

**STUDIES ON ECONOMIC TRANSITION
IN CHINA**

The Role of the Government
Securities Market

Fang Li

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TRANSITION IN CHINA

The Role of Government

Securities Market

by Fang Li

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To
My Husband Glenn and My Son Sam

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Foreword

Economic reality in China and East Asia is changing rapidly. It is important that economic theory and economic modelling keeps up with this dynamic change, especially mobilisation of hitherto untapped savings, deepening and widening of capital markets, more transparency in banking operations and supervision of non-banking financial institutions. There is also a growing influence of expectations about exchange and interest rates which traditional theory would only examine on very restrictive assumptions but which has been incorporated in a wider perspective by Fang Li.

Fang Li's book can be very useful to economic planners and experts in financial regulation in understanding the new trends. Her ideas and modelling are highly original, relevant and apply to regions, and not only the national level. Fang Li's continuing interest in these problems stem from a number of sources; earlier debates with her father (himself a economic expert); her initial post-graduate training in Japan; her research for a brilliant and successful doctoral thesis and her desire to bring the older theories of McKinnon up to date. She is also acutely aware of the need to bring out the problems encountered when there is imperfect knowledge between firms and banks—something not properly covered in the pre-1990 traditional theory of financial markets.

The analysis in this book will also assist theoretical reasoning by reminding us of capital constraints on individual enterprises—something that was revealed as very significant by the Asian financial crisis that unfolded in the period beginning 1st July 1997. Another feature is the link she provides stock exchange movement and the “re-

al" cost of money, which depends on what is happening in the real economy. This is surly the right focus of attention.

Recent volatility in capital markets across East Asia reminds us of the need to consider both investors' risk and rates of return which were raised in Gunnar Myrdals Monetary Equilibrium, as well as the dynamic inter-relationships between interest rates, stock exchange values, foreign exchange rates and maturation of debt. Li's framework allows us to more readily incorporate this interaction and its results.

I would like to make a couple of points about the value of this book for economists studying economic policy in the Peoples Republic of China. One should pay attention to the very insightful review, a sort of modern economic history of past experiences in planning and in regulation of the financial sector. It shows Deng was correct to allow special economic zones to start the long process of developing markets in shares, debentures and official paper assets. Given China's needs to tap and mobilise savings, the previous system of only allowing groups to purchase fixed-interest securities and debentures in each other (using profit residual and other idle funds) could not handle the massive demand for capital and its quick circulation around the economy. Once sectors of the farmers became rich they needed an outlet, too, for their new earnings to produce interest income, and paper claims to a future stream of income appealed to them.

Li shows that the basic savings funds which were required by accelerating economic growth was suddenly becoming available—the task was to design the institutional framework for mobilising liquid resources for re-assignment across economy. This is not to say that the problem of industrialisation was only a financial one (though this was certainly a bottleneck), but that there was a problem of financial organisation that was not being done efficiently in a system dom-

inated by rural communes and over-centralised economic planning.

As productivity in agriculture rose following the agrarian reform unleashed in 1978-1979, investment in industry and investment in agriculture became non-competitive, and this much better situation was largely due to the gradual use of capital markets.

A second point relates to the need for more transparency in financial policy-making and especially in implementation. The whole thrust of Li's analysis is that capital mobilisation and redistribution of the loanable funds coming increasingly onto capital markets is best done when there is plenty of information, more knowledge in the hands of economic agents and more democracy in the decision making process. This is true, not only for China but for East Asia as a whole.

Fang Li's book is satisfying to read because it is analytically sharp but also a realistic basis for financial and banking policy change. This nice combination is often rare in the world of capital and financial economics. It allows no room for either excessive abstract reasoning nor for ideological over-kill. Rather it is a stimulus to practical reform with the goal of improved efficiency in order to benefit all sectors and all economic agents.

I welcome the publication of her ideas and I applaud the dedicated way she has constructed her research, with her proven ability to deliver new insights, useful pointers and forthright conclusions.

Professor Bruce McFarlane

Former Full Professor
The University of Newcastle
Australia

Acknowledgement

This book is based on my Ph. D. dissertation of 1998. I am pleased to have had the opportunity to study the financial reform in China. The period since the late 1970's was one of transition and rapid change within China's financial sector. For these reasons writing a thesis on banking, monetary management and the securities market in China has been a challenge. Hence, I would like to thank my supervisors at the time Dr. Dietrich Fausten for his help, guidance and constructive criticism and associate supervisor Dr Xiaokai Yang.

I am honoured to record my gratitude to many other people who helped me in the process of writing my thesis. I am especially grateful to my many friends at Monash University (Australia):

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The research has been, in various forms, presented at interna-

tional symposiums and academic seminars in Australia and Hong Kong. My thanks to all the participants in the above seminars and conferences for their invaluable comments.

It is a pleasure to express my heartfelt gratitude to my husband Glenn, my son Sam and my parents who all shared in the difficulties faced during my study period. Without their support and understanding, this thesis would never have been completed

Finally, my thanks are given to those who accepted my interviews, assisted me to collect research material and provided valuable help during my research trip in Shenzhen, Beijing and Shanghai in 1992 and 1993. I wish that the reforms in China bring increased prosperity, peace and happiness to all the people of China and that my study helps illuminate the difficulties faced by the reformers during these times of transition.

Fang Li