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Regional capital mobility in China: 1978–2006

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We examine cross-region capital mobility in China and track how the degree of mobility has changed over time. The effects of fiscal and redistributive activities of different levels of government in China on private capital mobility are taken into account. Our results indicate that there was a significant improvement in capital mobility over time in China, particularly for private capital in the more developed regions. The central and provincial governments, via their taxation, spending, and transfers, loosen the relationship between private saving and investment and appear to promote capital mobility, particularly for less developed regions. There are considerable differences between more and less developed regions in terms of the degree of capital market integration and the improvement in capital mobility over time. The results have important policy implications on global re-balancing as well as regional development gap and risk-sharing within China.

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1. Introduction

While China has made great strides in economic reforms and development, her financial system is still considered being far from efficient and domestic capital markets are fragmented (Boyreau-Debray and Wei, 2005). An integrated capital market where private funds can flow freely is essential for the Chinese economy to sustain its growth and achieve better efficiency. In this paper, we examine capital mobility in China and how the degree of mobility has changed over time. We also take into account of

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the effects of fiscal and redistributive activities of different levels of government in China on cross-region capital mobility.¹

After 1978, economic reforms experimented along the coastal areas such as Guangdong and Shanghai have resulted in rapid development in these regions. They have become the engine of economic growth for the whole country. However, this might have contributed to a widening economic development gap between these coastal and the more inland regions. The Chinese central government in 2000 initiated a “Develop the West” program to promote a more balanced growth across China (Lin and Liu, 2008). At the same time, China is under increasing pressure from her major trading partners to rely less on foreign demand in an effort to curb global imbalances. The 2007–2009 global financial crisis gives rise to yet another incentive for China to turn more to domestic demand as a propeller of growth.

Furthermore, the composition of the domestic absorption matters a great deal here. Prasad (2009) shows that the economic growth of China has been driven mainly by investment rather than by consumption. Greater capital mobility would enhance the ability of households to borrow for consumption of both home and foreign goods. Higher consumption spending would then generate a more sustainable growth driven by domestic demand in China and contribute toward global re-balancing. Xu (2008) finds evidence of low degree of consumption risk sharing across Chinese provinces; he suggests that one should focus on the mechanisms that have prevented regions from sharing their risks within China. Increased capital mobility is essential for more active cross-region borrowing and lending that would in turn facilitate risk sharing and confer corresponding welfare gains.

In short, understanding capital market integration at the national and regional levels is important toward the goals outlined above. Recognizing there may be vast regional differences, we also estimate the degree of capital mobility for different regions based on their level of economic development. In light of these recent developments, it is hoped that our estimation results bear some policy relevance.

In a pioneering study, Feldstein and Horioka (hereafter FH) (1980) evaluate the degree of cross-country capital mobility by estimating the correlation between saving and investment, also referred to as the saving-retention rate, based on cross-sectional data of OECD countries. They argue that if capital mobility is high, incremental saving in one country would seek investment opportunities with the highest possible risk-adjusted returns around the world, resulting in low correlation between national saving and national investment. Under financial autarky, a country's domestic investment must be financed exclusively by her domestic saving, resulting in perfect correlation between national saving and investment. In their results, the estimated saving-retention rate is quite high and is not statistically different from unity. This implies low capital mobility and contradicts a general consensus that capital is highly mobile among the OECD countries. While many subsequent studies of international capital mobility using cross-sectional, time-series, and panel data largely confirm the FH results, they provide alternative explanations and interpretations to this puzzle, including government policies such as budget deficit and current account targeting (Summers, 1988; Roubini, 1988; Bayoumi, 1990). In addition, Baxter and Crucini (1993) and Mendoza (1991), among others, show that incorporating adjustment costs in inter-temporal models with built-in mobile capital can produce a correlation between domestic saving and investment as high as that observed in the data.

Some studies have adapted the FH framework to examine capital mobility across regions within a country. A key advantage of examining domestic capital mobility via the FH framework is that, unlike national sovereignties, provinces are not subject to the current account solvency constraint that complicates the interpretation of the saving-retention rate. Bayoumi and Rose (1993) and Thomas (1993) estimate the saving-retention rate for the UK; Yamori (1995) and Dekle (1996) for Japan; Sinn (1992) for the US; and Thomas (1993) as well as Helliwell and McKittrick (1999) for Canada. For

¹ Capital mobility is defined in this paper as free flows of funds across regions. Since financial markets in China are still underdeveloped and the number of financial instruments being traded is limited, a related but different concept of market completeness in which financial instruments covering a wider range of contingencies are traded is not examined here.

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