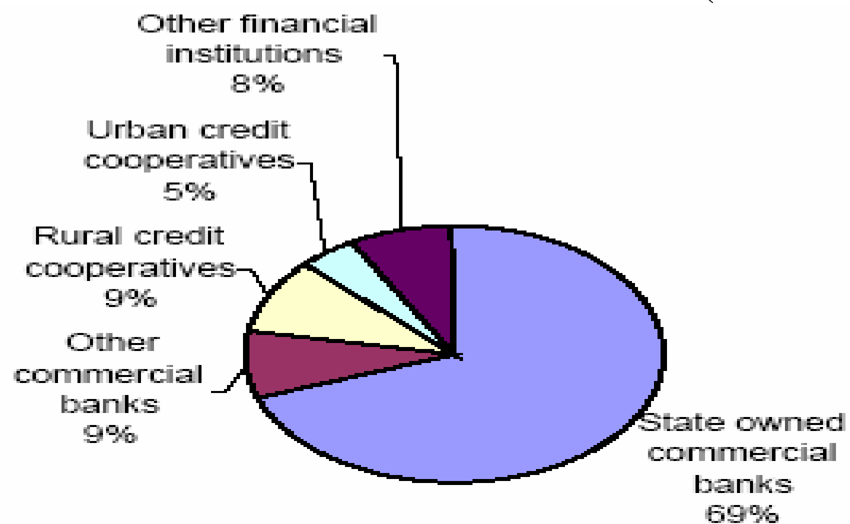
Appendix

FIGURE 1: Financial Sources of Fixed Asset Investment



Source: Chen, H. (2003)

FIGURE 2: Asset Distribution of Financial Institutions (end of 1999)



Source: Ligang S. (2001)