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# Journal of International Money and Finance

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## Regional capital mobility in China: Economic reform with limited financial integration



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### A B S T R A C T

#### JEL classification:

F15  
O18  
O53  
C11  
C23

#### Keywords:

Regional capital mobility  
China capital market integration  
Permanent income model  
Panel time-varying coefficient model

This paper assesses the changes in the regional capital mobility in China during the period of economic reform in 1978–2008 by employing a panel time varying coefficient (TVP) model. This approach is much more suitable to model China's evolution in the regional capital mobility than a standard structural break model as China's reforms took place gradually and were often implemented over several stages. Using the TVP model, we find that (1) China's provincial capital mobility demonstrated a moderate improvement over the sample period, but worsened temporarily between 1994 and 1997. This is probably due to the government's effort to combat inflation which reduced the investment and transfers to regions; (2) regions with the most developed and least developed provinces experienced higher degree of capital mobility improvement than those in the middle.

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## 1. Introduction

After Feldstein and Horioka (1980) measured international capital mobility by the correlation between national saving and investment, Feldstein (1983), Murphy (1984), Obstfeld (1989, 1996), and Tesar (1991) documented relatively high saving and investment correlation among the OECD countries. The estimates were generally above 0.5, and in some cases statistically insignificantly different from unity. This evidence for low international capital mobility ran counter to the widely held consensus of

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relatively high international capital mobility. To reconcile this empirical result with the assumption of high international capital mobility, Cantor and Mark (1988), Mendoza (1991), Backus et al. (1992), Baxter and Crucini (1993) incorporated adjustment costs for domestic investment, as well as other frictions, into models which also assumed free capital mobility.

Coakley et al. (1996) argued that these cross-country studies are subject to the current account solvency constraint, which complicates the interpretation of the saving retention rate. As such, another group of papers apply the Feldstein and Horioka (1980) framework to *intra-national* cases. For example, Bayoumi and Rose (1993), Helliwell and McKittrick (1999), Yamori (1995), and Dekle (1996) use the framework to study provincial and regional capital mobility within a country, which generally is not subject to the same constraint. The first two studies focus on UK and Canada respectively, and the latter two on Japan.

Although the Feldstein and Horioka (1980) framework has been widely adopted as a measure of capital mobility, it falls short in its theoretical foundation. By adopting the permanent income model, with a fraction of current income consumers, originally developed by Campbell and Mankiw (1990a, b), Shibata and Shintani (1998) constructed an alternative way to measure capital mobility. Instead of focusing on the correlation between national saving and investment, they estimate the correlation between national consumption and net output under the theoretical framework of a small open economy with permanent income consumers, and restrictions on capital mobility. Decressin and Disyatat (2008) extended this framework and measured capital market integration within the OECD and across Canadian provinces when liquidity-constraint agents are present. Huang (2010) further incorporated the terms-of-trade factor into the framework and estimated the degree of capital mobility controlling for the effect of the terms-of-trade. In general, the advantage of such a framework over the Feldstein–Horioka approach is that it has a solid theoretical model embedded in the partial equilibrium permanent income setup.

In this paper, we gauge the regional capital mobility across China by utilizing the above framework of Campbell and Mankiw (1990a, b) over the sample period of 1978–2008. Since China is now the world's second largest economy with a huge current account surplus against its major trading partners, a study of this topic is of importance in several aspects.

*First*, China started its economic reform and opening up policy in 1978. During the last three decades, China has been experiencing a high rate of economic growth, up to 10% on average. Since this reform is market-oriented, many are eager to find out if any integrated capital markets across China has been established.

*Second*, the growth miracle of China is driven largely by the fast growth in the export-oriented industries along the coastal line of China, while the vast west region is left out<sup>1</sup>(Fleisher et al., 2010). Has this export performance produced any effect on the cross region capital mobility? Since China is now under intense international pressure to balance its huge current account surplus, export dependency will have to give way to enhanced domestic consumption demand in the future. For this reason, a more integrated capital market across regions would facilitate the effectiveness of the stimulus policies which aimed at promoting domestic demand and global rebalancing. Our results show that in the absence of widespread financial integration, a global stimulus package originating from China may not have any prominent effect, since changes in the domestic consumption across regions are closely tied to changes in the regional net income.

Much effort has been devoted to evaluating the financial and capital market integration in China. Boyreau-Debray and Wei (2004) applied the Feldstein and Horioka (1980) framework to the provincial level saving and investment data in China from 1952 to 2001 and found that there was no improvement in the provincial capital mobility across China over this period. Using the same framework, Li (2010) applied the panel cointegration method to the provincial data from 1978 to 2006. He came to the same conclusion that capital market integration within China was low and there was practically no improvement during the sample period. Chan et al. (2011b), using the framework of both Feldstein and Horioka (1980) and Shibata and Shintani (1998), evaluated the provincial capital mobility in China

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<sup>1</sup> The central government realized this unbalanced growth among different regions in China, so they implemented several policies to develop the western region. For example, in 2000, the central government launched a large scale policy dubbed "Develop The West" to finance public and private projects in the western region.

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