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Financial Intermediation and Economic Growth: Chinese Experience

Abstract

This paper examines the role of the financial intermediation in China's economic development during the post-reform period. Before the reform, China's financial system was characterized by an all-inclusive mono-bank system. The role of financial intermediation was extremely limited on resource allocation, because most investments were financed by state budget. Since the onset of economic reform in 1978, China's financial sector has experienced a remarkable development. Firstly, financial deepening is impressive. Financial depth measured by the ratio of M2 to GDP has increased from 24.55 percent in 1978 to 152.07 percent in 2000, that is to say an annual growth rate of 8.64 percent (IFS, 2001). Secondly, a large number of financial institutions have been established, and the financial system tends to be diversified. Finally, the corporate financing has shifted from state budget appropriations to bank loans. The financial intermediaries play a more and more important role in resource allocation. However, China's financial sector is far from efficient. It is dominated by the four state-owned banks and suffers from government interventions. Most of financial resources are allocated to the inefficient state-owned enterprises. The non-state sector, locomotive of China's economic growth, finds it difficult to obtain external financing from formal financial sector. This misallocation of financial resources may result in a bad use of capital and a deterioration of productivity. Thus, it may threaten the durability of China's economic development. Nevertheless, the case study of China's financial intermediation efficiency and its impact on growth has received little attention. Hence this paper attempts to fill the void in the literature. Firstly, given that the traditional indicators don't apply to China's situation, several modified indicators are proposed to measure the true development of financial intermediation. It allows us to better understand to which extent and in what sense China's financial intermediation makes progress during the post-reform period. Secondly, using a dataset of 29 provinces for the period 1978-1998, we introduce the indicators of financial intermediation into the traditional growth regression framework, and then employ the GMM-System estimator in order to address the econometric problems induced by individual-specific effects, endogeneity, and the use of lagged dependent variables. Our results show that the choice of the financial intermediation indicators is very important. Because the assumption that the quality of financial services is positively correlated with the size of financial sector is violated, the traditional indicators fail to capture the real development of China's financial intermediation, and hence their use can lead us to find that the financial intermediation has a negative impact on China's economic growth, which contradicts theoretical conclusions and most of empirical findings. However, when we use the modified indicators, which we think are better adapted for China's situation, the econometric results conform to the general theoretical and empirical evidence. Financial intermediation favours capital formation, contributes to productivity amelioration, and therefore reinforces growth. Finally, we draw out some policy implications concerning improving financial intermediation efficiency and financial resource allocation, favouring financial sector diversification, promoting competition among financial institutions, and state-owned enterprises reform.

CHEN Hao

CERDI, Université d’Auvergne
65, boulevard François-Mitterrand
63000 Clermont-Ferrand
France

Mobile: 0033 660189655

E-mail: Achille77fr@yahoo.fr