

# Ineffective Finance, Financial Leakage and China's Economic Growth

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## **Abstract**

In the gradual process of our transition economy, it presents the phenomenon that financial low efficiency and economy of the high-growth coexist. It's believed in the article that under the condition that our country implements strong control over financial policy with unique high savings, financial leakage occurs in public economy system and gets kept by non-public economy which is outside the system, making informal correction to financial allocation efficiency. This results in the coexistence of financial low efficiency and economic high-growth. From the angle of financial non-regular leak, the article analyzed the economic transition process of economic growth in China and put forward suggestions and countermeasures on financial efficiency improvement or development.

**Key words:** *transition economy; financial leakage; financial efficiency; economic growth*

## **1 Introduction**

More and more researches have proved that there exists informal financial markets represented by folk debit and credit outside Chinese formal financial system (Kellee Tsai, 2001), providing capital and financial support for non-state-owned economy, which has been fully verified. And few people noticed another way to provide capital support for non-state economy, namely state-owned enterprise capital outside leakage (we call it financial leakage). Researches have found that the part of financial resources going into the sector of the economy out of the system gets kept directly or indirectly, realizing the correction of the initial allocation of financial resources. (Xin Nianjun, 2006) In practice, this kind of informal "take inversely and keep smoothly" revises financial efficiency, promotes the development of economy which is limited outside the system and discriminated by finance and pushes forward the economic growth objectively. In theory, we can consider it as one of the motivations of China's financial low efficiency and economic high growth. In practice, it also conforms to the development of Chinese economic transition.

## **2 Financial leakage and mechanism analysis under strong controlled financial policy**

Chinese transition economy still achieved the economic high growth under strong controlled financial policy. From the angle of capital, it was partly because the outgoing leakage of the state-owned sectors' financial fund went into the non-state-owned economy field, got configured efficiently, supported the development of the non-state economy and promoted the growth of Chinese economy directly.

### ***2.1 The funds leakage of state-owned sectors' fund leakage under strong controlled financial policy***

As for the erosion way and absorber of financial resources which come out from state-owned economic sectors leakage, we can explain them roughly through figure below: ① The state-owned economy transfers funds or assets directly to domestic non-state-owned economy and

individuals, which is a quite apparent form in the state-owned enterprise restructuring process. For example, it invests bank loans to private enterprises or even strips out a new private enterprise from original state-owned enterprises. So the high quality assets of original state-owned enterprises are transferred to new enterprises, causing capital leakage ② Leakage occurs in a form of chain debts. Under strong controlled financial policy, state-owned sectors can get capital from state-owned banks easily. And in the economic transactions between non-state-owned economy department and state-owned enterprises, the debtor is often the non-state sectors whose capital is limited. This kind of liabilities is much more likely to become bad accounts receivable. State-owned enterprises often play the role of fund net supplier in chain debt and cause capital leakage as a result of the fact that they enjoy "soft budget constraint" treatment with no need to pay off the debts on expiry day.③ Leakage is produced by corruption. This phenomenon carries strong gray properties but obviously it does exist. To be honest, after its founding, China stayed in the most serious corruption times in early period of transition. Corruption has become the most serious social pollution and the rent as well as economic loss caused by corruption every year are extremely breathtaking.(Hu Angang ,2000).Capital behind corruption flows into domestic personal or private enterprises and overseas ,of course.

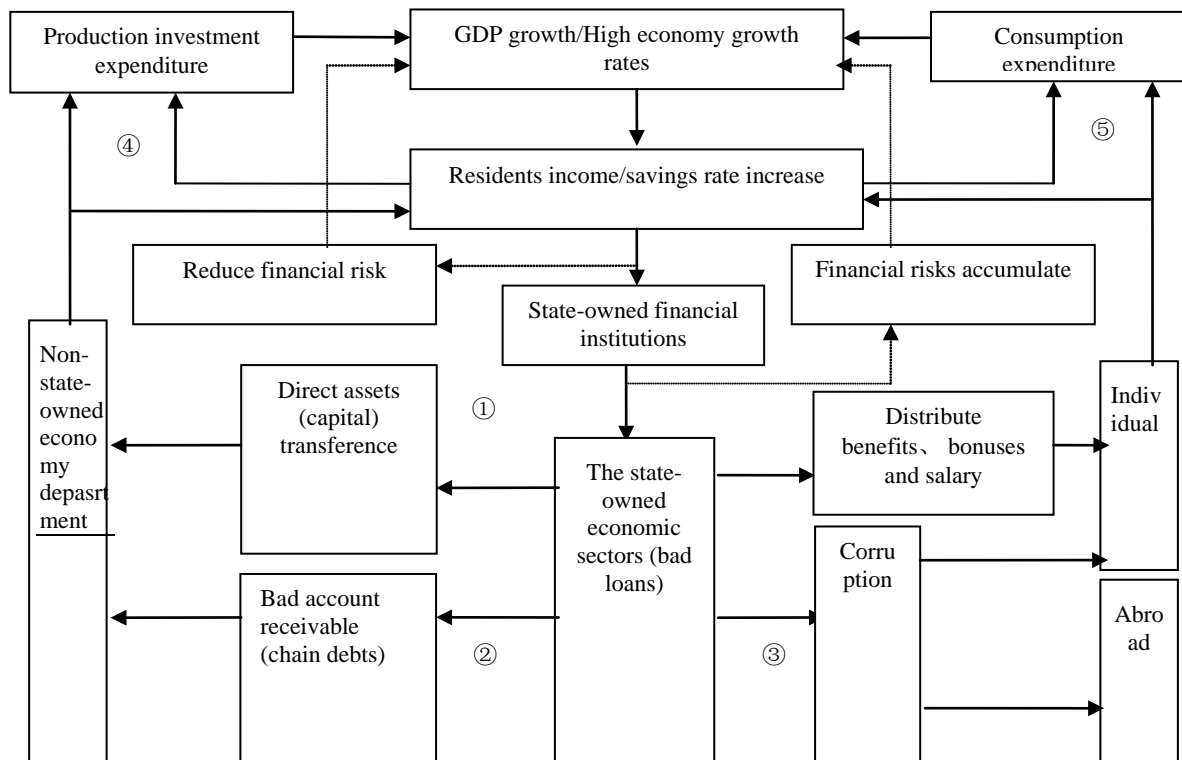


Fig 1: State-owned departments' capital leakage and effect schemes

## 2.2 The mechanism analysis of state-owned economic sectors' financial leakage effect

In figure above ,as mentioned above, through channel ①②③, bad loans of state-owned

economy flowed respectively into non-state-owned economy, resident individuals or abroad in various forms in which process the bad loans rate in financial institutions rose and financial risk accumulated constantly. Part of the funds (not include those flowed abroad) became bank deposits in saving form, allowing financial sectors to maintain high savings rates and plenty of credit funds. At the same time, non-state-owned enterprises and individuals put the funds into investing production and consumption expenditure.(Look at ④⑤) To some extent, it weakened negative effects of our credit ownership discrimination, which got funds effectively used in the more efficient non-public economy and promoted the rapid growth of economy. Whilst part of bad loans ,including bonuses releasing、welfare、salary and those flowing into individual pockets or families through corruption, are used as consumer spending, increased social effective demand to a certain extent and promoted economic growth indirectly. Under the condition that both consumer spending and production investment spending increased, dynamic economic activities and enhanced economic growth rate resulted in rising residents wage income and household saving rate accordingly which provide not only a more abundant credit capital source for state-owned financial institutions but also more production investment funds sources and consumer spending funds guarantee, constructing an informal leakage effect cycle.

The financial leakage in state-owned economic departments promoted the development of on-state-owned and even the entire national economy and was beneficial to the increase of residents' income and money supply of national finance state-owned banks. However, as for financial leakage, its fountain was informal. And various rent-seeking behavior and corruption were inevitable to happen and caused significant loss of state-owned assets. Meanwhile, if we failed to constrain and guide the illegal capital from the angle of system and law ,then its risk will continue to accumulate and expand, doing damage to social and economic development. So we could draw a conclusion that although the financial resources leakage of state-owned economic departments had certain positive role, its external non-economic effect outweigh further external economic effect.

### **3 Chinese financial efficiency improvement and development at later stage of transition**

After 30 years of transition process, our country has been at later stage of transition. From the angle of sustainable development, financial leakage should never exist in a market leading economic system, although it could fix financial allocation efficiency in short term."The reverse configuration of financial resources and low internal efficiency of financing system will surely constrain and block Chinese economic sustainable development so that the real economic growth rate is lower than the potential rate"(Zhang Zongxin ,1998) Our government has also realized that it is unsustainable to sacrifice financial sector efficiency for economic growth mode. So it constantly introduced appropriate policies in recent years to promote the reform of the financial system.(Kong Lingfeng ,2010) We believe that we must start from various ways, strengthen the construction of system and enterprise reform, increase supervision and push forward the private finance development if we want to realize economic growth and social progress under high financial efficiency and change the paradox phenomenon—financial low efficiency and economical high growth.

#### ***3.1 Continue to push forward the reform of state-owned enterprise property rights and improve state-owned enterprises operating efficiencies***

Entity enterprise's low efficiency means great decrease of financial asset quality. So it's of

vital importance to promote operating efficiencies of state-owned enterprises if we want to improve financial efficiency. Predecessors' research shows that the root of state-owned enterprises' low efficiency mainly lies in the incompleteness of state-owned property constraints and incentive mechanism. Although state-owned property subject has been already clear, the corresponding appraisal, evaluation, supervision and management are extremely inadequate for property operation efficiency and effect. Whilst it is necessary to introduce competition mechanism, break the monopoly and utilize external constraint forces to improve operational efficiency.

### ***3.2 Promote the reform of state-owned commercial banks property and strengthen financial supervision and credit constraints***

One of important reasons for state-owned financial departments' low problems lies in credit management and supervision. Through the reform and management of property right of state-owned banks, it is indispensable to form a corporate governance structure of commercial banks corresponding to that of state-owned enterprises, improve credit management and strengthen constraints, achieving marketization of financial price and behaviour.

Meanwhile, the characteristics of our country's strong control over finance should gradually fade in the process of marketization so that the situation that government leads the development of finance can be changed. Of course, as the core department of modern economy-finance, our country must strengthen the supervision of it ,constrain the state-owned property right, construct a scientific incentive mechanism in order to increase efficiency and benefits.

### ***3.3 Promote the development of private finance and construct multi-level financial system***

In the economic transition process of our country, there is a basic phenomenon that enterprises outside the system can hardly get enough credit capital. So the leakage of financial resources from the economy inside the system becomes one source of funds of non-state-owned economy. Accordingly, based on the grappling of both sides, all kinds of corruption and rent-seeking phenomenon emerge in endlessly. Although it helps to obtain certain financial resources, the cost may be far higher than that of financing in the credit markets. To solve this problem, we must start from widening its financing channel, promote folk financial development and construct the multi-level financial system to form a competitive situation, which is beneficial to meet non-state-owned economy's financing needs.

### ***3.4 Define and standardizing the government's behavior reasonably***

At early stage of transition when economy outside the system had not grown fully, the government's strong control over finance guaranteed the realization of economic growth targets and avoided excessive inflation, whose effect was beyond question. However, with the reformation in economic system, the government behavior should gradually exit from the forefront and get defined and formulated reasonably according to legal principle. Only when we loosen financial control and change the situation where government leads the financial development and makes excessive intervention can we truly reform and develop the finance as well as improve its efficiency according to the internal law of market economy.

#### **4 The prospect of research**

Judging from the current study, many experts and scholars have made researches about financial low efficiency and economical high growth in the process of Chinese transition economy. The results show that the financial repression which is under Chinese strong control over finance goes against economic growth. For example, the reallocation of bad loan assets will sharpen the polarization between the rich and the poor; Corruption will undermine social stability; High bad loans rate will accumulate financial risks etc. Some scholars have noticed financial leakage effect on economic growth. But relevant empirical research is little as a result of the "gray" properties of financial leakage, the difficulty to monitor financial scale and flow effectively and the serious information asymmetries, which can't illuminate and validate conclusions. We believe that the reverse configuration of financial resources and inefficient financing will inevitably block the sustainable economic development of China, resulting in that the true economic growth rate is below potential growth rate. Therefore, we can infer from the research trend that subsequent researched should focus on comprehensive analysis of externality of financial leakage, utilization of more empirical analysis method, an objective understanding of the effect and hazards of financial leakage, exploration of a deeper path to financial reform, ways to implement the reform of financial system and dispersed processing to systematic risks which are accumulated in financial system so as to form a benign mechanism in which financial quantity and efficiency can be promoted together.

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