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Trade openness, financial openness, and financial development in China

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This paper investigates the impact of trade and financial openness on financial development in China. We use three sets of indicators of financial development to distinguish size, efficiency and competition as aspects of financial development. The empirical results, using dynamic panel estimation techniques, suggest that both trade and financial openness are statistically significant determinants of financial efficiency and competition, but that openness has a negative impact on the size of financial development. Our results also suggest that the marginal effects of openness on financial efficiency and competition are positive for the most open provinces but negative for the least open regions, while the marginal effects of openness on the size of financial development are generally negative for most provinces in the sample. The results reflect a mismatch problem between the distribution in the types of trading companies and the distribution of financial resources, and also indicate that local incumbents may be strong impediments to financial development in China.

1. Introduction

Both theoretical and empirical research highlight the potentially important nexus between financial development and economic growth (e.g. Beck et al., 2000; Darrat et al., 2006; Ductor and Grechyna, 2015; Guariglia and Poncet, 2008; Levine, 1997). The frontier of the literature in this

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field is shifting toward an examination of the sources of financial development from the perspectives of financial liberalization (McKinnon, 1973), legal systems (La Porta et al., 1998), government ownership of banks (Andrianova et al., 2008), and political stability (Girma and Shortland, 2008).

Another important source of financial development, noticed in a small but growing number of studies, is openness. The relevant literature has focused mainly on two-variable relation between trade openness and financial development (Beck, 2002; Braun and Raddatz, 2005; Do and Levchenko, 2004; Mishkin, 2009), financial openness and financial development (Chinn and Ito, 2006; Levine, 2001), and financial openness and trade openness (Aizenman and Noy, 2009). These studies generally find positive links between openness and financial development and between trade and financial openness across developed and developing economies.

The seminal work of Rajan and Zingales (2003), however, suggests that findings based on the examinations of the two-variable relationships are likely to be incomplete and even misleading. Rajan and Zingales suggest an important three-variable relationship among trade openness, financial openness, and financial development. In particular, they establish that trade openness without financial openness is unlikely to lead to financial development and they verify their hypothesis using data for 24 industrialized countries for 1913–1999. Rajan and Zingales (2003) put forward the interest group theory to summarize their research results. They argue that interest groups, in particular industrial and financial incumbents, frequently stand to lose from financial development. This is because financial development creates opportunities for new firms to be established, which breeds competition and erodes incumbents' interests. They suggest that incumbents' opposition to financial development will be weaker when an economy is open to both trade and finance (capital flows).

Baltagi et al. (2009) address Rajan and Zingales's (2003) hypothesis, using data for both developing and industrialized countries. They highlight the interactive effects of trade and financial openness on financial development in assessing the simultaneous openness hypothesis. The interaction between trade and financial openness can be used to assess the marginal effect of rising trade (financial) openness on financial development conditional on financial (trade) openness. Because the hypothesis indicates that an economy opens up to trade when its capital account is closed, there will be calls for additional financial repression to protect industrial incumbents, which would prevent financial development from taking off. Thus, the marginal effect of trade openness should be non-positive when the capital account is relatively closed.

The results in Baltagi et al. (2009) show that both trade and financial openness are statistically significant determinants of banking sector development and that opening up either trade or finance without opening up the other could still generate gains in financial development. The empirical results pertaining to developing countries in Law (2009), nonetheless, show that the simultaneous opening of trade and capital accounts has a positive impact on financial development, which appears to support Rajan and Zingales' hypothesis. Law notes that his finding should be interpreted with caution because his sample countries are from the developing world, where the financial sector is mostly driven by the banking sector.

The subtle disparity in these studies, which use a selection of different countries, implies that the pattern of the interactions among trade/financial openness and financial development may differ significantly among countries. Although using cross-country data can enlarge sample sizes, the corresponding results may be difficult to interpret consistently and some unique features pertaining to an individual country will not be discovered due to the diversity of historical experiences, cultural norms and financial contexts in different countries.

Thus, to enhance the understanding of the relationship between trade/financial openness and financial development in different countries, there is value in performing studies on individual countries with a diverse set of measures of financial development, when the relevant panel data for individual countries are obtainable. In this paper we adopt such an approach to gain insight into the dynamic impact of trade openness and financial openness on financial development in China, whose high economic growth over the recent decade has received great attention in the world and where financial development (particularly size indicators) also appears to have progressed dramatically since the mid-1990s (Zhang et al., 2012).

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