China's Financial System and the Law*

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Law plays a different role in China's financial system than in most developed economies. China's financial system is dominated by a large banking sector. The role of the stock market in allocating resources in the economy has been limited and ineffective. The most successful part of the financial system, in terms of supporting the growth of the overall economy, is a shadow banking sector that consists of alternative financing channels, governance mechanisms, and institutions. These by and large do not rely on the law but on other enforcement mechanisms. The co-existence of this sector with banks and markets can continue to support the growth of the Hybrid Sector (non-state, non-listed firms).

* Prepared for and presented at the Cornell International Law Symposium held on February 21, 2014. We are grateful to Robert C. Hockett and participants in the Symposium for their interesting and helpful comments. We also thank the editorial team for doing a very thorough check of the paper and sources.

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47 CORNELL INT'L L.J. 499 (2014)

Introduction

In most financial systems, the law plays a crucial role. Finance is a process by which lenders provide money to borrowers now in exchange for payments in the future. The law usually provides a way of making such promises credible. Allen, Qian and Qian (AQQ) point out that China operates differently.[1] During the last thirty-five years or so, China has been one of the most successful economies in terms of growth.[2] In 2014, the IMF predicts that it will overtake the U.S. and become the largest economy in the world in terms of Purchasing Power Parity.[3] China has achieved this despite formal financial institutions, poorly functioning markets, and an ineffective legal system underpinning their operation.

In this paper, we provide a comprehensive review of China's financial system and the legal system associated with it.[4] Almost every functioning financial system includes financial markets and intermediaries (e.g. a banking sector), but how these two standard financial sectors contribute to the entire financial system and economy differs significantly across different countries.[5] In this regard, we discuss what has worked and what has not within the two sectors in China and consider the effects of further development on the entire economy. We also examine a shadow financial sector, which operates outside the markets and banking sectors and consists of alternative financing channels, governance mechanisms, and institutions.

We draw three main conclusions about China's financial system and its future development. First, China's financial system has been dominated by a large banking system. This is clear when China's banking system and financial markets is compared with those of both developed and emerging countries.[6] Even with the entrance and growth of many domestic and for-

1. Franklin Allen, Jun Qian & Meijun Qian, *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57, 59 (2005) [hereinafter AQQ, *Law, Finance, and Economic Growth*].

2. *See China Overview*, THE WORLD BANK (Apr. 1, 2014), http://www.worldbank.org/en/country/china/overview.

3. Ann Williams, *Did China Just Overtake the US as World's Largest Economy? Well, Yes and No*, THE STRAITS TIMES (Oct. 9, 2014, 3:18 PM), http://www.straitstimes.com/news/business/economy/story/did-china-just-overtake-the-us-worlds-largest-economy-well-yes-and-no-20.

4. This paper draws heavily on our previous work, including AQQ, *Law, Finance, and Economic Growth*; Franklin Allen, Jun Qian, & Meijun Qian, *China's Financial System: Past, Present, and Future, in* CHINA'S GREAT ECONOMIC TRANSFORMATION 506 (Loren Brandt & Thomas G. Rawski eds., 2008) [hereinafter AQQ, *Past, Present, and Future*]; Franklin Allen, Jun Qian, Chenying Zhang & Mengxin Zhao, *China's Financial System: Opportunities and Challenges*, *in* CAPITALIZING CHINA 46 (Joseph P.H. Fan & Randall Morck eds., 2013) [hereinafter AQZZ, *Opportunities and Challenges*]. In particular, much of the data and many of the arguments made are from the latter paper.

5. *See* Franklin Allen & Douglas Gale, *A Welfare Comparison of Intermediaries and Financial Markets in Germany and the U.S.*, 39 EUR. ECON. R. 179, 180 (1995).

6. *See* AQZZ, *Opportunities and Challenges*, *supra* note 4.

eign banks and financial institutions in recent years, China's banking system is still mainly controlled by the four largest state-owned banks.[7] All of these "Big Four" banks have become publicly listed and traded companies in recent years; the government is the largest shareholder and retains control of these institutions.[8] This ownership structure has served these banks well by avoiding the problems encountered by the major financial institutions in developed countries that were at the center of the 2007-2009 global financial crisis.[9] Continuous improvement of the banking system, including further development of financial institutions outside the Big Four banks and extension of more credit to productive firms and projects, can help stabilize China's financial system in the short run and can be especially timely given the uncertainties in the Chinese and global economies.[10]

Our second conclusion concerns China's financial markets. Two domestic stock exchanges, the Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE) were established in 1990.[11] The scale and importance of the stock exchanges are insignificant compared to the banking sectors; the stock exchanges have not been effective in allocating resources in the economy, because these stock exchanges remain speculative and driven by insider trading.[12] In recent years, the stock market has witnessed significant development.[13] As such, financial markets are likely to play an increasingly significant role in the economy.[14] We discuss several issues and potential problems related to increasing the size and scope and improving the efficiency of the stock and other financial markets.

Third, we find that the most successful part of the financial system, in terms of supporting the economy's overall growth, is neither the banking sector nor the financial markets. Rather it is a sector of alternative financing channels, such as informal financial intermediaries; internal financing and trade credits; and coalitions among firms, investors, and local govern-

7. *See infra* Table 4-B; AQZZ, *Opportunities and Challenges*, *supra* note 4, at 2.

8. Michael Wines, *China Bank I.P.P. Raises $19 Billion*, N.Y. TIMES (July 6, 2010), http://www.nytimes.com/2010/07/07/business/global/07ipo.html?_r=0.

9. *See* Tarhan Feyzioğlu, *Does Good Financial Performance Mean Good Financial Intermediation in China?* 4–5 (Int'l Monetary Fund, Working Paper No. 170, 2009), *available at* https://www.imf.org/external/pubs/ft/wp/2009/wp09170.pdf.

10. *See* AQQ, *Past, Present, and Future*, *supra* note 4, at 2.

11. SHELDON GAO, DOW JONES INDEXES, CHINA STOCK MARKET IN A GLOBAL PERSPECTIVE 1 (2002), *available at* http://people.stern.nyu.edu/jmei/b40/ChinaIndexCom.pdf.

12. Allen Berger et al., *Bank Ownership and Efficiency in China: What Will Happen in the World's Largest Nation*, 33 J. BANKING & FIN. 113, 114 (2009) ("The banking industry is larger than the stock markets in China, and as shown below, is very inefficient–particularly the Big Four banks."); Michael Pettis, *Why China's Financial Markets Are Inefficient*, CHINA SPECTATOR (Nov. 28, 2013, 7:05 AM), http://www.businessspectator.com.au/article/2013/11/28/china/why-chinas-financial-markets-are-inefficient.

13. Jennifer N. Carpenter et al., *The Real Value of China's Stock Market* 1 (2014), *available at* http://people.stern.nyu.edu/jcarpen0/pdfs/Carpenter%20Lu%20Whitelaw%202014%20-%20The%20Real%20Value%20of%20China's%20Stock%20Market.pdf.

14. *Id.* at 21.

ments.[15] This alternative system is often referred to as the shadow banking system.[16] Many of these financing channels do not rely on the law for enforcement but depend on other enforcement mechanisms, such as competition in product and input markets, as well as trust, reputation, and relationships.[17] This alternative financial sector, together with the banking system and the financial markets, has supported the growth of a "Hybrid Sector" with various types of ownership structures.[18] Our definition of the Hybrid Sector includes all non-state, non-listed firms, including privately or individually owned firms, and firms that are partially owned by *local* governments (e.g. Township Village Enterprises or TVEs).[19] The growth of the Hybrid Sector has been much higher than that of the State Sector (state-owned enterprises or SOEs, and all firms where the central government has ultimate control) and the Listed Sector (publicly listed and traded firms, with most of them having been converted from the State Sector).[20] The Hybrid Sector contributes to most of China's economic growth, and it employs the majority of the labor force.[21] The co-existence of the alternative financial sector with banks and markets can continue to fuel the growth of the Hybrid Sector.[22]

This paper draws heavily on our previous work including "Law, Finance, and Economic Growth in China" by Franklin Allen, Jun Qian & Meijun Qian (AQQ (2005)), "China's Financial System: Past, Present, and Future," a chapter in China's Great Economic Transformation, also by Franklin Allen, Jun Qian, and Meijun Qian (AQQ (2008)); and "China's Financial System: Opportunities and Challenges," a chapter in Capitalizing China by Franklin Allen, Jun Qian, Chenying Zhang & Mengxin Zhao (AQZZ (2013)). The remaining sections are organized as follows. In Section I, we briefly review the history of China's financial system, present aggregate evidence on China's financial system, and compare China's financial system to those of developed and other developing countries. In Section II, we examine China's banking system and how it has changed over time. In Section III, we briefly examine the growth and irregularities of financial markets, including the stock market, and listed firms. We also consider the effects of several initiatives to develop new markets and further develop existing markets, as well as changes in corporate governance

15. AQZZ, *Opportunities and Challenges*, *supra* note 4, at 96.

16. Jing Jiang, *Shadow Banking in China: Battling the Darkness*, THE ECONOMIST (May 10, 2014), http://www.economist.com/news/finance-and-economics/21601872-every-time-regulators-curb-one-form-non-bank-lending-another-begins.

17. AQZZ, *Opportunities and Challenges*, *supra* note 4, at 96.

18. AQQ, *Past, Present, and Future*, *supra* note 4, at 506.

19. *Id.* at 507. We include firms partially owned by local governments in the Hybrid Sector for two reasons. First, despite the ownership stake of local governments and the sometimes ambiguous ownership structure and property rights, the operation of these firms resembles more closely that of a for-profit, privately-owned firm than that of a state-owned firm. Second, the ownership stake of local governments in many of these firms has been privatized.

20. *Id.* at 507–08.

21. *Id.* at 508.

22. *Id.*

among listed firms. In Section IV, we examine the shadow financial sector, including alternative financial channels and governance mechanisms. Motivated by the success of this financial sector and firms in the Hybrid Sector, we also compare the advantages and disadvantages of using the law as the basis of finance and commerce. When converting RMB into US dollar, we use the exchange rate of US$1 = RMB 8.28 (*yuan*) for transactions and events occurring before 2005, and we use the spot rate at the end of each year for activities that occur during and after 2005.

I. Overview of China's Financial System

A. A Brief Review of the History of China's Financial System

China's financial system was well developed before 1949.[23] One key finding in reviewing the history of this period, including the rise of Shanghai as one of the financial centers of Asia during the first half of the 20th Century, is that the development of China's commerce and financial system as a whole was largely *outside* of the formal legal system.[24] For example, despite the introduction of Western-style courts in Shanghai and other major coastal cities in the early 1900s, most business-related disputes were resolved through mechanisms outside of the courts, including guilds (merchant coalitions), families and local notables.[25] In Section IV.C below, we argue that modern equivalents of these non-legal dispute-resolution and corporate governance mechanisms are behind the success of Hybrid Sector firms in the same areas in the 1980s and 1990s. These alternative mechanisms may be more responsive in adapting to changes in a fast-growing economy like China than the law and legal institutions.

After the founding of the People's Republic of China in 1949, all of the pre-1949 capitalist companies and institutions were nationalized by 1950.[26] Between 1950 and 1978, China's financial system consisted of a single bank - the People's Bank of China (PBOC). This bank was owned and controlled by the central government under the Ministry of Finance. It served as both the central bank and a commercial bank, controlling about

23. For more descriptions of the pre-1949 history of China's financial system, *see* AQQ, *Past, Present, and Future*, *supra* note 4. For more anecdotal evidence on China's financial system in the same period, *see, e.g.*, William C. Kirby, *China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China*, 54 J. ASIAN STUD. 43 (1995).

24. *See* AQQ, *Past, Present, and Future*, *supra* note 4, at 509.

25. *See* Kirby, *supra* note 23, at 45. For descriptions of family- and community-based mechanisms for contract enforcement, *see, e.g.*, Stephanie P. Chung, *Changes and Continuities: Evolution of a Chinese Family Business (1876-2004)*, 3 ASIA EUR. J. 259, 260 (2005). When examining how disputes were resolved both in and outside of court, Goetzmann and Köll concluded that the passing of China's first Company law in 1904, which was intended to provide a better legal environment for business and commerce, did not lead to actual changes in corporate governance or the better protection of minority shareholder rights. *See* William Goetzman & Elisabeth Köll, *The History of Corporate Ownership in China: State Patronage, Company Legislation, and the Issue of Control*, *in* A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS 150–51 (Nat'l Bureau of Econ. Research ed., 2005).

26. *See* Kirby, *supra* note 23, at 56.

93% of the total financial assets of the country and handling almost all financial transactions.[27] Functioning primarily to finance the physical production plans, the PBOC used both a "cash-plan" and a "credit-plan" to control the cash flows in consumer markets and transfer flows between branches.[28]

The first main structural change began in 1978 and ended in 1984.[29] By the end of 1979, the PBOC dissociated itself from the Ministry and became a separate entity, while three state-owned banks took over some of its commercial banking businesses. The Bank of China[30] (BOC) was given the mandate to specialize in transactions related to foreign trade and investment; the People's Construction Bank of China (PCBC), created in 1954, was set up to handle transactions related to fixed investment, especially in manufacturing; and the Agriculture Bank of China (ABC) was created in 1979 to manage all banking business in rural areas. The PBOC itself was formally established as China's central bank.[31] Finally, the fourth state-owned commercial bank, the Industrial and Commercial Bank of China (ICBC) was formed in 1984, and took over the rest of the commercial transactions of the PBOC.[32]

For most of the 1980s, the development of China's financial system can be characterized by the fast growth of financial intermediaries outside of the "Big Four" banks.[33] Regional banks (partially owned by local governments) were formed in the Special Economic Zones in the coastal areas; in rural areas, a network of Rural Credit Cooperatives (RCCs), which are similar to credit unions in the United States, was set up under the supervision of the ABC; and Urban Credit Cooperatives (UCCs), counterparts of the RCCs in the urban areas, were also founded.[34] Non-bank financial intermediaries, such as the Trust and Investment Corporations (TICs), which operated in selected banking and non-banking services with restrictions on both deposits and loans, emerged and proliferated in this period.[35]

The most significant event for China's financial system in the 1990s was the inception and growth of China's stock market.[36] Two domestic stock exchanges (SHSE and SZSE) were established in 1990 and grew quickly, with respect to the total market capitalization and trading volume, during most of the 1990s and in recent years.[37] The real estate market paralleled the stock market, growing from nonexistent in the early 1990s to

27. *See* AQQ, *Past, Present, and Future*, *supra* note 4, at 509.
28. *See id.*
29. *See id.*
30. BOC, which is among the oldest banks currently in operation, was originally established in 1912 as a private bank and specialized in foreign currency related transactions. *Id.*
31. *Id.* at 509–10.
32. *Id.* at 510.
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.*

being a significant market in recent years. Both the stock and real estate markets have experienced major corrections during the past decade, and are characterized by high volatilities and speculative short-term behaviors by many investors.[38]

These patterns are due, in part, to the fact that the development of a supportive legal framework and institutions has been lagging behind that of the markets.[39] For example, China's first bankruptcy law governing SOEs was passed in 1986 on a trial basis, but the formal Company Law did not become effective until the end of 1999.[40] This version of the Company Law governs all corporations with limited liability, publicly listed and traded companies, and branches or divisions of foreign companies, as well as the organization structure, securities issuance and trading, accounting, bankruptcy, and mergers and acquisitions of those companies.[41] China enacted a new bankruptcy law in August 27, 2006 that became effective June 1, 2007.[42] We provide a brief analysis of the status and problems of the stock market and real estate market in Section V below.

Following the Asian Financial Crisis in 1997, financial sector reform focused on state-owned banks, especially the problem of NPLs.[43] We will further discuss this issue in Section II. China's entry into the WTO in December 2001 marked the beginning of a new era, as we continue to observe increasing competition from foreign financial institutions and more frequent and larger-scale capital flows.[44]

A developed financial system is characterized by, among other factors, the substantial role played by institutional investors.[45] In China, institutional investors began to emerge in the late 1990s: the first closed-ended fund, from which investors cannot withdraw capital after initial investment, was set up in 1997, and the first open-ended fund, from which investors can freely withdraw capital (subject to share redemption restrictions), was established in 2001.[46] By November 2013, there were 89 fund companies.[47] The total net assets value (NAV) increased from RMB 11 billion (or US $1.3 billion) in 1998 to RMB 2.58 trillion or $322 billion in May 2008,

38. *See* Daniel Chow, *China's Response to the Global Financial Crisis: Implications for U.S.-China Economic Relations*, 1 GLOBAL BUS. L. REV. 47, 65 (2011); Jing Leng, *The Interaction Between Domestic and Overseas Capital Markets and Corporate Governance of Chinese Listed Companies*, 7 STUD. INT'L FIN. ECON. & TECH L. 273, 284 (2005).

39. *See* AQQ, *Past, Present, and Future*, *supra* note 4, at 510.

40. *See id.*

41. *See id.* For more details on this law and its scope, *see* CHINA SEC. REGULATORY COMM'N (CSRC), http://www.csrc.gov.cn/pub/csrc_en (last visited June 6, 2014).

42. *See* AQQ, *Past, Present, and Future*, *supra* note 4, at 510.

43. *See id.* The China Banking Regulation Committee (CBRC) was also established to oversee the banking industry.

44. *See id.*

45. *See* AQQ, *Past, Present, and Future*, *supra* note 4, at 511.

46. *See id.*

47. *List of Fund Management Companies (November 2013)*, CHINA SEC. REGULATORY COMM'N, http://www.csrc.gov.cn/pub/csrc_en/participants/FundsRelatedList/FundManagementCompanies/201401/t20140110_242346.html (last visited Oct. 7, 2014).

which was still small compared to the assets within the banking sector.[48] In 2003, a few Qualified Foreign Institutional Investors (QFII) entered China's asset management industry, where they have been operating through forming joint ventures with Chinese companies.[49] In 2011, China approved the RMB Qualified Foreign Institutional Investors (RQFII), which allows QFII to invest in Chinese stock and bond markets within a predetermined limit.[50] On the other hand, China allowed Qualified Domestic Institutional Investors (QDII) to invest in overseas markets beginning in July 2006.[51]

At the national level, the China Investment Corporation (CIC) was established in September 2007 with the intent of utilizing the accumulated foreign reserves for the benefit of the state, and part of the foreign reserves were placed under management at the establishment.[52] CIC makes occasional announcements about its investments, but the overall transparency of its investment strategy is low.[53] Since inception, CIC has made some aggressive investment decisions, including the well-publicized $3 billion (pre-IPO) investment in private equity group Blackstone, and the $5 billion investment in Morgan Stanley (this took the form of mandatory convertible bonds that can be converted into almost 10% of the firm's equity).[54]

Endowed with limited capital and given the problems with the administration of the pension system, pension funds have not played a significant role in the stock or bond markets.[55] With a fast aging population and the growth of household disposable incomes, further development of a multi-pillar pension system that includes individual accounts with employees' self-contributed and tax-exempt funds that can be directly invested in the financial markets can lead to the development of both the financial system and the fiscal system, as well as the development of social stability.[56]

48. Franklin Allen et al., *A Review of China's Financial System and Initiatives for the Future*, *in* CHINA'S EMERGING FINANCIAL MARKETS: CHALLENGES AND OPPORTUNITIES 8 (James R. Barth, John A. Tatom & Glenn Yago eds., 2009) [hereinafter, Allen et al., *A Review of China's Financial System*].

49. AQQ, *Past, Present, and Future*, *supra* note 4, at 511.

50. YONG ZHEN, CHINA'S CAPITAL MARKETS 250 (2013).

51. Allen et al., *A Review of China's Financial System*, *supra* note 48, at 49.

52. *Fund Profile: China Investment Corporation (CIC)*, THE SOVEREIGN WEALTH FUND INITIATIVE (Feb. 2012), http://fletcher.tufts.edu/SWFI-OLD/~/media/Fletcher/Microsites/swfi/pdfs/2012/profiles/CIC%20Fund%20Profile_Final.pdf (last visited Oct. 7, 2014).

53. Michael H. Cognato, *China Investment Corporation: Threat or Opportunity?*, *in* 19 NBR ANALYSIS: UNDERSTANDING CHINA'S NEW SOVEREIGN WEALTH FUND 21 (July 2008).

54. *Id.* at 21–22.

55. AQQ, *Past, Present, and Future*, *supra* note 4, at 511.

56. *Id.*

Figure 1: Overview of China's Financial System

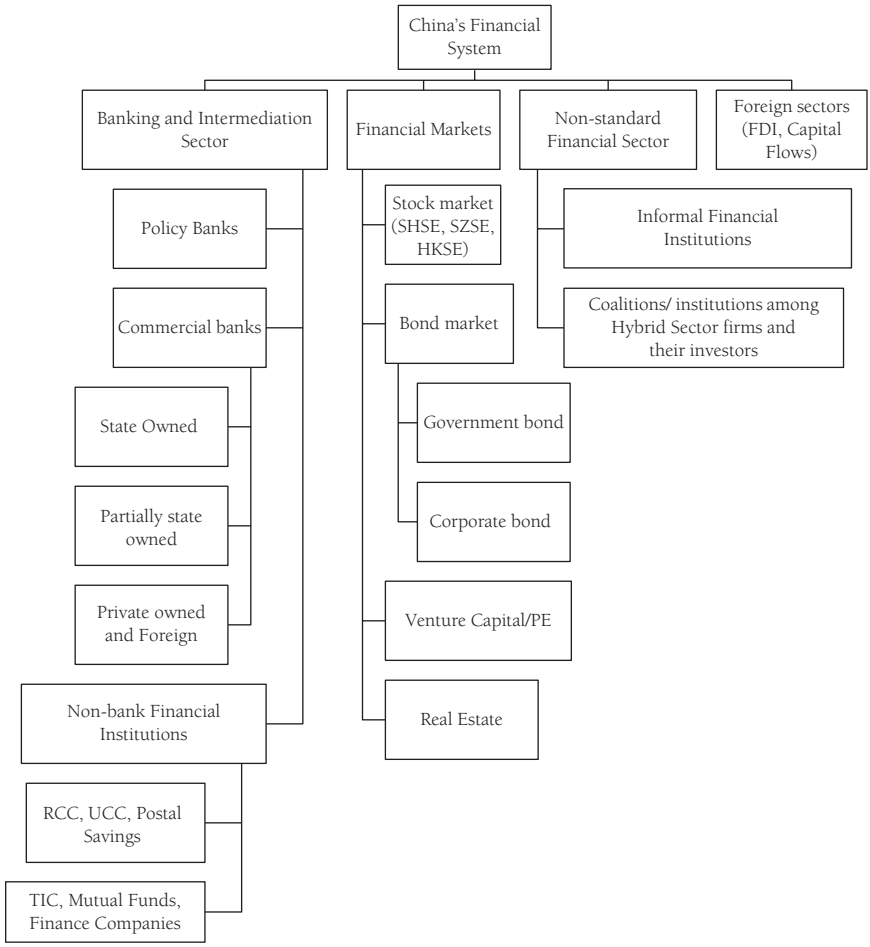


Figure 1 depicts the current structure of the entire financial system. In what follows, we will describe and examine each of the major sectors of the financial system. In addition to the standard sectors of banking and intermediation, and financial markets, we will document the importance of the shadow financial sector.[57]

57. Due to space limitations, we do not cover China's "foreign sectors" in this paper. For discussions on the history and the role of these sectors in supporting the growth of the economy, *see, e.g.*, Eswar Prasad & Shang-Jin Wei, *The Chinese Approach to Capital Inflows: Patterns and Possible Explanations*, *in* CAPITAL CONTROLS AND CAPITAL FLOWS IN EMERGING ECONOMIES: POLICIES, PRACTICES, AND CONSEQUENCES (Sebastian Edwards, ed., 2007) for a review.

B. Size and Efficiency of the Financial System: Banks, Markets, and Alternative Finance

In Table 1, we compare China's financial system to those of other major emerging economies, with measures for the size and efficiency of banks and markets taken from Levine (2002), Demirgüç-Kunt and Levine (2001), and data from the World Bank's Global Financial Development Database (GFDD). We present average figures from 2001-2011 for each country as well as the average of all the other emerging economies (excluding China). We first compare the size of a country's banks and equity markets relative to that country's gross domestic product (GDP). In terms of total market capitalization, China's stock market, at 63% of its GDP over the period 2001-2011, is slightly larger than the 57% of GDP average of the other major emerging economies.[58] "Value traded" is perhaps a better measure of the actual size of the market than "market capitalization," because the latter includes non-tradable shares or tradable shares that are rarely traded.[59] However, the majority of the bank credit goes to state-owned firms in China and only a small fraction goes to firms in the Hybrid Sector (more evidence of this is given below).[60] In addition, NPLs account for a larger percentage of all the loans in China at 11% than the average percentage in other emerging economies at 8%, indicating that China's banking sector still has room to improve its efficiency.[61]

58. *See infra* Table 1.

59. Allen et al., *A Review of China's Financial System*, *supra* note 48, at 11.

60. AQZZ, *Opportunities and Challenges*, *supra* note 4, at 77.

61. *See supra* Table 1; *see also id.* at 72. Levine (2002) uses bank overhead cost/total assets to measure banking sector efficiency, and used this measure to construct the "Structure Efficiency" and "Finance Efficiency" measures. However, the World Bank Financial Database no longer reports the overhead cost/assets ratio. We replace the overhead costs/assets ratio with the NPLs/loans ratio as an alternative measure of efficiency and use this variable to define other efficiency measures in Table 1.

Table 1: Comparing financial systems: Banks and Markets (average 2001-2011)

This table compares financial markets and banking sector of China with those of other large emerging economies. All the measures on the size and efficiency of banks and markets are based on Levine (2002) and Demirgüç-Kunt and Levine (2001), and data is from the World Bank's Global Financial Development Database (GFDD) which was published in April 2013. We present the 2001-2011 average figures for all countries (except for "Structure Regulatory," which are based on 2005 figures). Average of other emerging economies are (simple) averages across other emerging economies *excluding* China.

	Size of Banks and Markets				Structure Indices: Markets vs. banks*				Financial Development** (banking and market sectors)		
Measures	Bank credit/ GDP	NPL/ Total Loans	Value traded /GDP	Market cap. /GDP	Structure Activity	Structure Size	Structure Efficiency	Structure Regulatory	Finance Activity	Finance Size	Finance Efficiency
China	1.11	0.11	0.82	0.63	-0.13	-0.24	-1.17	16	-0.04	-0.15	0.88
Argentina	0.13	0.07	0.03	0.36	-0.68	0.44	-1.59	7	-2.44	-1.33	-0.42
Brazil	0.36	0.04	0.25	0.51	-0.16	0.16	-1.72	10	-1.06	-0.74	0.82
Egypt	0.45	0.18	0.20	0.50	-0.36	0.05	-1.04	13	-1.06	-0.65	0.03
India	0.38	0.05	0.60	0.62	0.20	0.21	-1.48	10	-0.65	-0.63	1.05
Indonesia	0.22	0.09	0.13	0.28	-0.22	0.11	-1.61	-	-1.54	-1.21	0.18
Malaysia	1.08	0.09	0.40	1.31	-0.43	0.09	-0.93	10	-0.36	0.15	0.65
Mexico	0.16	0.03	0.07	0.27	-0.33	0.24	-2.13	12	-1.95	-1.37	0.43
Pakistan	0.24	0.14	0.50	0.23	0.32	-0.02	-1.51	10	-0.93	-1.27	0.56
Peru	0.21	0.06	0.03	0.44	-0.86	0.33	-1.59	8	-2.24	-1.05	-0.31
Philippines	0.28	0.10	0.08	0.47	-0.51	0.23	-1.32	7	-1.63	-0.89	-0.08
Russian	0.28	0.05	0.31	0.54	0.05	0.28	-1.56	-	-1.06	-0.82	0.79
S. Africa	0.69	0.03	0.92	2.03	0.12	0.47	-1.19	8	-0.20	0.15	1.46
Sri Lanka	0.28	-	0.03	0.18	-0.95	-0.18	-	7	-2.07	-1.30	-
Thailand	0.96	0.09	0.49	0.59	-0.29	-0.21	-1.28	9	-0.33	-0.24	0.75
Turkey	0.24	0.08	0.39	0.26	0.20	0.04	-1.68	12	-1.03	-1.19	0.69
Ave. for Ems	0.40	0.08	0.29	0.57	-0.26	0.15	-1.47	9.46	-1.23	-0.83	0.47

Table 1 Notes: *: Structure indices measure whether a country's financial system is market- or bank-dominated; the higher the measure, the more the system is dominated by markets. Specifically, "structure activity" is equal to log(value traded/bank credit) and measures size of bank credit relative to trading volume of markets; "structure size" is equal to log(market cap/bank credit) and measures the size of markets relative to banks; "structure efficiency" is equal to log[(market cap ratio/GDP)×(bank NPLs/bank total loans)] and measures the relative efficiency of markets vs. banks; finally, "structure regulatory" is the sum of the four categories in regulatory restriction, or the degree to which commercial banks are allowed to engage in security, firm operation, insurance, and real estate: 1- unrestricted; 2-permit to conduct through subsidiary; 3-full range not permitted in subsidiaries; and 4-strictly prohibited.

**: Financial development variables measure the entire financial system (banking and market sectors combined), and the higher the measure, the larger or more efficient the financial system is. Specifically, "finance activity" is equal to log (total value traded ratio×private credit ratio), "finance size" is equal to log (market cap ratio×bank private credit ratio), and "finance efficiency" is equal to log (total value traded ratio/bank NPL ratio).

The next two columns of Table 1 (Structure Indices) compare the relative importance of financial markets versus banks, with a lower score indicating that banks are more important relative to markets. China's score for "Structure Size" (log of the ratio of Market Capitalization/Total Bank Credit) is negative, suggesting that the size of total market capitalization is actually smaller than that of bank credit, and the score is lower than the average of other emerging economies. Its score for "Structure Activity" (log of the ratio of Total Value Traded/Total Bank Credit) is negative, indicating that the trading volume of markets is still smaller than bank credit, and its Structure Activity is slightly larger than the average of other emerging economies. Taken together, these numbers suggest that the financial systems of most emerging economies, including that of China, remain bank-dominated.[62] In terms of "Structure Efficiency" (log of product (market capitalization/GDP) × (bank NPLs/bank total loans)), which denotes the relative efficiency of markets versus banks, China has a higher score than most other developing countries, suggesting that its banks are relatively less efficient than markets when compared to the efficiency of other countries.[63] "Structure Regulatory" is based on 2005 data and measures the extent to which commercial banks are restricted in participating in activities outside commercial lending. China's score of 16 is higher than most other countries, suggesting that by law commercial banks in China face tight restrictions in operating in other areas.[64]

We also compare the development of the financial system (Financial Development), including both banks and markets (the last three columns of Table 1). China's overall financial market size, in terms of both "Finance Activity" (Log of product of (Total Value Traded/GDP) × (Bank credit/GDP)) and "Finance Size" (Log of product of (Market capitalization/GDP) × (Bank credit/GDP)), is larger than the average market size of other emerging countries.[65] For "Finance Efficiency" (Log of (Total Value Traded/GDP)/Bank NPLs Ratio), China's measure is also higher than the average measure of other emerging countries.[66] Based on the evidence from the past decade, we can conclude that China's banks and markets, or at least the formal sectors of the financial system, are, relative to the size of China's economy, as large as or larger than that of other major emerging economies.[67] However, the banking sector does not lend much to the Hybrid Sector, which, as we will see in Section IV, is the dynamic part of the economy.

Related to the size of banks and markets is the question: where do most firms get their capital and funds? As shown in AQQ (2005) and AQQ (2008), the four most important financing sources for all firms in China, in terms of firms' *fixed asset investments*, are domestic bank loans,

62. AQZZ, *Opportunities and Challenges*, *supra* note 4, at 72.
63. AQQ, *Past, Present, and Future*, *supra* note 4, at 514.
64. Allen et al., *A Review of China's Financial System*, *supra* note 48, at 11.
65. *Id.* at 14.
66. *Id.*
67. *Id.*

firms' self-fundraising, the state budget, and FDI, with self-fundraising and bank loans carrying most of the weight. Self-fundraising, falling into the category of alternative finance (non-bank, non-market finance), includes proceeds from capital raised from *local* governments (beyond the state budget), communities, and other investors; internal financing channels such as retained earnings; and all other funds raised domestically by the firms. It is important to point out that equity and bond issuance, which are included in self-fundraising (but fall into the category of formal external finance), apply only to the Listed Sector, and account for a small fraction of this category.[68]

While the Listed Sector has been growing rapidly, SOEs are on a downward trend, as privatization of these firms is still in progress.[69] Around 30% of the funding for publicly traded companies comes from bank loans, and this ratio has been very stable.[70] Around 45% of the Listed Sector's total funding comes from self-fundraising, including internal financing and proceeds from equity and bond issuance.[71] Moreover, equity and bond sales, which rely on the use of external markets, only constitute a small fraction of total funds raised in comparison to internal financing and other forms of fundraising.[72] Combined with the fact that self-fundraising is also the most important source of financing for the State Sector—around 45% to 65% of total funding—we can conclude that alternative channels of financing are important even for the State and Listed Sectors.[73]

Not surprisingly, self-fundraising plays an even more important role for firms in the Hybrid Sector, accounting for close to 60% of total funds raised, while individually owned companies—a subset of the Hybrid Sector—rely on self-fundraising for 90% of total financing.[74] Self-fundraising includes all forms of internal finance, capital raised from family and friends of the founders and managers, and funds raised in the form of private equity and loans.[75] Since firms in this sector operate in an environment with legal and financial mechanisms and regulations that are likely poorer than those available for firms in the State and Listed Sectors, financing sources here may work differently from how they work in the State and Listed Sectors, and may also work differently from self-fundraising conducted in developed countries.[76]

68. AQZZ, *Opportunities and Challenges*, *supra* note 4, at 73.
69. *Id.*
70. *Id.*
71. *Id.*
72. *Id.*
73. *Id.* at 73–74.
74. *Id.* at 74.
75. *Id.*
76. *Id.*

II. The Banking and Intermediation Sector

In this section, we examine the status of China's banking and intermediation sector. After reviewing aggregate evidence on bank deposits and loans, we review evidence on the growth of non-state banks and financial intermediaries.

A. Aggregate Evidence on Bank Deposits and Loans

As in other Asian countries, China's household savings rates have been high throughout the reform era.[77] Given the growth of the economy, the sharp increase in personal income, and limited investment opportunities, it is not surprising that total bank deposits from individuals have been growing quickly since the mid-1980s.[78] From Figure 2-A, residents in metropolitan areas contribute the most to total deposits beginning in the late 1980s, while deposits from enterprises (including firms from all three sectors) provide the second largest source. The role of deposits from government agencies and organizations (including non-profit and for-profit organizations, not shown in the figure) has steadily decreased over time.[79]

77. *Id.*
78. *Id.*
79. *Id.*

Table 2-A: Comparisons of Total Savings and Deposits (in US$ billions)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
China															
Demand deposits[a]	320	391	465	533	647	777	899	1030	1265	1671	1931	2683	3337	3778	4038
Savings deposits[b]	606	674	722	820	961	1143	1445	1748	2069	2363	3187	3811	4556	5575	6540
Time deposits[c]	100	114	136	171	199	253	307	410	676	878	1205	1661	2153	2633	3115
Time & Savings Dep/GDP	68%	73%	72%	75%	80%	85%	91%	95%	101%	92%	100%	114%	111%	110%	117%
Japan															
Demand deposits[a]	1793	2259	2073	1838	2567	3523	3795	3541	3523	3683	4560	-	-	-	-
Time, savings & foreign currency deposits	7921	8997	8059	5351	5383	5416	5448	4642	4536	4778	6160	-	-	-	-
Time & Savings Dep/GDP	181%	185%	184%	142%	131%	118%	114%	109%	106%	106%	110%	-	-	-	-
South Korea															
Demand deposits[a]	18	22	23	27	36	38	46	54	67	66	50	63	68	71	80
Time, savings & foreign currency deposits	185	251	289	315	383	410	467	485	546	543	471	574	681	731	825
Time & Savings Dep/GDP	46%	54%	61%	64%	63%	64%	58%	57%	56%	52%	58%	63%	66%	68%	69%
India															
Demand deposits[a]	24	28	31	32	35	44	60	71	89	114	96	119	145	122	118
Time, savings & foreign currency deposits	140	161	175	198	235	277	333	368	460	647	653	800	983	987	1079
Time & Savings Dep/GDP	34%	36%	39%	42%	45%	45%	45%	45%	47%	51%	56%	58%	57%	59%	59%

Source: IMF and CEIC database

Notes: [a]: Demand deposits, balance of the accounts can be withdrawn on demand of customers (e.g., check-writing); [b]: Savings deposits, interest-bearing accounts that can be withdraw but cannot use as Money (e.g., no checking writing); [c]: Time deposits, savings accounts or CD with a fixed term.

Table 2-B: Breakdown of Bank Loans (end-of-year figures in RMB billions)

Year	Total Loans	Short-term Loans	Industrial Loans	Commercial Loans	Infrastructure Construction Loans	Agricultural Loans	Loans to TVEs	Privately Owned Firms	Joint Ventures & Cooperative Firms
1994	3,997.60	2,694.87	994.83	1,050.98	61.72	114.39	200.24	15.59	79.23
1995	5,054.41	3,337.20	1,177.47	1,283.71	79.93	154.48	251.49	19.62	99.91
1996	6,115.66	4,021.00	1,421.33	1,533.26	97.38	191.91	282.19	27.98	134.63
1997	7,491.41	5,541.83	1,652.66	1,835.66	159.11	331.46	503.58	38.67	189.10
1998	8,652.41	6,061.32	1,782.15	1,975.24	162.87	444.42	558.00	47.16	248.75
1999	9,373.43	6,388.76	1,794.89	1,989.09	147.69	479.24	616.13	57.91	298.58
2000	9,937.11	6,574.81	1,701.93	1,786.85	161.71	488.90	606.08	65.46	304.98
2001	11,231.47	6,732.72	1,863.67	1,856.34	209.96	571.15	641.30	91.80	326.35
2002	13,129.39	7,424.79	2,019.05	1,797.31	274.80	688.46	681.23	105.88	269.74
2003	15,899.62	8,366.12	2,275.60	1,799.44	300.21	841.14	766.16	146.16	256.94
2004	17,819.78	8,684.06	2,389.66	1,707.41	278.01	984.31	806.92	208.16	219.84
2005	19,469.04	8,744.92	2,251.67	1,644.76	298.37	1,152.99	790.18	218.08	197.53
2006	22,534.72	9,853.44	2,865.4	1,667.15	361.26	1,320.82	622.20	266.76	183.27
2007	26,169.09	11,447.79	3,362.33	1,783.33	374.19	1,542.93	711.26	350.77	206.91
2008	30,339.46	12,518.17	3,614.29	1,773.22	368.46	1,762.88	745.4	422.38	227.08
2009	39,968.48	14,661.13	3,876.92	1,948.33	364.68	2,162.25	902.9	712.10	218.03
2010	47,919.56	16,623.34	–	–	–	–	–	–	–
2011	54,794.67	20,313.26	–	–	–	–	–	–	–
2012	62,990.96	24,827.28	–	–	–	–	–	–	–

Source: Statistical Yearbooks of China, CEIC database (1985 - 2012)

Figure 2-A: Sources for Bank Deposits in China

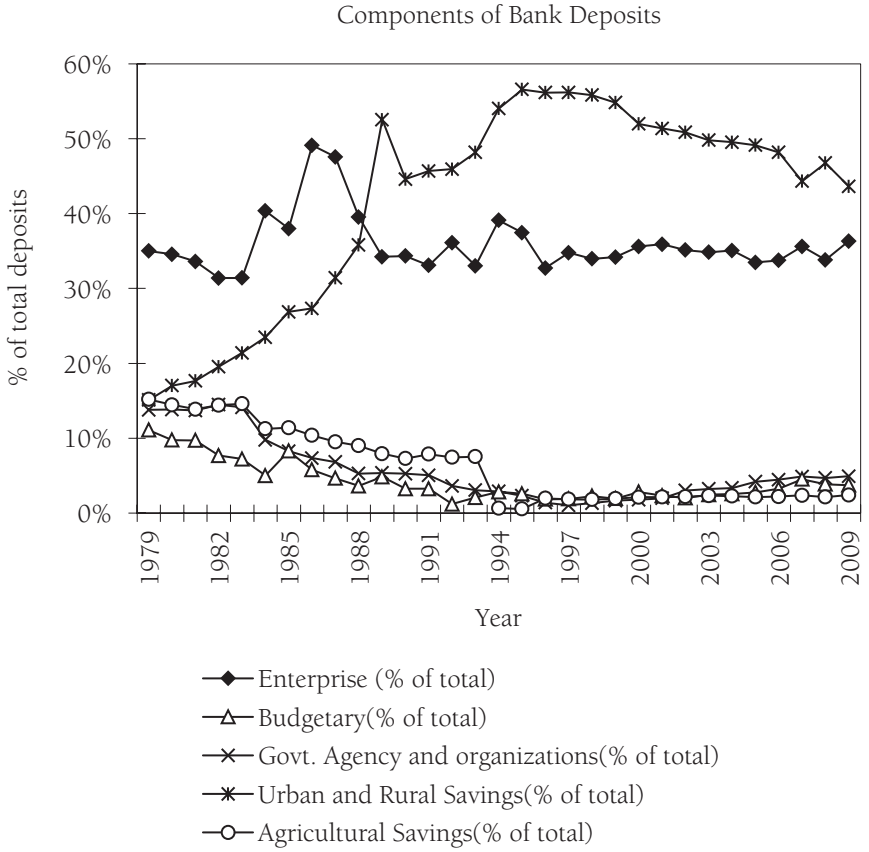


Table 2-A compares total savings and bank deposits in China, Japan, South Korea, and India, during the period of 1997-2012. In terms of the ratio of Time and Savings Deposits/GDP, China maintains the highest or second highest level (an average of over 90% in recent years), while Japan leads the group in terms of total amount. Looking at the breakdown of bank deposits, interest-bearing "savings deposits" are by far the most important form of deposits in China, providing a good source for bank loans and other forms of investment. Figure 2-B compares total (non-state) bank credit (over GDP) extended to Hybrid Sector firms in China and privately owned firms (including those publicly listed and traded) in Taiwan and South Korea. For South Korea, we also plot the bank credit ratios during its high economic growth period of the 1970s and 1980s (each year appearing on the horizontal axis indicates the time period for China, while a particular year *minus* 20 indicates the time period for South Korea). We can see that the scale and growth of China's 'hybrid' bank credit during 1991-2009 are far below that of the private bank credit of Taiwan and South Korea in the same period, but are similar to those of South Korea twenty years ago.

Figure 2-B: Comparing Total Bank Credit extended to private/hybrid sectors

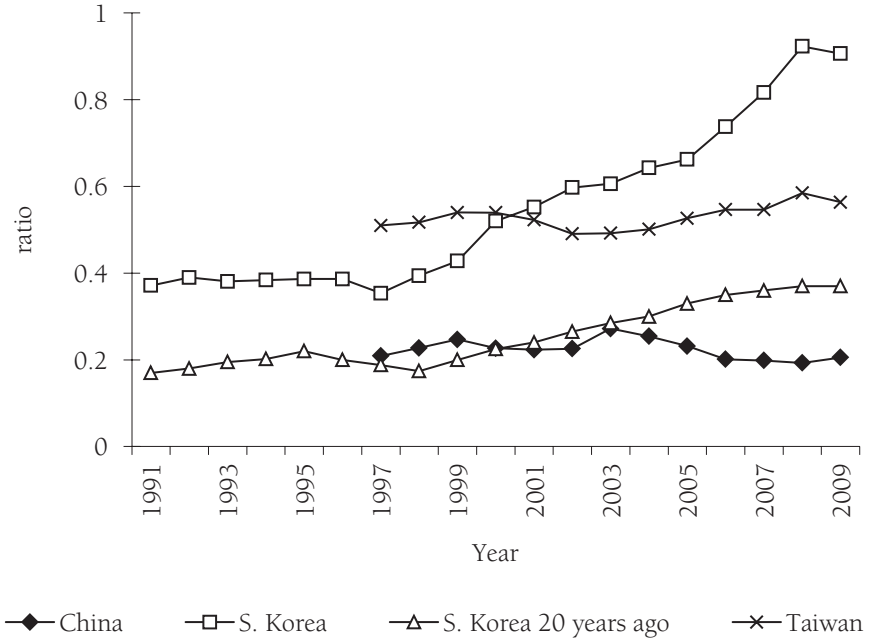


Table 2-B breaks down China's bank loans by maturities, loan purposes, and borrower types during the period of 1994–2012.[80] While there has been a shift from short-term to long-term loans (first two columns), the majority of loans goes to SOEs in manufacturing industries (Industrial Loans and Commercial Loans).[81] Most of the "Infrastructure/Construction Loans" (a small component of total loans) fund government sponsored projects, while the size of "Agricultural Loans" is much smaller.[82] More importantly, the size of loans made to TVEs, privately- and collectively-owned firms, and joint ventures (last three columns), all of which belong to the Hybrid Sector, is also much smaller.[83]

B. Growth of Non-state Financial Intermediaries

The development of both non-state banks and other (state and non-state) financial institutions will allow China to have a stable and functioning banking system in the future.[84] In addition to boosting the overall efficiency of the banking system, these financial institutions provide funding

80. We have not been able to obtain the continuous data under the old classification since 2010 because the PBOC changed the breakdown method of bank loans in terms of loan purposes and borrower types at that time.

81. *Id.*

82. *Id.*

83. *Id.* at 76–77.

84. *See generally* International Bank for Reconstruction and Development, *China: Financial Sector Assessment*, World Bank 6 (2011).

to support the growth of the Hybrid Sector.[85]

Recent Development of Shadow Banking

Due to the strong demand of capital by the real economy, shadow banking—which includes trust loans, entrusted loans, loans by small-scale lending companies, corporate bonds, and informal finances, etc.—has been growing rapidly since 2009.[86] We will leave the development of corporate bonds for Part IV and informal financing for Part V. In this part we will elaborate on trends of trust loans, entrusted loans and loans by small-scale lending companies. The growth of banks' wealth management products also reflects the development of the shadow banking system.[87] However, here we do not include wealth management products into shadow banking as this would involve double counting.

Due to the limited loan quota of the banking system and the strong demand of capital by the real economy, financing through shadow banking has been growing rapidly since 2009.[88] First, we examine the entrusted loans, trust loans and corporate bonds, all of which are included in the total social financing. The term Total Social Financing (TSF), first introduced by the governor of the PBOC, Xiaolian Hu, in her speech on December 24, 2010, is a liquidity measure which covers loans in local currency, loans in foreign currency, entrusted loans, trusted loans, bank acceptance bills, net corporate bond financing, and non-financial enterprise equity financing.[89] The PBOC elaborated on the statistics' details and the meanings of this term in *China's Monetary Policy Report Quarter Four of 2010* in January 2011,[90] and it started to publish monthly data for this indicator. Since then, this indicator has been seen as one of the most important monetary indicators in China, because traditional monetary indicators such as M2 fail to take all of the social financing sources into account.[91] Table 3-A describes the breakdown of China's total social financing from 2002 to

85. *See* Allen et al., *supra* note 4, at 3–4.

86. *See* Kate Mackenzie, *Deflating Shadow Credit in China*, FIN. TIMES (Feb. 27, 2013), http://ftalphaville.ft.com/2013/02/27/1397152/deflating-shadow-credit-in-china.

87. *Id.*

88. Jamil Anderlini, *Into The Shadows: Risky Business, Global Threat*, FIN. TIMES (June 15, 2014), http://www.ft.com/intl/cms/s/2/a123375a-d774-11e3-a47c-00144feabdc0.html#axzz3Ffw4w9Vp.

89. *See* COUNTRY REPORT NO. 14/235: PEOPLE'S REPUBLIC OF CHINA, INTERNATIONAL MONETARY FUND 42 (2014).

90. The term Total Social Financing (TSF), is defined by the PBOC as the total funds that the real economy obtained from the financial system over a certain period of time. It measures money offered by domestic suppliers, including financial institutions, Chinese households and non-financial entities. Thus, it offers a view of both borrowers and lenders. It also excludes proceeds from government bonds, which are used for government spending and deficit coverage, as well as all foreign-related items, such as foreign direct investment (FDI) and overseas debt. *See* Bob Davis, *Slower China Credit Is a Risk to Growth*, WALL ST. J. (June 9, 2013), http://online.wsj.com/news/articles/SB10001424127887324299104578534340906234614.

91. *See generally* Zhou Xiaochuan et al., THE PEOPLE'S BANK OF CHINA ANNUAL REPORT 2010 (2011), *available at* http://www.pbc.gov.cn/image_public/UserFiles/english/upload/File/Annual%20Report%202010.pdf.

2012. During that period, trust loans, entrusted loans, and net corporate bond financing ranked in the top three sources for social financing in terms of average annual growth, with the rate of 58.0%, 53.7%, and 51.0%, respectively.[92] The average annual growth rate of total social financing from 2002 to 2012 is 22.9%, much higher than the growth rate of M2 (18.3%) and that of the outstanding bank loans (17.0%) within the same period, indicating that the other sources of financing have been growing dramatically in the recent years.[93] By 2012, loans in both local and foreign currency accounted for 57.9% of total social financing.[94] Entrusted loans, trust loans, and net corporate bond financing accounted for only 8.1%, 8.1% and 14.3%, respectively, but are on an upward trend.[95] Besides these three sources, loans by small-scale companies also have been growing rapidly since 2010.[96] By September 2013, the amount of outstanding loans by small-scale lending companies was RMB 753.5 billion.[97] The total number of small-scale lending companies grew from about 2,500 in December 2010 to 7,398 in September 2013.[98]

The high growth of credit through shadow banking is driven by the following factors. First, the bank loan quota is still restricted by the regulatory requirements.[99] Thus, the funding demand is much higher than the supply of bank loans.[100] In this situation, shadow banking has been growing rapidly to meet the demand of funds by the real economy.[101] Second, due to the restrictions on real estate loans, the funding demand in real estate and for local government financing platforms cannot be satisfied.[102] In this case, those real estate enterprises can only get funds through trust loans or other sources.[103] Third, the growth rate of bank deposits was

92. *See* Monetary Policy Analysis Group of the People's Bank of China, China Monetary Policy Report, Quarter Four, 2012, The People's Bank of China 5–6 (2013), *available at* http://www.pbc.gov.cn/image_public/UserFiles/english/upload/File/%E8%B4%A7%E5%B8%81%E6%94%BF%E7%AD%96%E6%8A%A5%E5%91%8A(1).pdf.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* at 5–7.

97. Due to the fast growth of small-scale lending companies, the PBOC started to release the quarterly report on small-scale lending companies since the fourth quarter of 2010. *See generally* Micro Credit Company Statistics by Provinces (Municipalities) (2013), The People's Bank of China, *available at* http://www.pbc.gov.cn/publish/english/955/2013/20131030084112766413637/20131030084112766413637.html [hereinafter Micro Credit Company Statistics].

98. *See China Microfinance*, *Micro-Credit Companies*, Micro Finance China, *available at* http://www.microfinancechina.org/micro-credit-companies.html; Micro Credit Company Statistics, *supra* note 97.

99. *See generally* Margaret K. Lewis, *Criminal Law Pays: Penal Law's Contribution to China's Economic Development*, 47 Vand. J. Transnat'l L. 371, 423–24 (2014).

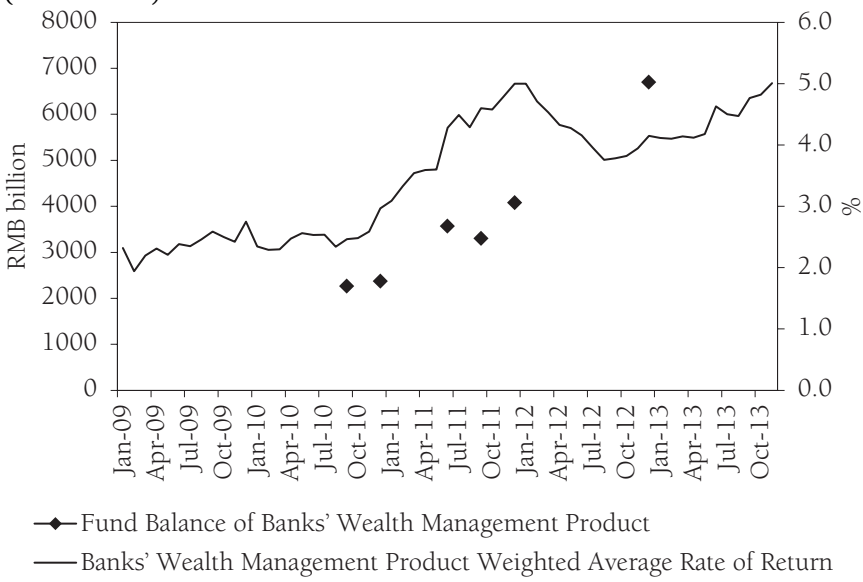
100. *See id.*

101. *See* Jiang, *supra* note 16.

102. *See generally* Chinese Shadow Banking: Understanding KRIs and Risk Scenarios, Thomson Reuters Accelus, *available at* http://accelus.thomsonreuters.com/whitepaper/chinese-shadow-banking-understanding-kris-and-risk-scenarios.

103. *See id.*

Figure 2-C: Recent Growth of Banks' Wealth Management Products (2009–2013)



much lower than that of bank loans for a long period starting from 1979, except the years of 1984 to 1986, 1988, and 1997.[104] Since 2009, the opposite situation has started to take place.[105] This is partly due to the restricted deposit interest rate and the relatively higher required return of financial assets by Chinese households, and also partly due to the drop of trade surplus and capital inflows after 2009.[106] In order to meet the requirement of the ratio of loan to deposit (LTD) set by the CBRC, banks have to raise funds by issuing wealth management products.[107]

104. *See generally* AQZZ, *Opportunities and Challenges*, *supra* note 4, at 63–138.

105. *See generally* Allen et al., *The IPO of Industrial and Commercial Bank of China and the 'Chinese Model' 'of Privatizing Large Financial Institutions*, EUR. J. FIN. (2012).

106. *See id.* at 93.

107. *See generally The People's Bank of China Annual Report 2012*, THE PEOPLE'S BANK OF CHINA (2013), *available at* http://www.pbc.gov.cn/publish/english/4133/2013/20130829090453489508948/20130829090453489508948.html.

Table 3-A: Breakdown of Total Social Financing in China (RMB billion)

Year	Total amount of Social Financing	Loan in Local Currency	Loan in Foreign Currency	Entrusted Loan	Trust Loan	Bank Acceptance Bill	Net Corporate Bond Financing	Non-financial Enterprise Equity Financing
2002	2,011.2	1,847.5	73.1	17.5		(69.5)	36.7	62.8
2003	3,411.3	2,765.2	228.5	60.1		201.1	49.9	55.9
2004	2,862.9	2,267.3	138.1	311.8		(29.0)	46.7	67.3
2005	3,000.8	2,354.4	141.5	196.1		2.4	201.0	33.9
2006	4,269.6	3,152.3	145.9	269.5	82.5	150.0	231.0	153.6
2007	5,966.3	3,632.3	386.4	337.1	170.2	670.1	228.4	433.3
2008	6,980.2	4,904.1	194.7	426.2	314.4	106.4	552.3	332.4
2009	13,910.0	9,594.2	926.5	678.0	436.4	460.6	1,236.7	335.0
2010	14,019.0	7,945.1	485.5	874.8	386.5	2,334.6	1,106.3	578.6
2011	12,829.0	7,471.5	571.2	1,296.2	203.4	1,027.1	1,365.8	437.7
2012	15,763.0	8,203.8	916.3	1,283.8	1,284.5	1,049.9	2,255.1	250.8

Source: Aggregate Statistics from the People's Bank of China (China's Central Bank) and CEIC, 2002 - 2012.

Table 3-B: State-owned and Private Banks in China (RMB billion)

Types of Banks	Total Assets	Total Deposits	Outstanding Loans	Profit[1]	NPL rate (%)
			2012		
Big Five Banks	60,040.0	–	–	754.6	1.0
Other Commercial Banks	35,874.0	–	–	–	–
1) Joint Equity	23,527.0	–	–	136.8	0.7
2) City Commercial Banks	12,347.0	–	–	252.6	0.8
Foreign Banks	2380.4	1307.2	–	16.34	0.5
Urban Credit Cooperatives	–	3.3(-Sep.)	–	–	–
Rural Credit Cooperatives	7,953.5	5,974.0	–	65.4	–
			2011		
Big Five Banks	53,634.0	–	–	664.7	1.1
Other Commercial Banks	28,363.5	–	–	–	–
1) Joint Equity	18,379.0	–	–	200.5	0.6
2) City Commercial Banks	9,984.5	–	–	108.1	0.8
Foreign Banks	2153.5	1220.2	934.63	16.7	0.4
Urban Credit Cooperatives	3.0	5.5	3.46	0.02	–
Rural Credit Cooperatives	7,204.7	5,570.3	3955.12	53.1	–
			2010		
Big Five Banks	46,894.0	–	–	515.1	1.3
Other Commercial Banks	22,756.6	–	–	–	–
1) Joint Equity	14,904.0	–	–	135.8	0.7
2) City Commercial Banks	7,852.6	–	–	77.0	0.9
Foreign Banks	1742.3	967.7	818.54	11.9	0.5
Urban Credit Cooperatives	2.2	9.7	6.78	0.01	–
Rural Credit Cooperatives	6,391.1	5,050.0	3601.63	23.3	–
			2009		
Big Five Banks	40,089.0	29,506.5	20,151.7	400.1	1.8
Other Commercial Banks	17,465.0	15,041.5	9,606.6	–	–
1) Joint Equity	11,785.0	10,548.7	6,707.4	92.5	1.0
2) City Commercial Banks	5,680.0	4,492.8	2,899.2	49.7	1.3
Foreign Banks	1,349.2	668.8	727.1	6.5	0.9
Urban Credit Cooperatives	27.2	39.5	–	0.2	–
Rural Credit Cooperatives	5,492.5	4,742.1	5,421.3	22.8	–
			2008		
Big Five Banks	31,836.0	23,696.1	15,029.3	354.2	2.8
Other Commercial Banks	12,941.2	11,072.2	7,162.4	–	–
1) Joint Equity	8,809.2	7,801.8	5,054.5	84.1	1.3
2) City Commercial Banks	4,132.0	3,270.4	2,107.9	40.8	2.3
Foreign Banks	1,344.8	533.5	762.1	11.9	0.8
Urban Credit Cooperatives	80.4	76.2	–	0.62	–
Rural Credit Cooperatives	5,211.3	4,173.6	3,753.2	21.9	–
			2007		
Big Five Banks	28,007.0	20,067.7	13,850.9	246.6	8.05
Other Commercial Banks	10,589.9	9,023.3	5,684.4	–	–
1) Joint Equity	7,249.4	6,432.0	4,001.9	56.4	2.15
2) City Commercial Banks	3,340.5	2,591.4	1,682.6	24.8	3.04
Foreign Banks	1,252.5	390.0	700.0	6.1	0.46
Urban Credit Cooperatives	131.2	134.1	84.7	0.77	–
Rural Credit Cooperatives	4,343.4	3,534.9	3,256.1	19.3	–

			2006		
Big Five Banks	24,236	18,285.1	11,426.2	197.5	9.22
Other Commercial Banks	8,038.4	7512.8	5526.6	–	–
1) Joint Equity	5,444.6	5,396.5	4,156.9	43.4	2.81
2) City Commercial Banks	2,593.8	2,116.2	1,369.7	18.1	4.78
Foreign Banks	927.9	244.0	485.9	5.8	0.78
Urban Credit Cooperatives	183.1	157.9	100.7	1.0	–
Rural Credit Cooperatives	3,450.3	3,040.2	2,747.6	18.6	–
			2005		
Big Five Banks[2]	21,005.0	16,283.8	10,224.0	156.1	10.49
Other Commercial Banks	6,502.2	6,261.1	4,576.6	–	–
1) Joint Equity	4,465.5	4,570.0	3,487.7	28.9	4.22
2) City Commercial Banks	2,036.7	16,91.2	1,088.9	12.1	7.73
Foreign Banks	715.5	179.3	363.8	3.7	1.05
Urban Credit Cooperatives	203.3	181.3	113.1	0.9	–
Rural Credit Cooperatives	3,142.7	2,767.4	2,319.9	12.0	–
			2004		
Big Four Banks	16,932.1	14,412.3	10,086.1	45.9	15.57
Other Commercial Banks	4,697.2	4,059.9	2,885.9	50.7	4.93
1) Joint Equity	–	–	–	17.6	5.01
2) City Commercial Banks	1,693.8	1,434.1	904.5	8.5	11.73
Foreign Banks	515.9	126.4	255.8	18.8	1.34
Urban Credit Cooperatives	171.5	154.9	97.9	0.4	–
Rural Credit Cooperatives	3,101.3	2,734.8	1,974.8	9.65	–
			2003		
Big Four Banks	16,275.1	13,071.9	9,950.1	196.5	19.74
Other Commercial Banks	3,816.8	3,286.5	2,368.2	–	7.92
1) Joint Equity				14.6	6.5
2) City Commercial Banks	1,465.4	1,174.7	774.4	5.4	14.94
Foreign Banks	333.1	90.7	147.6	18.1	2.87
Urban Credit Cooperatives	148.7	127.1	85.6	0.01	–
Rural Credit Cooperatives	2,674.6	2,376.5	1,775.9	4.4	–
			2002		
Big Four Banks	14,450.0	11,840.0	8,460.0	71.0	26.1
Other Commercial Banks	4,160.0	3,390.0	2,290.0	–	–
1) Joint Equity	2,990.0	–	–	–	9.5
2) City Commercial Banks	1,170.0	–	–	–	17.7
Foreign Banks	324.2	–	154.0	15.2	–
Urban Credit Cooperatives	119.0	101.0	66.4	–	
Rural Credit Cooperatives	–	1,987.0	1,393.0	–	–
			2001		
Big Four Banks	13,000.0	10,770.0	7,400.0	23.0	25.37
Other Commercial Banks	3,259.0	2,530.7	1,649.8	12.9	–
1) Joint Equity	2,386.0	1,849.0	1,224.0	10.5	12.94
2) City Commercial Banks	873.0	681.7	425.8	2.4	–
Foreign Banks	373.4	–	153.2	1.7	–
Urban Credit Cooperatives	128.7	107.1	72.5	2.6	–
Rural Credit Cooperatives	–	1,729.8	1,197.0	–	–

Table 3-B Notes:
1. It is before tax profit up to 2006, and after tax profit from 2006-2012.
2. Big four (stated owned) banks refer to Bank of China, China Construction Bank, Industrial and Commercial Bank of China, and Agricultural Bank of China. Big five banks are the Big four Banks and the Bank of Communications.
Source: Almanac of China's Finance and Banking 2000-2012, CEIC data base, Quarterly Monetary Report of PBOC.

Table 3-C: Comparison of Assets Held by China's Non-Bank Intermediaries (RMB billion)

This table compares *total assets* held by banks and non-bank intermediaries during the period 1995-2012.

Year	State-owned Banks	RCCs	UCCs	Insurance Companies	TICs	Non-deposit Intermediaries	Other Commercial Banks	Foreign Banks
1995	5,373.3	679.10	303.92	–	458.60	48.97	536.91	42.90
1996	6,582.7	870.66	374.78	–	563.70	82.02	769.98	55.30
1997	7,914.4	1,012.20	498.94	–	636.40	100.42	948.61	75.80
1998	8,860.9	1,143.11	560.63	–	802.50	120.97	1,128.18	118.40
1999	9,970.6	1,239.24	630.15	260.4	907.50	137.08	1,376.89	191.40
2000	10,793.7	1,393.06	678.49	337.4	975.90	160.82	1,828.26	379.20
2001	11,188.2	1,610.80	780.02	459.1	1,088.30	223.67	2,255.70	341.80
2002	13,549.6	2,205.21	119.23	649.4	1,544.10	408.10	2,997.72	317.90
2003	16,275.1	2,674.62	148.72	912.3	–	495.58	3,816.80	331.10
2004	16,932.1	3,103.30	171.50	1,185.4	–	–	4,697.20	515.90
2005	21,005.0	3,142.7	203.3	1,529.6	–	–	6,502.2	715.5
2006	24,236.0	3,450.3	183.1	1,973.1	–	–	8,038.4	927.9
2007	28,007.0	4,343.4	131.2	2,900.4	–	–	10,589.9	1,252.5
2008	31,836.0	5,211.3	80.4	3,341.8	–	–	12,941.2	1,344.8
2009	40,089.0	5,492.5	27.2	4,063.5	–	–	17,465.0	1,349.2
2010	46,894.0	6,391.1	2.2	5,048.2	–	–	22,756.6	1,742.3
2011	53,634.0	7,204.7	3	6,013.8	–	–	28,363.5	2,153.5
2012	60,040.0	7,953.5	–	7,354.6	–	–	35,874.0	2,380.4

Source: Aggregate Statistics from the People's Bank of China (China's Central Bank) and CEIC, 2000 - 2012.

Development of Other Non-state Banks

Table 3-B provides a (partial) breakdown of the different types of banks. Although the largest four or five banks (the fifth largest bank is the Bank of Communications, also state-owned) dominate in every aspect of the banking sector during the period of 2001–2012, the role of other banks in the entire banking sector cannot be ignored.[108] Table 4-C provides evidence on the growth of non-bank intermediaries. Overall, the growth of these non-bank intermediaries has been impressive since the late 1990s.[109] Among them, "other commercial banks" (many are state-owned), RCCs, and TICs hold the largest amount of assets; the size of foreign banks and mutual funds (not listed in the table) is minuscule, but these are likely to be the focus of development in the near future.[110] In an effort to boost lending to the private sector and improve competition in the banking system, the CBRC granted private capital the same entry standards to the banking industry as other capital in May 2012.[111] The CBRC indicated that private companies may buy into banks through private stock placements, new share subscription, equity transfers, and mergers and acquisitions.[112] Further, private investment is also welcomed in trust, financial leasing, and auto-financing companies.[113] As a development on this front, after the Third Plenum of the 18th CPC Central Committee in November 2013, the government also allowed private investors that meet certain requirements to set up small and medium-sized banks and other financial institutions.[114] Finally, our coverage of non-bank financial institutions excludes various forms of informal financial intermediaries, some of which are deemed illegal but overall provide a considerable amount of financing to firms in the Hybrid Sector.

III. Financial Markets

In this section, we examine China's financial markets, including the stock markets, and the recent addition of venture capital and private equity markets as well as asset management industries. We also compare, at the aggregate level, how firms raise funds in China and in other emerging economies through external markets in order to determine if China's expe-

108. AQZZ, *Opportunities and Challenges*, *supra* note 4, at 64.

109. *See generally* AQZZ, *Opportunities and Challenges*, *supra* note 4.

110. Postal savings, which are deposit-taking institutions affiliated with local post offices, constitute another form of non-bank intermediation that is not reported in Table 3-B due to a lack of time series data. However, at the end of 2008, total deposits within the postal savings system exceeded RMB 2079 billion, or 9.5% of all deposits in China. *See* MICHAEL MARTIN, CONG. RESEARCH SERV., R42380, CHINESE BANKING SYSTEM: ISSUES FOR CONGRESS 5 (2012).

111. *See* Grant Turner, Nicholas Tan & Dena Sadeghian, *The Chinese Banking System*, RESERVE BANK OF AUSTRALIA BULLETIN 57–58 (Sept. 2012).

112. *Id. at* 58–60.

113. *Id.*

114. *See* John Howkins, *Guest Post: The Third Plenum and Cultural Industries*, FIN. TIMES (Nov. 26, 2013, 4:30 AM), http://blogs.ft.com/beyond-brics/2013/11/26/guest-post-the-third-plenum-and-cultural-industries.

rience is unique. We then briefly review publicly traded companies' financing and investment decisions. Finally, we discuss the further development of financial markets as well as corporate governance and the performance of listed firms.

A. Overview of Stock Markets

After the introduction of China's domestic stock exchanges in 1991, the SHSE and SZSE initially underwent rapid growth.[115] However, in the long run they have not done so well.[116] Figure 3 compares the performance of some of the major stock exchanges around the world, as measured by the "buy-and-hold" return in the period January 1992 and December 2013.[117] The figure plots inflation-adjusted real returns. Over this period, the performance of the value-weighted SHSE index (the calculation for the SZSE is similar) is below that of the DAX (Germany), which has the best performance among the group, and that of the S&P 500 (U.S.), FTSE (U.K.), CAC (France), and only slightly better than the Nikkei Index (Japan), the worst among the group. By the end of 2013 it was at about the same level in real terms as at the start of 1992.

Table 4-A: A Comparison of the Largest Stock Markets in the World in December 2013

Ranking	Stock Exchange	2013 Dec Market cap US bn	2013 Dec share turnover
1	NYSE Euronext (US)	17,950	70.9%
2	NASDAQ OMX (US)	6,085	144.6%
3	Tokyo SE Group	4,543	129.6%
4	London SE Group	4,428	46.5%
5	NYSE Euronext (Europe)	3,584	355.2%
6	**Hong Kong Stock Exchange**	**3,101**	**40.9%**
7	**Shanghai SE**	**2,497**	**151.6%**
8	TMX Group	2,114	62.6%
9	Deutsche Börse	1,936	67.8%
10	SIX Swiss Exchange	1,541	45.4%
11	**Shenzhen SE**	**1,452**	**269.3%**
12	Australian SE	1,387	57.7%
	China (SHSE, SZSE, HKSE)	7,050	127.14%

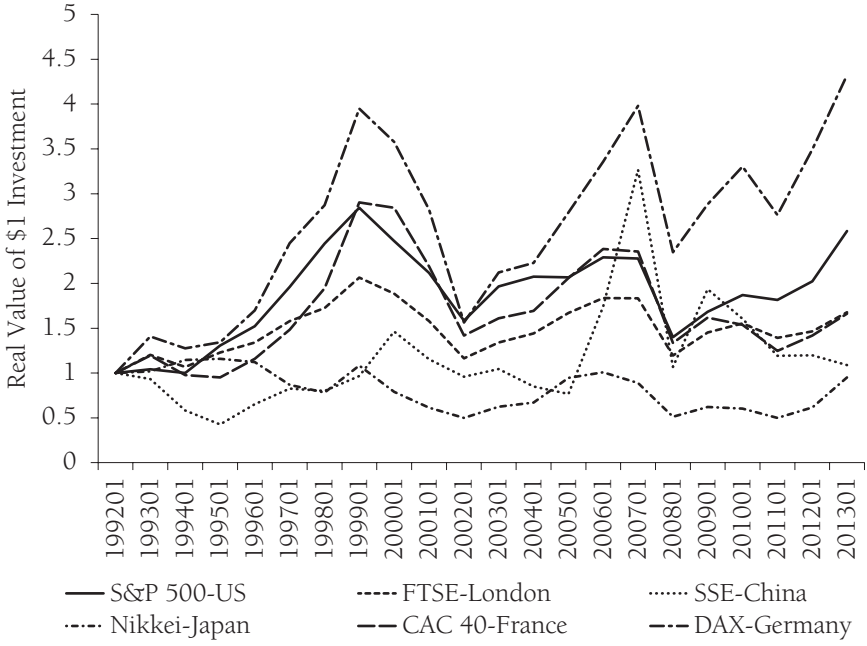
Notes: All figures are from http//:www.world-exchanges.org, the web site of the international organization of stock exchanges. Turnover velocity is the total turnover of domestic stocks for the year expressed as a percentage of the total market capitalization.

115. *See* Sonia L. Wong, *China's Stock Market: A Marriage of Capitalism and Socialism*, 26 CATO J. 389, 389 (2006), *available at* http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2006/11/cj26n3-1.pdf.

116. *See generally* Gao, *supra* note 11.

117. This is the gross return at December 2013 from 1 unit of currency invested in each of the valued-weighted stock indexes at the beginning of 1992.

Figure 3: A Comparison of Performance of Major Stock Indexes (Buy-and-hold returns of $1 between Jan. 1992 and Dec. 2013)



As Table 4-A indicates, at the end of 2013, the SHSE was ranked the seventh largest market in the world in terms of market capitalization, while the SZSE was ranked the eleventh. The Hong Kong Stock Exchange (HKSE), where selected firms from mainland China have been listed and traded, was ranked the seventh largest in the world. Needless to say, the Chinese financial markets will play an increasingly important role in world financial markets.[118] Also from Table 4-A, "turnover velocity" is the annual total turnover for all the listed firms expressed as a percentage of the total market capitalization, and the figures for SZSE and SHSZ are among the highest, suggesting that there is a large amount of speculative trading especially among small- and medium-cap stocks in the Chinese markets, as these stocks are more easily manipulated than large cap stocks.[119]

There are two other markets established to complement the two main exchanges.[120] First, a fully electronically-operated market ("*Er Ban Shi Chang*" or "Second-tier Market," similar to the NASDAQ) for Small and

118. *See* Carpenter et al., *supra* note 13.

119. *See* Lily Fang, Jun Qian & Huiping Zhang, Out of the Limelight but in Play: Trading and Liquidity of Media and Off-media Stocks 21–22 (Jan. 28, 2012) (unpublished) (on file with Social Science Research Network), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1964440.

120. *See* Robert Cookson, *Chinese IPOs: Bumper Year Raises Expectation for 2010*, FIN. TIMES (Feb. 2, 2010, 4:05 PM), http://www.ft.com/intl/cms/s/0/30665c74-0ed1-11df-bd79-00144feabdc0.html#axzz3Fae9rlpd.

Medium Enterprises (SMEs) was opened in June 2004.[121] It was designed to lower the entry barriers for SME firms, especially newly established firms in the high-tech industries.[122] By the end of February 2007, there were 119 firms listed in this market.[123] Second, *San Ban Shi Chang* or "Third-tier Market" was established to deal primarily with de-listing firms and other over-the-counter (OTC) transactions.[124] Since 2001, some publicly listed firms on both SHSE and SZSE that do not meet the listing standards have been delisted and the trading of their shares shifted to this market.[125] In 2006, "New Third-tier Market" (or "Xin San Ban Shi Chang") was established to deal with the equity transactions of non-listed shareholding companies' in a high-tech zone (with the name of "Zhong Guan Cun") in Beijing.[126] The companies on this market can be transferred to the GEM or small and medium-sized plate if approved by the CSRC.[127] On October 23, 2009, China launched a NASDAQ-style Growth Enterprises Market (GEM, or "Chuang Ye Ban") with 28 companies that were mainly from the hi-tech, electronic, and pharmaceutical industries.[128] The main purpose of GEM is to provide financing for small and medium sized private enterprises.[129] The first ten firms seeking to list on the GEM drew a combined RMB 784 billion in subscriptions in September 2009, while the second and third sets had eighteen firms, including Huayi Brothers Media, China's largest privately owned film company.[130] In June and August 2010, the SZSE started to release the index of GEM— ChiNext and ChiNext Composite, respectively.[131] Since 2012, the development of China's stock

121. *See* Alexandra Harney & Richard McGregor, *Fish Eyes and Pearls in China*, FIN. TIMES (July 5, 2004, 5:00 AM), http://www.ft.com/intl/cms/s/0/e6bd76ca-ce21-11d8-95cb-00000e2511c8.html#axzz3Fae9rlpd.

122. *Id.*

123. *See* Jamil Anderlini, *On Asia: Renaissance Gives Shenzhen Added Stature*, FIN. TIMES (Aug. 3, 2007, 4:57 PM), http://www.ft.com/intl/cms/s/1/a09c3ada-41d9-11dc-8328-0000779fd2ac.html#axzz3Fae9rlpd.

124. *See No Flash Boys in China's Sleepy Over-the-Counter Markets*, BLOOMBERG NEWS (Apr. 14, 2014, 6:08 AM), http://www.bloomberg.com/news/2014-04-14/no-flash-boys-in-china-s-sleepy-over-the-counter-markets.html.

125. *See, e.g.*, Lydia Guo, *China Cosco: More Fire Sales Ahead*, FIN. TIMES (May 27, 2013, 8:55 AM), http://blogs.ft.com/beyond-brics/2013/05/27/china-cosco-more-fire-sales-ahead/ ("Cosco has fallen into this special treatment category, with its trading name changed to 'ST Cosco.' The 'ST' is a warning of delisting risk, a severe embarrassment to the state-controlled company.")

126. *See* Winnie Liu, *China's OTC Market: The Shortcut*, ASIAN VENTURE CAPITAL J. (May 28, 2014, 1:33 PM), http://www.avcj.com/avcj/analysis/2346915/chinas-otc-market-the-shortcut.

127. *Id.*

128. *See* Robert Cookson, *Demand Swamps New Chinese Exchange*, FIN. TIMES (Oct. 30, 2009, 4:21 PM), http://www.ft.com/intl/cms/s/0/4ca1ac3c-c56f-11de-8193-00144feab49a.html#axzz3Fae9rlpd. Note that GEM is also commonly referred to as "ChiNext." *See* Emma Saunders, *Economic News Digest*, FIN. TIMES (Nov. 2, 2009, 1:20 PM), http://blogs.ft.com/money-supply/2009/11/02/economic-news-digest-16/.

129. *See* Cookson, *supra* note 128.

130. *See* Saunders, *supra* note 128.

131. Wei Shen, *Face Off: Is China a Preferred Regime for International Private Equity Investments - Decoding a China Myth from the Chinese Company Law Perspective*, 26 CONN. J. INT'L L. 89, 145 (2011).

market has been accelerated.[132] On July 8, 2012, the State Council approved the National Equities Exchange and Quotations to extend the "new third-tier market" to a nation-wide market in Beijing, Tianjin, Shanghai, and Wuhan.[133] On December 14, 2013, the State Council finally decided to enlarge the volume of the new third-tier market, allowing all kinds of small and medium enterprises to do equity transactions on this market.[134] Other recent developments in the stock market include the pilot of preference shares and the possible IPO transformation from an approval-based system to a registration-based system.[135] Preference shares are a mature species in the stock market of developed countries, whereas in China they were just promoted soon after the Third Plenary Session in November 2013.[136] Thus, the pilot program has been seen as a major innovation in China's stock market.[137] First, the pilot helps to accelerate the development of direct financing and to provide investors with more diversified investment channels.[138] Second, it helps commercial banks to innovate capital instruments to meet regulatory capital requirements, as the issue of preference shares is included in Tier-1 capital.[139] The other surprisingly aggressive reform in November 2013 for the stock market was a pledge by the central government to turn the current approval-based system of IPOs into a registration-based one, potentially removing a stumbling block that has distorted supply and demand, and artificially inflated valuations of new stock offerings.[140] The approval-based system has long been criticized as one of the fundamental deficiencies in China's stock

132. *See generally* Josh Noble, *China's Shenzhen index outshines Shanghai*, FIN. TIMES, Aug. 12, 2013, http://www.ft.com/intl/cms/s/0/3df78366-0317-11e3-9a46-00144feab7de.html#axzz3Fae9rlpd.

133. Lan Xinzhen, *Expansion of the new third board will ease financing woes*, CHINA (Jan. 3, 2014) http://www.china.org.cn/opinion/2014-01/03/content_31079761.htm.

134. *CSRC Implements the State Council Decisions on Relevant Matters Concerning National SME Share Transfer System, Marking Major Progress in the Development of Multi-tiered Capital Markets*, CHINA SEC. REGULATORY COMM'N (Dec. 14, 2013), *available at http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201401/t20140126_243284.html.*

135. *CSRC Implements the State Council's Guiding Opinions on Launching the Pilot Program for Preferred Shares*, CHINA SEC. REGULATORY COMM'N (Nov. 30, 2013), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201402/t20140211_243686.html; *CSRC Releases Opinions on Further Promoting the IPO System Reform*, CHINA SEC. REGULATORY COMM'N (Nov. 13, 2014), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201402/t20140214_243817.html.

136. *CSRC Implements the State Council's Guiding Opinions on Launching the Pilot Program for Preferred Shares*, *supra* note 135.

137. Cai Xiao, *CSRC announces rules for preferred company shares*, CHINA DAILY, Mar. 22, 2014, http://www.chinadailyasia.com/business/2014-03/22/content_15126525.html.

138. *CSRC Implements the State Council's Guiding Opinions on Launching the Pilot Program for Preferred Shares*, *supra* note 135.

139. *Id.*

140. *Q&A by CSRC Spokesperson on the Opinions on Further Promoting the IPO System Reform*, CHINA SEC. REGULATORY COMM'N (Nov. 30, 2013), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201401/t20140108_242271.html.

market.[141]

Despite rapid recent development in China's stock market, there is evidence that the market is still not efficient because prices and investor behavior are not necessarily driven by the fundamental values of listed firms.[142] For example, Morck et al. find that stock prices are more "synchronous" in the sense that stock prices move up and down together in emerging countries like China than in developed countries.[143] They attribute this phenomenon to poor minority investor protection and the imperfect regulation of markets in emerging countries.[144] In addition, there have been numerous lawsuits alleging insider trading and manipulation.[145] In many cases, unlike well-known companies in developed markets stricken by corporate scandals like Enron, managers and other insiders from Chinese companies did not use any sophisticated accounting and finance maneuvers, even by China's standards, to hide their losses.[146] These cases reveal that the inefficiencies in the Chinese stock markets can be partially attributed to poor and ineffective regulation.[147] We discuss below issues relating to regulation, market efficiency, and the further development of China's financial markets.

B. Overview of Bond Markets

Table 4-B provides information on China's bond markets. The government bond market had an annual growth rate of 22.2% during the period of 1990-2012 in terms of newly issued bonds, while total outstanding bonds reached RMB 7,199.36 billion (or $1137.7 billion) by the end of 2012.[148] The second largest component of the bond market is called "policy financial bonds." These bonds are issued by "policy banks," which operate under the supervision of the Ministry of Finance; the proceeds of bond issuance are invested in government-run projects and industries, such as infrastructure construction (similar to municipal bonds in the United States).[149] Compared to government-issued bonds, the size of the corporate bond market is relatively small. However, it has been growing quickly in recent years.[150] In terms of the amount of outstanding bonds,

141. Shen Hong et al., *Reforms Could Put China's IPO Market Back in Business* (Nov. 15, 2013), http://blogs.wsj.com/chinarealtime/2013/11/15/reforms-could-put-chinas-ipo-market-back-in-business/.

142. Franklin Allen et al., *Law, Institutions and Finance in China and India*, *in* EMERGING GIANTS 137 (Barry Eichengree et al. eds, Oxford University Press, 2010).

143. Randall Morck et al.,*The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements?*, THE NAT'L BUREAU OF ECON. RESEARCH, http://www.nber.org/china/shangmorck.pdf (last visited Oct 8, 2014).

144. *Id.* at 2.

145. Franklin Allen, Jun Qian, Meijun Qian & Mengxin Zhao, *Review of China's Financial System and Initiatives for the Future* 21 (Wharton Fin. Inst. Ctr., Working Paper No. 08-28, 2008), *available at http://ssrn.com/abstract=1185877*.

146. *Id.* at 21.

147. *Id.* at 22.

148. *See infra* Table 4-B.

149. *See Allen, supra* note 145, at 22.

150. *Id.*; *see also* Michelle Leung, *The Rise of China's Corporate Bond Market,* S&P DOW JONES INDICES, MCGRAW HILL FINANCIAL INDEXOLOGY BLOG 1 (June 18, 2014, 10:30

the size of the corporate bond market was less than one fourth of the size of the government bond market in 2008, and has grown to around 63% by 2012.[151]

The small size of the bond market, especially the corporate bond market, relative to the stock market, is common among Asian countries.[152] AQQ (2008) compares different components (bank loans to the private sectors or the Hybrid Sector of China; stock market capitalization; public/government and private/corporate bond markets) of the financial markets around the world at the end of 2003.[153] Compared to Europe and the U.S., we found that the size of both the government (public) and corporate (private) bond markets is smaller in Asia (Hong Kong, South Korea, Malaysia, Taiwan, Singapore, Indonesia, Philippines, and Thailand), excluding Japan; even in Japan, the size of the corporate bond market is much smaller compared with its government bond market.[154] We also found that the size of all four components of China's financial markets are small relative to that of other regions and countries, including bank loans made to the Hybrid Sector (private sector) in China (other countries).[155] Moreover, the most under-developed component of China's financial markets is the corporate bond market (labeled "private" bond market).[156]

C. Evidence on the Listed Sector

In this section, we briefly examine publicly listed and traded companies in China. It is worthwhile to first clarify that firms from the Hybrid Sector can become listed and publicly traded.[157] AQQ (2005) found that 80% of their sample of more than 1,100 listed firms were converted from former SOEs.[158] In recent years, the government has attempted to change the composition of listed firms by relaxing regulations toward Hybrid Sector firms, including the establishment of the recently opened GEM.[159]

PM), http://www.spindices.com/documents/education/practice-essentials-rise-of-chinas-corporate-bond-market.pdf.

151. Franklin Allen et al., *China's Financial System: Opportunities and Challenges*, 70 tbl.5-B (Nat'l Bureau of Int'l Research, Working Paper No. 17828, 2012), *available at* http://www.nber.org/papers/w17828.

152. As the IPO was suspended from October 2012 to December 2013, the total amount of the enterprise bonds issued (RMB 649.9 billion) in 2012 surpassed the total amount of capital raised in the domestic stock market (RMB 585.0 billion) for the first time in recent years. *Id.*; *see also* Allen, *supra* note 145, at 56 tbl.1.

153. Allen et. al, *supra* note 145, at 56 tbl. 1.

154. *Id.* at 56, 58 tbls.1 & 3-A pnls.A & B.

155. *Id.* at 56, 58, 61, 67 tbls.1, 3-A & 5-A figs. 4-A, 4-B, 4-C & 4-D.

156. *Id.* at 62 tbl.5-B.

157. Yǒuxiàn Zérèn Gōngsī Shèlì Dēngjì Tíjiāo Cáiliào Guīfàn (有限责任公司设立登记提交材料规范), [The Establishment of a Limited Liability Company Registered to Submit Material Specification] (promulgated SAIC Enterprise Registration Bureau) (SAIC)(China), *available at* http://www.saic.gov.cn/ywbl/bszn/nzdjzn/gsdjtjclgf/201402/t20140228_142367.html.

158. AQZZ, *Opportunities and Challenges*, *supra* note 4, at 81, 111 tbl.8-A pnl.B.

159. Xinhua, *China's Nasdaq-style GEM starts trading*, Sina English (Oct. 30, 2009), http://english.sina.com/business/p/2009/1029/281487.html; Wáng Xīn (王鑫), *Chuàngyè Bǎn Zhōngyú Zài Shēnzhèn Shǎn Liàng Kāibǎn* (*创业板终于在深圳闪亮开板*) [*GEM has finally opened in Shenzhen, shiny plate*] Shenzhen Special Zone Daily (Oct. 24,

Table 4-B: China's Bond Markets: 1990 - 2012 (Amount in RMB billion)

This table presents the development of China's bond markets. "Policy Financial Bonds" are issued by "policy banks," which belong to the Treasury Department, and the proceeds of bond issuance are invested in government run projects and industries such as infrastructure construction (similar to municipal bonds in the U.S.)

	Treasury Bonds			Policy Financial Bonds			Corporate Bonds		
Year	Amount Issued	Redemption Amount	Balance	Amount Issued	Amounts Redemption	Balance	Amounts Issued	Amounts Redemption	Balance
1990	19.72	7.62	89.03	6.44	5.01	8.49	12.4	7.73	19.54
1991	28.13	11.16	106.00	6.69	3.37	11.81	24.9	11.43	33.11
1992	46.08	23.81	128.27	5.50	3.00	14.31	68.37	19.28	82.20
1993	38.13	12.33	154.07	0.00	3.43	10.88	23.58	25.55	80.24
1994	113.76	39.19	228.64	0.00	1.35	9.53	16.18	28.20	68.21
1995	151.09	49.70	330.03	–	–	170.85	30.08	33.63	64.66
1996	184.78	78.66	436.14	105.56	25.45	250.96	26.89	31.78	59.77
1997	241.18	126.43	550.89	143.15	31.23	362.88	25.52	21.98	52.10
1998	380.88	206.09	776.57	195.02	32.04	512.11	15.00	10.53	67.69
1999	401.50	123.87	1,054.20	180.09	47.32	644.75	15.82	5.65	77.86
2000	465.70	152.50	1,367.40	164.50	70.92	738.33	8.30	0.00	86.16
2001	488.40	228.60	1,561.80	259.00	143.88	853.45	14.70	0.00	100.86
2002	593.43	226.12	1,933.60	307.50	155.57	1,005.41	32.50	0.00	133.36
2003	628.01	275.58	2,260.36	456.14	250.53	1,165.00	35.80	0.00	169.16
2004	692.39	374.99	2,577.76	414.80	177.87	1,401.93	32.70	0.00	201.86
2005	704.20	404.55	2,877.40	585.17	205.30	1,781.80	204.65	3.70	401.81
2006	888.33	620.86	3144.87	898.00	379.0	2,300.80	393.83	167.24	553.29
2007	2313.91	584.68	4874.10	1109.02	413.36	2992.68	505.85	288.09	768.33
2008	855.82	753.14	4976.78	1082.30	406.38	3668.6	843.54	327.78	1285.06
2009	1792.70	707.15	5795.00	1167.80	374.53	4481.88	1662.90	440.00	2440.59
2010	1977.83	1004.34	6768.49	1319.27	564.84	5236.32	1549.15	509.92	3467.18
2011	1710.01	1095.85	7382.65	1997.27	731.70	6501.88	2354.80	1021.56	4645.68
2012	1615.42	1798.71	7199.36	2141.50	–	–	3736.55	–	–
Yearly Growth	22.17%	28.19%	22.10%	30.21%	26.79%	37.20%	29.62%	26.18%	29.76%

Source: Aggregate Statistics from the People's Bank of China (China's Central Bank) 2000 - 2012 and the Statistical Yearbook of China 2000-2012.

Until the share reform announced in 2005 and implemented in 2006–2007, listed firms in China issued both tradable and non-tradable shares (Table 5-A).[160] The non-tradable shares were either held by the government or by other state-owned legal entities (i.e., other listed or non-listed firms or organizations).[161] Table 5-B shows that, in 2009, non-tradable shares constituted around half of all shares (53%, column 2), but fell rapidly from 2010 to 2012.[162] By the end of 2012, the non-tradable shares constituted around 24% of all shares, and the rest majority of tradable shares were Class A shares.[163] Among the tradable shares, Class A and B shares are listed and traded in either the SHSE or SZSE. Originally, Class A shares were issued to and traded by Chinese investors while Class B shares were issued to and traded by foreign investors including those from Taiwan and Hong Kong and QFIIs.[164] While the two share classes issued by the same firm are identical in terms of shareholder rights (e.g. voting and dividend rights), B shares were traded at a significant discount relative to A shares and were traded less frequently than A shares.[165] The "B share discount" has been reduced significantly since the CSRC allowed Chinese citizens to invest and trade B shares with foreign currency accounts in 2001.[166] In addition, Class H shares, issued by companies registered in mainland China and approved by the CSRC to get listed in HK, are traded on the HKSE.[167] Finally, there are N shares and S shares for firms listed in the U.S. and Singapore but operating in China (we omit discussions on these shares since they are not listed on the domestic exchanges).[168] After the share reforms discussed below government shares became G shares and are tradable.

2009), http://www.szse.cn/main/aboutus/bsyw/39740769.shtml; *see also* Cookson, *supra* note 128.

160. Andrea Beltratti, Bernardo Bortolotti & Marianna Caccavaio, *The Stock Market Reaction to the 2005 Non-Tradable Share Reform in China* 7–8 (ECB Working Paper Series, Working Paper No. 1339, May 2011), *available at* http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1339.pdf.

161. *Id.* at 8.

162. *See infra* Table 5-B.

163. *Id.*

164. Beltratti et al., *supra* note 160, at 10; *see also* Jianping Mei, Joše A. Scheinkman & Wei Xiong, *Speculative Trading and Stock Prices: Evidence from Chinese A-B Share Premia*, 10-2 ANNALS OF ECONOMICS AND FINANCE 225, 234–36 (2009).

165. Mei, Scheinkman & Xiong, *supra* note 164, 234–236 & tbl.1. Explanations of the B share discount include: 1) Foreign investors face higher information asymmetry than domestic investors, 2) lower B share prices compensate for the lack of liquidity (due to low trading volume), and 3) the A share premium reflects a speculative bubble component among domestic investors.

166. *See id.*

167. Dennis Hudachek, *The Complete Guide To Chinese Share Classes*, ETF.COM: WHITE PAPERS (Nov. 12, 2012), http://www.etf.com/sections/white-papers/15113-the-complete-guide-to-chinese-share-classes.html?showall=&fullart=1&start=5.

168. *Id.*; *see also* Yap Lian Seng & Qiu Yang, *Making SGX Attractive to S-Chips*, LEXOLOGY STAMFORD LAW CORPORATION (Aug. 18, 2014), http://www.lexology.com/library/detail.aspx?g=0db983fc-6c21-4e52-b1c3-9e3c7c08266a.

Table 5-A: Types of Common Stock Issued in China

Tradable?		Definition
No (Private block transfer possible)	**State-owned shares* (G shares after recent reform and tradable)**	Shares that are controlled by the central government during the process when firms are converted into a limited liability corporation but before listing. These shares are either managed and represented by the Bureau of National Assets Management or held by other state-owned companies, both of which also appoint firms' board members. After reforms announced in 2005 and implemented in 2006-7 state shares became G shares and are tradable.
	Entrepreneur's shares	Shares reserved for firms' founders during the same process described above; different from shares that founders can purchase and sell in the markets.
	Foreign owners	Shares owned by foreign industrial investors during the same process
	Legal entity holders	Shares sold to legal identities (such as other companies, listed or non-listed) during the same process.
	Employee shares	Shares sold to firm's employees during the same process.
Yes (Newly issued shares)	**A Shares**	Shares issued by Chinese companies that are listed and traded in the Shanghai or Shenzhen Stock Exchange; most of these shares are sold to and held by Chinese (citizen) investors.
	B Shares	Shares issued by Chinese companies that are listed and traded in the Shanghai or Shenzhen Stock Exchange; these shares are sold to and held by foreign investors; starting in 2001Chinese investors can also trade these shares.
	H Shares	Shares issued by selected Chinese companies listed and traded in the Hong Kong Stock Exchange; these shares can only be traded on the HK Exchange but can be held by anyone.

*: There are sub-categories under this definition

We next describe standard corporate governance mechanisms in the Listed Sector. First, according to the 2005 Company Law, listed firms in China have a two-tier board structure: the Board of Directors (five to nineteen members) and the Board of Supervisors (at least three members), with supervisors ranking above directors.[169] The main duty of the Board of Supervisors is to monitor firms' operations as well as the activities of top managers and directors; the board consists mostly of representatives of shareholders and employees, with the rest of the board represented by either officials chosen from government branches or executives from the

169. Gongsi Fa (中华人民共和国公司法) [Companies Law of the People's Republic of China] (promulgated by the Standing Committee of the Tenth National People's Congress of the People's Republic of China, Oct. 27, 2005, effective Jan. 1, 2006) Ch. IV §§ 3,4 Arts. 109, 118 (China) *available at* http://www.china.org.cn/china/LegislationsForm2001-2010/2011-02/11/content_21898292.htm.

Table 5-B: Tradable vs. Non-tradable Shares for China's Listed Companies

Year	Shanghai SE: State/total shares	Non-tradable/ total shares	Tradable/ total shares	A/total shares	A/Tradable shares*
1992	0.41	0.69	0.31	0.16	0.52
1993	0.49	0.72	0.28	0.16	0.57
1994	0.43	0.67	0.33	0.21	0.64
1995	0.39	0.64	0.36	0.21	0.60
1996	0.35	0.65	0.35	0.22	0.62
1997	0.32	0.65	0.35	0.23	0.66
1998	0.34	0.66	0.34	0.24	0.71
1999	0.43	0.65	0.35	0.26	0.75
2000	0.44	0.64	0.36	0.28	0.80
2001	0.50	0.64	0.36	0.29	0.80
2002	0.52	0.65	0.35	0.26	0.74
2003	0.57	0.64	0.35	0.27	0.76
2004	0.58	0.64	0.36	0.28	0.77
2005	0.57	0.62	0.38	0.30	0.78
2006	0.36	0.65	0.35	0.27	0.81
2007	0.37	0.69	0.31	0.28	0.90
2008	0.47	0.58	0.42	0.37	0.91
2009	0.49	0.53	0.47	0.50	0.98
2010	–	0.32	0.68	0.58	–
2011	–	0.26	0.74	0.61	–
2012	–	0.24	0.76	0.64	–

^: Non-tradable shares include "state-owned" and "shares owned by legal entities"; This column is calculated as "(Non-tradable in Shanghai SE+ Non-tradable in Shenzhen SE)/(Market cap in Shanghai SE + Market cap in Shenzhen SE)"
*: tradable shares include A, B, and H shares;
Source: China Security Regulation Committee Reports (2000-2006), CEIC database and http://www.csrc.gov.cn

parent companies; directors and top managers of the firms cannot hold positions as supervisors.[170] The company has the discretion to decide the number of representatives of employees on the Board of Supervisors, but representatives of employees must account for at least one third of the board.[171] The Board of Directors serves similar duties as its counterpart in the U.S., including appointing and firing CEOs.[172] According to the "one-share, one-vote" scheme adopted by firms in the Listed Sector, shareholders including the state and legal person shareholders that typically own the majority of shares appoint the board members.[173] Specifically, the Chairman and one or two Vice Chairmen of the Board are elected by the remaining directors who have the majority of votes; with the approval of the Board, the CEO and other top managers can become members of the Board.[174] The CSRC requires at least one third of the board and a minimum of two

170. *See id.* at Chs. II, IV §§ 2,4 Arts. 54, 118–19.
171. *See id.* at Ch. IV §§ 3,4 Arts. 109, 118.
172. *See id.* at Arts. 47, 109.
173. *See id.* at Arts. 104, 106, 130.
174. *See id.* at Art. 110.

people on the Board to be independent.[175]

Since the law does not specify that every member of the Board must be elected by shareholders during general shareholder meetings, in practice some directors are nominated and appointed by the firms' parent companies; the nomination process is usually kept secret, particularly when nominating board members for former SOEs.[176] Since not all members of either board are elected by shareholders, a major problem with the board structure is the appointment of and contracting with the CEOs.[177] Based on firm-level compensation data which has been available since 1998 due to disclosure requirements, Fung et al. (2003) and Kato and Long (2004) concluded that no listed firms grant stock options to CEOs or board members.[178] The situation is somewhat different now.[179] Among overseas listed SOEs, barriers to exercising stock options have been overcome, and some senior executives have been granted stock options and have received substantial rewards; examples include the former chairman of CNOOC Wei Liucheng and Bank of China-Hong Kong former chairman Liu Mingkang (*Caijing* Magazine, 2008). However, the cash-based compensation level for CEOs is still much lower than the compensation level for their counterparts in developed countries, and the consumption of perks, such as company cars, is prevalent.[180]

Second, the existing ownership structure, characterized by the large amount of non-tradable shares including cross-holdings of shares among listed companies and institutions, makes it difficult for value-increasing M&As.[181] In many deals, a Hybrid Sector non-listed firm 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.[182] Such an acquisition can be the means through which low quality, non-listed companies bypass listing standards and access financial markets (e.g., Du et al., 2008).

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175. Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (Zhengjianfa [2001] No. 102) (promulgated by the China Securities Regulatory Commission, Aug. 16, 2001), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69191.html (China).

176. STOYAN TENEV, CHUNLIN ZHANG & LOUP BREFORT, WORLD BANK AND INT'L FIN. CORP., CORPORATE GOVERNANCE AND ENTERPRISE REFORM IN CHINA: BUILDING THE INSTITUTIONS OF MODERN MARKETS 91 (2002).

177. *See* ALEX BRYSON, JOHN FORTH & MINGHAI ZHOU, CTR. FOR ECON. PERFORMANCE, WHAT DO WE KNOW ABOUT CHINA'S CEOS? EVIDENCE FROM ACROSS THE WHOLE ECONOMY 2 (2012).

178. Takao Kato & Cheryl Long, *Executive Compensation, Firm Performance, and Corporate Governance in China: Evidence from Firms Listed in the Shanghai and Shenzen Stock Exchanges* 17 (Inst. for the Study of Labor, Discussion Paper No. 1767, 2005).

179. *See generally* Wen Xiu & Ming Shuliang, *China's Execs Sweating Over Stock Options*, CAIJING.COM.CN (June 27, 2008, 4:35 PM), http://english.caijing.com.cn/2008-06-27/100071919.html.

180. *See* Kato & Long, *supra* note 178 at 16, 18.

181. *See* Julan Du, Oliver M. Rui & Sonia M.L. Wong, *Financing-Motivated Mergers and Acquisitions: Evidence from Corporate China* 2–3 (Chinese Univ. of Hong Kong, Working Paper, 2008).

182. *Id.* at 7–8.

Third, one factor contributing to the occurrence of corporate scandals is the lack of institutional investors (including non-depository financial intermediaries) as they are a recent addition to the set of financial institutions in China.[183] Professional investors would perhaps not be so easily taken in by simple deceptions.[184] Another factor is that the enforcement of laws is questionable due to the lack of legal professionals and institutions.[185]

Fourth, the government plays the dual roles of regulator and blockholder for many listed firms, including banks and financial services companies.[186] The main role of the CSRC, whose functional counterpart in the U.S. is the SEC, is to monitor and regulate stock exchanges and listed companies.[187] The government exercises its shareholder control rights in listed firms through the Bureau of National Assets Management, which holds large fractions of nontradable shares, or other SOEs (with holdings of non-tradable shares).[188] Moreover, the government's dual roles can lead to conflicting goals, such as maximizing profits as shareholder versus maximizing social welfare as regulator or social planner, in dealing with listed firms, which in turn weaken the effectiveness of both of the government's roles.[189] Based on a sample of 625 firms with 28% of the CEOs being ex- or current government bureaucrats, Fan et al. (2007) find that the three-year post-IPO average stock returns of the sample underperform the market by 20%, and the underperformance of firms with such politically-connected CEOs exceeds those without politically-connected CEOs by almost 30%.[190] Firms with politically-connected CEOs are also more likely to appoint other bureaucrats, and not personnel with relevant professional experience to boards of directors.[191]

183. *See* TENEV ET. AL., *supra* note 176, at 81, 111, 113.

184. *See* Joseph D. Piotroski & T.J. Wong, *Institution and Information Environment of Chinese Listed Firms*, *in* CAPITALIZING CHINA 201 (Joseph P.H. Fan & Randall Morck, eds., 2013).

185. Yi Zhang, *Law, Corporate Governance, and Corporate Scandal in an Emerging Economy: Insights from China* 9–11 (Peking Univ., Working Paper, 2006), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=957549.*

186. Katharina Pistor, *The Governance of China's Finance*, *in* CAPITALIZING CHINA 35, 37–38 (Joseph P.H. Fan & Randall Morck, eds., 2013).

187. *About CSRC*, CHINA SEC. REGULATORY COMM'N (Oct. 10, 2014), http://www.csrc.gov.cn/pub/csrc_en/about.

188. *Main Functions and Responsibilities of SASAC*, STATE-OWNED ASSETS SUPERVISION AND ADMINISTRATION COMMISSION (SASAC) (Oct. 11, 2014), http://www.sasac.gov.cn/n2963340/n2963393/2965120.html.

189. *See* Pistor, *supra* note 186, at 41, for a description of the complicated relationships among various regulatory agencies and the central government branches, and how these relationships affect the decision-making process of regulations and enforcement.

190. Joseph P.H. Fan & T.J. Wong, *Politically-connected CEOs, Corporate Governance and Post-IPO Performance of China's Newly Partially Privatized Firms*, 4, 33 (Chinese Univ. of Hong Kong, Working Paper, 2004).

191. *Id.* at 24.

D. Private Equity/Venture Capital and the Funding of New Industries

Allen and Gale (1999, 2000a) have suggested that stock market-based economies, such as the U.K. in the 19th century and the U.S. in the 20th century, have been more successful in developing *new* industries than intermediary-based economies such as Germany and Japan.[192] They argue that markets are better than banks for funding new industries, because evaluation of these industries based on experience is difficult, and there is wide diversity of opinion.[193] Stock market-based economies such as the U.S. and U.K. also tend to have well-developed systems for the acquisition and distribution of information, so the cost of information to investors is low.[194] Markets then work well because investors can gather information at low costs and those that anticipate high profits can provide the finance to the firms operating in the new industries.[195]

A key part of this process is the private equity and venture capital sector.[196] Venture capitalists are able to raise large amounts of funds in the U.S. because of the prospect that successful firms will be able to undertake an IPO.[197] With data from 21 countries, Jeng and Wells (2000) found that venture capital is less important in other countries, and the existence of an active IPO market is the critical determinant of the importance of venture capital in a country.[198] This is consistent with the findings of Black and Gilson (1998); after comparing the U.S. and Germany, Black and Gilson found that the primary reason venture capital is relatively successful in the U.S. is because of the active IPO market.[199]

These facts imply that the development of active venture capital and private equity markets can increase the financing for China's new industries.[200] What is unusual about China is that it currently has the ability to develop both traditional industries, such as manufacturing, and in the near future new, high-tech industries, such as aerospace, computer software, semiconductors, and bio-genetics.[201] China's development is different

192. *See* Franklin Allen & Douglas Gale, *Diversity of Opinion and Financing of New Technologies*, 8 J. FIN. INTERMEDIATION 68, 68–70 (1999) [hereinafter *New Technologies*]; Franklin Allen & Douglas Gale, *Diversity of Opinion and Resource Allocation*, in COMPARING FINANCIAL SYSTEMS 403, 406 (2000) [hereinafter *Resource Allocation*].

193. *Id.*

194. *Id.*

195. *Id.*

196. *See, e.g.*, Samuel Kortum & Josh Lerner, *Assessing the Contribution of Venture Capital on Innovation*, 31 RAND J. ECON. 674, 674–75 (2000) (analyzing venture capital funding's positive affect on patenting industry); *see also* Leslie A. Jeng & Philippe C. Wells, *The Determinants of Venture Capital Funding: Evidence Across Countries*, 6 J. CORP. FIN. 241, 242 (2000).

197. *See* Jeng & Wells, *supra* note 196, at 242; *see also* Bernard S. Black & Ronald J. Gibson, *Venture Capital and the Structure of Capital Markets: Bank versus Stock Markets*, 47 J. F. ECON. 243, 245 (1998).

198. *See* Jeng & Wells, *supra* note 196, at 241.

199. *See* Black & Gibson, *supra* note197, at 245–46.

200. *See* Jeng & Wells, *supra* note 196, at 245 ("The past performance of venture capital-backed companies shows that venture capital has been very successful at backing companies with innovative technologies and tremendous growth potential.")

201. *See* Allen et al., *supra* note 145, at 34.

from the experience of South Korea and Taiwan in the 1970s and that of most other emerging economies in the 1990s, because the latter countries focused on developing manufacturing industries first.[202] In relation to developing traditional industries like Korea and Taiwan in the 1970s, China has already followed suit in first introducing advanced[203] technologies from developed countries and "nationalizing" these technologies within designated companies before moving toward the more advanced technologies.[204] Allen and Gale (1999, 2000a) argue that banks are better than financial markets for funding mature industries because there is wide agreement on how they are best managed, so the delegation of the investment decision to a bank works well.[205] This delegation process, and the economies of scale in information acquisition through delegation, makes bank-based systems more efficient in terms of financing the growth in these industries.[206] Therefore, the banking system can contribute more in supporting the growth and development of these industries than markets.[207]

E. Asset Management Industries

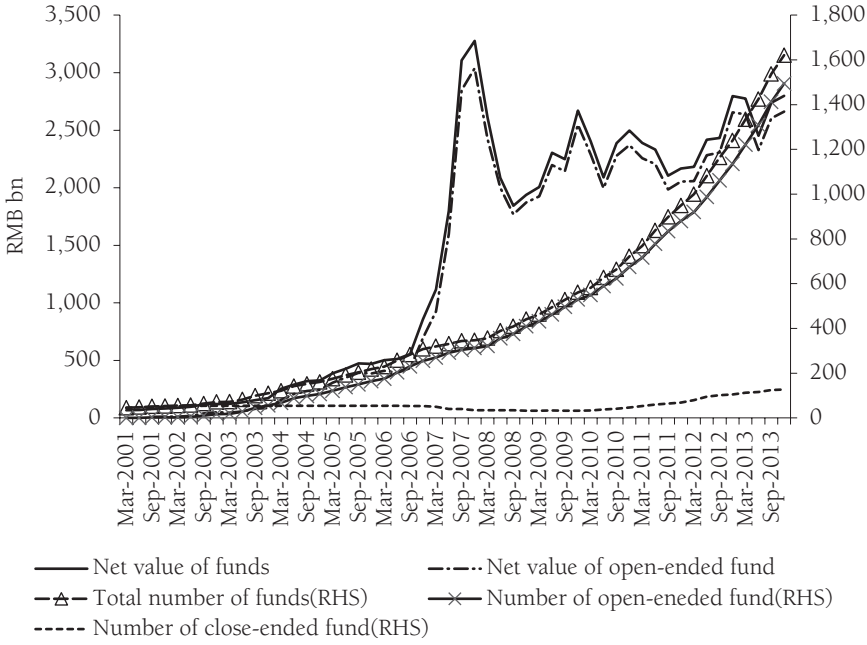
The mutual fund industry in China has gone through three stages of development.[208] The first stage is between 1992, when China's first fund *LiuBo* was established, and 1997, when the first version of the mutual fund regulation was drafted and passed by the CSRC.[209] The *LiuBo* Fund was a closed-end fund with NAV RMB100 million RMB ($12.5 million) and began to trade on the SHSE in 1993.[210] While the industry experienced fast growth in the few years after 1992, lack of regulation and problems associated with fund trading hampered the further development of the industry.[211] The first open-end fund *Hua An Chuangxin* was established in September of 2001, following the announcement of the proposal for open-end fund investment by the CSRC, a milestone for China's mutual fund industry.[212]

Figure 4 shows the development of the mutual fund industry in China. The total net assets value increased from RMB 11 billion ($1.3 billion) in 1998 to about RMB 2.80 trillion ($456.6 billion) in the fourth quarter of 2013.[213] In 2001, the NAV of all funds was about 0.8% of GDP and 1.19% of total national savings; these figures rose to 5.39% of GDP and 10.56% of

202. *Id.*
203. That is advanced relative to domestic companies but not the most advanced technologies.
204. *Id.*
205. *See New Technologies*, *supra* note 192, at 68–70; *Resource Allocation*, *supra* note 192, at 405.
206. *Id.*
207. *Id.*
208. *See* Allen et al., *supra* note 145.
209. *Id.*
210. *Id.*
211. *Id.*
212. *Id.*
213. Allen et al., *supra* note 145, at 7.

total savings in 2012.[214] The growth of open-end funds contributed to most of the growth in the industry.[215] The most popular investment style is actively managed domestic equity, with only a few index funds and exchange traded funds (ETFs).[216]

Figure 4: Growth in China's Mutual Fund Industry (1998–2013)



Many mutual fund companies are owned by securities and other financial services companies.[217] Like their counterparts in the U.S., management fees are the major source of income for fund companies, accounting for about 80% of total income.[218] Administration fees account for 9% of total income, and the rest of the income comes from investment and other incomes.[219] More than half of the fund managers have a master-level or higher academic degree, and the majority of them are 36 to 45 years old.[220]

The first fund managed by a qualified foreign institutional investor (QFII) was set up in 2002.[221] The State Administration of Foreign

214. *Id.* at 35.
215. *Id.*
216. Allen et al., *supra* note 145, at 35.
217. *Id.*
218. *Id.*
219. *Id.*
220. *Id.*
221. *See* Keith Robinson et al., *The Qualified Foreign Institutional Investor Program in China-Recent Developments, New Opportunities and Ongoing Challenges*, 20 THE INVESTMENT LAWYER 1 (2013).

Exchange (SAFE) is the government agent that regulates the QFII funds.[222] The QFII Act allows foreign investors to invest in Chinese securities, with the intention of introducing sophisticated foreign investors to the Chinese market and with the hope that their presence would improve market efficiency.[223] In addition, with the exercise of their shareholder rights, the presence of foreign investors can also help improve corporate governance of the Listed Sector.[224] However, the original QFII rules imposed restrictions on foreign investors, such as a capital lock-up period of one to three years limiting capital withdrawal (and leaving China) and other operating restrictions.[225] In August 2006, the CSRC revised QFII rules to promote more participation from foreign investors.[226] Under the new rules, there has been a significant increase in applications from foreign investors for QFII quotas.[227]

Most of the institutions in the first group of QFII applicants were securities companies and investment banks, with other financial services companies such as insurance companies and pension fund companies also on the list.[228] By the end of July 2006, China had approved a total of $7.495 billion foreign investment capital quota from 45 QFIIs, or three quarters of the then ceiling of $10 billion capital inflow through QFIIs.[229] In December 2007, the investment quota tripled, rising from $10 billion to $30 billion.[230] In September 2009, draft rules were issued by SAFE to increase the upward limit of investment for an individual QFII institution to $1 billion from the previous $800 million.[231] As of November 2013, there were a total of 251 approved QFIIs operating in China.[232] With the development of RMB internationalization, RMB Qualified Foreign Institutional Investors (RMBFII) was approved by the State Council in August 2011, allowing foreign institutional investors to invest in domestic securities market within an approved quota.[233] The initial quota was RMB 20 billion ($3.2 billion) in January 2012 and was increased to RMB 144.6 bil-

222. *Id.* at 2.
223. *Id.*
224. Allen et al., *supra* note 145, at 35.
225. *Id.*
226. *See* Y. Nancy Yi, *China's Capital Flow Regulation: The Qualified Foreign Investor and the Qualified Domestic Institutional Investor Programs*, 28 REV. BANKING & FIN. 299, 300 (2009).
227. *See generally id.*
228. *See* Robinson et al., *supra* note 221, at 2.
229. Allen et al., *supra* note 145, at 35.
230. *Id.* at 35–36.
231. Allen et al., *supra* note 145, at 36.
232. Report, *List of QFIIs (Until November 2013)*, CHINA SEC. REGULATORY COMM'N (Jan. 20, 2014), http://www.csrc.gov.cn/pub/csrc_en/OpeningUp/RelatedLists/QFIIs/201401/t20140120_242787.htm.
233. *China Expands RQFII, QFII Investment Quota*, CHINA DAILY USA (Apr. 3, 2012), http://usa.chinadaily.com.cn/business/2012-04/03/content_14976215.htm; *China's Renminbi Qualified Foreign Institutional Investors (RQFII) Pilot Scheme Expanded*, ALLEN & OVERY (May 10, 2013), http://www.allenovery.com/publications/en-gb/Pages/China%E2%80%99s-Renminbi-qualified-foreign-institutional.aspx.; YONG ZHEN, *supra* note 50, at 250.

lion ($23.3 billion) in November 2013.[234]

The approval of qualified domestic institutional investors (QDII) to invest in overseas markets came after QFII, in July 2006.[235] The QDII funds invest in stocks, bonds, real estate investment trusts and other mainstream financial products in markets such as New York, London, Tokyo and Hong Kong.[236] Similar to the QFII scheme, it is a transitional arrangement that provides limited opportunities for domestic investors to access foreign markets at a stage in which a country/territory's currency is not freely convertible and capital flows are restricted.[237] As of early 2008, ten fund companies had obtained the approval to launch QDII.[238] The total number of QDII funds reached 75 in July 2009.[239] The performance of the QDII funds has been less than stellar.[240] Going forward, the probable continuing appreciation of the RMB against major international currencies including the dollar is a major concern for QDII investors.[241]

IV. The Shadow Financial Sector and Evidence on Hybrid Sector Firms

In this section we study how the shadow financial sector supports 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 formal corporate governance mechanisms. Due to data limitations, much of this evidence is by necessity in the form of anecdotes or the results of a survey.[242]

We first compare the Hybrid Sector with the State and Listed Sectors to highlight the importance of its status in the entire economy in Section IV.A. Second, we consider survey evidence in Section IV.B. Finally, Section IV.C provides discussions and comparisons of alternative financing channels and governance mechanisms that support the growth of the

234. *China Expands RQFII, QFII Investment Quota*, supra note 260; RICHARD MAZZONCHI ET AL., KWM CONNECT: QFII AND RQFII- A PRACTICAL INSIGHT TO RECENT DEVELOPMENTS 2 (2013); Xie Yu, *Investors Brace for Bullish Market*, CHINA DAILY USA, (Dec. 10, 2013), http://usa.chinadaily.com.cn/business/2013-12/10/content_17164724.htm; YONG ZHEN, *supra* note 50, at 250.

235. JAMES R. BARTH ET AL., CHINA'S EMERGING FINANCIAL MARKETS: CHALLENGES AND OPPORTUNITIES 49 (2009).

236. *Id.*

237. *Id.*

238. *Id.*

239. Allen et al., AQZZ, *Opportunities and Challenges*, *supra* note 4, at 117.

240. Aidan Yao & Honglin Wang, *What are the Challenges and Problems Facing China's Outward Portfolio Investment: Evidence from the Qualified Domestic Institutional Investor Scheme* 1 (Hong Kong Inst. for Monetary Research, Working Paper No. 31/2012, 2012).

241. *See id.* at 5.

242. All firms including Hybrid Sector firms must disclose accounting and financial information to the local Bureau of Commerce and Industry that audits most reports. However, these data are then aggregated into the Statistical Yearbook without any firm-level publications. *See* AQZZ, *Opportunities and Challenges*, *supra* note 4, at 122.

Hybrid Sector versus formal financing channels (through banks and markets) and governance mechanisms (laws and courts).

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

Figure 5-A compares the level and growth of *industrial output* produced in the State and Listed Sectors combined vs. that of the Hybrid Sector from 1998 to 2012.[243] The output from the Hybrid Sector has been steadily increasing during this period and exceeded that of the other two sectors in 1998. The total output in 2011 is almost $11,444 billion for the Hybrid Sector, while it is around $4,812 billion in the State and Listed Sectors combined.[244] The Hybrid Sector grew at an annual rate of over 30% between 1998 and 2011, while the State and Listed Sectors combined grew at around 20% during the same period.[245] In addition, the growth rates for investment in fixed assets of these sectors are comparable (*China Statistics Yearbooks*; and AQQ (2005)), which implies that the Hybrid Sector is more productive than the State and Listed Sectors. In fact, with large samples of firms (from sources) with various ownership structures, Liu (2007) and Dollar and Wei (2007) find that the returns to capital figure is much higher in non-state sectors than the State Sector, and that a capital reallocation from state to private sectors will generate more growth in the economy.[246] Fan et al. (2006) and Li et al. (2007) find that state-owned firms in China have a much easier access to the debt market and accordingly higher leverage than non-state firms.[247] One reason for the differences is that due to government protection (for economic and social/political reasons) the costs for bankruptcy and financial distress are much lower for state-owned firms.[248] These firms also have easier access to bank loans, especially credit extended by state-owned banks.[249]

243. China's National Bureau of Statistics (NBS) revised its total industrial output statistics in the 2000 Yearbook without any explicit explanations. The NBS significantly revised down outputs in previous years (i.e. 1997) compared to the 1998 Yearbook. To be consistent and avoid confusion, we only use data from NBS after 1998.

244. Due to data limitations, our calculations underestimate the State and Listed Sectors' output. For these sectors, we used as the total output the SOE's output and that of listed firms for which the State has at least a fifty percent ownership stake. However, this calculation excludes output from listed firms that are *not* majority owned by the State. The output for the Hybrid Sector is the difference between the total output and the total for the other two sectors. However, as mentioned above, only about 20%of listed firms do not have the State as the largest owner. Therefore, the total output for these firms is t unlikely to change our overall conclusion about the Hybrid Sector's dominance over the other two sectors.

245. There is an ongoing process of privatizing SOEs. Potentially, this may bias the growth rate in favor of the Hybrid Sector as there are firms shifting from the State Sector to the Hybrid Sector. Yet the overwhelming majority of SOEs became Listed Sector firms (the main channel through which SOEs were partially privatized prior to 2004). Thus, this process is unlikely to change the validity of the results.

246. *See* Allen et al., *supra* note 48, at 123–24.

247. *Id.* at 124.

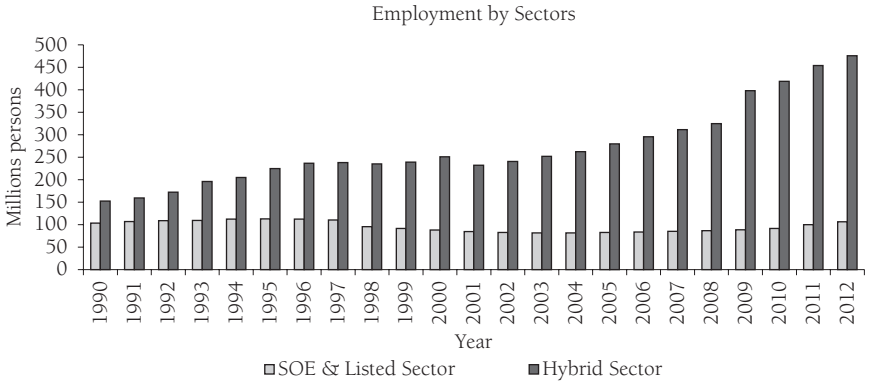
248. *Id.*

249. *Id.*

All of the above facts make the growth of the Hybrid Sector even more impressive. Not surprisingly, there has been a fundamental change among the State, Listed, and Hybrid Sectors in terms of their contribution to the entire economy. In 1980, the State Sector contributed more than two thirds of China's GDP and (non-agricultural) privately owned firms, a type of Hybrid Sector firm, were negligible contributors; but in 2011, the State Sector only contributed 15% of the GDP (*China Statistical Yearbook*, 1998-2012).[250] The above trend of the Hybrid Sector replacing the State Sector is likely to continue in the near future.[251]

Figure 5-A: Comparing the Sectors – Industrial Output

Figure 5-B: Comparing the Sectors – Employment



250. *Id.*
251. *Id.* at 124.

Figure 5-B presents the number and growth of non-agricultural employees in the three sectors. The Hybrid Sector is a much more significant source of employment opportunities than the State and Listed Sectors.[252] Over the period from 1990 to 2012, the Hybrid Sector employed an average of over 73% of all non-agricultural workers; the TVEs (part of the Hybrid Sector) have been the most important employers providing (non-agricultural) jobs for residents in the rural areas, while (non-agricultural) privately-owned firms employ more than 40% of the workforce in the urban areas.[253] Moreover, the number of employees working in the Hybrid Sector has been growing at 5.3% over this period, while the labor force in the State and Listed Sectors has been shrinking.[254] These patterns are particularly relevant for China, given its vast population and potential problem of unemployment.[255]

B. Survey Evidence

Much of the information concerning the Hybrid Sector comes from surveys.[256] We focus on evidence in AQQ (2005) and Cull and Xu (2005). The most significant findings of these surveys regarding financing channels are the following. First, during the startup stage, funds from founders' family and friends are an essential source of financing.[257] Banks can also play an important role.[258] Since 2010, peer-to-peer lending, which refers to direct lending through special websites to unrelated individuals without the involvement of any financial institution as an intermediary, has grown rapidly.[259] Second, internal financing, in the form of retained

252. Franklin Allen, Jun Qian & Meijun Qian, *Will China's Financial System Stimulate or Impede the Growth of Its Economy*, *in* 129 ASIA PROGRAM SPECIAL REPORT, CHINA'S ECONOMY: RETROSPECT AND PROSPECT 34, 39 (Loren Brandt et al. eds., 2005), https://www2.bc.edu/~qianju/Wilson-ChinaReport-072005.pdf.

253. Allen et al., *supra* note 145, at 42.

254. Our calculations of the total number of workers employed by the Hybrid Sector actually underestimate the actual work force in the sector, because the *Chinese Statistics Yearbooks* do not provide employment data for all types of firms (by ownership structure), especially small firms, in the Hybrid Sector. *Id.* at 36.

255. NAT'L BUREAU OF STATISTICS OF CHINA, *Employment and Wages: 4-1 Employment*, CHINA STATISTICAL YEARBOOK 2013, http://www.stats.gov.cn/tjsj/ndsj/2013/indexeh.htm.

256. *See, e.g.*, NAT'L BUREAU OF STATISTICS OF CHINA, *Employment and Wages: Brief Introduction*, CHINA STATISTICAL YEARBOOK 2013, http://www.stats.gov.cn/tjsj/ndsj/2013/indexeh.htm.

257. AQQ, *Law, Finance, and Economic Growth*, *supra* note 1, at 60.

258. *Id.*

259. Takeshi Jingu, Nomura Research Inst., *Risks and Opportunities in China's Growing P2P Lending Market*, 202 IAKYARA 1 (2014), http://www.nri.com/~/media/PDF/global/opinion/lakyara/2014/lkr2014202.pdf. Since the peer-to-peer lending is still beyond the scope of regulators, there are no official statistics on this. According to Xinhua News, one of China's official websites, by the end of 2012, outstanding loans on domestic online P2P platforms stood at RMB 10 billion ($ 1.6 billion) and there were about 200 lending platforms at that point, with about 50,000 investors. Gao Changxin, *PBOC to Set Up P2P Custodians to Prevent Fraud*, XINHUANET (Nov. 27, 2013, 1:22:44 PM), http://news.xinhuanet.com/english/business/2013-11/27/c_132922240.htm. Since P2P online lenders have met the market's demand for fast mini-loans, the businesses are mainly facing to those start-ups. *Id.* However, due to the absence of regula-

earnings, is also important.[260] During a firm's growth period, financing from private credit agencies (PCAs) and trade credits, rather than banks, are key channels for firms in AQQ's sample.[261] As documented by Tsai (2002), PCAs take on many forms, from shareholding cooperative enterprises run by professional money brokers, lenders, and middlemen, to credit associations operated by a group of entrepreneurs (raising money from group members and from outsiders to fund firms; *zijin huzushe*), to pawnshops and underground private money houses.[262]

As far as corporate governance is concerned, when asked about what type of losses concern them the most if the firm failed, every firm's founders/executives (100%) included in the AQQ study said reputation loss is a major concern, while only 60% of them said economic losses are of major concern.[263] Competition also appears to be an important factor ensuring firms are well run.[264]

Cull and Xu (2005) find that firms in most regions and cities rely on courts to resolve less than 10% of business-related disputes (the highest percentage is 20%), with a higher reliance on courts in coastal and more developed areas.[265] One reason that firms go to courts to resolve a dispute is because the courts are authoritative; the dispute will be resolved, even though the resolution may not be fair (e.g., Clarke et al. 2008).[266]

C. Discussion on How the Shadow Financial Sector Works

In this subsection, we first discuss mechanisms within the shadow financial sector in supporting the growth of the Hybrid Sector. We then compare these alternative institutions that operate outside the legal system with the law and legal institutions that have been widely regarded as the basis for conducting finance and commerce. There are two aspects to alternative financing channels in the Hybrid Sector.[267] The first is the way in which investment is financed.[268] The second is corporate governance.[269] We consider each in turn.

Once a firm is established and doing well, internal finance can pro-

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tions and entrance requirements, the sector is so chaotic that some local media reported in October 2013 that at least one P2P lending company went bankrupt every day. *Id.* After the Third Plenum Session of the 18th CPC Central Committee, it is reported that the PBOC is planning to introduce third-party custodians into P2P lending, after the numerous cases of fraud emerged from 2012 to 2013. *Id.*

260. AQQ, *Law, Finance, and Economic Growth*, *supra* note 1, at 94.

261. *Id.* at 94–95.

262. KELLY S. TSAI, BACK-ALLEY BANKING: PRIVATE ENTERPRISE IN CHINA 37, 39 (2002).

263. AQQ, *Law, Finance, and Economic Growth*, *supra* note 1, at 96.

264. *Id.* at 97.

265. Robert Cull & Lixin Colin Xu, *Institutions, Ownership and Finance: The Determinants of Profit Reinvestment Among Chinese Firms*, 77 J. FIN. ECON. 117, 126 (2005).

266. Donald Clarke, Peter Murrell & Susan Whiting, *The Role of Law in China's Economic Development*, *in* CHINA'S GREAT ECONOMIC TRANSFORMATION 375, 414 (Loren Brandt & Thomas G. Rawski eds., 2008).

267. Allen et al., *supra* note 252.

268. *Id.*

269. *Id.*

vide the funds necessary for growth.[270] AQQ (2005) find that about 60% of the funds raised by the Hybrid Sector are generated internally.[271] Of course, internal finance is fine once a firm is established. However, use of this method raises the issue of how firms in the Hybrid Sector acquire their "seed" capital, which may be the most crucial financing during a firm's life cycle.[272] AQQ present evidence on the importance of alternative and informal channels, including funds from family and friends, and loans from private (unofficial) credit agencies (see also Tsai (2002)).[273] There is also evidence that financing through illegal channels, such as smuggling, bribery, insider trading and speculations during early stages of the development of financial markets and real estate market, and other underground or unofficial businesses can also play a critical role in the accumulation of seed capital.[274]

Perhaps the most significant corporate governance mechanism is competition in product and input markets, which has worked well in both developed and developing countries (e.g., McMillan 1995, 1997; Allen and Gale 2000b).[275] What we see from the success of Hybrid Sector firms in WenZhou and other surveyed firms recounted in AQQ, suggest that it is only those firms that have the strongest comparative advantage in an industry (of the area) that survived and thrived. A relevant factor for competition in an industry is entry barriers for new firms, as lower entry barriers foster competition. Djankov, La Porta, Lopez-de-Silanes, and Shleifer (DLLS hereafter, 2002) examine entry barriers across 85 countries, and find that countries with heavier (lighter) regulation of entry have higher government corruption (more democratic and limited governments) and larger unofficial economies.[276] With much lower barriers to entry compared to other countries with similar (low) per capita GDP, China is once again an "outlier" in the DLLS sample given that China is one of the least democratic countries, and such countries tend to have high barriers to entry.[277] Survey evidence from AQQ (2005) reveals that there exist nonstandard methods to remove entry barriers in China, which can reconcile these seemingly contradictory facts.[278]

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270. *Id.*

271. *Id.*

272. *Id.*

273. *Id.*; *see also* TSAI, *supra* note 289.

274. Allen et al., *supra* note 252.

275. Chong-En Bai et al., *Corporate Governance and Market Valuation in China* 9 (The Williamson Davidson Inst., Working Paper No. 564, 2003); Franklin Allen & Douglas Gale, *Corporate Governance and Competition*, *in* CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES 23, 56–60, 61–62 (Xavier Vives ed., Cambridge Univ. Press 2000); John McMillan, *China's Nonconformist Reforms*, 11 INST. ON GLOBAL CONFLICT AND COOPERATION 3, 4, 6, 8 (1994); John McMillan, *Markets in Transition*, *in* 2 ADVANCES IN ECONOMICS AND ECONOMETRICS (David M. Kreps & Kenneth F. Wallis eds., Cambridge Univ. Press 1997).

276. Simeon Djankov et al., *The Regulation of Entry*, 117 Q. J. ECON. 1, 1 (2002)

277. *Id.* at 26–27, 35; *see also* AQQ, *Law, Finance, and Economic Growth*, *supra* note 1, at 97.

278. AQQ, *Law, Finance, and Economic Growth*, *supra* note 1, at 97–99.

Additional mechanisms of corporate governance are reputation, trust, and relationships.[279] Greif (1989, 1993) argues that certain traders' organizations in the 11th century were able to overcome problems of information asymmetry and the lack of legal and contract enforcement mechanisms, because they had developed institutions based on reputation, implicit contractual relations, and coalitions.[280] Certain aspects of the growth of these institutions resemble what worked to promote commerce and the financial system in China prior to 1949 (e.g., Kirby (1995)) and the operation of the shadow financial sector today (AQQ (2005)), in terms of how firms raise funds and contract with investors and business partners. In addition, Greif (1993) and Stulz and Williamson (2003) point out the importance of cultural and religious beliefs for the development of institutions, legal origins, and investor protections.[281]

The above factors are of particular relevance and importance to China's development of institutions.[282] Without a dominant religion, some argue that the most important force in shaping China's social values and institutions is the set of beliefs first developed and formalized by *Kongzi* (Confucius).[283] This set of beliefs clearly defines family and social orders, which are very different from western beliefs on how legal codes are formulated.[284] Using the World Values Survey conducted in the early 1990s, LLSV (1997b) find that China has one of the highest levels of social trust among a group of 40 developed and developing countries.[285] We interpret high social trust in China as being influenced by Confucian beliefs. Throughout this paper and AQQ (2005; 2008) we have presented evidence that reputation and relationships make many financing channels and governance mechanisms work in China's Hybrid Sector.

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279. Avner Greif, *Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders*, 49 J. ECON. HIST. 857, 859, 865, 881 (1989) [hereinafter Greif, *Reputation and Coalitions*]; Avner Greif, *Contract Enforceability Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525, 526, 530, 531, 544 (1993) [hereinafter Greif, *Contract Enforceability Institutions*].

280. Greif, *Reputation and Coalitions*, *supra* note 306, at 859, 865, 881; Greif, *Contract Enforceability Institutions*, *supra* note 306, at 526, 530, 531, 544.

281. Greif, *Contract Enforceability Institutions*, *supra* note 306, at 525; René Stulz & Rohan Williamson, *Culture, Openness, and Finance*, 70 J. FIN. ECON. 313, 316–17, 346 (2003).

282. Martin King Whyte, *The Chinese Family and Economic Development: Obstacle or Engine?*, 45 ECON. DEV. & CULTURAL CHANGE 1, 6–7, 8, 13, 14, 20 (1996); Geert Hofstede & Michael Harris Bond, *The Confucius Connection: From Cultural Roots to Economic Growth*, 16 ORGANIZATIONAL DYNAMICS 5 (1988).

283. King Whyte, *supra* note 309, at 6–7, 8, 13, 14, 20; Hofstede & Harris Bond, *supra* note 309, at 5; AQQ, *Law, Finance, and Economic Growth*, *supra* note 1, at 60, 97.

284. King Whyte, *supra* note 309, at 6–7, 8, 13, 14, 20; Hofstede & Harris Bond, *supra* note 309, at 5; AQQ, *Law, Finance, and Economic Growth*, *supra* note 1, at 60, 97.

285. Interestingly, the same survey, used in LLSV (1997b), finds that Chinese citizens have a low tendency to participate in civil activities. However, our evidence shows that with effective alternative mechanisms in place, citizens in the developed regions of China have a strong incentive to participate in business and economic activities. AQQ, *Law, Finance, and Economic Growth*, *supra* note 1, at 97; Rafael La Porta et al., *Trust in Large Organizations*, 87 AM. ECON. REV. 310, 318 (1997).

There are other effective corporate governance mechanisms.[286] First, Burkart et al. (2003) link the degree of separation of ownership and control to different legal environments, and show that *family-run* firms will emerge as the dominant form of ownership structure in countries with weak minority shareholder protections, whereas professionally managed firms are the optimal form in countries with strong protection.[287] Survey evidence on the Hybrid Sector in AQQ and empirical results on the Listed Sector, along with evidence in Claessens et al. (2000, 2002) and ACDQQ (2008), suggests that family firms are a successful norm in China and other Asian countries.[288] Second, Allen and Gale (2000a) show that, if cooperation among different suppliers of inputs is necessary and all suppliers benefit from the firm doing well, then a good equilibrium with no external governance is possible, as internal, mutual monitoring can ensure the optimal outcome.[289] AQQ (2005) and ACDQQ (2008) present evidence on the importance of trade credits as a form of financing for firms in the Hybrid Sector.[290] Cooperation and mutual monitoring can ensure payments (as long as funds are available) among business partners despite the lack of external monitoring and contract enforcement.[291] The importance of trade credits is also found in other emerging economies (e.g., ACDQQ (2012) on India) as well as in developed countries (Burkart et el. (2011) on the U.S.).[292]

It is worth mentioning how entrepreneurs and investors alleviate and overcome problems associated with government corruption.[293] According to proponents of institutional development (e.g., Rajan and Zingales 2003b; Acemoglu and Johnson 2005), poor institutions, weak government, and powerful elites can severely hinder China's long-run economic

286. Oliver Hart, *Corporate Governance: Some Theory and Implications*, 105 ECON. J. 678 (1995). Mike Burkart, Fausto Panunzi & Andrei Shleifer, *Family Firms* 3–4, 6, 21, 22, 37 (Nat'l Bureau of Econ. Research, Working Paper No. 8776, 2002).

287. Burkart et al., *supra* note 313, at 3–4, 6, 21, 22, 37.

288. *See,* e.g., AQQ, *Law, Finance, and Economic Growth*, *supra* note 1, at 89, 98; Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741, 2743, 2750, 2769–70 (2002); Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 82, 103, 110 (2000). Franklin Allen et al., *The Financial System Capacities of China and India* 22–23, 22 n.12 (2008) (unpublished working paper) (on file with author).

289. FRANKLIN ALLEN & DOUGLAS GALE, COMPARING FINANCIAL INSTITUTIONS 16–17, 375–98 (MIT Press 2000).

290. *Id.* at 3, 20, 21; AQQ, *Law, Finance, and Economic Growth*, *supra* note 1, at 60, 95, 98.

291. ALLEN & GALE, *supra* note 289, at 316–17, 375–98.

292. Franklin Allen et al., *Financing Firms in India*, 21 J. FIN. INTERMED. 409, 410, 422, 424, 441 (2012). Mariassunta Giannetti, Mike Burkart & Tore Ellingsen, *What You Sell is What You Lend? Explaining Trade Credit Contracts*, 24 REV. FIN. STUD. 1261, 1261–62 (2011).

293. *See generally* ADB/OECD Anti-Corruption Initiative for Asia and the Pacific, *Strategies for Business, Government, & Civil Society to Fight Corruption in Asia and the Pacific* (2009).

growth.[294] However, our evidence shows that corruption has not prevented a high rate of growth for China's firms, even in Hybrid Sector firms, where legal protection is perhaps weaker and problems of corruption worse compared to firms in the State and Listed sectors.[295]

A potentially effective solution for corruption is competition among local governments/bureaucrats from different regions within the same country.[296] Entrepreneurs can move from region to region to find the most supportive government officials for their private firms, which in turn motivates officials to lend "helping hands" rather than "grabbing hands" in the provision of public goods or services (e.g., granting of licenses to start-up firms); otherwise, there would be an outflow of profitable private businesses from the region (Allen and Qian 2009).[297] This remedy is typically available in a large country with diverse regions like China.[298] Complementing this view, Xu (2011) reviews China's unique institutional foundation of a "regionally decentralized authoritarian system," in which the sub-national governments have considerable autonomous power over regional economic decisions while simultaneously remaining under the control of the central government.[299] Under this structure, local governments play a major role in supporting TVEs, allocating bank credits to firms, and choosing good firms to get listed.[300] This system alleviates the information problem that regulators face, and creates incentives for sub-national governors though personnel control and regional competition.[301] Xu argues that this governance structure is responsible for the spectacular economic growth of China, despite weak enforcement of formal laws.[302]

To summarize, the extraordinary economic performance of China in recent decades, especially that of the Hybrid Sector, raises questions about the conventional wisdom of using the legal system as the basis of commerce.[303] Given the importance of legal systems to many economic systems, "Most observers would characterize the economic performance in China and India as 'successful *despite* the lack of western-style institu-

294. Gregory C. Chow, *Challenges of China's Economic System for Economic Theory*, 87 AM. ECON. REV. 321 (1997); Udo C. Braendle, Tanja Gasser & Juergen Noll, *Corporate Governance in China–Is Economic Growth Potential Hindered by Guanxi?*, 110 BUS. & SOC'Y REV. 389, 400-01, 402 (2005); Daron Acemoglu & Simon Johnson, *Unbundling Institutions*, 113 J. POL. ECON. 949 (2005); RAJAN RAGHURAM & LUIGI ZINGALES, SAVING CAPITALISM FROM THE CAPITALISTS: UNLEASHING THE POWER OF FINANCIAL MARKETS TO CREATE WEALTH AND SPREAD OPPORTUNITY (Random House 2003).

295. AQZZ, *Opportunities and Challenges*, *supra* note 4, at 77-78.

296. Franklin Allen & Jun Qian, *Corruption and Competition* 19, 20, 21, 23 (2007) (unpublished working paper) (on file with authors).

297. *Id.*

298. Franklin Allen, Jun Qian, Chenying Zhang & Mengxin Zhao, *China's Financial System: Opportunities and Challenges*, *in* CAPITALIZING CHINA 46 (Joseph P.H. Fan & Randall Morck eds., 2013).

299. *See* Chenggang Xu, *The Fundamental Institutions of China's Reforms and Development*, 49 J. ECON. LITERATURE 1076, 1078 (2011).

300. *See id.* at 1079.

301. *See id.* at 1116-17.

302. *See id.* at 1077.

303. Allen et al., *supra* note 48, at 46.

tions,'" and the failure to adopt western institutions will be one of the main factors to halt the long-run economic growth.[304] By contrast, Allen and Qian (2010) argue that China's economy has been successful *because of* this lack of western-style institutions, in that conducting business outside the legal system in fast-growing economies such as China can actually be superior to using the law as the basis for finance and commerce.[305]

Focusing on dispute resolution and contract enforcement mechanisms based on the law and courts vs. alternative mechanisms operating outside the legal system, Allen and Qian (2010) argue that despite many well-known advantages, there are disadvantages in using legal institutions.[306] First, recent research on political economy factors, and in particular, work by Rajan and Zingales (2003a,b), shows that rent-seeking behaviors by vested interest groups can turn legal institutions into barriers to changes.[307] We expect these problems to be much more severe in developing countries and the costs of building good institutions can be enormous.[308] One way to solve this problem is *not* to use the law as the basis for commerce, but instead to use alternative mechanisms *outside* the legal system.[309] Evidence presented in this paper and other related work on China and other emerging economies (e.g., ACDQQ (2012) on India) suggests that these alternative mechanisms can be quite effective.

Second, in democracies there can be a lengthy political process before significant changes can be approved (by the majority of the population and/or legislature), and the people in charge of revising the law (e.g., politicians and judges) may lack the expertise of business transactions and have limited capacity (time and effort) to examine the proposed changes.[310] In

304. *See* Franklin Allen & Jun Qian, *Comparing Legal and Alternative Institutions in Finance and Commerce*, *in* GLOBAL PERSPECTIVES ON THE RULE OF LAW 1 (James Heckman & Robert Nelson, Routledge eds., 2010).

305. *Id.*

306. *Id.* at 4–5.

307. *Id.*

308. *Id.* A frequently discussed and controversial topic concerns intellectual property rights including patents and copyrights. The practice of enforcing intellectual property rights by courts is much more vigilant and prevalent in developed countries than in developing countries such as China. An extensive literature in economics has found mixed evidence on the relationship between patent/copyright protection and the pace of innovations. While exclusive property rights provide strong incentives for innovations and do lead to more innovations in a few industries such as chemicals and pharmaceuticals, excessive protection deters competition, which is another important factor in spurring innovations. *Id.* at 3.

309. *Id.* at 5.

310. *Id.* at 28. A good example is the U.S. payment system. At the beginning of the 21st century the U.S. had a 19th century system: Checks had to be physically transported from where they were deposited to a central operations center, then to the clearer, and then back to the banks they were drawn on. Despite repeated calls for changes from the banks and businesses, the U.S Congress did not act on this simple yet costly problem until after September 11, 2001. All commercial flights were grounded for several days, completely halting the check clearing process. The Check Clearing for the 21st Century Act was signed in October 2003, allowing electronic images to be a substitute for the original checks, and thus the clearing process is no longer dependent on the mail and transportation system. *See id.* at 24–26.

the context of a fast-growing and frequently changing economy such as China, Allen and Qian (2010) show that there is an additional advantage of using alternative institutions because this type of system can adapt and change much more quickly than when the law is used.[311] In particular, competition can ensure the most efficient mechanism prevails, avoiding a political process that requires persuading the legislature and the electorate to revise the law when circumstances change.[312]

To conclude, we argue that while legal institutions along with formal financing channels are an integral part of developed economies' institutions, alternative mechanisms and financing channels play a much more prominent role in emerging economies. These alternative mechanisms can be superior to legal mechanisms in supporting business transactions in certain industries or entire economies.[313] Therefore, the development of alternative dispute resolution and contract enforcement mechanisms alongside the development of legal and other formal institutions can promote a broader base of economic growth that is also more sustainable in emerging economies.[314] The coexistence of and competition between alternative and legal mechanisms can also exert positive impact on the development of legal institutions by promoting adaptation and preventing disproportionate influence from interest groups.[315]

Summary and Concluding Remarks

One of the most frequently asked questions about China's financial system is whether it 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 our findings to the financial systems of other countries, is in three parts. First, the large banking sector dominated by state-owned banks has played a much more important role in funding the growth of many types of firms than the financial markets.[316] Second, the stock market has been growing fast since 1990, but has played a relatively limited role in supporting the growth of the economy.[317] However, the role of the financial markets in the economy will become increasingly more significant.[318]

If we can show that the banking sector and financial markets have not impeded the growth of the economy, our third conclusion is that alternative financing channels have had great success in supporting the growth of the Hybrid Sector—the sector which contributes most of the economic growth, compared to the State and Listed Sectors. The shadow financial sector relies on alternative financing channels, including internal finance,

311. *Id.* at 5.
312. *Id.* at 5–6.
313. *Id.* at 6.
314. *See id.* at 6.
315. *Id.*
316. Allen et al., *supra* note 48, at 54.
317. *Id.* at 54–55.
318. *Id.* at 55.

and on alternative governance mechanisms, such as those based on trust, reputation and relationships, and competition in output and input markets to support the growth of the Hybrid Sector.[319] It is possible that these alternative institutions are superior to western-style legal institutions in supporting a fast-growing economy such as China's.[320]

We believe the formal financial sector of banks and financial markets will continue to develop; an ever-improving legal structure is desirable to facilitate this continued development. However, the informal and shadow banking sectors also have a great deal to contribute on an ongoing basis. These sectors do not rely on conventional legal underpinnings. The lack of conventional underpinning in the shadow banking sector should not be discouraged, as this structure can be an advantage in the growth of China's economy.

319. *Id.* at 55.
320. *Id.*