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The Effectiveness of Law, Financial Development, and Economic Growth in an Economy of Financial Repression: Evidence from China

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Summary. — In an economy characterized by financial repression, enhancing the legal system may hinder the development of some aspects of the financial sector, especially informal arrangements aiming at circumventing the repression. Using Chinese provincial data in the 1990s, we find that enhanced legal system suppresses private investment and has no effect on financial depth although it increases the private share of bank credits and bank competition. We interpret these findings as evidence showing the existence of the leakage effect that moves financial resources from the privileged state sector to the rationed private sector. In addition, we find that enhanced legal system does not have a significant effect on the average GDP growth rate. We conclude that the smooth functioning of the legal system requires other institutions to complement.

Key words — legal system, financial development, financial repression, economic growth

1. INTRODUCTION

Financial development is a key factor to promote economic growth (Beck, Levine, & Loayza, 2000; Levine, 1997). Recent research identifies the written law as a prominent determinant of financial development and economic growth (Beck, Demirguc-Kunt, & Levine, 2003; Beck, Demirguc-Kunt, & Maksimovic, 2004; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998; Levine, 1998, 2003). However, this view has been challenged by Berkowitz, Pistor, and Richard (2003), Pistor, Raiser, and Gelfer (2000), and Pistor (2002) who have found that the effectiveness of law is more important than the written law in promoting financial development in transition and developing countries. While these studies focus on the gross effect of the law on financial development, this paper aims at moving the study one step forward to decompose the channels by which the effectiveness of law influences financial development when financial repression is a significant characteristic of the economy. Financial repression widely exists in developing and transition countries (Mckinnon, 1973, 1993; Shaw, 1973). One consequence of financial repression is the creation of a privileged sector and an unprivileged sector with the former having access to cheap credits and the latter being rationed out. Under this situation, the relationship between the legal system and financial development may be more complicated than what it first looks like.

The Chinese provinces provide a good case for the test of this relationship. While they are subjected to the same written law, both the effectiveness of law and financial development in these provinces show remarkable variations. The Chinese financial system has a clear flavor of repression. The interest rate is set by the central bank to be much lower than the market rate, and the banking sector is overwhelmingly dominated by four large state-owned banks. A consequence is serious credit rationing that favors the state sector and suppresses the private sector. However, the private sector has been China's growth engine in the last 15 years, so there is a clear mismatch between the allocation of financial resources and the forces of economic growth.

Among a few studies on law and economic development in China, Allen, Qian, and Qian (2005) study the Chinese legal system by using the La Porta *et al.* (1998) legal indices and find that the Chinese system is incomplete compared with La Porta *et al.'s* sample countries; nevertheless, they find that China's economic growth has been largely sustained by the informal sector where the formal legal system only plays a marginal role. Pei (2001) also finds that a gap exists between China's remarkable growth records and its weak enforcement of commercial contracts although the latter has been improved in the 1990s. Alford (2000) points out the insufficiency to just look at China's formal laws when one evaluates the Chinese legal system; instead, he directs researchers to attend to the interplay of the formal law and informal enforcement mechanisms. [1]

This paper extends the above studies by providing a case study of the interplay between the formal legal system and informal arrangements that are conducive to economic growth in China's distorted financial system. Our key argument is that there exists a leakage process that moves financial resources from the state sector to the private sector. This movement circumvents the rationing imposed on the

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private sector and provides a mechanism for informal financing arrangements to support the growth of the private sector. So it is a socially efficient movement. A lax legal system allows for risk-sharing between the bank and the state sector when it comes to risks associated with the investment diverted to the private sector. Enhancing court enforcement shifts more risk to the managers in the state sector who will then reduce investment in the private sector. As a result, private investment will fall, so probably will the total amount of credits issued by the bank because the state sector's demand for credit may fall. Therefore, enhancing court enforcement may hurt financial development and becomes detrimental to economic growth when the private sector's access to credits is rationed.

In this paper, we study the effects of enhancing one key element of the effectiveness of law, the enforcement of court rulings, on economic growth as well as four key indicators of financial development, that is, share of private investment, share of private bank credit, financial depth, and bank competition. These indicators are frequently studied in the literature (Levine, 1997). One innovation of this paper is that we construct a unique objective measure of the effectiveness of law, that is, the ratio of closed cases (abbreviated as RCC in subsequent text) in all commercial court cases in a year. China has been notorious in enforcing court ruling; RCC thus is a good measure for the quality of court enforcement.

Our work is closely related to an emerging literature on the value of law in transition countries. Recent works show that law has played an increasingly positive role in protecting business transactions in these countries, including China (Murrell, 2001). Nevertheless, it is hard to deny that law in China is still weak and certainly does not match her remarkable growth record to the degree expected by the conventional wisdom. Our work complements two lines of research. One, represented by Berkowitz *et al.* (2003), emphasizes the local conditions for the legal system to work. For most transition countries, law is a transplanted institution so the readiness of the recipient country is crucial to make the transplanted law work. The other line of research emphasizes the role of informal arrangements in the absence of a sound legal system. The explanations put forward by Alford (2000) and Allen et al. (2005) on China's success are but two examples. Other researchers find similar results in other transition countries. For example, McMillan and Woodruff (1999) find in Vietnam that private entrepreneurs succeed in their businesses by relying on self-helping actions such as building reputations, trade credits, and reinvestment of profits. To the extent that financial repression is an intrinsic characteristic of the Chinese economy, our work reinforces the argument of the first line of research that local conditions are critical for law to function properly; and to the extent that the leakage effect is a result of private agents' self-helping actions, our work complements the second line of research.

The rest of the paper is organized as follows: Section 1 introduces the Chinese background and discusses the mechanism of the leakage effect under financial repression. Section 2 proposes several testable hypotheses regarding the effects of the effectiveness of law on the four indicators of financial development as well as on economic growth. Section 3 introduces the data and discusses the variables. Section 4 provides empirical results of the tests of the hypotheses proposed in Section 2 using RCC as the measure for the effectiveness of law. Two sets of robustness checks are then performed, one using a smaller sample of the period 1991–96 and the other using an alternative measure for the effective of law. Section 5 concludes the paper.

2. FINANCIAL REPRESSION AND THE LEAKAGE EFFECT

(a) *Financial repression in China*

Financial repression is an intrinsic characteristic of the Chinese banking system. In the planning period of 1952–78, low interest rates were adopted to provide low-cost finance for China's heavy industry-oriented industrialization (Lin, Cai, & Li, 1996). Financial repression has continued after the open-door policy was adopted in the late 1970s. The official interest rates have been consistently lower than the rates found in the informal credit market by 50–100% (Garnaut, Song, Yao, & Wang, 2001). In recent years, a band of 10% below and 50% above the official benchmark rate has been allowed for banks when they lend to small- and medium-sized firms. But the market rate is still 50% above the higher bound. Aggravating the situation, the Chinese banking system is overwhelmingly dominated by the four large state-owned banks.[2] In the early 1990s, credits issued by these four state-owned banks consisted of more than 90% of the total amount of formal bank credit in the country. This ratio was kept at 77% by 2000 (PBOC, 2000). Three of the four big banks, CBIC, BOC, and CCB, have been partially listed in overseas markets in recent years. But their dominance has still been overwhelming. By 2005, their share of the credits was still 60% (Sun, 2007). These banks suffer from serious problems caused by huge non-performing loans and inefficient operation. The whole banking system was virtually in a bankrupt position by the end of the 1990s as its net worth had become negative (Lardy, 1998, pp. 109–111). The amount of non-performing loans reached 2.5 trillion yuan at the end of the 1990s. In recent years, the performance of the banking sector has been improved due to governance changes through public listing. In addition, several asset management companies have been established to take up the bad loans of the four largest state banks. However, as of the first quarter of 2007, the amount of outstanding non-performing loans was still 1.25 trillion yuan, or 6.63% of the total amount of outstanding loans.[3] Financial repression and the dominance of inefficient state banks have led to serious credit rationing in the banking sector. The non-state sector has suffered the most. Although its share in China's total GDP has surpassed 60%, this sector has received less than 20% of the formal bank credit in most of the last decade, and the other 80% has all gone to the state sector (Garnaut *et al.,* 2001). As of 1998, 94% of all state bank loans went to state enterprises even though one-third of them were loss-making (Dwight, 2004).

The non-state sector becomes the target of rationing for both political and economic reasons. On the political side, the rationing can arise from the government's intention to maintain employment in the state sector (Brandt & Zhu, 2000). Because many SOEs are inefficient, cheap credits are needed to keep them float. Under the constraint of limited resources, the private sector is often sacrificed. In addition, while a default by an SOE is tolerable in the Chinese banking system, a default by a private firm will surely raise the concern as to whether the loan officer has received under-the-table benefits from the firm. It is therefore rational for a loan officer to be highly cautious when he decides on a loan to a private firm. The economic reason is more practical. Cull and Xu (2000) find that the state banks were able to identify good firms even in the early 1990s indicating that making profits was a goal of the banks. Most of the firms in the non-state sector are small and medium-sized firms that intrinsically have a higher risk of default than the SOEs, which are usually large and have a lower risk of failure. Therefore, banks' discrimination on non-