Review
Reviewed Work(s): The Heart of Economic Reform: China’s Banking Reform and State Enterprise Restructuring by Donald D. Tong
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financial service providers and regulatory intervention by the WTO and international financial institutions. Notwithstanding such minor shortcomings, *Back-Alley Banking* is based on impressive and insightful scholarship, and I recommend it to all researchers, students and policy-makers interested in China’s political economy.

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*The Heart of Economic Reform* attempts to provide a holistic view of China’s ‘unfinished’ economic reforms. It seeks to link the potential success of the much-debated financial-sector reforms to those of the state-owned enterprises (SOEs), which in turn hinge on the establishment of a functioning social welfare system. Its contribution lies in the fact that these issues are often treated separately. It is a useful source for those who wish to gain an overview of these topics, though the strengths of the arguments are sometimes weakened by less-than-perfect editing.

Donald Tong describes the critical roles of the financial sector in mobilizing savings and channelling funds from savers to investors. Since the onset of economic reforms in 1978, rural and urban households have replaced the government as the main saver and provider of capital for investment. A high savings rate is therefore important in sustaining high growth, which highlights the banks’ role in providing sufficiently attractive rates of returns to savers.

China’s banking sector is still dominated by the four state-owned commercial banks, which are major absorbers of household savings, but they are highly controlled by the government and their funds are invested mostly in state-owned enterprises and public projects. Though the establishment of special policy banks in 1999 relieved the four banks of some of this lending, they are still expected to finance the loss-making SOEs, and non-state enterprises are frequently discriminated against in credit provision. Partially offsetting this, a number of non-state commercial banks emerged during the 1990s—such as the Guangdong Development Bank and the Bank of Communications—as a result of increasing credit demand from the rapidly growing non-state sector alongside a desire by local governments to finance local development. However, the size of the non-state bank sector is still small, and its assets accounted for only eight percent of the total as of 1996.

Rural and urban credit cooperatives, along with trust and investment companies, have also characterized China’s financial development. The credit cooperatives have been significant in collecting savings from rural and urban households and in channelling them to the development of the village and
tOWNSHIP ENTERPRISES AND TO THE URBAN NON-STATE SECTOR, WHILE THE TRUST AND INVESTMENT COMPANIES, WHICH ARE AFFILIATED EITHER WITH PROVINCIAL GOVERNMENTS OR WITH THE STATE BANKS, HAVE EMERGED IN RECENT DECADES AS A RESULT OF INCREASING DEMANDS FOR FINANCIAL SERVICES THAT THE STATE-OWNED COMMERCIAL BANKS COULD NOT FULFIL. OVERALL, THESE SEVERAL TYPES OF NON-BANK FINANCIAL INSTITUTIONS ARE STILL DWARFED BY THE STATE BANKS: THE COMBINED ASSETS OF THE FORMER CONSTITUTED ONLY ONE-FIFTH OF THE ASSETS OF ALL FINANCIAL INSTITUTIONS.

CAPITAL MARKETS HAVE PLAYED A LIMITED ROLE IN FINANCING CHINA’S DEVELOPMENT. THE STOCK EXCHANGES ARE CONTROLLED BY THE CENTRAL GOVERNMENT AND SERVE PRIMARILY AS A VEHICLE FOR FINANCING SOEs. THIS IS REFLECTED IN THE CUMBERSOME LISTING PROCEDURES BY WHICH THE COMPANIES ARE SELECTED BY THE GOVERNMENT, RATHER THAN BY INVESTMENT BANKS OR BASED ON ANY COMPANY FUNDAMENTALS.

Tong argues that the banking sector’s weakness is due in large part to the state banks’ continued financial support to loss-making SOEs. It is also due to low interest spreads resulting from the central bank’s regulations on interest rates to ensure low costs of finance for the SOEs, which significantly narrows the state banks’ profit margins despite the limited competition they face. The government is unable to let go of insolvent state enterprises because they are key providers of social benefits to their employees. Tong’s calculations show that wage bills account for only 58 per cent of the SOE’s total labour costs, while employees’ housing, pensions, healthcare and education costs take up nearly 40 per cent (p.136). He also suggests that a large number of loss-making SOEs would have been able to break even or even show profits if they were relieved of these responsibilities, since the social-service expenditures were roughly equal to their financial losses. Hence, reform of the social welfare system becomes a prerequisite for restructuring the state enterprises and the financial sector.

The central government’s efforts to reform the social welfare system have produced limited results. The new Bankruptcy Law, which allows indebted SOEs to go bankrupt only if they have sufficient funds to finance lay-off expenses, is ineffective in protecting creditor rights. The new pension system that stipulates contributions by three parties (enterprise, employee and the government) into a pension pool suffers from funding shortages because many loss-making SOEs have been unable to meet their payment requirements.

The first two-thirds of the book reads like a textbook, explaining the role of finance in economic development, the evolution of China’s financial system and the lack of effectiveness of China’s financial institutions in channelling savings into investment. There is a disjuncture between this and the last third of the book, which presents ‘recent developments’ in the financial sector reforms and assumes some background knowledge. It would have been worthwhile for the author to devote more coverage and analysis to the recent reform efforts and to have put some effort into updating the manuscript, which is a revised PhD dissertation—a large part of this book seems rather dated, as the most recent data is only up to 1996.

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