

Will China's Financial System Stimulate or Impede the Growth of Its Economy?

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What is the role of China's financial system in supporting the growth of its economy, and how will it develop in the future? Almost every functioning financial system includes financial markets and intermediaries (e.g., a banking sector), but how these two sectors contribute to the entire financial system and economy differs significantly across countries. Although there is no consensus regarding the prospects of China's future economic growth, a prevailing view on China's financial system speculates that it is one of the weak links in the economy, and it will hamper future economic growth.

Based on our analysis, including the comparison between China's financial system and that of other countries, we draw three main conclusions about China's financial system and its future development. First, the continuing effort of reforming the banking system, in particular, reducing the amount of non-performing loans (NPLs) of the major banks to normal levels, is probably the most important task for China's financial system in the near future. Second, financial market development needs to be promoted. Regulation should be improved, domestic financial intermediaries that act as institutional investors should be encouraged, new products and services should be developed, and more financial professionals such as accountants and lawyers should be trained. The large holdings of shares held by various government entities in listed companies should be reduced by announcing and carrying out a plan to sell them off slowly over time.

Third, in a companion paper, we find that the most successful part of the financial system, in terms of supporting the growth of the overall economy, is not the banking sector or stock markets, but rather other mechanisms including internal finance, non-bank financial intermediaries and coalitions of various forms among firms, investors, and local governments.¹ Many of these channels rely on alternative governance mechanisms, such as trust, reputation and relationships and on competition. These meth-

ods of financing have supported the growth of a "Hybrid Sector" of firms with various types of ownership structures.² The growth of the Hybrid Sector has been much higher than that of the State Sector (state-owned firms including all firms where the government has ultimate control) and the Listed Sector" (publicly listed and traded firms), and contributes most of the growth of the economy. Going forward, we believe these alternative channels and mechanisms should be encouraged. They can co-exist with the banks and markets and can continue to fuel the growth of the Hybrid Sector. The rest of the article expands on these themes.

HISTORY AND CURRENT STATUS OF CHINA'S FINANCIAL SYSTEM

Prior to 1978, China's financial system consisted of a single bank — the government owned and controlled People's Bank of China (PBOC), which served as both the central bank and a commercial bank, controlling about 93 percent of the total financial assets of the country and handling almost all financial transactions. The first main structural change occurred in 1978, when the single bank was split into four state-owned banks: the PBOC was formerly established as China's central bank, the Bank of China (BOC) was given the mandate to specialize in transactions related to foreign trade and investment, the People's Construction Bank of China (PCBC) was set up to handle transactions related to fixed investment (in manufacturing), and the Agriculture Bank of China (ABC) was set up to deal with all banking business in rural areas. The financial sector was further diversified in 1984. The fourth state-owned commercial bank, the Industrial and Commercial Bank of China (ICBC) was formed to take over all commercial transactions of the PBOC. This period also witnessed the entry of non-state owned banks, including foreign financial institutions (branches and offices), into the financial system.

China's domestic stock exchanges, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE), were established in 1990. These have been growing very fast since then. However, the corporate bond market is virtually non-existent.

Financial sector reform has focused on state-owned banks since 1997, especially the problem of NPLs. Finally, China's entry into the World Trade Organization (WTO) in 2001 marked the beginning of a new era, in which increasing foreign competition and the continuing growth of the non-state financial institutions are the defining characteristics.

In Table 1 we compare China's financial system to those in other countries using the standard classification system introduced to the law and finance literature by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (hereafter LLSV, 1997, 1998), with some measures taken from Asli Demirgüç-Kunt and Ross Levine.³ The LLSV (1997, 1998) sample includes 49 developed and developing countries with four legal origins, but excludes China. It can be seen that China's banking system is important in terms of size, with its ratio of total bank credit to gross domestic product or GDP (1.11) higher than even the German-origin countries (with a weighted average of 0.99). However, when we consider bank credit issued (or loans made) to the Hybrid Sector only, China's ratio dropped sharply to 0.24, suggesting that most of the bank credit is issued to companies in the State and Listed Sectors. Moreover, China's banking system is not efficient: Its overhead cost to total assets (0.12) is much higher

than the average of French-origin countries (0.05), the next highest group of countries.

In contrast to the banking sector, China's stock markets are smaller than most of the other countries, both in terms of market capitalization and the total value traded as a fraction of GDP. Notice that "total value traded" is a better measure than "market capitalization" to measure the actual size of the market, because the latter includes non-tradable shares, while the former measures the fraction of total market capitalization traded in the markets, or the "floating supply" of shares in the markets.

In summary, China's financial system primarily consists of a large but inefficient banking sector while stock markets are still quite small relative to GDP.

BANKING SYSTEM: THE PROBLEM OF NPLS AND REFORMS

China's banking sector is dominated by four large and inefficient state-owned banks. The most glaring problem for China's banking sector is the amount of NPLs within the four largest state-owned banks. A large fraction of these bad loans resulted from poor lending decisions made for state-owned enterprises (SOEs), many of which were due to political or other non-economic reasons, and these loans accumulated over the years without ever being resolved. The additional problem is that data availability on NPLs is limited. This lack of disclosure of NPLs fuels speculation that the problem must be severe. Many commentators believe that

Table 1. A Comparison of Financial Systems: Bank-based vs. Market-based Measures (Value-weighted approach)

Measures	English Origin*	French Origin*	German Origin*	Scandinavian Origin*	Sample average	China
Bank credit/GDP	0.62	0.55	0.99	0.49	0.73	1.11 (0.24) ^a
Overhead Cost/Bank Total Assets	0.04	0.05	0.02	0.03	0.03	0.12
Total value traded/GDP	0.31	0.07	0.37	0.08	0.27	0.11
Market Cap/GDP	0.58	0.18	0.55	0.25	0.47	0.32

Notes: All the measures for countries other than China are from Asli Demirgüç-Kunt and Ross Levine, *Financial Structure and Economic Growth: Cross-Country Comparisons of Banks, Markets, and Development* (Cambridge, Massachusetts: MIT Press, 2002). Measures on China are authors' own calculations using definitions from the same book.

*: The numerical results for countries of each legal origin group are calculated based on a value (GDP of each country)-weighted approach. a: Numbers in bracket indicate bank credit issued to only the Hybrid Sector (instead of total bank credit).

Source: *Almanac of China's Finance and Banking* (Editorial Bureau of Almanac of China's Finance and Banking, 2000); *China Statistical Yearbook* (China Statistics Press, 2000).



the true amount of NPLs is much higher than the officially announced figures suggest.

Table 2, based on the Asian Banker database on banks, compares the announced NPLs and profitability of the entire banking system (not just state-owned banks) in China and other major Asian economies. NPLs, either as a fraction of total new loans made by all banks or as a fraction of GDP in a given year, are the highest in China from 2000–2002 (Panel A). The comparison includes the period during which Asian countries recovered from the 1997 financial crisis, and the period during which the Japanese banking system was disturbed by a prolonged bad loan problem. In addition, the profitability of China's banking system, measured by the return to equity or assets, is also among the lowest in the same group of countries (Panel B).

In recent years, the Chinese government has taken active measures to solve this problem. First, four state-owned asset management companies were formed with the goal of assuming these NPLs and liquidating them. Second, state-owned banks have

improved their loan structure by increasing loans made to individual lenders while being more active in risk management and monitoring of loans made to SOEs. Third, there has been a boom in the entry and growth of non-state financial intermediaries within the banking system, and this trend is expected to continue with more foreign banks entering the domestic credit markets in the near future as a result of China's entrance into the WTO. All the above facts taken together can explain why NPLs have been falling during the period of 2000–2002 (Panel A of Table 2). However, due to the lack of transparency on the disclosure of bank statements, the improvement shown here could be significantly overstated, and thus should be viewed cautiously.

As stated above, we believe that the continuing effort of reforming and improving the banking system is one of the most important tasks for China in the near future. In fact, China's central bank has injected foreign currency reserves into 2 of the big 4 state-owned banks to improve their balance sheets, so that these banks can go public. Given that

Table 2. A Comparison of Non-performing Loans and Profitability of Banking Systems

Panel A Non-performing Loans (% of total loans made and % of GDP)

	1997	1998	1999	2000	2001	2002
China	n/a	2.0 (2.2)	9.5 (10.6)	18.9 (24.9)	16.9 (22.7)	12.6 (15.2)
Hong Kong	1.3 (3)	4.3 (10.2)	6.3 (13.9)	5.2 (12.6)	4.9 (12.9)	3.7 (9.6)
India	n/a	7.8 (1.6)	7.0 (1.6)	6.6 (1.6)	4.6 (1.7)	2.2 (0.8)
Indonesia	0.3 (0.2)	11.8 (4.6)	8.1 (2.0)	13.6 (3.2)	9.9 (2.2)	4.5 (0.9)
Japan	2.7 (5.4)	5.1 (10.8)	5.3 (10.9)	5.8 (11.5)	9.2 (15.3)	7.4 (12.8)
South Korea	2.9 (5.1)	4.8 (6.3)	12.9 (12.9)	8.0 (8.6)	3.4 (3.4)	2.5 (2.6)
Taiwan	2.4 (3.2)	3.0 (3.9)	4.0 (5.7)	5.2 (7.6)	6.2 (9.4)	4.1 (5.2)

Panel B Banking System Profitability (% return on equity and % return on assets)

China	6.6 (0.21)	4.0 (0.2)	3.2 (0.18)	3.9 (0.21)	3.5 (0.21)	4.16 (0.21)
Hong Kong	18.7 (1.8)	11.0 (1.0)	18.2 (1.6)	18.8 (1.6)	15.7 (1.4)	15.6 (1.4)
India	17.0 (0.9)	9.7 (0.5)	14.2 (0.7)	10.9 (0.5)	19.2 (0.9)	19.6 (1)
Indonesia	-3.8 (-0.3)	n/a	n/a	15.9 (0.3)	9.7 (0.6)	21.1 (1.4)
Japan	-18.6 (-0.6)	-19.2 (-0.7)	2.7 (0.1)	-0.7 (0)	-10.4 (-0.5)	-14.5 (-0.6)
South Korea	-12.5 (-0.6)	-80.4 (-3.0)	-34.0 (-1.5)	-7.0 (-0.3)	15.8 (0.7)	13.1 (0.6)
Taiwan	11.2 (0.9)	9.5 (0.8)	6.9 (0.6)	5.1 (0.4)	4.0 (0.3)	-5.2 (-0.4)

Notes: NPL is measured as % of total loans made, and as % of GDP (numbers in brackets). Both the loan and NPL are the aggregate of all banks in a country. The profitability is measure as the return on average Equity (ROAE), and the return on average Assets (ROAA). The latter is presented in the brackets.

Source: The Asian Banker data center 2003, <http://www.theasianbanker.com>.

China's total foreign exchange reserve at the end of 2004 was US\$610 billion while the total amount of NPLs as of the end of 2002 was 15 percent of GDP (Panel A of Table 2), or US\$188 billion (using the US\$1 = 8.28 RMB exchange rate), the foreign reserve itself should be more than enough to remove the NPLs off the books of all the banks in China.

Whether the government will do exactly this remains to be seen, but it is clear that the ultimate source of solving the problems of NPLs lies in overall economic growth. As long as the economy maintains its strong growth momentum so that the government's potential for raising taxes also increases, the government can always assume the remainder of the NPLs without significantly affecting the economy. This is the positive perspective. The negative perspective is that NPLs may be much bigger than the official statistics suggest. If the growth of the economy significantly slows down in the near future, while the accumulation of NPLs continues, the banking sector problems could lead to a financial crisis. This could spill over into other sectors of the economy and cause a slowdown in growth or a

recession. In this view the NPL problem poses a serious problem to China's continued prosperity.

FINANCIAL MARKETS AND LISTED FIRMS: GROWTH AND IRREGULARITIES

China's domestic stock exchanges, the SHSE and SZSE, have been growing very fast since their establishment in 1990. At the end of 2002, the combined total market capitalization, including non-tradable shares, of these two exchanges ranked 11th among the largest stock exchanges in the world (Table 3). The Hong Kong Stock Exchange (HKSE hereafter) ranked 10th. If we rank the combined size of all stock exchanges in a country, China would rank fifth, behind only the United States, Japan, the United Kingdom, and France.

As fast as the growth of China's stock markets has been, they are not efficient in that prices, and investors' behavior do not reflect fundamental values of listed firms. In Table 3, "Concentration" measures the fraction of total market capitalization of an exchange that is coming from the combined capital-

Table 3. A Comparison of the Largest Stock Markets in the World (2002)

Rank	Stock Market	Total Market Cap (US\$ billion)	Concentration (%)	Turnover Velocity (%)
1.	NYSE	9,015	61.3	94.8
2.	Tokyo	2,095	60.6	67.9
3.	Nasdaq	1,994	63.1	159.8*
4.	London	1,800	84.5	97.3
5.	Euronext	1,538	72.3	153.6
6.	Deutsche Börse	686	72.0	125.1
7.	Toronto	570	67.8	67.9
8.	Swiss	547	81.2	138.6
9.	Italian	477	66.1	120.7
10.	China (Hong Kong)	463	83.0	39.7
11.	China (Domestic)	463	29.4	224.2

Notes:

1. All figures (except those relating to China's domestic exchanges) are from <http://www.fibv.com>, the web site of the international organization of stock exchanges. The Chinese data is from <http://www.csrc.gov.cn>, the web site for the China Security Regulation Committee (CSRC).
2. All figures relate to the period of 01/01/2002 to 12/31/2002.
3. **Concentration** measures the fraction of total market capitalization of an exchange that is coming from the combined capitalization of the largest firms ranked in the top 5 percent (by capitalization).
4. **Turnover velocity** is the total turnover for the year expressed as a percentage of the total market capitalization.
5. (*) The published number for Nasdaq includes double counting. The number shown is half the published number to make it comparable to the figures for the other exchanges.

ization of the largest firms ranked in the top 5 percent (by capitalization). The dominance of large-cap stocks in China is the lowest among major stock exchanges in the world, with its concentration ratio of 29.4 percent less than half of that of Tokyo, which has the second-lowest concentration. Stocks are traded extremely frequently in China, as shown by the highest "Turnover Velocity," defined as the total turnover for the year expressed as a percentage of total market capitalization, among the largest exchanges.

The inefficiencies in the Chinese stock markets can be partly attributed to poor and ineffective regulation. The current process of listing companies fosters both a problem of adverse selection among firms seeking an initial public offering (IPO), and a moral hazard problem among listed firms. First, the going public process, including obtaining listing quota/permission and disclosing information, is inefficient due to bureaucracy, fraudulent disclosure, and lack of independent auditing. As a result, certain non-state-owned firms from the Hybrid Sector with solid growth potential find it costly to gain access to the stock market, while the same process of going public is relatively easier for some large and inefficient companies from the State Sector.⁴ Second, once listed, managers in firms with severe agency problems do not have an incentive to manage assets to grow, but rather to rely on the external capital market to raise funds (mainly through mergers and acquisitions, and seasoned offerings of securities) to pursue private benefits. If China is to develop a vibrant high-tech sector with fast growing companies, it would be helpful if such firms could have easy access to the public markets.

Another way to improve the efficiency of China's stock markets is to encourage the further development of domestic financial intermediaries that can act as institutional investors. Insurance companies, pension funds, mutual funds, and hedge funds, which are currently relatively small compared to those in Europe, Japan, and the U.S., can provide a level of stability and professionalism that is lacking in China's markets.

In terms of the role of financial markets in helping firms raise funds, both the scale and relative importance (compared with other channels of financing) of China's external markets are not significant. For example, for the ratio of External Capital (i.e., funding external to the firm) and gross national product (GNP), the LLSV (1997) sample average is 40 per-

cent, compared to China's 16 percent (using only the floating supply or value traded part of the stock market, rather than the total market capitalization); for the ratio of total debt (including bank loans and bonds) over GNP, the LLSV sample average is 59 percent, compared to China's 35 percent. When we relate and compare the aggregate financing channels with the growth of the economy during different growth periods, we find that the development of China's markets as sources of funding external to the firm relative to its overall economic growth is not dramatically different from other emerging countries. One of the common patterns emerging from these comparisons is that the development of external markets trails that of the growth of the overall economy. This is not surprising given that the development of these markets requires a minimum efficiency for a country's institutions including the legal system, accounting standards, and the development of associated professionals. By contrast, during the early stages of economic growth, alternative institutions and mechanisms alone can support the growth of firms and the overall economy, as is the case for China based on our evidence.

Firms in the Listed Sector in China issue both tradable and nontradable shares. The nontradable shares are either held by the state/government or by other legal entities, (i.e., other listed or non-listed firms or organizations), and constitute a majority of all shares. The standard corporate governance mechanisms are limited and weak in the Listed Sector. Listed firms have a two-tier board structure: the Board of Directors and the Board of Supervisors. Rather than being elected by shareholders, a significant fraction of both boards are officials chosen from government branches, or executives from the parent companies, and the nomination process is usually kept secret. The external governance mechanisms are also weak. First, the existing ownership structure, characterized by the large amount of nontradable shares including cross-holdings of shares among listed companies and institutions, makes it difficult to carry out value-increasing mergers and acquisitions (M&As).⁵ Second, institutional investors do not have a strong influence on management or on the stock market, as they are a very recent addition to the set of financial institutions in China. Third, ineffective bankruptcy implementation makes the threat and penalty for bad firm performance non-credible. Fourth, the government plays the dual roles of regulator and blockholder for many

listed firms, including banks and financial services companies, which can lead to conflicting goals in dealing with listed firms and weakens the effectiveness of both of its roles. Finally, based on a large sample of listed firms, we find that on average Chinese firms have concentrated ownership (among the state and founder's families), tend to under-pay dividends to their shareholders, and have lower Tobin's Q, compared to firms in countries studied by LLSV.

One of the major problems Chinese stock markets face is caused by the large amount of shares in listed companies owned by the government and government entities. This overhang creates great uncertainty about the quantity of shares that will be tradable going forward. Investors fear that if prices go up then the government will sell their holdings and this will prevent further price rises or even depress them. This uncertainty has caused share prices to stagnate despite the very high levels of growth in the economy. In order to remove this uncertainty the government should announce a plan for selling these shares slowly over time. Each year a small amount would be sold so that the market

could easily absorb the shares. Such a plan might take several decades to complete. Once announced the plan should be carried out without any deviation irrespective of the prevailing circumstances.

In summary, the overall evidence on the comparison of China and other countries' external markets is consistent with LLSV (1997, 1998) predictions: With an underdeveloped legal system and weak investor (both shareholder and creditor) protection, the fact that China has small external markets comes as no surprise. Figure 1 compares China's legal system and external financial markets to those of LLSV countries. The horizontal axis measures overall investor protection in each country, while the vertical axis measures the (relative) size and efficiency of that country's markets for funds external to the firm. Countries with English common-law systems (French civil-law systems) lie in the top-right region (bottom-left region) of the graph, while China is placed close to the bottom-left corner of the graph.

Finally, going forward, in addition to improving the regulatory environment surrounding listed firms and the stock market, China should develop finan-

Figure 1. Comparison of Legal and Financial Systems

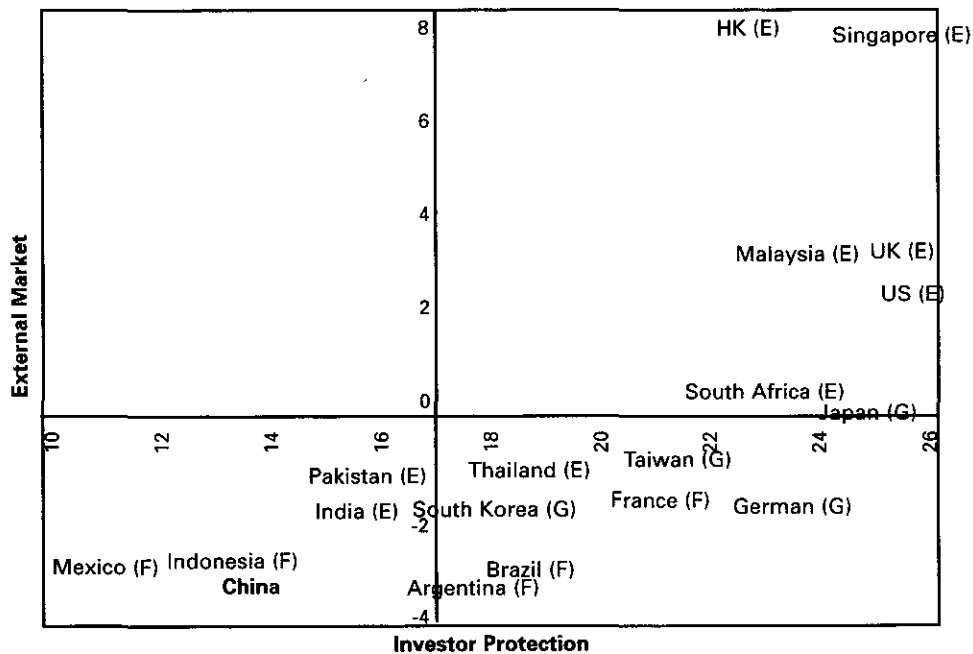


Figure 1 compares China's legal system and external financial markets (i.e., those for raising funds from outside the firm) to those of LLSV countries (LLSV, 1997, 1998). Following LLSV (1997, 1998), the score on the horizontal axis measures overall investor protection in a country. It is the sum of (overall) creditor rights, shareholder rights, rule of law, and government corruption. The vertical axis measures the (relative) size and efficiency of that country's external markets. The score of a country measures the distance of the country's overall external markets score (external cap/GNP, domestic firms/Pop, IPOs/Pop, Debt/GNP, and Log GNP) to the mean of all countries, with a positive (negative) figure indicating that this country's overall score is higher (lower) than the mean.

cial markets that are diversified and more balanced. This includes the further development of the bond market (including both government and corporate bond markets), the venture capital market so as to support the growth of high tech firms, and the real estate market. Moreover, more financial products such as derivative securities should be introduced to the market so that investors can form more balanced portfolios in addition to stocks.

ALTERNATIVE FORMS OF FINANCING

The weaknesses of the banking sector and limited size of the stock markets raise the question of how China's phenomenal growth over the last two decades has been financed. Our view is that alternative channels of finance allow firms in the Hybrid Sector to raise funds and to grow from start-ups to successful industry leaders. We also examine the alternative governance mechanisms employed by investors and firms that can substitute for China's weak formal corporate governance mechanisms.

A Comparison of the Hybrid Sector vs. the State and Listed Sectors

In terms of the growth of *industrial output* produced in the three sectors from 1996 to 2002, the Hybrid Sector grew at an annual rate of 14.3 percent, while the State and Listed Sectors combined grew at only 5.4 percent annually during the same period. In addition, the growth rate for investment in fixed assets of the Hybrid Sector is comparable to that of State and Listed Sectors combined, which implies that the Hybrid Sector is actually more productive than the State and Listed Sectors. Finally, there has been a fundamental change among the State, Listed, and Hybrid Sectors in terms of their contribution to the entire economy: the State Sector contributed 76 percent of China's total industrial output in 1980, but in 1996 it only contributed 28.5 percent; in 1980 individually/privately owned firms, a type of Hybrid Sector firms, were negligible, but in 1996 they contributed 15.5 percent of total industrial output.

The Hybrid Sector is a much more important source for employment opportunities than the other two sectors. Over the period from 1995 to 2002, the Hybrid Sector employed an average of over 70 percent of all non-agricultural workers, while the Township Village Enterprises (TVEs, a type of Hybrid Sector firm) are by far the most important employer

for workers from the rural areas. Moreover, the number of employees working in the Hybrid Sector has been growing at 1.5 percent over this seven-year period, while the labor force in the State and Listed Sectors has been shrinking. These patterns are particularly important for China, given its vast population and potential problem of unemployment.

Discussion on How Alternative Financing Channels Work

There are two important aspects to alternative financing channels in the Hybrid Sector. The first is the way in which investment is financed. The second is corporate governance. We consider each in turn.

Once a firm is established and doing well, internal finance can provide the funds necessary for growth. We found earlier that about 60 percent of the funds raised by the Hybrid Sector are generated internally. Of course, internal finance is fine once a firm is established but this raises the issue of how firms in the Hybrid Sector acquire their "seed" capital, perhaps the most crucial financing during a firm's life cycle. We have presented evidence on the importance of alternative and informal channels, including funds from family and friends. There is also evidence that financing through illegal channels, such as smuggling, bribery, and other underground or unofficial businesses also play an important role in the accumulation of seed capital. Though a controversial issue for the government, our view, based on similar episodes in the history of other developing countries, is that as long as the purpose of money making is to invest in a legitimate company, it may be more productive for the government to provide incentives for investment rather than to expend costs discovering and punishing these activities.

Perhaps the most important mechanism for corporate governance within the non-standard financial sector that supports the growth of the Hybrid Sector is trust, reputation and relationships.⁶ According to the World Values Survey conducted in the early 1990s, China has one of the highest levels of social trust among a group of 40 developed and developing countries. Without a dominant religion, one can argue that an important force in shaping China's social values and institutions is the set of beliefs first developed and formalized by *Kong Zi* (Confucius). This set of beliefs clearly defines family and social orders, which are very different from the western beliefs on how legal codes should be formulated.

The second important mechanism is *competition* in product and input markets, which has worked well in both developed and developing countries.⁷ What we see from the success and life cycles of hybrid sector firms, such as those in Wenzhou of Zhejiang province, is only those firms that have the strongest comparative advantage in an industry (of the area) that survived and thrived. Based on survey evidence, we also find that entrepreneurs utilize various methods to remove entry barriers during their startup period, which, in turn, leads to more competition in the industries.

SUMMARY AND CONCLUDING REMARKS

We began this article by asking whether China's financial system will stimulate or hamper its economic growth. Our answer to this question, based on examining the history and current status of the financial system and comparing them to those of other countries, is in three parts. First, the large but inefficient banking sector has been the dominant force in the financial system, and has played a central role in funding the growth of all types of firms. However, it is currently plagued by the problem of NPLs, which, if not corrected properly, may cause major economic difficulties. Second, the stock market has been growing very fast since 1990, but has played a limited role in supporting the growth of the economy. However, the role of the financial markets is likely to change in the near future and they will play an increasingly important role in the economy. Third, while the banking sector and financial markets have done enough *not* to slow down the growth of the economy, the alternative financing channels have had great success in supporting the growth of the Hybrid Sector, which contributes most of the economic growth as compared to the State and Listed Sectors. The non-standard financial sector relies on alternative financing channels including internal finance, and on alternative governance mechanisms, such as those based on trust, reputation and relationships, and competition to support the growth of the Hybrid Sector. Going forward, we believe that these alternative financing channels and governance mechanisms should be encouraged rather than replaced. They should be allowed to co-exist with the banks and markets and continue to fuel the growth of the Hybrid Sector.

We conclude by pointing out the most significant challenge for improving China's financial system: Economic stability is crucial for the continuing development of the Chinese economy, and the stability of the financial system relates to economic stability in three dimensions. The continuing effort to reduce and eventually bring down NPLs to normal levels is important in avoiding a banking crisis, while the effort to improve the regulatory environment surrounding the financial markets (including governance and accounting standards) can certainly help prevent a stock market crash/crisis. The entrance of China to the WTO introduces cheap foreign capital and technology, but free capital inflow and foreign competition and speculation also bring the risk of a twin crisis (foreign exchange and banking/stock market crisis), which severely damaged emerging economies in Asia in 1997. In order to prevent such a crisis, policies toward improving the financial system must be made along with supportive fiscal and trade policies.

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ENDNOTES

1. Franklin Allen, Jun Qian and Meijun Qian, "Law, finance, and economic growth in China," *Journal of Financial Economics* 77 (2005), 57-116.
2. The Hybrid Sector includes 1) privately owned companies (but *not* publicly listed and traded) where controlling owners can be Chinese citizens, investors (or companies) from Taiwan or Hong Kong, or foreign investors or companies; and 2) collectively—and jointly—owned companies, where joint ownership among local government, communities, and institutions is forged.
3. See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, "Legal determinants of external finance," *Journal of Finance* 52 (1997), 1131-1150; and "Law and finance," *Journal of Political Economy* 106 (1998), 1113-55. See also Asli Demirgüç-Kunt and Ross Levine, *Financial Structure and Economic Growth: Cross-Country Comparisons of Banks, Markets, and Development* (Cambridge, Massachusetts: MIT Press, 2002).

4. While few privately owned firms from the Hybrid Sector do become listed and publicly traded, we find that more than 80 percent of listed companies from their sample (more than 1,100 companies) are converted from SOEs. See Franklin Allen, Jun Qian and Meijun Qian, "Law, finance, and economic growth in China," *Journal of Financial Economics* 77 (2005), 57–116.
5. According to the *China Mergers and Acquisitions Yearbook* (Posts & Telecom Press, Beijing, China, 2004), there were 925 M&A's involving listed firms in 2003 totaling US\$9.35 billion, which is about 1.8 percent of the total market capitalization. In many deals, a Hybrid Sector firm (non-listed) acquires a listed firm that is converted from an SOE, but the large amount of non-tradable shares held by the state remain intact after the transaction.
6. See Avner Greif, "Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders," *Journal of Economic History* 49 (1989), 857–882; and "Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition," *American Economic Review* 83 (1993), 525–548.
7. For example, see John McMillan, "China's Nonconformist Reform," *Economic Transition in Eastern Europe and Russia: Realities of Reform*, ed. Edward Lazear (Stanford: Hoover Institution Press, 1995), 419–433; John McMillan, "Markets in Transition," in *Advances in Economics and Econometrics* Vol. 2, ed. David Kreps and Kenneth Wallis (Cambridge: Cambridge University Press, 1997), 210–239; Franklin Allen and Douglas Gale, *Comparing Financial Systems* (Cambridge: MIT Press, 2000), and "Corporate governance and competition," in *Corporate Governance: Theoretical and Empirical Perspectives*, eds., Xavier Vives (London: Cambridge University Press, 2000), 23–94.