Beating the Trap of Financial Repression in China

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What is the future of China's financial sector? Will it continue to be stable? Will it be more efficient? In addressing those questions, we need to review China's financial system of the reform era (1978 to the present). I argue that the key feature of that system has been a mild financial repression that has helped China maintain the financial stability needed for reform. But the repression has been inflicting increasing costs in terms of lowering economic efficiency. Moreover, having been implemented by various policies in the reform era, China's financial repression tends to be self-propelling and self-sustaining, creating a low-efficiency trap that prevents financial sector liberalization. In order to beat the trap, I argue that the ongoing financial reform must aim at breaking up the dominant state banks into smaller, manageable independent banks. Alternative reform strategies aimed at restructuring state banks are likely to be futile. To achieve the objective of breaking up the largest state banks, two preconditions must be satisfied and should be the focus of the current reform. The first precondition is to restructure the central government's public finances, and the second is to properly deal with the nonperforming loans of the state banks.

Financial Repression as an Expedient Reform in China

Financial repression refers to a policy regime that creates a wedge between the actual rate of return to financial assets and the nominal rate of return to the investors. As a result, incentives to hold financial assets are reduced and the development of the economy's financial

sector is dampened. In extreme forms, financial repression can render the return to holding financial assets negative, driving away investors from financial assets.

China's financial system in the reform era can be characterized by a mild financial repression. For most of the reform era, the rate of return on financial assets, except for cash, has been kept positive but very low. The main government policy instrument responsible for the mild financial repression has been maintaining the monopoly of the financial sector by state banks, resulting in restricted competition in the financial sector. More specifically, there are a few important and related policy components. To begin with, entry of new banks (whether state or nonstate) is under strict central government control. Likewise, the central government also has maintained tight control over the entry of nonbank financial institutions such as insurance companies and credit cooperatives. In addition, new financial instruments that compete with bank deposits and central government bonds have been very carefully controlled. These include corporate shares in stock markets, corporate bonds, and various local government bonds.

The main reason for maintaining a mild financial repression has been to rely on the state monopoly of the financial sector to maintain macroeconomic stability. Chinese policymakers argue that it is essential to maintain the monopoly of state banks in order to capture household deposits, curb the growth of aggregate demand, and maintain a healthy trend of financial deepening. In addition, by keeping interest rates on deposits low, state banks can boost their profits, which are an important source of government revenue. Low deposit rates also enable the state banks to offer cheap credit to sinking state enterprises that otherwise would require much higher direct budgetary subsidies.

Indeed, the consequences of the mild financial repression worked out as intended. This is reflected in a group of stylized facts. First, state banks have attracted a rapidly increasing amount of deposits; in each of the years since reform, the deposit growth rate has outpaced that of gross domestic product (GDP). Financial deepening has progressed steadily (see Table 1). Second, the central government has obtained a large amount of quasi-fiscal revenue (also known as "extra-budgetary" revenue) from the financial sector, which has compensated Beijing's diminishing share of fiscal revenue in the GDP (see Table 2 and Table 3). Third, because of these two effects, the tightly controlled financial sector has provided strong support for the central government in its efforts to maintain macroeconomic stability. Overall, during the reform era, inflation has not gone out of control in China.

TABLE 1

FINANCIAL DEEPENING

Year	Cash in Circulation (billions of yuan)	Household Bank Deposit (billions of yuan)	Increase Over Previous Year (%)	M2 (billions of yuan)[a]	GDP (billions of yuan)	Cash in Circulation/ GDP (%)	Household Bank Deposits/ GDP (%)	M2/GDP (%)
1978	—	21.06	—	—	362.4	5.91	5.81	—
1979	—	28.10	33.43	—	403.8	—	6.96	—
1980	—	39.95	42.17	—	451.8	—	8.84	—
1981	—	52.37	31.09	—	486.2	—	10.77	—
1982	—	67.54	28.97	—	529.5	—	12.76	—
1983	—	89.25	32.14	—	593.4	—	15.04	—
1984	—	121.47	36.10	—	717.1	—	16.94	—
1985	98.78	162.26	33.58	519.89	896.4	11.02	18.10	58.00
1986	121.84	223.76	37.90	672.09	1,020.2	11.94	21.93	65.88
1987	145.45	307.33	37.35	833.09	1,196.2	12.16	25.69	69.64
1988	213.40	380.15	23.69	1,009.98	1,492.8	14.30	25.47	67.66
1989	234.40	514.69	35.39	1,194.96	1,690.9	13.86	30.44	70.67
1990	264.44	703.42	36.67	1,529.34	1,854.8	14.26	37.92	82.45
1991	317.78	911.03	29.51	1,934.99	2,161.7	14.70	42.14	89.51
1992	433.60	1,154.54	26.73	2,540.22	2,663.8	16.28	43.34	95.36
1993	586.47	1,520.35	31.68	3,487.98	3,463.4	16.93	43.90	100.71
1994	728.86	2,151.88	41.54	4,692.35	4,662.2	15.63	46.16	100.65
1995	788.53	2,966.23	37.84	6,075.05	5,847.8	13.48	50.72	103.89
1996	880.20	3,852.08	29.86	7,609.49	6,788.4	12.83	56.16	110.94
1997	1,017.51	4,627.98	20.00	8,864.49	7,446.2	13.67	62.14	119.05
1998	1,120.46	5,340.75	15.40	10,175.00	7,939.5	14.11	67.26	128.16

[a]M2 is equal to sum of cash in circulation and all bank deposits.
SOURCE: *Almanac of China's Finance and Banking*, various years.

TABLE 2

CURRENCY SEIGNIORAGE AND IMPLICIT TAXATION ON BANK
DEPOSITS (PERCENT OF GDP)

	Inflation Tax	Real Expansion	Currency Seigniorage[a]	Implicit Tax on Bank Deposits[b]
1986	0.7	1.5	2.2	1.33
1987	1.1	0.7	1.8	3.07
1988	0.9	3.9	4.8	1.12
1989	0.8	0.5	1.3	−0.09
1990	0.7	−0.7	−0.0	−1.11
1991	1.0	1.5	2.5	0.70
1992	1.7	3.0	4.7	5.61
1993	2.0	3.6	5.6	4.40
1994	1.9	3.3	5.2	4.43
1995	2.3	0.10	2.40	7.6
Average 1986–95	1.4	1.7	3.1	2.66
1996	0.79	0.14	0.93	4.5
1997	0.00	0.18	0.18	3.2
1998	−0.36	0.13	−0.23	2.0
Average 1996–98	0.14	0.15	0.29	3.23

[a]Currency seigniorage is the sum of the inflation tax and real expansion.
[b]In calculating the implicit tax on bank deposits, a zero real interest rate is assumed as the opportunity cost of capital. Also, inflation compensation for household term deposits maturing in over three years is not taken into account.
SOURCES: 1986–94, from Hofman (1998, Tables 5 and 6); 1995–98, calculated by the author from *Almanac of China's Finance and Banking,* various years.

The traditional economics literature generally criticizes financial repression as an anti-growth and anti-development policy regime because it dampens the growth of the financial sector, which is believed to be important for economic development.[1] The Chinese experience offers an interesting alternative view. It shows that for economies under reform, maintaining macroeconomic stability is perhaps even more important than improving the efficiency of the financial sector.[2]

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[1]See McKinnon (1973), Shaw (1973), and Roubini and Sala-i-Martin (1995) for systematic and analytical expositions on this view.

[2]In the context of proper sequencing of reform, McKinnon (1993) has been arguing for this point. However, he stops short of endorsing financial repression. Instead, he argues for a delay of financial sector liberalization.

TABLE 3

GOVERNMENT FISCAL REVENUE

	Budgetary Revenue (billions of yuan)[a]	Extra-Budgetary Revenue (billions of yuan)	GDP (billions of yuan)	Budgetary Revenue as Share of GDP (%)	Adjusted Extra-Budgetary Revenue as Share of GDP (%)[b]	Estimated Off-Budget Revenue as Share of GDP (%)[c]	Estimated Total Fiscal Revenue as Share of GDP (%)[d]
1978	113.2	—	362.4	31.24	3.50	5.62	40.36
1979	114.6	—	403.8	28.38	3.50	5.11	36.99
1980	116.0	—	451.8	25.68	3.50	4.62	33.80
1981	117.6	—	486.2	24.19	3.50	4.35	32.04
1982	121.2	80.3	529.5	22.89	4.55	4.12	31.56
1983	136.7	96.8	593.4	23.04	4.89	4.15	32.08
1984	164.3	118.8	717.1	22.91	4.97	4.12	32.00
1985	200.5	153.0	896.4	22.37	5.12	4.03	31.52
1986	212.2	173.7	1,020.2	20.80	5.11	3.74	29.65
1987	219.9	202.9	1,196.2	18.38	5.09	3.31	26.78
1988	235.7	236.1	1,492.8	15.79	4.74	2.84	23.37
1989	266.5	270.9	1,690.9	15.76	4.81	2.84	23.41
1990	293.7	412.2	1,854.8	15.83	6.67	2.85	25.35
1991	314.9	324.3	2,161.7	14.57	4.50	2.62	21.69
1992	348.3	385.50	2,663.8	13.08	4.34	2.35	19.77
1993	434.9	143.30	3,463.4	12.56	4.14	2.26	18.96
1994	521.8	186.30	4,662.2	11.19	4.00	2.01	17.20

TABLE 3 (*continued*)

GOVERNMENT FISCAL REVENUE

	Budgetary Revenue (billions of yuan)[a]	Extra-Budgetary Revenue (billions of yuan)	GDP (billions of yuan)	Budgetary Revenue as Share of GDP (%)	Adjusted Extra-Budgetary Revenue as Share of GDP (%)[b]	Estimated Off-Budget Revenue as Share of GDP (%)[c]	Estimated Total Fiscal Revenue as Share of GDP (%)[d]
1995	624.2	240.6	5,847.8	10.67	4.00	1.92	16.59
1996	740.8	389.3	6,788.4	10.80	4.00	1.94	16.74
1997	865.11	282.6	7,446.2	11.62	3.80	1.90	16.9
1998	987.60		7,939.5	12.49			

[a]Budgetary revenue data are net of subsidies to the losses of state-owned enterprises. Data after adjustment should give slightly higher figures.
[b]Adjusted extra-budgetary revenue is 30 percent of reported extra-budgetary revenue between 1978 and 1992, and 100 percent of reported extra-budgetary revenue afterwards.
[c]Off-budgetary revenue is estimated at 30 percent of local budgetary revenue.
[d]Total fiscal revenue equals the sum of budgetary revenue, extra-budgetary revenue, and off-budget revenue.
SOURCE: *Statistical Yearbook of China*, various years.

A deeper political economy reason is that financial repression is like a flat tax on savers in an economy. When the government cannot commit to a rule-based income tax scheme and tends to tax arbitrarily, it may be better to rely on financial repression to collect taxes while forgoing the use of direct personal income taxation. In doing so, worries of high inflation and the subsequent political instability force the government to be moderate in the use of financial repression, which creates an upper limit on the flat tax rates implied by financial repression.[3]

The Trap of Financial Repression

Macroeconomic stability achieved through a mild financial repression does not come without costs. A major cost is inefficiency of financial intermediation. Specifically, financial repression in the reform era has prevented bank credit from flowing into productive investment projects. The main reason is that the central government and, to some extent, local governments have treated the ever-increasing deposits in the state banks as inexpensive resources to supplement their fiscal needs. For example, instead of confronting the challenges of collective payroll taxes to pay pensions for retirees of state enterprises, it is very tempting for local governments to instruct enterprises to pay pensions on their own. In return, local governments use their influences on local branches of state banks to offer cheap loans to state enterprises. Obviously, this practice is not a productive use of bank credit. Meanwhile, those much more productive nonstate enterprises, which are increasingly important to China's economic growth, are left hungry for bank credit. Table 4 and Table 5 show that the nonstate sector, which has become the main engine of economic growth, has only obtained a tiny amount of short-term loans from the state banks. The state banks' monopoly position, in both the deposit and the lending markets, has given them little incentive to search for and to evaluate good investment projects. The difficulty of increasing lending to nonstate enterprises in recent years illustrates the low efficiency of state-owned banks.

In other words, China's financial sector has helped provide macroeconomic stability necessary to win political support for reforms in the nonfinancial sector. The cost has been microeconomic inefficiency in the financial sector. With the gradual progress of reforms in

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[3]See Bai et al. (1999) and Bai et al. (2001) for more detailed institutional analysis of this point.

TABLE 4

CONTRIBUTIONS TO INDUSTRIAL GROWTH: STATE SECTOR
VERSUS NONSTATE SECTOR (PERCENT)

| | | Nonstate Sector | |
	State Sector	Collective	Private
1986	45.27	42.92	11.80
1987	48.83	39.33	11.82
1988	47.62	40.93	11.43
1989	52.51	33.50	13.98
1990	37.79	34.84	27.35
1991	43.73	36.12	20.14
1992	32.54	45.54	21.90
1993	31.36	39.11	29.52
1994	14.35	46.33	39.31
1995	33.49	14.60	51.90
1996	8.78	57.68	33.52
1997	4.71	29.10	66.17

NOTE: Each year's total increase in industrial output is scaled to 100.
SOURCE: *China Statistical Yearbook* (1998: Table 13-6).

the nonfinancial sector, the dismal condition of the financial sector is
a major obstacle to China's economic growth and reform.

Moreover, after being implemented for years, the policy regime of
financial repression has gained a life of its own. I call this problem
"the trap of financial repression" because, once caught in this regime,
it is very difficult to escape. The reason is simple: state banks gain

TABLE 5

THE NONSTATE SECTOR'S SHARE IN TOTAL SHORT-TERM
LOANS FROM STATE BANKS (PERCENT)

	Township and Village Enterprises	Private Firms	Sino-Foreign Joint Ventures
1994	7.43	0.57	2.94
1995	7.53	0.58	2.99
1996	7.01	0.69	3.34
1997	9.08	0.69	3.41
1998	9.21	0.78	4.10

NOTE: Each year's total short-term loan is scaled to 100.
SOURCES: Calculated from *China Statistical Yearbook* (1998: Table 18-3) and
China Statistical Yearbook (1999: Table 19-3).

vested interests and are hostile to liberalization of the financial sector, which inevitably allows entry of competing financial institutions and financial products.

More important, there is a positive feedback mechanism that strengthens financial repression by enhancing the monopolistic positions of the largest state banks. The mechanism works through the issue of nonperforming loans, which are consequences of financial repression. Under financial repression, state banks obtain cheap deposits and lend them cheaply to poor-performing state enterprises that often fail to pay back the loans. Thus, nonperforming loans pile up. In the Chinese case, nonperforming loans are believed to be between 20 to 30 percent of total loans outstanding of state banks.

To address this problem, China has relied on two policy options: (1) recapitalization of the state banks and (2) dilution of the proportion of bad loans. In order to recapitalize the state banks, the government either injects funds directly by issuing government bonds or by raising tax revenue, or floats shares of state banks on the stock markets. In order to dilute the proportion of nonperforming loans, the government encourages state banks to attract cheap deposits and to invest those funds in government bonds or sound projects. Nevertheless, the prevalence of nonperforming loans means that the size of state banks will increase, perhaps at a faster pace than before. With the rapid increase in the size of state banks, it will be even more difficult to demonopolize and reform them. Both recapitalization and dilution strategies are embraced and implemented by the Chinese policy community.

Beating the Trap of Financial Repression

To beat the trap of financial repression, it is necessary to break up the five largest state banks. They are already among the top 50 banks in the world in terms of assets (see Table 6). Because of their large size, the government will not allow them to fail, which makes them vulnerable to inefficient borrowers. Moreover, market competition is lax, transparent and effective internal governance is difficult if not impossible to establish, and, most importantly, the large state-owned banks have enormous political influence. All these problems have been experienced during the reform era and are the cause of financial repression. Breaking up the large state banks is not only beneficial in the long run but also essential for the success of financial reform (Li, Li, and Wang 1997).

There are a few common but unwarranted concerns with breaking up the largest state banks. First, there is a vague notion that in order

85

TABLE 6
An International Comparison of China's Largest State Banks, 1999

Bank	Assets		Capital Asset Ratio		Profits on Average Capital		NPL to Loan Ratio[a] (%)	Total Assets to GDP[b] (%)	GDP Basis Countries
	Million US$	World Rank	%	Rank	(%)	Rank			
Industrial & Commercial Bank of China	427,546	18	5.13	672	2.3	883	N.A.	43.13	China
Bank of China	316,214	28	4.83	719	3.5	850	14.86	27.50	China, Hong Kong
China Construction Bank	265,845	38	4.96	700	7.0	743	N.A.	26.82	China
Agricultural Bank of China	244,293	45	6.67	480	–1.0	918	N.A.	24.65	China
Bank of Communications	58,454	120	4.82	721	11.4	602	N.A.	5.90	China
Deutsche Bank	843,761	1	2.06	988	24.5	227	1.44	5.55	Germany, USA, Japan
CITI Group	716,937	2	6.65	483	35.6	61	1.40	4.72	USA, Japan, Germany
BNP Paribus	701,853	3	2.84	958	32.9	85	6.30	4.83	France, USA, Japan
Bank of Tokyo-Mitsubishi	678,244	4	3.84	870	15.0	490	4.84	4.47	Japan, USA, Germany

TABLE 6 (*continued*)

Bank	Assets		Capital Asset Ratio		Profits on Average Capital		NPL to Loan Ratio[a]	Total Assets to GDP[b]	GDP Basis Countries
	Million US$	World Rank	(%)	Rank	(%)	Rank	(%)	(%)	
Bank of America	632,574	5	6.04	558	32.6	88	0.85	4.16	USA, Japan, Germany
UBS	613,637	6	3.01	946	28.3	145	N.A.	4.59	Switzerland, USA, Japan
HSBC	569,139	7	5.01	689	28.0	152	4.00	3.93	UK, USA, Japan
Fuji Bank	531,184	8	4.26	811	11.9	587	4.37	3.66	Japan, USA, France
Sumitomo Bank	507,959	9	4.10	832	10.4	636	6.70	3.34	Japan, USA, Germany
HypoVereinsbank	505,559	10	2.91	953	5.5	797	2.40	3.33	Germany, USA, Japan
Dai-Ichi Kangyo Bank	471,977	11	4.98	696	7.9	718	N.A.	3.10	Japan, USA, Germany
Norinchukin Bank	469,900	12	3.15	938	7.6	731	6.25	3.09	Japan, USA, Germany
ABN AMRO Bank	459,994	13	3.87	867	26.0	194	N.A.	4.12	Netherlands, USA, Germany
Credit Suisse	451,829	14	3.91	862	25.0	217	N.A.	2.97	Switzerland, USA, Japan
Sakura Bank	443,367	15	5.20	662	5.2	808	N.A.	2.92	Japan, USA, Germany

[a]NPL refers to nonperforming loans.
[b]GDP used in calculating the ratio of total assets to GDP is the summation of GDP of the countries in which the bank operates.
SOURCES: *The Banker*, July 2000; *World Development Indicators Database*, World Bank, February 2000.

to compete with the imminent entry of foreign banks after China's accession to WTO, China's banks need to become larger rather than smaller. This notion is completely wrong. Foreign banks will not compete with Chinese banks in all regions and all submarkets. Instead, they are most likely to concentrate in a few highly profitable regions and sub-markets. Senior officials of Chinese state banks apparently are aware of this.[4] In other words, foreign banks will compete with Chinese banks not by sheer size of capital but by nimbleness and relatively high efficiency.[5]

The other common but unwarranted concern is that it is difficult to regulate a large number of small banks. It is true that, other things being equal, the more banks there are, the more difficult it is to regulate them. But the key point is that, from a regulator's point of view, a large bank is qualitatively different from a small bank, especially in a nonmarket environment. With a large bank, the relative political power of the regulating agency diminishes and its capacity to regulate dwindles. Examples from China's economic reform are plentiful.

How to Break up the Largest State Banks?

Reforms to break up the largest state banks are difficult to implement. To ease the difficulty, two preconditions must be met, and they should be the focus of the current reform efforts. The first precondition is a proper restructuring of the taxation system in order to break the government's strong financial reliance on profits generated by the state banks. The second is a satisfactory resolution of the issue of the nonperforming loans.

As discussed above, the central government has relied upon China's state banks for quasi-fiscal revenue in order to offset the impact of the central government's diminishing share of fiscal revenue in GDP. Apparently, if the state banks were to break up, interest rates on deposits would increase due to competition, profit of the state banks would decline, and cheap credit would no longer be readily available from the state banks to support the government. Unless the government can find ways to make up the lost quasi-fiscal revenue, either the budget deficit will increase rapidly, which may lead to

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[4]This awareness was revealed in my private conversations with a few senior officials of the People's Bank of China and of one of the largest state commercial banks in China.

[5]Even if foreign banks intend to compete with Chinese counterparts in the size of capital, it is not likely to be feasible because capital controls will still be in place after China's WTO accession.

inflationary pressure, or the government will find it imperative to reverse the reform of the financial sector.

What are the policy options to increase government tax revenue? The usual proposal to strengthen efforts to collect taxes may not be effective and perhaps may even be counter-productive, as it may lead to intensified arbitrary taxation that dampens private incentives. A relevant option in the short run is for the government to transform various existing implicit taxes on state banks into a special profit tax on all banks regardless of their ownership status. With the progress of reform, profits of the banking sector should be increasing. Banks will be and should be tightly regulated so that the collection of the profit tax should be relatively easy. The general profit tax on all banks will help make up the loss of quasi-fiscal revenue. Meanwhile, as long as macroeconomic stability is maintained, financial deepening will continue and the resulting seigniorage revenue to the central bank will supplement government tax revenue.

The second precondition is properly dealing with nonperforming loans. The existence of nonperforming loans is a very common excuse to keep the large size of state banks. In addition, after breaking up, the newly established banks should be given a clean slate to compete in the market place. Much has been discussed on the issue of nonperforming loans. Most analyses suggest that nonperforming loans be stripped from state banks with an injection of the same amount of capital financed by government bonds. But the problem of how to deal with the stripped-off nonperforming loans remains. Simply wiping out the obligations of the debtors—as is the case with debt-equity swaps—is the least desirable option as this creates enormous incentive problems leading to more nonperforming loans in the future. What should be done is to make effective changes in the property rights (or control) structure of state enterprises. For each enterprise involved, this requires first a period of exchanges of claims of nonperforming debt followed by granting the new nonperforming debt holders proper control rights of the enterprise so that they can initiate real changes in enterprise operation. This way, the maximum amount of nonperforming debt can be recovered. More importantly, debtor enterprises are restructured for better operation and managers are punished for losing control rights so that the possibility of the future emergence of nonperforming loans is minimized.[6]

Once the two preconditions are satisfied, by what rules should the

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[6]See Li and Li (1996) for a detailed description of the proposed approach to nonperforming debt restructuring.

reform break up the largest banks? Should the break-up follow geographic divisions with each new bank concentrating in a few regions? No. Doing this would limit competition among banks and reduce the benefit of asset diversification across regions. Moreover, under this plan, each regional bank is exposed to direct political influence of the local authorities. Should the break-up be along sectorial or industrial lines in lending operations? No. Again, this would limit competition and compromise banks' capacity of risk management. In addition, this would easily create disparate initial conditions for the new banks to operate and to compete in the market place. The break-ups should aim at creating new banks that are diversified across regions and sectors and are similar in size.

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