Creating Real Capital Markets in China

James A. Dorn

> Markets without divisible and transferable property rights are a sheer illusion. There can be no competitive behavior, real or simulated, without dispersed power and responsibility. And it will not do to disperse the one without the other.
>
> —G. Warren Nutter

China's Illusion

Since 1978, China has embarked on a dramatic reform effort to create a modern economy and to increase the standard of living for the Chinese people. Much progress has been made by liberalizing trade and opening to the outside world. The market has largely replaced "the plan" as the mechanism for coordinating economic activity. Yet the state continues to play a major role in the ownership and allocation of capital. Communist Party leaders wish to "revitalize" state-owned enterprises (SOEs) and "recapitalize" state-owned banks without privatization, in order to maintain their monopoly on power.

The goal of creating viable socialist capital markets is an illusion. The reality is that modern global capital markets require a transparent legal framework that protects private property rights and allows the free flow of information. Asset prices will then reflect the capitalized value of future profits. Without the right to freely buy and sell shares of stock in organized markets, and without freely determined interest rates, there can be no real capital markets and no way to determine true asset values.

Denying Chinese entrepreneurs the freedom to specialize in ownership and risk taking will place them at a huge disadvantage in creating a financial architecture that can rival that of the West. As

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long as the state has a majority stake in enterprise ownership, investment decisions and managerial appointments will be politicized.

China's accession to the World Trade Organization (WTO) will begin a process of opening China's pseudo capital markets to foreign competition and expertise. Foreign banks are expected to have full access to the local currency market within five years of China's accession to the WTO. Most restrictions on foreign equity holding will be relaxed and Western legal and accounting firms will have greater market access. Geographical limits on foreign insurance firms will be eliminated and those firms will be allowed to offer a wider range of services including pension annuities. Other liberalization measures, especially allowing foreign firms direct trading and distribution rights within China, will spur competition and create an ever larger nonstate sector (Groombridge 2000: 6–7).

The projected positive impact of WTO membership on China's financial architecture has been noted by Mark Groombridge in a much cited policy study:

> WTO membership will promote financial-sector reform by granting unprecedented market access to foreign financial institutions. Increasing the market share of foreign institutions will have a direct and immediate positive impact on the allocation of capital, providing new sources of capital for Chinese enterprises previously neglected by the state banking sector. Furthermore, foreign institutions will subject Chinese banks to intense competitive pressure, thereby forcing them to modernize their operations [Groombridge 2000: 8].

Those expected benefits, however, should not blind us to the fact that, to create real capital markets, China will need to undergo political reform. The state must leave the ownership of capital to private individuals who bear ultimate responsibility for the allocation of capital assets and are not subject to political control. That transformation will require major changes in the institutional infrastructure and a new way of thinking about the role of property rights in China's socialist market economy. The WTO can help push China in that direction, but grass-roots pressure will also have to apply at some point if China is to become a more open society that treats people equally under the law and secures property rights.

Preventing a Financial Meltdown

It is difficult to get a firm grip on the true condition of SOEs and state banks because of the poor quality of the data and the corrupt accounting practices. Moreover, capital controls have masked the seriousness of China's financial picture. Nicholas Lardy of the Brookings Institution has argued that "China's major banks are even weaker than most official data suggest. . . . On a realistic accounting, these banks' capital adequacy is negative, and they are insolvent" (Lardy 1998a: 95). He estimates that nonperforming loans of state-owned banks may be as high as 40 percent of outstanding loans (Lardy 1998b: 35, n. 10). Recent statements by the Bank of China tend to confirm his view (Kynge 2001: 1).

Beijing has propped up SOEs and created asset management companies to take over nonperforming loans of state banks. Those measures, however, are not sufficient to cure the institutional rot that lies at the heart of China's ownership system, including confiscatory discretionary fees levied by local officials that discourage private entrepreneurs and generate great uncertainty.[1]

Private firms are being starved of capital even though the nonstate sector has been the dynamic force in propelling China's economic growth. The government—that is, the Chinese Communist Party (CCP)—remains the dominant owner of capital, and central authorities decide which firms will be allowed to float shares on the stock exchanges. Recapitalizing state banks is meaningless if those banks continue to lend to SOEs and are driven by politics, not markets.

If China is to revitalize its firms and banks, and prevent a financial meltdown, it must restructure and open its capital markets, not simply inject more funds into dying institutions. Private owners, with exclusive claims to net income and transferable shares, must be given greater scope and access to capital. Some progress is being made, including a move to liberalize loan and deposit rates, but much remains to be done (Kynge 2000).

The real test of China's resolve to strengthen its enterprises and liberalize its financial sector will come once China accedes to the WTO. Clinging to puffed-up profit reports from SOEs that have monopoly power and bailing out state-owned banks with the hard-earned savings of the Chinese people will not pass muster. Eventually, the Chinese people will demand a greater range of investment opportunities, including the right to hold foreign exchange and to invest in foreign assets without state intervention. Satisfying those demands will require substantial institutional and political reform, so

[1]J. Ray Bowen and David Rose attribute the lack of privately owned, publicly traded corporations (PPCs) to the high discretionary fees (*kejuan zashui*). They argue that "until China undertakes reforms which credibly protect the firm owner's property right of residual claimancy by eliminating the practice of *kejuan zashui*, there is virtually no hope that true PPCs will ever emerge" (Bowen and Rose 1998: 450).

China is more apt to creep toward privatization than to rush toward it (Dorn 2000).

The challenge will be for the leadership to realize that China's future as a modern financial center will depend on establishing trust, so that investors—both foreign and domestic—have clearly defined rights to enterprise profits and can discover asset values in competitive markets. The political problem will be to get government out of the business of allocating capital and to allow effective private ownership—something the CCP has not been willing to do.

The freedom to specialize in ownership and risk taking—and, thus, to choose among an array of assets with varying combinations of risk and reward—is an important factor promoting wealth creation.[2] As *private* wealth grows, people will have an incentive to protect it against the state. That is why the CCP is so afraid of private property rights. Yet, if private ownership is not widespread, China will never have a modern financial architecture, and investment decisions will continue to be politicized.

The difficulty is to provide an incentive for China's leaders to accept private ownership as the norm rather than as the exception. Constitutional changes to give further protection to private property would be a welcome sign, but entrenched interests that favor state ownership are too strong to allow the changes necessary for full-scale privatization. That is why China's entry to the WTO is an important step toward a more robust private sector.

Although the CCP has supported the sale of small- and medium-sized SOEs, there is no consensus on letting go of large SOEs. Turning those enterprises into joint-stock companies in order to inject new capital will not transform them into profitable private enterprises as long as the state is the majority owner. And private investors will have little interest in those firms as long as the CCP retains control. As one private investor in Hong Kong stated, "Why would you buy a piece of paper from some country when the entity issuing it is not for profit, run by a bunch of bureaucrats with no prior experience . . . with no rule of law, or representation on the board?" (Leahy and McGregor 2000: 20, quoting Bill Kaye of the Pacific Group).

By artificially supporting the Shanghai and Shenzhen stock exchanges, the Chinese government is creating a fool's paradise. Many investors are going to be disappointed when the asset bubble breaks and values fully reflect underlying profitability rather than exagger-

[2]Armen Alchian (1977: chap. 5) presents an excellent discussion of the wealth-enhancing effect of allowing people to specialize in ownership, and thus in risk taking, by holding private property rights that are transferable and exclusive.

ated expectations based on political statements by top officials. The sooner China moves toward creating real capital markets, the less long-run damage will occur to the general economy as a result of bringing asset values into line with reality.

Allowing the Chinese people to specialize in ownership and allowing foreigners to help build China's capital markets will strengthen both the financial and the real sectors. One of the key lessons from the Asian financial crisis, as Alan Greenspan noted, is that "diversity within the financial sector provides insurance against a financial problem turning into economy-wide distress." Thus, "the difficult ground work for building the necessary financial infrastructure—improved accounting standards, bankruptcy procedures, legal frameworks [to protect property rights] and disclosure—will pay dividends of their own" (Greenspan 1999a: 10).[3]

Capital Freedom and the Exchange Rate Regime

Any ban on the use of currency attenuates property rights in the currency and weakens its value. Capital controls have allowed the mainland to accumulate large foreign exchange holdings and exercise some flexibility in conducting monetary policy. But if China is to be a major player in the new global economy, it will have to allow the free flow of capital and make its currency fully convertible. A clear choice will then have to be made between fixed and floating exchange rates—that is, between controlling the price of foreign exchange and controlling the domestic money supply to achieve long-run price stability. Under floating exchange rates, the market would determine the price of foreign exchange and the People's Bank of China (PBOC) would be free to focus solely on achieving a stable value of the renminbi (RMB). To be credible, however, the PBOC would have to commit itself to a monetary rule and avoid stop-go monetary policy. The lesson of the Asian financial crisis is that pegged exchange rates—as opposed to permanently fixed or freely floating rates—invite disaster in a world of mobile capital.

[3]Like Alchian, Greenspan emphasizes the importance of being free to specialize in risk bearing, which is exactly what private ownership permits people to do. According to Greenspan (1999b: 1–2), "The redistribution of risk induces more investment in real assets and hence engenders higher standards of living. . . . Any means that shifts risk from those who choose to withdraw from it to those more willing to take it on permits increased investment without significantly raising the perceived degree of discomfort from risk that the population overall experiences." China wastes that opportunity through its system of state ownership in which risks are socialized and hence, due to moral hazard, actually enlarged.

Focusing on zero expected inflation as the primary goal of monetary policy would provide a framework for monetary stability and help China deal with its weak financial sector. Letting market forces determine the foreign exchange value of the RMB would free the PBOC's large foreign exchange reserves for productive investments. Allowing people the right to hold any currency and invest in foreign assets would increase the wealth of the nation.

China has been able to maintain its pegged exchange rate of 8.28 RMB to the U.S. dollar, and it has the reserves to maintain that rate for the foreseeable future. However, if export growth slows, foreign investment drops off, and capital flows out of the mainland, the exchange rate will become overvalued. Maintaining the present peg will become increasingly costly for the domestic economy, because the PBOC would have to tighten monetary policy in an already deflationary environment. Falling asset prices would further weaken the fragile banking system, and diminished profit expectations would increase unemployment. In such an environment, devaluation would be the lesser of two evils—and letting the RMB float would be the preferred option.

The Costs of Capital Controls

Although China's closed capital account helped the authorities protect the foreign exchange value of the RMB during the Asian financial crisis, capital controls also impose costs. Indeed, the lack of a fully convertible RMB means that the cost of holding RMB rises, so investors must receive a higher return to compensate for the added risk and loss of freedom—both of which discourage private investment. Capital controls also breed corruption as profit-seeking individuals and firms find ways to circumvent the government-imposed restrictions on the use of currency. The large errors and omissions component in China's balance of payments reflects the fact that investors have little confidence in socialist capital markets. From 1991 through 1998, more than $100 billion illegally left the mainland for safe havens in Hong Kong and elsewhere (Fu 2000). The lesson is clear: to attract and retain capital in a world of mobile capital, China will have to earn the confidence of international investors. A fully convertible RMB cannot be achieved without serious damage to the Chinese economy *unless* China adheres to the rule of law, limits the power of government, and protects property rights.

The first step toward a fully convertible RMB is to put banks on a sound footing and clean up their balance sheets—but in a way that minimizes moral hazard. Foreign banks and investors should be allowed to buy the assets of failing banks and acquire effective ownership rights. International banks can play an important role in modernizing China's financial architecture. SOEs and state-owned banks should be allowed to go bankrupt if they are insolvent.

Again, all those changes require political reform. Thus, progress toward capital freedom will depend on the outcome of the 16th Communist Party Congress in 2002 and the 2003 session of the National People's Congress (NPC). If U.S.-China relations deteriorate and the hard-liners prevail, then all bets are off. But if relations improve once China joins the WTO, the path toward capital freedom will be more certain and the RMB could be fully convertible within five years after China's accession to the WTO (Hu 2001).

China's Socialist Legacy

China's present financial system is plagued by the legacy of state ownership of the means of production and centralized investment planning. Although Beijing has made substantial progress in dismantling Soviet-style socialism since it began its opening to the market in 1978, the CCP refuses to abandon its adherence to the primacy of state ownership. The government still controls the bulk of investment funds, and SOEs (which employ 66 percent of the urban work force but produce only 30 percent of industrial output value) absorb nearly 80 percent of those funds. The lack of private property rights and the politicization of investment decisions have resulted in low returns on investment (*The Economist* 1998a, 1998b: 65).

Instructing state-owned banks to make loans on a commercial basis is like instructing government bureaucrats to be efficient. The absence of bankruptcy and the culture of common property produce an environment that is hostile to profit maximization and wealth creation but conducive to corruption and rent seeking. To stem adverse behavior, the state imposes myriad rules and regulations that hamper innovation and efficiency. Only a change in effective ownership rights that is tilted toward private property and freedom of contract will produce lending on a purely commercial basis.

The injection of new funds into state-owned banks that continue to lend to SOEs is a recipe for disaster. Another dose of financial morphine is not what China's dying banks and SOEs need. Piecemeal reforms may postpone the day of reckoning, but the time will come when SOEs must be taken off the artificial life support system and put on a purely market-based system. That will mean getting the state completely out of enterprises and denationalizing banks. Divesting the state of ownership and management rights means a total transformation of China's socialist market economy. The political barriers to doing so are huge.

The Prospect for Real Reform

As long as the CCP has a monopoly on power and the state prevents widespread private ownership and a free capital market, the nonstate sector will continue to be the victim of SOEs' unlimited appetite for investment funds, and corruption will prevail. The misallocation of capital means that China's growth rates have been overstated and that future growth is being jeopardized. As Hugo Restall of the *Asian Wall Street Journal* observed, "China has actually been cannibalizing its savings to keep its growth spurt going. If reform isn't undertaken soon, the government won't have the borrowing capacity left to fix the banks. There could be an economic—and political—reckoning" (Restall 1999: A14).

It is not enough to argue for recapitalizing state-owned banks through government borrowing. China must change the very nature of its banks by privatizing them and allowing foreign ownership of both banks and nonbank financial institutions. The problem, of course, is that such a radical change would undermine the very essence of communism and require radical political reform, which is why hard-liners continue to resist liberalization.

It is notable that the NPC has amended Articles 5 and 11 of the Constitution to read: "The People's Republic of China practices ruling the country in accordance with the law and building a socialist country of law" (Art. 5), and "Individual, private and other non-public economies that exist within the limits prescribed by law are major components of the socialist market economy" (Art. 11).

The NPC now needs to reinforce those amendments by giving teeth to a constitutional provision that promises protection of "the lawful rights and interests of individual and private economies" (Art. 11). What China needs is a system of checks and balances that effectively limits the power of government and expands the private sphere.

From Market Socialism to Market Liberalism

The deepening dilemma for the CCP is that if it does not open China's doors to foreign financial competition and increase privatization, China will never become a major player in the global financial system and future growth will suffer, creating pressure for political reform; but if it does liberalize the capital market, the last vestige of Soviet-style socialism will disappear and the people will stray even further from the CCP's ideology. In either case, the end of communism seems certain.[4]

But that will not occur overnight. The West must be patient and not stray from its effort to engage China and thus to use trade as a lever to further weaken the CCP and to give the Chinese people hope for the future of freedom. Economic liberalization has advanced human rights in China compared with the days of the Cultural Revolution (Dorn 1996). Much remains to be done, but ultimately the Chinese people will have to fight for their freedom and determine their own political system. U.S. policy toward China should not lose sight of that reality.

In the short run, China will be able to maintain its peg to the dollar, but in the longer run, the mainland must choose between a flexible exchange rate with an independent monetary policy and a fixed exchange rate with loss of monetary independence. Floating is the most likely outcome, in which case global market forces will quickly act to reward sound policies and penalize unsound ones.

China's financial future ultimately will depend on the creation of an institutional infrastructure that protects private property rights and encourages prudent risk taking. To foster that change, the Chinese people will have to develop a new mindset—one that accepts the notions of a spontaneous market order and individual responsibility, as opposed to state direction and socialization of risk. People will have to "throw off the old skin and change the bones," in the words of ex-Marxist professor Cao Siyuan. They will have to realize that "to attain springtime development and transformation, the only road is privatization" (Cao as quoted in Becker 1999).

Conclusion

Creating real capital markets in China will not be easy. As Dumeng Zhang, a research associate of the China Strategic Institute, notes, "The party will continue to favor the large state-owned businesses in an effort to gain overall control of China's economy through the use of state assets" (Zhang 1997: 15). The CCP's control will be weakened by China's accession to the WTO, the forces of globalization, and the information revolution, to be sure. Yet the fact remains that "the future of a true market economy based on private ownership depends on bolder policy initiatives, which will require the willingness of the

[4]For an in-depth treatment of the forces that are working to bring about the collapse of China's old economic and political structures, see Chang (2001).

CCP to share political power and control with other forces" (Zhang 1997: 15).

In the event that China fails to meet the challenge of moving from market socialism to market liberalism, there is little the West can do. Offering assistance from the International Monetary Fund as a carrot for reform is not a long-run solution and may actually delay meaningful reform. Russia is the most obvious example.[5]

The real key for China's future prosperity is not better government planning and foreign aid. The key is adopting a constitution that protects persons and property against the discretionary power of government and that lays a framework for freedom under the rule of law. That is the legacy of Hong Kong and the challenge for China.

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[5]On the failure of the IMF to bring about meaningful reform and, hence, to provide only short-term adjustment assistance, see Vásquez (2000: chap. 14). He finds that the IMF has provided credit for 20 or more years to 70 countries, making them into "loan addicts."

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