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ARTICLE

FINANCIAL REPRESSION, FINANCIAL LEGAL GOVERNANCE AND ECONOMIC GROWTH IN CHINA

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Abstract Financial repression usually exists in developing countries. By nature, it is like a hidden tax and can liquidate public debt of the government effectively. The policy of financial repression will likely hinder financial deepening, negatively influence the building-up of efficient and inclusive financial systems, and eventually harm sustainable economic growth in the long run. The fine legal infrastructure plays an important role in financial deepening and development. In China the major measures to reduce financial repression and improve the legal governance in finance are the following: the strict respect and protection of private property rights, including the obligation rights of the common depositors against the banks and the shareholders' rights of the common investors, the respect and protection of the contract freedom and contract enforcement, the sequential openness of financial market entry and introduction of the principle of free and equal competition in the financial market, and the improvement of the judicial system to increase the adaptability of Chinese law, such as the strengthening of judicial independence and the establishment of case law.

Keywords financial repression, financial deepening, legal governance, economic growth

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INTRODUCTION

A great deal of foreign and domestic research literature shows that financial development has a primary influence on sustainable economic growth in the long run.[1] Finance can be divided into indirect finance (banks) and direct finance (securities). It is said that the development of banks and securities market is a good indicator of economic growth.[2] From the aspect of micro economics, financial institutions are of great

[1] Robert G. King & Ross Levine, *Finance, Entrepreneurship, and Growth: Theory and Evidence*, 32 Journal of Monetary Economics 513, 513–542 (1993); R. Atje & B. Jovanovic, *Stock Markets and Development*, 37 European Economic Review 632, 632–640 (1993); R. Levine & S. Zervos, *Stock Markets, Banks, and Economic Growth*, 88 American Economic Review 537, 537–558 (1998); T. Beck, R. Levine & N. Loayza, *Finance and the Sources of Growth*, 58 Journal of Financial Economics 261, 261–300 (2000); TAN Ruyong, 中国金融发展和经济增长关系的实证研究 (*Empirical Research on the Relation of Financial Development and Economic Growth in China*), 10 经济研究 (Economic Research Journal) 53, 53–61 (1999); ZHOU Li & WANG Ziming, 中国各地区金融发展与经济增长实证分析 (*Empirical Analysis about Financial Development and Economic Growth in Different Areas of China*), 10 金融研究 (Journal of Financial Research) 1, 1–13 (2002); WANG Zhiqiang & SUN Gang, 中国金融发展规模、结构、效率与经济增长关系的经验分析 (*Empirical Analysis of the Relation of the Scale, Structure and Efficiency of China's Financial Development and Economic Growth*), 7 管理世界 (Management World) 13, 13–20 (2003).

[2] See Levine & Zervos, Id. at 537–558.

importance to corporate and industrial expansion.[3] Although there are different views on this issue, massive existing evidence supports a strong relation between financial development and economic growth. In addition, the theory of law and finance which rose in the mid to late 1990s, emphasizing and highlighting the role of the legal systems in explaining the international differences of financial development.[4] The theory argues that in the countries where the legal systems provide stronger protections of private property rights, private contracts, and the rights of investors, ordinary residents are more willing to invest in the corporations, and this leads to the prosperity of financial market. On the contrary, the legal systems that are weak in protecting private property rights and private contracts hinder corporate finance and the development of finance. In the early 1970s, American professors McKinnon and Shaw proposed the theory of financial repression and financial deepening, which has a far-reaching impact. This theory argues that financial repression, mainly showing as the repression on real interest rates by the government, commonly exists in developing and transition countries, and it hinders financial deepening.[5] In the environment of financial repression, the government allocates disposable scarce credit resources to the so-called priority sectors, thus hindering economic development by having adverse impacts on the amounts and output rates of investment. China, as an emerging power and with a transitional economy, is confronted with the arduous task of deepening the reform of financial system step by step and maintaining a healthy and sustainable national economic growth which has not only the quantity but also the high quality.

Since the launch of the reform and opening up policy in 1978, China's economic development has achieved a great success in the past more than three decades. Particularly after China joined the WTO in 2001, its GDP more than tripled in only 12 years, an annual rate of growth of 10.09%. China's macroeconomic performance in the past decade has been characterized by high domestic investment, high dependence on the foreign market and a low consumption ratio. In the long run, however, this current growth model may not last forever. China has paid much environmental price and the industrial debt has risen to about 250 percent of GDP. Because of lacking technology and

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[3] A. Demirgüç-Kunt & V. Maksimovic, *Law, Finance, and Firm Growth*, 53 Journal of Finance 2107, 2107–2137 (1998); Raghuram G. Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 American Economic Review 559, 559–586 (1998).

[4] Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer et al, *Legal Determinants of External Finance*, 52 Journal of Finance 1131, 1131–1150 (1997); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer et al, *Law and Finance*, 106 Journal of Political Economy 1113, 1113–1155 (1998).

[5] Ronald I. McKinnon, *Money and Capital in Economic Development*, Brookings Institution (Washington, DC), at Sections I, II & III (1973); Edward S. Shaw, *Financial Deepening in Economic Development*, Oxford University Press (London), at Sections I & II (1973); Vicente Galbis, *Financial Intermediation and Economic Growth in Less-Developed Countries: A Theoretical Approach*, 13 Journal of Development Studies 58, 58–72 (1977); Basant K. Kapur, *Alternative Stabilization Policies for Less Developed Countries*, 84 Journal of Political Economy 777, 777–795 (1976); Maxwell J. Fry, *Money and Capital or Financial Deepening in Economic Development?*, 10 Journal of Money, Credit and Banking 464, 464–475 (1978).

innovation, Chinese firms are also often at the bottom of the product value curve and earn a smaller share of the profit in the competitive world economy. How to change China's growth strategy, push it into the long-run sustainable economic growth and avoid the "middle income trap" is a huge theoretical and practical problem.

Based on the theory of financial repression and financial deepening and the law and finance theory, and also from the perspective of law, finance and economic growth, this article discusses how to carry on a better and more concrete construction of the legal governance in finance under China's special background of financial repression, ameliorate the financial repression, deepen the financial development, and push forward the long run sustainable economic growth, which has both the high quantity and quality, in China.

I. FINANCIAL REPRESSION

A. Concept and Characteristics

Financial repression is a phrase to describe that the government takes several measures to get funds. In a free market without the purposed control of the government, the funds would go into the other places. This phrase was first raised by the economists, Edward S. Shaw and Ronald I. McKinnon from Stanford University in 1973.[6] Afterwards, this phrase is used to describe the way of financial systems that emerging countries had haven before they undertook the extensive financial reform starting in the 1980s.[7] These emerging powers include South Korea, Malaysia, Thailand, Mexico, Argentina, Brazil, Chile, etc. However, financial repression also existed in developed countries after the end of the Second World War and extended to the 1980s in varying degrees. After the financial crisis in 2008, public debt of the governments in developed countries and emerging countries both rose significantly, and thus many countries began taking financial repression measures at different levels again.[8]

The main characteristics of financial repression are as follows:

Firstly, it is directly or indirectly controlling interest rates. Currency itself is a commodity and has its price. The price is interest. The price of the commodity should be determined by the relation of supply and demand in the market. However, in reality, since governments are usually debtors or some governments want to protect its state-owned banks and enterprises, governments will likely take the measure of controlling interest rates to achieve real results of liquidating government debts or transferring wealth to state-owned banks and enterprises when the inflation exists simultaneously.

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[6] See Shaw, Id.; McKinnon, Id.

[7] Pierre-Richard Agénor & Peter J. Montiel, *Development Macroeconomics* (3rd edition), Princeton University Press (Princeton), at Sections I, II & III (2008).

[8] Carmen Reinhart, Jacob Kirkegaard & Belen Sbrancia, *Financial Repression Redux*, 48 Finance and Development 22, 22–26 (2011).

Secondly, it is creating and maintaining captured domestic residents who can supply credit for the government conveniently. This can be achieved through many relatively simple and subtle regulations and measures. For example, the limitation of capital accounts, which can control the transfer of the capital overseas, including investment in foreign securities markets, the high requirement of deposit reserves, which is actually a tax on banks when the deposit interest rate is low and the inflation exists,[9] "prudent" supervisions requiring domestic financial institutions to hold government bonds, the majority of which are pension funds, which are usually called social security funds in China, in history, and so on.

Thirdly, it is taking other measures. For example, the government directly owns in whole or in part the shares of the banks in some countries like China and India, intensely manages banks and other financial institutions, restricts the entry into finance industry, explicitly or implicitly directs the banks to grant credit to specific enterprises or industries,[10] and so on.

B. The Effects of Financial Repression: Implicit Tax and Liquidation of Government Debts

Throughout the history, the ratio of public debt of the government to gross national product can be reduced through the following measures: the growth of economy, financial austerity plans, obvious insolvency or reorganization of public debt, sudden and surprising eruption of inflation, and stable financial repression with stable inflation. Among them, the most delicate and effective measure is the last one. The low nominal interest rates help reduce the cost of debt and then the negative real interest rates generated by inflation help liquidate or erode the real value of government debt. In this way, inflation need not be very high or completely surprising to market participants. Therefore, financial repression produces a secret transfer of wealth from creditors to debtors, namely from the average depositors to the government. In essence, it is like a type of tax as part of the government fiscal revenue, which can liquidate public debt of the government effectively.[11] Such type of financial repression tax is different from income tax, consumption tax, or sales tax because its tax rate is determined by the degree of financial repression and inflation. Compared with distinct fiscal and tax measures, it is secret, opaque, and difficult for the average residents to be understood easily.[12]

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[9] Philip Brock, *Reserve Requirements and the Inflation Tax*, 21 Journal of Money, Credit and Banking 106, 106–121 (1989).

[10] David O. Beim & Charles W. Calomiris, *Emerging Financial Markets*, McGraw-Hill/Irwin (New York), at Sections I, II & III (2001).

[11] Alberto Giovannini & Martha de Melo, *Government Revenue from Financial Repression*, 83 American Economic Review 953, 953–963 (1993); Chong-En Bai, David D. Li & Yingyi Qian et al, *Financial Repression and Optimal Taxation*, 70 Economic Letters 245, 245–251 (2001).

[12] See Reinhart, Kirkegaard & Sbrancia, fn. 8 at 22–23.

Before the First World War, the rules of free capital market and the international capital flow reached the top under the gold standard. However, the recession started after the First World War. The Great Depression that broke out in 1929 and the Second World War afterwards finally ended laissez-faire banking. After the Second World War, fixed exchange rates and the regulations of international capital market, which was being strictly controlled at that time, were established under the Bretton Woods system. The results were the very low nominal interest rates and the various degrees of inflation in developed countries. The real interest rates in developed countries and emerging countries were both significantly negative, no matter they were government bonds, discount rates of central banks, deposits or loans. It remained very low in about subsequent 35 years, and the average level was negative. This commonly existing financial repression mechanism played an important role in reducing or "liquidating" the huge amounts of government debt accumulated by many developed countries during the Second World War. Some scholars have provided evidence from the perspective of political economy, showing that during such a long period, a strong government accompanied by a weak central bank can impose capital controls so that the government can obtain more seigniorage and hold interest rates very low artificially to facilitate the reduction of domestic debt.[13] Some scholars further pointed out that between 1945 and 1980, the government revenue with the liquidation effect generated by financial repression in U.S., Britain and Italy was about 3.2%, 3.6% and 5.3% of their own GDP, and about 18.9%, 26% and 127.5% of their own tax income separately each year.[14] Although another period of free capital flow began in around 1980, the outbreak of global financial crisis in 2008 again caused the interest rates in many developed countries to be negative. In recent years, governments of many developed countries have taken several measures to create or increase the need of public debt or directly interfere with private deposits. For example, in France, in 2010, the government changed the pension reserve fund (*Fonds de Reserve Pour Les Retraites*) as the captured buyer of French government bonds. In Spain, in 2010, the government set up the rules for the upper limit of deposit interest rates. In Britain, in 2009, Financial Services Authority required the banks, investment banks, and subsidiaries or branches of foreign institutions in Britain to hold more government bonds.

In developing countries, the issues of financial repression and inflation are more serious. Among the several incidents, a well-known one is that Latin American countries completed obvious liquidation of the remaining part of domestic monetary debt when the inflation was high in the mid to late 1980s and in the early 1990s. However, in the 1980s and 1990s, many emerging countries lifted controls of interest rates, capital accounts and

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[13] Alberto Alesina, Vittorio Grilli & Gian Maria Milesi-Ferretti, *The Political Economy of Capital Controls*, in L. Leiderman & A. Razin eds. *Capital Mobility: New Perspectives*, Cambridge University Press (Cambridge), (1993).

[14] Carmen Reinhart, Jacob Kirkegaard & Belen Sbrancia, *The Liquidation of Government Debt*, NBER Working Paper, Mar. 2011.

exchange rates, and thus completed the financial liberalization reform. However, after the financial crisis in 2008, many emerging countries — such as Brazil, Peru, Indonesia, the Philippines, Thailand, and Russia — took measures to control the inflow of foreign capital, often using hot money, again.

C. The Situation of China

1. The Repression on Interest Rates. — The financial repression is a major characteristic of China's financial industry. It firstly appeared on the persistent repression on interest rates by the government. Before 1979, under the planned economy, the general level of interest rates was low, and the low interest rate system was used to provide low-cost funds for the heavy industry according to the prior development strategy.[15] Since 1979, with the implementation of the reform and opening up policy, the interest rate has started to be reformed towards the direction of marketization, but the government's repression on interest rates has not changed fundamentally. In a long period of time, it is embodied in the fact that the People's Bank of China specifies the ceiling limit of deposit rates and the bottom limit of loan rates. Even though on July 20, 2013, the People's Bank of China removed away the bottom limit of the loan's interest rates of the banks, a further advancement of the reform of interest rates liberalization, China's financial repression policy on interest rates has not changed fundamentally because the upper limit of the savings deposit interest rates remains still. With the rise of inflation in China in the last more than one decade, combined with the repression of interest rates, China's real deposit rates were always very low, and usually negative. The real negative or low interest rates lead to the decreasing of the true return on savings deposits, and it was in nature a hidden tax on household savings. Some scholars pointed out that the amount of hidden tax levied on household savings from February 2002 to the first quarter of 2008 is approximately RMB255 billion, which is equivalent to 4.1% of the GDP at that time. This hidden tax is roughly equal to the threefold of the personal income tax, the only tax which is imposed on the residents' income directly.[16]

The entities that have benefited from this implicit tax on household savings are mainly the state-owned banks, the state-owned enterprises (SOEs), the central bank, and the government itself.

First, the state-owned banks are the big beneficiaries of financial repression. The regulation of the upper limit of deposit interest rates and the bottom limit of loan interest rates (just cancelled on July 20, 2013) by the People's Bank of China makes those state-owned banks enjoy stable and high spread income. In particular, since the proportion of demand deposits in bank deposits is often high, usually accounting for

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[15] HAN Hanjun, 中国利率政策：回顾与展望 (*China's Policy of Interest Rates: Retrospect and Prospect*), 1 上海经济研究 (Shanghai Journal of Economics) 40, 40–44 (1997).

[16] Nicholas R. Lardy, *Financial Repression in China*, Policy Briefs in International Economics 08–8 (September), Washington: Peterson Institute for International Economics, (2008).

about a half, and the real interest rate of demand deposits is also very low and often negative, state-owned banks can obtain more benefits from the spread between the banks' deposits taking and lending business easily.

Second, the SOEs are another big beneficiary of financial repression. The ownership discrimination exists in the allocation of bank credit capital in China, which means that the private enterprises are in a bad position and the most of the bank loans are offered to the SOEs. When inflation exists, the real loan interest rate comes from the nominal loan interest rate of banks minus the producer price index. Therefore, when the inflation is high, the real interest rate of the loans obtained by SOEs from state-owned commercial banks is actually very low, and often negative. In this way, those SOEs get an actual revenue and subsidy. Although this is the case, the rate of no-performance loans is high because many SOEs operate inefficiently. Eventually, the government has to inject capital into those state-owned commercial banks or help them strip the no-performance loans, and thus it brings a huge burden or cost for government budget.[17] Meanwhile, the policy of the repression of the interest rates also leads to excessive demand of the enterprises for the low-cost loans, the real interest rate of which is very low, and thus the excessive investment has been trigged. The rapid growth of currency just results from the need to satisfy such excessive demand for currency.[18] Currently, China's national balance sheet has started to look ragged. According to the calculations of some international financial institutions, China's industrial debt is at c.a. 250 percent of GDP. It is nearly the same as the American level, but the problem is that China is at a much lower development stage than the US. China has piled on 83 percent debt/GDP from 2007 to 2014. In this period, total debt has quadrupled, certainly the world's largest ever credit buildup but also one of the fastest. Since 2013, China's central bank has started to de-leverage and tighten the monetary policy, and then China slowly goes towards a new dilemma stage — debt-deflation time.

Third, the People's Bank of China has obtained benefits that it granted to the commercial banks with cheap deposits to a great extent by dealing with the funds outstanding for foreign exchange on a large scale. In the last more than one decade, in order to maintain the foreign exchange rate and control the pace of the appreciation of the RMB, namely *renminbi*, which is China's currency, the Chinese government had to

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[17] LIU Ruiming, 金融压抑、所有制歧视与增长拖累——国有企业效率损失再考察 (*Financial Repression, Ownership Discrimination, and Negative Spillovers — SOE Efficiency Losses Revisited*), 10 经济学 (China Economic Quarterly) 603, 603–618 (2011); LU Wenpeng, 金融抑制、路径依赖与中国渐进改革中的制度性公共风险 (*Financial Repression, Path Dependence and Institutional Public Risk in China's Progressive Reform*), 4 复旦学报（社会科学版）[Fudan Journal (Social Sciences)] 8, 8–15 (2002); Kumiko Okazaki, *Banking System Reform in China: The Challenges of Moving Toward a Market-Oriented Economy*, Rand National Security Research Division, (2007).

[18] HUANG Guitian & HE Shijun, 结构扭曲与中国货币之谜——基于转型经济金融抑制的视角 (*Structural Distortion and China's Money Puzzle — From the Perspective of Financial Repression in the Transition Economy*), 373 金融研究 (Journal of Financial Research) 1, 1–13 (2011).

intervene in the foreign currency market massively. This intervention is partially reflected by the increase of the foreign currency reserve owned by the Chinese government, from $212 billion in the end of 2002 to $3.24 trillion in June 2012. In order to prevent the excessive increase of RMB currency supply caused by the massive sale of RMB (meaning the purchase of foreign currency), the People's Bank of China continuously increased the deposit-reserve ratio of banks from 6% in 2002 to 20% in July 2012. Banks are forced to put the large amounts of deposits into the People's Bank of China. The other measure to sterilize the increase of RMB currency supply is to sell plenty of central bank bills to those commercial banks. Those two measures of dealing with funds outstanding for foreign exchange impose a tax on banks in nature, because the nominal interest rate banks get on the deposit-reservation and the central bank bills is lower than the interest rate banks can get when they provide loans to general customers.

Finally, the government itself is a main beneficiary of financial repression. As said above, stable financial repression, along with modest inflation, can achieve the actual result of liquidating public debt of the government. In the past more than 20 years, the scale of Chinese government's financial deficits has expanded continuously in general. The financial deficits were RMB14.649 billion in 1990, RMB249.9 billion in 2000, RMB950 billion in 2009, RMB1.05 trillion in 2011, and RMB850 billion in 2011. The sum of China's total national debt is also increasing continuously. It was RMB120.9 billion in 1990, RMB1.3011 trillion in 2000 and RMB7.7708 trillion in 2011.[19] Apart from that, there are large amounts of hidden debt, the major part of which is the government's pension debt, contingent liability, which includes the government's debt not included in the budget, the loss in the food system and so on, and the local government debt. It is calculated that the ratio of public debt account to the GDP was approximately 47% in 1997, 55% in 2001 and 50% in 2012 respectively. This calculation is only based on the officially released data in China, and the true total debt of the central and local government may be much higher in fact. By the repression of interest rates, the government can decrease the cost and then reduce the actual amount of its debt.

2. The Control of Banks. — The further manifestation of financial repression is the strict control over banks by the government, particularly reflected in the controlling shares of the main banks owned by the government, the intervention in the operation of banks by the government, and the limitation of market entry in the banking industry by the government. Before the reform and opening up policy in 1978, the feature of China's bank system is that the banks are primarily owned by government and the banks are generally subject to the need of the centrally planned economy. Since then, the progressive reform has created a bank system consisting of several types of the banks. Currently, according to the ownership structure and service function, China's banks can be classified as the following types: first, policy banks. There are three banks that are all

[19] These figures come from China Statistical Yearbook and Financial Year Book of China.

wholly state-owned. Second, the large state-owned commercial banks through the reform of joint stock system. There are five banks, which are Industrial and Commercial Bank of China Limited (ICBC), China Construction Bank, Bank of China (BOC), Agricultural Bank of China (ABC) and Bank of Communications (BOCOM). The latest data reveals that the shares the government holds in these five banks are respectively 70.7%, 57%, 67.53%, 83.13% and 26.52%.[20] Third, the local banks. The main shareholders are the provincial governments or municipal governments. The local banks can be further divided into two types. One type is city commercial banks, such as China Guangfa Bank, Shanghai Pudong Development Bank, and Bank of Chongqing. Take Bank of Chongqing as an example. According to its balance sheet in 2010, Chongqing government holds 53.9% of the equity shares, the legal persons, most of which are SOEs or other state-owned entities, hold 43.2%, and the individual persons hold 2.8%, in which the managers of the bank hold 1.7%. The other type is community banks, rural commercial banks, rural cooperative banks, and rural credit cooperatives, and the total sum is about 3,300. Fourth, joint-stock commercial banks. This type includes banks such as China Everbright Bank and Shenzhen Development Bank (established in 1987 and merged with Ping An Bank in 2012. The new name is Ping An Bank after the merge), have been set up since China's reform of the banking industry and the governments hold a low portion of shares thereof. Fifth, the foreign banks. According to the bank's asset value in the end of 2010, the proportion of those six types of banks, namely policy banks, five state-owned commercial banks, city commercial banks, community banks and rural banks, joint-stock commercial banks and foreign banks, is separately 8.0%, 49.2%, 8.2%, 11.2%, 15.6%, 1.8%, and 5.9%.[21] As seen from the figures above, these various state-owned banks controlled by the government are absolutely dominating in China's banking system.

Besides, the Chinese government strongly intervenes in the operation of the banks. In the personnel management, the senior officers of state-owned commercial banks are always directly or indirectly appointed by the government sectors. Those officers are always assigned administrative ranks. According to their work performance, they might be adjusted to work in government sectors or other financial institutions. In the allocation of bank credit resource, those bank managers appointed by the government usually issue loans to the projects or units supported by the government according to the government's direct or indirect instruction. This often makes the banks become convenient tools to implement policy easily and possess rich administrative culture, hindering the complete commercialization and marketization of the banks and the flow of credit resource to the most profitable and productive projects or enterprises. Local government financing platform, which has been growing since 2008, is a good example. With the intervention by the governments, the local banks have granted many loans to the local investment

[20] Those figures come from the websites of the banks; DBS Vickers Securities, "China Banking Sector," May 19, 2009.

[21] These figures come from 2010 Annual Report of China Banking Regulatory Commission.

companies, and a large part of the money has gone to some projects which have the low rate of the investment return. So lots of no-performance loans have been generated.

Furthermore, the Chinese government has put many limitations on the market access of financial industry. The reform of China's last over 30 years is a progress deepening the marketization. During these years, with the rapid growth of GDP, a large proportion of industries in China have been opened up to the private enterprises. However, the banking industry is still not opened to the private capital so far, which means that the banking industry of china is still monopolized by the government.[22] The entering of private capital to the banking industry is still in the stage of reform and exploration. For example, the State Council passed a resolution to set up Wenzhou Financial Reform Pilot Area on March 28, 2012. The resolution has determined 12 primary missions of the financial reform in Wenzhou to lead and allow private capital to enter into the bank-based financial industry. On May 26, 2012, China Banking Regulatory Commission issued Implementing Opinions of the China Banking Regulatory Commission on Encouraging and Guiding Private Capital into the Banking Sector. Besides, even though the Administrative Regulation of the People's Republic of China on Foreign-Invested Banks issued on November 15, 2006 by the State Council stipulates that the banking industry of China will probably be fully opened to the outside world in order to fulfill its promise, which is made when China entered WTO, after December 11, 2006, there are many limitations in the aspect of market entrance of foreign capital into the banking industry in practice.[23]

3. The Control of the Securities Market. — The third demonstration of financial repression in China is the intense control of the securities market by the government, especially the ownership discrimination during the listing and the government's continued holding of shares after the listing. The original intention of the establishment of the securities market is to promote the reform of SOEs, support the listing of those enterprises, and realize their direct financing. Therefore, the development of the securities market is also accompanied by the financial repression. That is to say, by means of administrative approval and quota control of stock issuance, the government restrains the non SOEs from entering the capital market for financing and guarantees the abundant low-cost resources for the SOEs.[24] Although following the deepening of the securities market reform, especially the recent development of Growth Enterprise Market, the ownership discrimination is somewhat reduced, it has not been totally eliminated yet. Furthermore, after the listing of the SOEs, the government usually continues to hold the

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[22] ZHANG Rixin, 我国民营银行市场准入的时机选择与框架设计 (*On the Market Entrance of Private Banks in China: Time Selection and Framework Design*), 1 金融论坛 (Finance Forum) 18, 18–21 (2002); CHEN Ying, 对银行业市场进入壁垒的分析与思考 (*Analysis and Thoughts on Barriers to Market Entrance in Banking*), 3 中央财经大学学报 (Journal of Central University of Finance and Economics) 33, 33–38 (2006).

[23] ZHANG Jinqing & LIU Qingfu, 中国银行业市场准入承诺水平的测度与比较研究 (*Measurement and Comparison on the Level of Market Access in China Banking*), 279 财经问题研究 (Research on Financial and Economic Issues) 40, 40–46 (2007).

[24] See LU, fn. 17.

controlling shares of these listed companies. Thus, high centralization of shares and the dominance of the stated-owned shares are the features of the ownership structure of the listed companies in China. Given the probable existence of the controlling shareholders in listed companies, the controlling shareholders would usually tend to utilize the controlling power to tunnel the interests and empty the listed companies by means of various connected transactions which severely harm the interests of the medium and small investors who are mainly the common residents, and thus seriously impact their trust and confidence in the securities market in China.[25]

4. The Control of the Capital Accounts. — The fourth demonstration of financial repression in China is the strict control of capital accounts by the government. In order to prevent the capital flight, cross-border savings of the residents in China are prohibited. Presently, the cross-border investment of the residents can only be partly realized through qualified domestic institutional investor (QDII). QDII is a bridge system to the capital account liberalization, namely a system arrangement that conditionally allows domestic institutions, which are established inside our country and approved by the regulatory departments concerned to invest in stocks and bonds in the overseas capital markets, given the condition that the RMB is unconvertible under capital accounts and the capital market is unopened. Under the QDII system, Chinese residents' cross-border investment in the overseas capital markets can only be realized with limitations. Therefore, residents can only choose to deposit their personal properties in the domestic banks or invest in the domestic securities market. In the condition that the overseas investment is restricted, the real interest rate of the domestic deposit is very low and usually negative, unlawful acts such as fraud, insider transaction and market manipulation in the domestic securities market are very serious and the interests of the common investors cannot been protected powerfully, the common residents can only turn their investment direction to the real estate market, which leads to the price bubble of the real estate to a great extent. Meanwhile, some residents deposit their money in the "underground private banks," which are illegal and forbidden in China, of the black credit market, or directly run private civil lending. This causes the serious financial or social problems. In addition, the secret capital flight, transferring capital to overseas through various ways, becomes also serious in China.

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[25] LI Zengquan, SUN Zheng & WANG Zhiwei, "掏空"与所有权安排——来自我国上市公司大股东资金占用的经验证据 (*Tunneling and Ownership Structure — A Firm-Evidence about the Controlling Shareholder's Embezzlement of Listed Corporation's Funds in China*), 12 会计研究 (Accounting Research) 3, 3–13 (2004); SHI Shuiping, 控制权转移、控股股东与大股东利益侵占——来自上市公司高管变更的经验证据 (*Transfer of Control Right, Controlling Shareholder and Large Shareholders' Expropriation — Empirical Evidence from the Changing of Top Managers in Listed Companies*), 141 暨南学报（哲学社会科学版）[Journal of Jinan University (Philosophy & Social Science Edition)] 93, 93–104 (2009). Internationally, tunneling is a concept put forward by Johnson and the others (2000). Its significance is mainly that the shareholders who are able to control the company transfer the company property and profits for their own interest. See S. Johnson, R. La Porta & F. Lopez-de-Silanes et al, *Tunneling*, 90 American Economic Review 22, 22–27 (2000).

II. FINANCIAL REPRESSION AND ECONOMIC GROWTH

According to the vast international theoretical and empirical researches, the financial repression policy of a country goes against that country's financial deepening and the improvement and development of the financial system, and finally harms that country's long-term sustainable economic growth.[26] Financial institutions play a key role in the assessment of the promising enterprises and the offer of capital support to the enterprises which have the best prospects. Better financial system can increase the probability of the success of the innovations, and thus quicken the speed of economic growth.[27] Therefore, the level of the financial intermediaries is a good predictor of the long-term economic growth, the capital cluster and the acceleration of the productivity.[28] However, the financial repression amounts to levy government tax on the financial industry, which equals to levy tax on innovations because tax reduces net return of the financial intermediaries gained from supporting successful enterprises. Financial development can enhance social productivity. However, taxes on commercial banks, investment banks, funds and securities market created by financial repression methods such as the control over interest rates, the intervention in the allocation of credit resources, high deposit reserve ratio requirement and high inflation would impede the financial development, reduce the services offered by the financial system to the depositors, enterprises and producers, and thus ultimately do harm to the long-term sustainable economic growth.

In regard to the present situation of China's financial repression, the detailed analyses are as follows.

First, the government's repression on interest rates will likely cause numerous problems, which are against the financial deepening and the long-term sustainable economic growth, as the followings: (1) Through the repression on the interest rates, the government imposes a hidden tax on residents' deposits, which dramatically distorts demand structure of the national economy and consequently damages the sustainability of the rapid growth of economy. In the last decade, China's economic growth mainly relied on the continuous growth of the investment spending and constant increase of the external surplus, namely export surplus. As a significant part of the gross national product, the

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[26] See McKinnon, fn. 5; Shaw, fn. 5; R. G. King & R. Levine, *Finance and Growth: Schumpeter might Be Right*, 108 Quarterly Journal of Economics 717, 717–737 (1993); King & Levine, fn. 2; R. G. King & R. Levine, *Financial Intermediation and Economic Growth*, in C. Mayer & X. Vives eds. *Capital Markets and Financial Intermediation*, Cambridge University Press (Cambridge), at 156–189 (1993); Maxwell J. Fry, *In Favour of Financial Liberalisation*, 107 The Economic Journal 754, 754–770 (1997); Panicos O. Demetriades & Kul B. Luintel, *Financial Development, Economic Growth and Banking Sector Controls: Evidence from India*, 106 The Economic Journal 359, 359–374 (1996); Panicos O. Demetriades & Kul B. Luintel, *The Direct Costs of Financial Repression: Evidence from India*, 79 The Review of Economics and Statistics 311, 311–320 (1997).

[27] See King & Levine, fn. 1.

[28] Id.

consumption fell sharply. Compared to other countries and the early phase of China's reform, the residents' consumption in China currently contributes slightly to the economic growth. One of the main reasons is that the percentage of the residents' revenue of the GDP has been going down constantly in recent years. And one reason of the decrease is that the percentage of the residents' interest revenue of the GDP has been going down constantly. So the policy of interest rate repression goes contrary to the presently advocated goal of fueling economy by domestic demand; (2) the repression on the interest rate reduces the efficiency of the investment. In China, the central bank stipulates the nominal benchmark lending interest rate. Given the existence of the producer price inflation, the real lending interest rate is actually very low. The credit resources mainly flow to the SOEs and the projects sponsored by the government. These SOEs or projects are of low output rates and can hardly or even be impossible to have access to credit in the competitive market. This finally leads to the negative consequences that the rate of return and the efficiency of credit investment in China are very low; (3) the invisible subsidy to and invisible tax on the banks caused by financial repression make it hard to assess the actual operational level of commercial banks in China. It will probably impede the further marketization reform of the commercial banks, the development of a healthy and efficient bank system and the long-term sustainable growth of the national economy; (4) the repression on interest rate is not good for the development of a healthy and efficient capital market that is of great importance to economic growth. Under the circumstance that the return on deposits is negative, the residents' deposits tend to flow to stock market or house market and be used in speculative activities. In consequence, the securities market suffers extreme price fluctuation and the house price is excessively high. The repression on the interest rate also prevents China from the development of the bond market that is open to the common social investors; and (5) the repression on the interest rate will probably also cause the expansion of the underground finance, namely the illegal private banks, which is one form of the shadow banks likely causing financial systematic risks and financial crisis, and thus impact the stability of China's financial system and ultimately threaten the stable growth of China's economy.

Second, the repression on the banking industry will probably prevent China from establishing an efficient and international competitive bank system and ultimately do harm to the sustainable growth of the national economy. The government takes control of the major shares of the vast majority of banks, intervenes in the operation of the banks and limits the market entrance to the banking industry. These financial repression policies lead to the monopolistic operation of the banking industry by the government, block the marketization reform of the banking industry and hinder the enhancement of the efficiency and international competitiveness of the banking industry. Moreover, the actual no-performance loan ratio of the banks is usually high, and this often pushes the

government to inject capitals into state-owned commercial banks and use the public fiscal funds to rescue them implicitly several times. This thus causes the heavy fiscal burdens for the government.[29]

Third, the repression on the securities market, namely the ownership discrimination during the Initial Public Offerings (IPOs), the explicit or implicit direction to the mangers of the banks about the credit allocation and the continued holding of the major shares of the listed companies after listing, will probably impair the development and deepening of China's capital market and further go against the financial deepening and the long-term sustainable growth of the national economy. According to a statistics, private economy takes up 66% of the GDP, contributes 71% of the taxes, takes up 45% of the whole society's investment amount, employs 90% of the whole working population, and absorbs more than 80% of the newly increased non-agricultural working population. The private enterprises have become one of the main forces that push China's national economy.[30] At present, more than 65% of the patents, more than 75% of technical innovations and more than 80% of the product development are achieved by the private enterprises. The medium and small enterprises that are mainly private enterprises have become the main force of China's innovation.[31] One of the successful experiences of more than three decades' reform and open up policy is that the biases towards market economy and

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[29] In fact, China has implicit bank rescue activities. After the 1997 Asia Financial Crisis, the government adopted some measures to increase the capitals of the four state-owned commercial banks and reduce their no-performance debt. In Mar. 1998, the Standing Committee of the National People's Congress approved a plan put forward by the State Council. It was aimed to inject capital into the four state-owned commercial banks by means of issuing special government bonds. The injected capital was RMB270 billion (it amounts to 3% of the GDP or 55% of the fiscal revenue of the central government at that time). In addition, in 1999, the government established the four state-owned assets management companies to buy 1.4 trillion no-performance debts at book value from the four state-owned commercial banks and China Development Bank. The capital of the four state-owned assets management companies came from the capital injection of the Ministry of Finance, loans from the People's Bank of China and the issuance of their own bonds. After 2003, the government began the second round of capital injection. In Dec. 2003, through the investment of the State Administration of Foreign Exchange (it is a part of China's central bank in nature) by means of foreign exchange reserve (it is the public money of the government in nature), the government established Central Huijin Investment Ltd. Central Huijin Investment Ltd. injected capital into China's five largest state-owned commercial banks. In 2003, it injected 45 billion dollars into the Bank of China and China Construction Bank. In Jul. 2004, it injected RMB3 billion into Bank of Communication. In Apr. 2005, it injected 15 billion dollars into Industry and Commercial Bank of China. In Oct. 2008, it injected RMB130 billion into Agricultural Bank of China. These injected capitals came from China's foreign currency reserve, which is used to make investment in the form of dollars, and the loans, which are used to make investment in the form of RMB. See Kumiko Okazaki, *Banking System Reform in China — The Challenges of Moving Toward a Market-Oriented Economy*, available at http://www.rand.org/pubs/occasional_papers/ 2007/RAND_ OP194.pdf (last visited May 20, 2014).

[30] YAO Fan, 民营企业 30 年强国富民贡献辉煌 (*Thirty Years of Private-Owned Enterprises, Great Contribution to the Prosperity of the State and the People*), 法制日报 (*Legal Daily*), Feb. 1, 2009.

[31] HUANG Wenfu, 民营企业：全方位推动中国经济发展 (*Private-Owned Enterprises: Promote China's Economy Development Comprehensively*), 315 人民论坛 (People's Tribune) 49, 49–52 (2011).

political ideology about the forms of economic ownership at first shall be changed gradually. In order to admit, encourage, and develop private economy, China has already amended the Constitution four times, namely in 1988, 1993, 1999 and 2004. The ownership discrimination during the IPOs impedes the financing activities of the private enterprises, prevents a large number of innovative and competitive private enterprises from timely going public, financing and obtaining the needed funds for the enterprise's development. The phenomenon of the share dominance and the situation that the controlling shareholders using the controlling power to tunnel the interests and steal the assets of the listed company by means of various related transactions badly harm the interests of the public social investors and hurt their trust and confidence in China's stock market. These negative factors will likely drastically impair the liquidity of China's stock market,[32] impact its development, and ultimately hurt the long-term sustainable economic growth.

Finally, the rigid control of the capital accounts by the government, on one hand, deters the capital flight indeed, whereas on the other hand, blocks the channels of Chinese residents' investment. This is adverse to the diversification and investment income of the residents' financial assets and further restricts the growth of the residents' income and wealth. All the situations that the actual deposit rate is low and usually negative, that the interests of the social public investors in the domestic securities market cannot be effectively protected, that there is a purchase limit order in the real estate market, and that the government control the capital accounts rigidly, prevent the residents from investing overseas, make the common residents captured by the domestic financial repression policies. The residents' personal wealth is hardly increased and even decreased gradually in fact. It results in the low percentage of the residents' consumption demand and spending in the GDP, and thus hinders the objective of the consumption-driven economy. Therefore, in the long run, the rigid control of the capital accounts by the government runs counter to the long-term sustainable growth of China's economy.

III. LAW, FINANCE AND ECONOMIC GROWTH

A mass of international theoretical researches and empirical studies show that a favorable legal environment of a country plays a crucial role in its financial development and financial deepening; deep, developed, efficient and inclusive finance will likely further greatly promote economic growth of the country.[33] The results of these researches

[32] Two indicators of assessing the stock market liquidity are the turn-over, which equals to the market value of traded stocks divided by the total market value of all the listed stocks in one exchange, and traded value, which equals to the market value of the stocks of one exchange divided by GDP. The high turn-over is often considered as the indicator of low trading cost. The traded value assesses the percentage of the trading value in the GDP, and thus positively demonstrates the liquidity on the basis of the national economy. The vitality of the securities market lies in the liquidity of the stock market, and it is one of the important indicators of the maturity of the capital market.

[33] See La Porta, Lopez-de-Silanes & Shleifer et al, *Law and Finance*, fn. 4.

and studies are specially meaningful for China, which is looking for the best development model and testing it in the practice as a huge transition economy.

A. Legal Environment and Financial Development

A favorable legal environment of a country plays a decisive role in its financial development and financial deepening. From a global perspective, one may wonder why some countries have deep and developed financial markets while others do not? Why some countries have developed the necessary legal system for the investors protection and the system for the contract enforcement, supporting financial intermediary and finance market (especially capital market) in these countries, while others do not? There are several different explanations to these questions, such as political factor's determinism,[34] culture factor's determinism[35] and natural endowments determinism,[36] etc. The most influential and convincing explanation, however, is the theory of law and finance,[37]which gradually emerged in the world in the mid to late 1990s. The theory focuses on the effect of the traditional legal origins and the corresponding legal systems in respect of explaining the international differences in the financial development.

The theory first argues, where there are the legal origins and the legal systems protecting private property rights, supporting private contract arrangement, and protecting investors' legal rights, savers are more willing to finance the enterprises, and this leads to the prosperity of financial market. On the contrary, the legal origins and the legal systems not supporting private property rights and facilitating private contractual activities will probably inhibit corporate finance and impede financial development. The theory of law and finance stems from the evolvement of corporate finance theory in the past more than half a century. In corporate finance, both equity and debt are the legal claim on the corporate cash flow.[38] Finance, in nature, is a set of contracts. Therefore, contract law, company law, bankruptcy law and securities law of a country and the implementation of these laws, primarily determine the rights of securities holders and the operation of the

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[34] Marco Pagano & Paolo Volpin, *The Political Economy of Finance*, 17 Oxford Review of Economic Policy 502, 502–519 (2001); Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the 20th Century*, 69 Journal of Financial Economy 5, 5–50 (2003).

[35] Rene Stulz & Rohan Williamson, *Culture, Openness, and Finance*, 70 Journal of Financial Economy 313, 313–349 (2003).

[36] Stanley L. Engerman & Kenneth L. Sokoloff, *Factor Endowments, Institutions, and Differential Paths of Growth among New World Economies*, in Stephen Haber eds. *How Latin America Fell Behind*, Stanford University Press (Stanford), at 260–304 (1997); Kenneth Sokoloff & Stanley L. Engerman, *Institutions, Factor Endowments, and Paths of Development in the New World*, 14 Journal of Economic Perspectives 217, 217–232 (2000).

[37] See La Porta, Lopez-de-Silanes & Shleifer et al, *Legal Determinants of External Finance*, fn. 4; La Porta, Lopez-de-Silanes & Shleifer et al, *Law and Finance*, fn. 4.

[38] Franco Modigliani & Merton Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 American Economy Review 261, 261–297 (1958).

financial system. In an individual enterprise, inside managers and controlling shareholders are usually in the position of expropriating minority shareholders and creditors, and the legal system plays a vital role in determining the degree of such expropriation.[39] This kind of expropriation includes secret transfer and steal of corporate assets, employment of family members, and other tricks with which insiders benefit at the cost of minority shareholders and creditors.[40] The theory of law and finance emphasizes the differences between countries in the following three aspects: contract law, company law, bankruptcy law and securities law; the degree to which private property rights are emphasized in the legal systems; the efficiency of law enforcement, influence the degree of the expropriation, the public's confidence in purchasing securities and participating in financial market and the level of trust among the market participants. As a consequence, protecting private investors by means of law is a key decisive factor in financial development of a country.

The theory of law and finance emphasizes that the legal tradition and historical heritage of a country determine its means and attitude towards private property rights, private contracting activities, protection of investors and hence financial development. From the aspect of legal tradition and historical inheritance, there mainly exist two major legal origins and corresponding legal systems in the world, namely the English common law system and the European continental civil law system. The English common law system is mainly made by judges and subsequently incorporated into legislature; the European continental civil law system, mainly made by the scholar and legislator and dating back to Roman law. The civil law system can further be divided into the French civil law system, the German civil law system, and the Scandinavian law system of Northern Europe. The legal traditions of UK, France, and Germany spread to the whole world through occupation, colonization and imitation. Among these legal systems, regarding the protection of private property rights and private investors, the English common law system is the strongest, the French civil law system the weakest, while the German and Scandinavian civil law systems in the middle. Accordingly, the level of financial depth and development in the common law countries and regions, such as Britain, the US, Canada, Singapore, and Hong Kong, is the highest, the French civil law countries, such as France, Spain, Portugal, Greece, Italy, and Latin American countries, the lowest, while the German civil law countries and regions, such as Germany, Austria, Switzerland, Japan, South Korea, and Taiwan Province of China, and the Scandinavian civil law countries, such as Finland, Denmark, Norway and Sweden, in the middle.

When we explain the influence of the legal origins and legal systems on financial development, there are also two different but inter-related theories, namely the political mechanism and the adaptability mechanism. The political mechanism is based on two

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[39] See La Porta, Lopez-de-Silanes & Shleifer et al, *Legal Determinants of External Finance*, fn. 4.

[40] Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer et al, *Investor Protection and Corporate Governance*, 58 Journal of Financial Economy 3, 3–27 (2000).

points: One is that the degrees of the emphasis on protecting private investor's rights in different legal systems, compared with protecting the state's rights, are different. The other one is that the protection of private property rights forms the corner stone of financial development. Therefore, the differences determined by the historical development of the legal systems, can help explain the differences of financial development among the countries in the world.[41] Compared with the common law countries, the civil law countries tend to support the state's rights rather than the individual's property rights to a greater extent, which has negative effects on financial development. In the civil law countries, the states rarely offer the judges the tenure, grant the courts the independent discretion upon the cases involving the government, or permit the judicial review of the constitutionality of the laws. The states like building the legal institutions that strengthen their power. The powerful states are prone to willfully divert the social and financial resources to their favored ends, and to intervene in financial market.[42] The common law system, on the other hand, historically prefers to protect private property rights rather than the state's rights. The common law becomes a powerful tool of checks and balance for the purpose of promoting private property rights. As a result, the theory of law and finance claims that the English common law system, in comparison with the civil law system, supports financial development to a greater extent.

The second theory of the adaptability mechanism is based on these two points: One is that the different legal systems have the different adaptability towards the changing environment; the other one is that if the legal system of a country can only adapt to the changing environment slowly, a large gap between the financial needs of the economy and the capability of the legal system to support such needs will probably appear. The focus of the common law is on facts and deciding concrete cases, but not on adhering to the logical principles of codified law as the civil law. The common law system recognizing case law and judicial discretion is more likely to adapt to the changing environments effectively, while the civil law system stiffly observing the formalistic procedures and rigidly depending on judicial decisions which are narrowly based on the written statutory laws has the weaker adaptability.[43] Then written statutory laws evolve slowly, and thus are more likely subject to inefficient political pressure if compared with the common laws.[44] If the written statutory laws are always in the state of "catching up" and be pushed to the direction of inefficiency by legislative procedures, the efficient corporate finance and financial development will probably be impeded. Therefore, the

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[41] See La Porta, Lopez-de-Silanes & Shleifer et al, *Law and Finance*, fn. 4.

[42] Rafael La Porta, Florencio Lopez-de-Silanes & Cristian Pop-Eleches et al, *Judicial Checks and Balances*, National Bureau of Economic Research Working Paper 9775, (2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=410821 (last visited May 20, 2015).

[43] Ronald Coase, *The Problem of Social Cost*, 3 Journal of Law and Economy 1, 1–44 (1960).

[44] Richard A. Posner, *Economic Analysis of the Law*, Little-Brown (Boston), at Sections II & III (1973).

theory of adaptability mechanism claims that the countries and regions of the French civil law system, compared with the countries and regions of the German civil law system, especially with the countries and regions of the common law system, are less likely to develop effective and flexible financial systems.

Regarding the theory of law and finance, many scholars across the world have conducted a large number of empirical researches by collecting, counting, and analyzing actual data from many countries. These empirical researches support the opinions of the theory of law and finance. For instance, four scholars like Andrew Shleifer from Harvard University and University of Chicago, simply referred to as LLSV, have conducted statistics and analysis over the data of 49 countries in Europe, North and South America, Africa, Oceania and Asia, and further completed comparative quantitative analysis over the situations in these countries, regarding shareholder's rights, creditor's rights, efficiency of judicial system, level of rule of law, corruption, corporate insider's plunder, government's intervention in private contract, accounting criteria, structure and distribution of corporate stock equity, GNP, per capita GNP, equilibrium of income, and market capitalization, etc.[45] Professor Levine has carried through statistics and analysis over actual data concerning legal environment, banking industry development, and economic growth of more than forty countries in the LLSV research sample during 1976 to 1993, and this research further supports, with actual data, the causal relationship between legal environment and banking industry development in a country.[46] On the basis of previous research with Professor King,[47] Professor Levine also utilizes a data base containing the data of 77 countries from 1960 to 1989 to measure the levels of financial development of more than forty countries thereinto through four indexes. He then measures legal environment of these countries based on the criterions of legal system, creditor's rights, enforcement of contract and accounting criteria, and further analyzes the increase of per capita GDP of those countries from 1960 to 1989. By displaying the positive correlation among legal environment, finance, and economic growth, the final result strongly supports the close causal relationship between legal environment and financial development.[48] Three scholars including Beck have used different ways to measure financial development, and expanded their research to more than 100 countries. Their studies confirm also that the legal system helps explain the differences of financial development in the different countries.[49]

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[45] La Porta, Lopez-de-Silanes & Shleifer et al, *Law and Finance*, fn. 4.

[46] Ross Levine, *The Legal Environment, Banks, and Long-Run Economic Growth*, 30 Journal of Money, Credit, and Banking 596, 596–620 (1998).

[47] See King & Levine, fn. 1.

[48] Ross Levine, *Law, Finance, and Economic Growth*, 8 Journal of Financial Intermediation 36, 36–67 (1999).

[49] Thorsten Beck, AsliDemirgüç-Kunt & Ross Levine, *Law, Endowments, and Finance*, 70 Journal of Financial Economy 137, 137–181 (2003).

B. Finance and Economic Growth

There is a causal relationship between financial development and economic growth. The deep, developed, efficient and inclusive finance of a country will likely promote its economic growth, which is not only from the quantity perspective but also from the quality perspective.

Firstly, financial development could promote the generation of the information related to the possible investment ex ante and then improve the effectiveness and efficiency of the capital assignment. It is necessary to evaluate the company, the managers and the market conditions before making an investment decision. It may entail a large cost. However, financial intermediaries can help reduce the cost for collecting and disposing of the investment information, and thus facilitates the allocation of resources.[50] Capital is usually scarce and many entrepreneurs are looking for capital. Financial intermediaries with better information of the enterprises can invest in the more promising or creditworthy enterprises and achieve more effective resource allocation. Apart from the ability to identify the best production technology, financial intermediaries can also recognize the entrepreneurs who have the best opportunity to successfully start new products and new production procedures, and this then promotes the frequency of technological innovation.[51] Stock market can also stimulate the generation of the enterprise information. The developed stock market can stimulate the investors to do more researches about the enterprises for more gains, which may generate valuable information for optimal resource allocation.[52] Besides, a developed capital market can help the talented entrepreneurs get funds more easily, and thus promote the effective investment in human capital, which is of great importance to both the short term and long term economic growth of a country.[53]

Secondly, financial development can promote the monitoring of investment and the enhancement of corporate governance. Corporate governance is the core for understanding the impact of economic growth (in general) and financial factors (in specific).[54] The degrees of that people, who provide capital for enterprises, supervise and affect the capital utilization effectively is very important for the decisions on savings and

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[50] J. H. Boyd & E. C. Prescott, *Financial Intermediary-Coalitions*, 38 Journal of Economics Theory 211, 211–232 (1986).

[51] See King & Levine, fn. 1.

[52] R. C. Merton, *A Simple Model of Capital Market Equilibrium with Incomplete Information*, 42 Journal of Finance 483, 483–510 (1987).

[53] O. Galor & J. Zeira, *Income Distribution and Macroeconomics*, 60 Review of Economic Studies 35, 35–52 (1993).

[54] AsliDemirgüç-Kunt & Ross Levine, *Finance, Financial Sector Policies, and Long-Run Growth*, Policy Research Working Paper, The World Bank, (2008), available at http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2008/01/07/000158349_20080107115116/Rendered/PDF/wps4469.pdf (last visited Jun. 1, 2015).

distribution. The level of the effective enterprise supervision and the endeavor of the managers to maximize the enterprise value promoted by shareholders and creditors determine the level of the efficiency of resource allocation and the willingness of depositors to fund the production and innovation. Effective financial intermediaries can enhance the level of corporate governance and eventually affect economic growth from the perspective of both the quantity and the quality.[55]

Thirdly, financial development can promote the transaction, diversification and management of risks. Due to information cost and transaction cost, financial contract, financial market and financial intermediaries will be developed to make it easy to trade, control and collect risks, and this is very meaningful for resources allocation and economic growth. Banks, funds and securities market all provide all kinds of tools for trading, collecting and diversifying risks. Innovation can bring with high profits, but it has the risks. However, a developed financial system facilitates investors to invest in different creative projects, diversify the investment risks, and finally increase the investment in the creative activities. This will accelerate technological innovation and economic growth.[56] Furthermore, developed finance enhances market liquidation, and thus strengthens the liquidity ability of the investors and decreases the investors' liquidation risks. For these, the investors are more willing to hold different financial assets, such as stocks, bonds, fund shares or check account deposit. At the same time, capital market turns these liquid financial tools into long-term capital investment, which is needed for industrial innovation. Thus, the development and innovation of finance could promote new long-term capital investment for industrial innovation and eventually accelerate economic growth, which is not only from the quantity perspective, but more important from the quality perspective.[57]

Fourthly, financial development could promote the collection of savings and the efficiency of allocating the savings to the enterprises and programs, which have the highest output rates. In 1873, British scholar Bagehot argued that the main difference between Britain and other poor countries is that the British financial system could mobilize the resources for the huge projects. In this way, large programs will not fail for shortage of money. He clearly points out that this difference is not the actual deposit rate of a country but the ability to collect the social resources and distribute these savings to the most efficient programs.[58]

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[55] V. R. Bencivenga & B. D. Smith, *Some Consequences of Credit Rationing in an Endogenous Growth Model*, 17 Journal of Economic Dynamics and Control 97, 97–122 (1993); P. Harrison, O. Sussman & J. Zeira, *Finance and Growth: Theory and Evidence*, (1999), available at http://www.federalreserve.gov/pubs/feds/1999/199935/199935pap.pdf (last visited Jun. 1, 2015).

[56] See King & Levine, fn. 1.

[57] V. R. Bencivenga, B. D. Smith & R. M. Starr, *Transactions Costs, Technological Choice, and Endogenous Growth*, 67 Journal of Economic Theory 53, 53–177 (1995).

[58] W. Bagehot, *Lombard Street*, Henry S. King and Co. (London), (1873).

Fifthly, financial development usually promotes the trades of goods and services. Financial arrangement in trades will generally decrease the transaction cost and thus promote specialization and division of labor, technological innovation and economic growth. The core content of *The Wealth of the Nations* written by Adam Smith is the connection among the convenient transaction, specialization division, innovation and economic growth.[59] He makes a special research that the currency plays an important role in decreasing transaction cost, achieving high level specialization division and promoting technological innovation. When currencies become medium of exchange, transaction cost and information cost continue to decrease by financial innovation.[60] This will further promote trading and specialization division and eventually enhance economic growth.

Apart from the aforesaid theories supporting the idea that finance could promote economic growth, many empirical studies conducted by many scholars also support this idea. For instance, Professor King and Professor Levine study the relationship between financial development and economic growth in 77 countries from 1960 to 1989 and establish the regression relationship between the two.[61] Levine and Zervos investigate the two component parts of financial system: banks and the stock market. Their research shows that the stock market and banks have independent effects on economic growth.[62] Three academics including Beck find the strong connection between exogenous factors such as financial intermediaries and long-term economic growth by using transnational instrumental variables.[63] Besides, many scholars in China also analyze the causal relationship between finance and economic growth by the method of empirical studies. The results of the studies also support this positive correlation and casual relationship in general.[64]

IV. PATHS FOR AMELIORATION OF FINANCIAL REPRESSION AND PROMOTION OF LEGAL GOVERNANCE IN FINANCE

Some scholars in China have the opinions that under the financial repression environment in China, the bank loan resources mainly flow to the state sectors and the non-state sectors suffered the credit discrimination severely. But the financial leakage exists in reality. There are two main channels for the financial leakage. One is commercial credit, while the other is the transfer of assets and funds from SOEs to private sectors. For example, the SOEs may use the loans granted by banks for designated projects for other

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[59] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, W. Stahan & T. Cadell (London), (1776).

[60] See Demirgüç-Kunt & Levine, fn. 54.

[61] See King & Levine, fn. 1.

[62] See Levine & Zervos, fn. 1.

[63] See Beck, Levine & Loayza, fn. 1.

[64] TAN, fn. 1; ZHOU & WANG, fn. 1; WANG & SUN, fn. 1.

purposes such as investing in the private enterprises. Additionally, managers may transfer the capital and assets of the SOEs to the private enterprises in the course of the reorganization of the stated-owned enterprises. Most of these leakage activities are illegal behaviors. The loan policies and discipline for commercial banks issued by the financial regulator will exacerbate the credit discrimination, and thus aggravates the situation of "credit grudging" of the banks. As a result, purely improving the law construction cannot promote the all-round financial development, but prevent financial resources from flowing from inefficient state-owned economic sectors to efficient private economic sectors, and thus have huge negative effects on economic growth by reducing the proportion of private investment.[65] However, this understanding of the legal construction and the rule of law is quite narrow. The improvement of the law construction and the rule of law in finance does not simply means the financial regulators stipulate and implement the stricter bank loan policy and discipline, but actually involves the reform and improvement of the whole financial system in China, and touches upon the reform and improvement of the constitution, administrative law and other legal institutions related with finance. Such reform and improvement of the legal governance in finance will likely propel China's financial development and the long run sustainable economic growth comprehensively and fundamentally. In the followings, it will focus on several major questions of financial legal governance, which is conductive to ameliorate financial repression and promote the long run sustainable economic growth.

A. Strict Protection of Private Property Rights

Property is the foundation of human being's survival and development, and the property right is also a fundamental right of human rights. According to an international leading research, the degree of protecting private property rights and limiting state power for such protection determines the level of economic development, the wealthy of the residents and the development of the financial market in the different countries.[66] However, since the establishment of the People's Republic of China in 1949, the private property rights in China have always been a controversial problem. From the 1949 Common Program of the Chinese People's Political Consultative Conference, which

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[65] LU Feng & YAO Yang, 金融压抑下的法治、金融发展和经济增长 (*Legality, Financial Development and Economic Growth under Financial Repression*), 1 中国社会科学 (Social Science in China) 42, 42–55 (2004); Susan F. Lu & YAO Yang, *The Effectiveness of Law, Financial Development, and Economic Growth in an Economy of Financial Repression: Evidence from China*, 37 World Development 763, 763–777 (2009).

[66] Daron Acemoglu, Simon Johnson & James A. Robinson, *The Colonial Origins of Comparative Development: An Empirical Investigation*, 91 American Economy Review 1369, 1369–1401 (2001); Daron Acemoglu, Simon Johnson & James A. Robinson, *Reversal of Fortunes: Geography and Institutions in the Making of the Modern World Income Distribution*, 117 Quarterly Journal of Economics 1133, 1133–1192 (2002); Miriam Bruhm & Francisco A. Gallego, *Good, Bad and Ugly Colonial Activities: Do They Matter for Economic Development?*, 94 The Review of Economics and Statistics 433, 433–454 (2012); La Porta, Florencio Lopez-de-Silanes & Shleifer et al, *Law and Finance*, fn. 4.

functions as the interim constitution, to the 1954 Constitution, the 1975 Constitution, the 1978 Constitution and then the current 1982 Constitution and the four amendments of the 1982 Constitution in the year of 1988, 1993, 1999 and 2004, the understanding and protection of the private property rights in China have experienced a long zigzag journey. However, since 1978, accompanied by the implementation of China's reform and opening up policy, the protection of the private property rights has been gradually improved in legislation and also in the practice. Strengthening the protection of private property rights and the private economy also becomes one of the most important successful experiences of China's reform and opening up of the last more than 30 years. The "private property rights" concept was first clearly shown in the 2004 Constitution amendment and this amendment stipulates that "Citizens' lawful private property is inviolable" and "The State, in accordance with the law, protects the private property rights of the citizens and the inheritance right on the property" [Article 13(1) and Article 13(2) of the Constitution]. So far the legal status of private property rights in the Constitution was completely established for the first time.[67] Although China's Constitution is not actionable, its recognizance of the private property rights has the various deep and far-reaching significances. One of them is that the concrete private law, business law, criminal law and administrative law, which are actionable in China, must abide by the Constitution and implement the principle of the Constitution.

Property rights generally include ownership and *jus in re aliena* of movable and immovable property such as mortgage and easements, intellectual property rights, equity rights, obligatory rights and other property rights. In the modern society, among the private property of the common residents, apart from real estate, financial assets, which mainly include bank deposits, stock, bonds, futures and fund shares, become more and more important. And the state's protection degree of the residents' financial assets will directly determine the financial deepening and financial development, and in turn, affect the long-term sustainable economy growth in China.

1. Strict Protection of the Obligation Rights of the Residents on Their Bank Deposits. — The obligation rights of the residents on their bank deposits are one of the most important private property rights for residents. This is the case especially in such a country like China with high household savings, which are captive, and immature securities market. The long-term financial repression policy in China, namely the control of interest rates and the accompanying high inflation, makes the real deposit rates for residents very low and usually negative. This is, as discussed earlier in this article, a type of hidden taxation on residents' deposits in nature. However, without a clear legal basis and legal procedures, this secret taxation is in violation of the principle of taxation

[67] MO Jihong, 实践中的宪法学原理 (*Constitution Principles in Practice*), China Renmin University Press (Beijing), at 299–302 (2007).

legitimacy.[68] Thus, it constitutes the damage on residents' private property rights. But this kind of damage is highly invisible and concealed, and it is different from the forms of the apparent infringement of private property rights such as the regulatory taking of the residents' real property without the adequate compensation.

To protect the obligation rights of the residents on their bank deposits, China should gradually abandon the financial repression policy on interest rate control and conduct the following two reforms:

(1) Ought to continue promoting the market-oriented interest rate reform actively and orderly

China has accomplished some achievements in terms of market-oriented interest rate reform, such as the unlocking of the interbank lending interest rates and the deposit interest rates of foreign currency, and the new liberalization of the lending interest rates. Up till now, China's interest rate liberalization reform has entered into the most crucial step. That is to remove the upper limit of deposit interest rates. This gradual orderly liberalization will make the interest rates change freely in accordance with the supply and demand relationship of monetary capital in the market and the inflation situation. When the inflation exists, deposit interest rates will go up accordingly. It can ensure that the real deposit interest rates keep at a reasonable positive value usually and protect this type of residents' private property rights indeed. In addition, it will also simultaneously bring many other benefits to our economy such as reducing capital flight, increasing savings and investments, pushing China's commercial banks to improve the operation and management level and international competitive ability, improving the proportion of income in GDP, promoting the actualization of economic growth policy target driven by consumption, modifying the economic growth model, ensuring the sustainability of economic growth, and so forth.[69] Besides, from the perspective of private law autonomy and contract freedom, the government shall also relieve the administrative control on the capital price (*i.e.* interest rates) and allow market participants to freely determine the interest rates mainly based on market conditions. This will help implement the principle of contract freedom more thoroughly in China's market economy, make the allocation of the scarce market resources such as capital more efficient, and in hence promote the further improvement and development of Chinese market economy.

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[68] For the discussion about the principle of taxation legitimacy, please see LIU Jianwen & XIONG Wen eds. 财政税收法 (*Law of Public Finance & Law of Taxation*), Law Press China (Beijing), at 161–169 (2009); LIU Li, 税权的宪法控制 (*The Constitutional Control of the Tax Power*), Law Press China (Beijing), at 98–129 (2006).

[69] Currently, the People's Bank of China is actively promoting the market-oriented interest rate reform as well. One of the major contents is that the Shibor (Shanghai Interbank Offered Rate) which was officially launched by the People's Bank in 2007, and is fostered as the benchmark interest rate of money market in China and the supporting measure for the market-oriented interest rate reform. Accordingly, the fundamental legal document "Shanghai Interbank Offered Rate Implement Guideline" (Document No. 316 of China Banking Regulatory Commission [2006]) was also enacted.

Since September 2013, China has been operating a new form of free trade zone based in a particular area of Shanghai, called the China (Shanghai) Pilot Free Trade Zone. Later, several other areas (Tianjin, Fujian and Guangdong) in China are also granted as the special zones by the State Council and moving in the same direction. In the significance, this new reform has been compared to DENG Xiaoping's 1992 southern tour, which launched the zone-based foreign investment and trade policies. Then those policies formed the basis for China's industrial growth and integration into the global economy. Now, many new reform policies are being experimented in these new special trade zones. One of them is the financial reform, including the slow liberalization of capital account, renminbi cross-border use and interest rate marketization. For this reform, the People's Bank of China, and three regulatory commissions on banking, securities, and insurance, have adopted many new regulatory methods and the new financial architecture is being built there. It is being expected that those reform methods would be testified to be right and then be replicated and implemented in the other areas of China. This could lead China to step into a new stage of economic development.

(2) Ought to enhance the independence of China's central bank and strengthen its functions and responsibilities of stabilizing prices and controlling inflation

When the central bank controls the upper limit of deposit interest rates, the inflation makes the real interest rates of residents' deposits very low and usually negative. This is without doubt a hidden impairment on residents' private property rights. Also, high inflation will bring lots of harm on the society and economy. For example, it will reduce the purchasing power of the currency held by residents, and this is itself a hidden impairment on private property rights and will result in a lower living standard. The high inflation will also force the middle and low income groups to bear much more pressure, and the rise of asset price will result in the further centralization of social wealth to the high income class and eventually widen the gap between the poor and the rich in society. In addition, it will likely lead to the disorder of the price system, disrupt the signal system of the market economy, reduce the economic efficiency and make the economy instable. Furthermore, it will likely affect the optimal allocation of resources, and then damage long-term economic growth. Last but not least, high inflation can easily lead to credit boom and make the economy too hot for one period, then press the government to take the various measurers to cool the economy to avoid the burst of the bubble, and then push the economy to fall into the credit crunch, the deflation and slow, zero or negative economic growth for one period, or in the worse time the financial crisis happens and the economy falls into the great recession. This vicious circle goes against the long-run sustainable economic growth. Because of all the above mentioned reasons, to stabilize currency value becomes a fundamental monetary policy target for central banks of various developed countries.

In China, Article 3 of the Law of the People's Republic of China on the People's Bank of China regulates that "The aim of monetary policies shall be to maintain the stability of

the value of currency and thereby promote economic growth." According to this expression, currency stability is the precondition of economic growth and also is the method to promote economic development by the People's Bank of China, and thus to maintain the stability of the currency value is the primary goal for the People's Bank of China.[70] However, it does not stipulate the necessary key conditions for the People's Bank of China to formulate and implement monetary policy pursuing the primary goal of maintaining stability of currency value. Article 2(2) and Article 5(1) of this law separately regulate that "The People's Bank of China shall, under the leadership of the State Council, draw up and implement monetary policies, guard against and eliminate financial risks, and maintain financial stability" and that "The People's Bank of China shall report to the State Council its decisions concerning the annual supply of currency, interest rates, foreign exchange rates, and other major issues specified by the State Council for approval before they are implemented." It can be seen that the right of the People's Bank of China to formulate and implement monetary policies is almost completely controlled by the central government and it has little independence between the ordinary citizens and the government.

In the future, China should reform the legal institutions of the central bank in order to enhance the independence of China's central bank, strengthen the functions and responsibilities of stabilizing prices and controlling inflation, and thus keep the monetary policy healthy, stable and sustainable. Main specific suggestions are as follows:

First of all, it should be specified in the Law on the People's Bank of China that "The People's Bank of China keeps independent when drawing up and implementing monetary policies." Article 2(2) of the Law on the People's Bank of China, which stipulates that the People's Bank of China draws up and implements monetary policies under the leadership of the State Council, and Article 5 of the law, which stipulates that the People's Bank of China shall report to the State Council its decisions concerning the annual supply of currency, interest rates, foreign exchange rates, and other major issues specified by the State Council for approval before implementing them, shall be deleted off. Admittedly, the independence of the central bank is not absolute because it is still subject to the supervision of the National People's Congress (NPC) and the Standing Committee of the NPC, and the central bank must also work within the framework of the overall goal of the economic and financial policy set by the central government. Therefore, the proposed independence of the central bank should be interpreted as relative independence of central bank within the government. This is also the general model adopted by the developed economies such as the US and the UK.[71]

Secondly, the Law on the People's Bank of China should clearly establish "the

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[70] ZHU Chongshi & LIU Huiyun, 金融法教程 (*Finance Law*), Law Press China (Beijing), at 28 (2012).

[71] For the relative independence of U.S. Federal Reserve, please see *The Federal Reserve System: Purposes and Functions*, available at http://www.federalreserve.gov/pf/pdf/pf_complete.pdf (last visited May 20, 2015).

Central Bank Commission" on the basis of the current president and vice president system, and such Commission could be made up of 7 committee members. The committee members shall be nominated by the prime minister of the State Council and decided by the NPC. The term for the committee member shall be longer than the term for the prime minister of the central government, and 14 years can be a good choice. The appointment of the members shall adopt the rotation system, which means changing one of the members every two years. One chairman and one vice chairman should be set up in the Commission, appointed by the prime minister of the State Council from the committee members with the approval of the NPC. The term for the chairman and vice chairman can be 4 years. Through this system, the independence of the central bank could be guaranteed in respect of personnel and organization. Only when the independence of personnel and organization is established, can the independence of the central bank be ensured.[72]

Thirdly, the Central Bank Commission shall report to the NPC each year, report to its Standing Committee at regular intervals and accept inquiry and supervision. This will strengthen the supervision of the People's Bank of China by the highest authority and thus help establish and implement the central bank's accountability system indeed.

Fourthly, the causes for the removal of the central bank committee members shall only be limited to criminal crimes or serious misconducts, permanent incapacitation, chronic diseases and serious dereliction of duty and other major reasons, and shall be determine by the Supreme Court. Such strict limits on removal policy could guarantee the independence of the People's Bank when making monetary policies.

Fifthly, the transparency of the central bank in making and implementation of monetary policies should be enhanced. The central bank shall publish the information concerning the overall economy, the central bank's monetary policy and the intention of the policy timely, and shall encourage the public to understand and participate in the policy making process. This will probably help implement the central bank's monetary policy in reality and control not only the inflation but also the inflation expectations.[73]

2. Strict Protection of the Right of Ordinary Residents as Minority Shareholders. — The initial purpose of the development of the securities market in China is to help push forward the reform of the SOEs and help the SOEs obtain funds directly. The minority shareholders that are mainly composed of common residents have made great contributions to the promotion of the reform of the SOEs and the development of the securities market. However, the reform and development is a slow process in China. At present, the main characteristics of the ownership structure of the listed companies in

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[72] ZHOU Zhongfei, 论中央银行独立性的法律保障机制 (*Legal Safeguarding Mechanism for the Independence of Central Bank*), 1 政治与法律 (Political Science and Law) 30, 30–36 (2005).

[73] ZHANG Jianwei & LI Yan, 通胀预期管理与货币政策目标: 一个法律金融学的分析视角 (*Inflationary Expectations Management and the Objective of Monetary Policy*), 9 法学杂志 (Law Science Magazine) 14, 14–17 (2010).

China are the high centralization of shares and the dominance of the stated-owned shares. This problem is so serious that the controlling shareholders and the insider managers tunnel the interests and steal the assets of the listed companies by means of various related transactions. This harms the interests of the medium and small investors, who are mainly the common residents, severely. In order to maintain and strengthen minority shareholders' trust and confidence in the stock market in China, the protection of minority shareholders' rights must be improved and strengthened, and the minority shareholders should really benefit from the development of the securities market and national economy. Only by doing that can the securities market in China continue attracting the investors, including not only the local investors but also the foreign investors, and the capital, and can the scale and liquidity of the securities market in China keep growing. The protection of minority investors, of course, is a systematic project, involving many concrete regimes and aspects.

Given the current situation, the following items provide a good starting point:

(1) To strengthen the controlling shareholders' fiduciary duty to the minority shareholders and the company itself, and make them really take over the legal liability after their breach of the duty.[74]

(2) To put forward the gradual reform of the diffusion of the ownership structure in the listed companies. The ordinary minority shareholders will likely face two kinds of agency costs, one coming from the insider managers, and the other from the controlling shareholders, when there exist the controlling shareholders. The existence of this dual agency costs greatly increase the investment cost of the ordinary shareholders and harm the interests of the ordinary shareholders.

(3) To establish the securities class action institution, because this kind of institution will produce a great deterrent to the insider managers and the controlling shareholders.[75]

(4) To further improve the legal institution of the shareholders' derivative litigation and make it be used in the practice really.

(5) To improve the quality of the court trial greatly.

(6) To strengthen the intensity of and improve the quality of the securities

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[74] See generally, WANG Baoshu& YANG Ji, 论股份公司控制股东的义务与责任 (*The Duty and Liability of Controlling Shareholders of Joint Stock Companies*), 2 法学 (Legal Science) 60, 60–68 (2000); ZHU Ciyun & ZHENG Boen, 论控制股东的义务 (*The Duties of Controlling Shareholders*), 2 政治与法律 (Political Science and Law) 13, 13–22 (2002); ZHU Ciyun, 资本多数决原则与控制股东的诚信义务 (*The Capital Majority Rule and the Fiduciary Duty of Controlling Shareholders*), 4 法学研究 (Legal Science and Research) 104, 104–116 (2004).

[75] ZHANG Wusheng, 论群体性纠纷的解决机制——美国集团诉讼的分析和借鉴 (*The Solution of Group Disputes — Analysis and Transplant of the US Class Action*), 3 中国法学 (China Legal Science) 20, 20–30 (2007); GUO Li, 美国证券集团诉讼的制度反思 (*Further Thoughts on the US Securities Class Action*), 2 北大法律评论 (Peking University Law Review) 426, 426–446 (2009); ZHOU Xuefeng, 证券集团诉讼的滥用与制约 (*The Abuse and Restriction of Securities Class Action*), 2 西部法学评论 (Western Law Review) 59, 59–67 (2011).

administrative enforcement. In China, China Securities Regulatory Commission bears this task and should strive to do better.

(7) To improve the supervisory role of the social public media in the securities market.

(8) To strengthen the supervision function of the external audit and strengthen the independence, obligations and responsibilities of the certified public accountants.

(9) To promote the research and education in finance and financial law and expand the training of the financial talents.[76]

B. Strict Protection of Contract Freedom and Contract Enforcement

Finance is essentially a set of contracts. The banking business mainly includes deposit contract, loan contract, entrusted transfer contract, etc. In the capital market, which is mainly composed of stock market and bond market, stock investment and bond investment are private contract arrangements themselves. The legal institutions about the company are in essence a set of standardized contracts.[77] The interbank lending market, bill market, repurchase agreement market and short-term government bonds market in the monetary market are also a variety of financial contracts. The public offered funds or private funds, which mainly adopt the form of trust, limited partnership or corporation, are also the same. A variety of financial derivatives such as futures, share options, asset securitization and credit derivatives like CDO and CDS are essentially a variety of different contracts, are the contract arrangements set by financial market participants, and they play an important role in the promotion of financial innovation. For example, the Interim Measures for Administration of Derivatives Trading by Financial Institutions issued by China Banking Regulatory Commission defines derivatives in this way: "The term 'derivatives' shall mean a category of finance contracts whose value is dependent on one or more underlying assets or indices." Some scholars in China have also made a very good interpretation of financial derivatives trading from the perspective of contract.[78]

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[76] Strictly protecting the equity of the common residents as minority shareholders also indirectly includes the protection of securities investment fund shares purchased by them, because the holders of these funds generally also form minority investors after these funds are invested in China's securities market featured as the dominance of state-owned shares and thus also be expropriated by controlling shareholders and corporate managers controlled by these controlling shareholders. In addition, the fund management companies are also generally established and invested by state-owned financial institutions. Since the regulation and enforcement of the fiduciary duty of the insiders in fund management companies to fund investors is very weak, the fund shareholders are often looted by the insiders of fund management companies.

[77] LUO Peixin, 公司法的合同解释 (*Contract Interpretation of Company Law*), Peking University Press (Beijing), at 20–61 (2004).

[78] LIU Yan & LOU Jianbo, 金融衍生交易的法律解释——以合同为中心 (*The Contract-Centered Legal Interpretation of Financial Derivatives' Trading*), 1 法学研究 (Chinese Journal of Law) 58, 58–76 (2012); LIU Yan & LOU Jianbo, 情势变更原则对金融衍生品交易法律基础的冲击——以韩国法院对 KIKO 合约纠纷案的裁决为例 (*The Impact of the Principle of Change of Circumstances on the Legal Basis of Financial Derivatives' Trading — The Example of the South Korean Court Decision of KIKO Contract Dispute*), 5 法商研究 (Studies in Law and Business) 19, 19–27 (2009).

Since finance is essentially a set of contracts and contractual arrangements form the basis of financial activities, contract freedom and contract enforcement in the market should be strictly protected for the development of the financial intermediary and financial market. Protecting contract freedom means protecting the freedom of the market participants to determine whether to enter into a contract, the contracting party, the form, the content and the modification or termination of the contract, etc.[79] The contract should be abided by, namely *pacta sunt servanda*, as stipulated in Article 8 of China's Contract Law: "A legally formed contract has legal binding force on the parties. The parties shall fulfill their obligations as contracted, and may not arbitrarily modify or terminate the contract. A legally formed contract is protected by law." Therefore, the enforcement of a lawfully formed and effective contract should not only be binding on the parties, but also be guaranteed by the state public power. More importantly, the state public power generally cannot arbitrarily intervene in or change the content of a contract, or impede the execution of the private contract. Only by strictly protecting contract freedom and contract execution, can market participants engage in a variety of financial contracts according to the principle of private law autonomy and contract freedom, can market participants' enthusiasm, initiative and creativity be stimulated, and can financial development and financial innovation be promoted. Financial development and financial innovation will likely provide a good external financial environment for improving the enterprises' own innovation ability and finally facilitate the long run sustainable economic growth in China.[80]

Moreover, the strict protection of contract freedom and contract enforcement means reducing the government's direct control of and direct intervention in the financial market. It also means that the financial repression policy implemented by the government shall be cancelled gradually. The government's control on deposit interest rates distorts the prices of the capital in the financial market, distorts the price signals in the allocation of resources, restrains the freedom of contract in the deposit and lending market, and eventually reduces the efficiency of resource allocation.[81] The government's monopoly of the banking sector hinders the private capital flow into the banking sector, limits the freedom of contract in the subjects in the banking industry, and limits the freedom to set up a company in the banking sector. Company in nature is a legal person as an association of the shareholders, and the freedom to set up a company is the right of the association

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[79] CUI Jianyuan, 合同法 (*Contract Law*), Law Press China (Beijing), at 17–20 (2007).

[80] JIANG Shaohua, 鼓励企业自主创新的金融政策研究 (*Financial Policy Research about the Encouragement of the Independent Innovation of Enterprises*), 4 特区经济 (The Special Zone Economy) 246, 246–248 (2006); LIU Li & WAN Guangcai, 建立适合提高自主创新能力的金融体系 (*The Construction of a Financial System Suitable for Enhancing the Ability of Independent Innovation*), 12 特区经济 (The Special Zone Economy) 92, 92–94 (2006).

[81] FENG Jun & YUAN Zhigang, 融资合同、信号机制与中国金融结构改革 (*Finance Contract, Signal Mechanism and Financial Structural Reform in China*), 6 中国社会科学 (Social Science in China) 67, 67–76 (2005).

freedom, a fundamental right written in the Article 35 of the China's Constitution. Here it can also be seen that it is a significant realistic problem needed to be solved that how the fundamental rights such as the private property rights and the right of association freedom written in the Constitution shall be regulated in the civil and commercial law and implemented in practice in China. In addition, the ownership discrimination policy implemented by the government in the capital market limits the IPOs and the external financing of the private enterprises, reduces the investor's freedom of choice, and inhibits the contract freedom in subject in the capital market. Furthermore, the restrictions on the cross-border purchase of the securities for Chinese citizens are also restrictions on the residents' freedom of contract. Admittedly, a lot of people may argue that the financial industry is crucial to the national economy and people's livelihood, so the state control and state ownership are necessary. However, in fact, this consideration is unnecessary. It does not mean that the government has given up the power to supervise the financial sectors to cancel the financial repression policy, allow the private capital into the financial industry and expand the contract freedom principle in the financial industry. On the contrary, the more developed and sophisticated the financial market is, the more effective and stronger government regulation it needs. In the Western developed countries, the financial industries are all operated by private enterprises and this does not endanger the security of these countries. On the contrary, their business model has greatly improved the creativity, vitality, and international competitiveness of the financial industries in those countries. As the famous British legal historian Henry Sumner Maine says, the movement of the progressive societies has been a movement from status (an ascribed position) to contract (a voluntary stipulation).[82] Therefore, the development and progress of the financial market in China should also be a movement of "from status, determined by the propriety of the ownership such as the state ownership or private ownership, to the contract."

C. The Sequential Openness of Market Access and the Introduction of the Principle of Free and Equal Competition

At present, China's financial industry is still basically under the state monopoly. The government owns the controlling shares of the main financial enterprises and the government strictly restricts the finance market access. It is a strong financial repression. Like the other SOEs, the state-owned commercial banks also have the problems of soft budget constraints in the actual operation.[83] In the practice, the government often uses the public fiscal funds to bail out the state-owned commercial banks or provide financial

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[82] Maine, 古代法 (*The Ancient Law*), translated by SHEN Jingyi, The Commercial Press (Beijing), at 97 (1959).

[83] Janos Kornai, *The Soft Budget Constraint*, 39 Kyklos 3, 3–30 (1986); LIN Yifu & LI Zhiyun, 政策性负担、道德风险与预算软约束 (*Policy Burden, Moral Hazard and Soft Budget Constraint*), 2 经济研究 (Economic Research Journal) 17, 17–27 (2004).

subsidies for them, in order to deal with their huge no-performance loans.[84] In order to fundamentally improve the management efficiency and the international competitiveness of the Chinese financial enterprises, and to provide careful stewardship to the national public funds, China should deepen the reform of the financial system, gradually and sequentially relieve the constraint on the market entrance, and introduce the principle of free and equal competition. In the theoretical circle, there are already scholars who have discussed and suggested the entry of non-public capital into the industries and fields lying under the administrative monopoly, and the introduction of the fair competition of the enterprises having the different propriety of ownership.[85] In terms of legislation, in 2007, China promulgated the Anti-Monopoly Law, which puts all the industries and enterprises into the scope of the application of the law. As a whole, there are no exceptions of the application in the specific industries in the law. The intent of the legislator of the law is to gradually reduce the existence of the administrative monopoly in some industries and introduce the competition mechanism with the reform.[86]

In terms of policy formulation, in February 2005, the State Council issued Several Opinions on Encouraging, Supporting and Guiding the Development of the Economy of Non-Public Ownership such as Individual and Private Economies (Old Non-Public 36 Articles), which proposes that China should loosen the market entrance for non-public economy, allow non-public capital to step into the industry of financial services, and implement the principle of equal entry and fair treatment. In May 2010, the State Council promulgated the Certain Opinions of the State Council on Encouraging and Guiding the Healthy Development of Private Investment (New Non-Public 36 Articles), which once again prescribed the policy about encouraging and guiding private capital into the industry of financial services. In March 2012, the executive meeting of the State Council approved the Implementation of the General Plan of the Financial Comprehensive Reform Pilot Zone in Wenzhou of Zhejiang Province. In May 2012, for the implementation of the policies of encouraging and guiding private capital into the banking industry set in the Opinions, the China's Banking Regulatory Commission issued the Implementing Opinions on Encouraging and Guiding Private Capital into the Banking Sector. On September 29, 2013, China's Banking Regulatory Commission issued "The Notice about the Relevant Issues of the Banking Regulation in the China (Shanghai) Pilot

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[84] YU Qiao & ZHAO Changwen, 政治控制、财政补贴与道德风险：国有银行不良资产的理论模型 (*Political Control, Fiscal Subsidy and Moral Hazard: The Theoretical Model of No-Performance Assets in State-Owned Banks*), 6 经济研究 (Economic Research Journal) 73, 73–82 (2009).

[85] WANG Xiaoye, 非公有制经济的市场准入与反垄断法 (*The Market Access of Non-Stated-Owned Economy and the Anti-Monopoly Law*); WANG Xiaoye, 垄断行业改革的法律建议 (*Legal Advice of the Reform of Monopoly Industries*), in WANG Xiaoye, 王晓晔论反垄断法 (*WANG Xiaoye on Antitrust Law*), Social Science Academic Press (Beijing), at 365–372 & 373–377 (2010).

[86] CAO Kangtai & ZHANG Qiong eds. 中华人民共和国反垄断法解读——理念、制度、机制、措施 (*The Interpretation of the Anti-Monopoly Law of the People's Republic of China — Concept, System, Mechanism and Measures*), China Legal Publishing House (Beijing), at 21 (2007).

Free Trade Zone" through the admission of the State Council. It supports the entry of foreign banks into the zone and the entry of private capital into the banking in the zone. The initiatives described above show that China is developing towards the direction of the gradual opening of financial market access and the introduction of the principle of equal competition. The key is the practical implementation of these policies in the future.

In addition to the practical implementation of the above-mentioned policies, China must further improve the contents of its Anti-Monopoly Law and strengthen the practical implementation of this law. For example, the punitive damages, the criminal liability of the monopoly behavior and the private enforcement of this law should be added into this law through the amendment. Only with the good anti-monopoly law in the written paper and also in the practice, could the development of the financial market be ensured and accelerated, and also the rights and interests of the average residents as the financial consumers protected.

D. The Improvement of Judicial System

In order to safeguard and promote financial development, China should continue making efforts to push forward the reform of the judicial system.

1. The Necessity to Enhance Judicial Independence. — To effectively protect private property rights and private right of contract freedom from being interfered with or impaired by public power, judicial independence must be established to ensure the status and capacity of judicial authorities to check and balance the public power of the government, so that impartial judgment can be made in the property dispute cases involving the government. It is easy for the public government authorities, which are excessively powerful and easily not subject to the judicial balance, to disturb or infringe private property rights and private right of contract freedom, to distribute social resources to their preferred objectives according to their own will, and to intervene in the financial market. This consequently leads to the repression of the free competition and development of the financial market. The enhancement of judicial independence can effectively check and balance the public power of the government and help to build a healthy, stable and virtuous relationship between private society and political state. The judicial independence includes two inalienable parts, namely the independence of the judge and the independence of the court. A judge is unable to fulfill his/her responsibility without the independence of the court. Similarly, if a judge is stuck with the worries resulting from the independent judgment, the independent trial and judgment cannot be conducted and thus the judicial independence will never be achieved.[87] Article 123 and Article 126 of China's Constitution clearly prescribe that the people's court shall exercise its power independently. Article 8 of China's Judges Law and the other laws and

[87] ZHOU Hanhua, 论建立独立、开放与能动的司法制度 (*Discussion on Establishment of Independent, Open and Flexible Judicial Systems*), 5 法学研究 (Chinese Journal of Law) 4, 4–8 (1995).

regulations provide the guarantee for the judges to fulfill their duties independently. Due to the special system in China, however, the judicial independence stipulated in China's Constitution and China's Judges Law is not enforced very well in the practice. It is necessary for China to further improve the judicial independence through the judicial reform in future. After all, the judicial independence is a fundamental characteristic and principle of the modern society, which is under the rule by law.

In 2014, China started its broad legal reforms. One of the important reform points is to strengthen the independence of judicial departments and constrain the government officials from meddling with judicial investigations and trials. The officials who violate this principle, according to the reform, will be recorded in their performance review and punished accordingly. It should be said that the reform is definitely necessary and should be pushed forward persistently.

2. The Necessity to Recognize Case Law to Improve the Adaptability of the Laws. — There is no clear case law system in China despite of the existence of "similar or quasi case law system" in practice. For instance, the case requesting and replying system is a real but not denominated case law system, the case anthology and publication system is a tacit case law system, and the new case guidance system, launched by China's Supreme People's Court in 2010, is an implied case law system.[88] However, there is a need for China to establish a case law system clearly and officially, in order to meet the requirements for a good judicial system with the economic and social development. The establishment of the case law system will likely contribute to making up for the hysteresis and incompleteness of the existing statutes, enhancing the adaptability and activism of the laws upon continuously developing and changing realistic society,[89] improving the quality of the case trials and judicial judgment written by the judges, and building up the social prestige of the law, court and judge. Because financial industry itself is quite volatile and innovative, the case law system and judges' discretion system can adapt to the changes and developments of financial market most effectively, and thus will safeguard and promote the development of financial market most powerfully.

CONCLUSIONS

There is generally financial repression in both developing and transition countries. Financial repression is, in nature, a hidden tax and fiscal revenue of the government and it can liquidate public debt of the government effectively. In China, financial repression mainly refers to government's control over interest rates, monopoly control over the

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[88] WEI Shengqiang, 为判例制度正名——关于构建我国判例制度的思考 (*Justifying Case Law System — Thoughts on Establishment of Case Law System in China*), 3 法律科学 (Legal Science) 182, 182–192 (2011).

[89] The activism of the laws hereby is different from the "Judicial Activism" advocated in China's judicial circles. The latter is in nature more of a kind of administration-style judiciary. For detailed discussions, please see LIU Lianjun, 比较法视野下的司法能动 (*Judicial Activism in the View of Comparative Law*), 3 法商研究 (Studies in Law and Business) 19, 19–27 (2011).

banking industry, ownership discrimination during the process of going public and IPOs, and strict control over capital accounts. The policy of financial repression will likely inhibit financial deepening and the improvement and development of financial system — and finally damage sustainable economic growth. The good legal infrastructure plays a crucial role in financial deepening and development, and the developed, efficient and inclusive finance will likely greatly promote the long-run economic growth of a country. In China, the main methods to ameliorate financial repression and improve the legal governance in finance are the following: the strict protection of private property rights, including the strict protection of obligations rights of common depositors through the active and orderly liberalization reform of the interest rate and the strict protection of the rights of the common residents as minority shareholders, the strict protection of the contract freedom and the enforcement of the contract, the sequential opening up of financial market entrance and the introduction of the principle of free and equal competition in financial market, and the improvement of judicial system for the purpose of increasing the adaptability of Chinese Law, such as the strengthening of judicial independence and establishment of case law.