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State-owned Enterprises, Privatization and Capital Controls in Emerging and Developing Countries

A dissertation submitted in partial satisfaction
of the requirements for the degree

Doctor of Philosophy
in
Political Science

by

Ritong Lu

Committee in charge:

Professor Benjamin Cohen, Chair
Professor Neil Narang
Professor Kathleen Bruhn

March 2021

The Dissertation of Ritong Lu is approved.

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January 2021

State-owned Enterprises, Privatization and Capital Controls in Emerging and Developing Countries

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by

Ritong Lu

To my beloved family

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Abstract

State-owned Enterprises, Privatization and Capital Controls in Emerging and Developing Countries

by

Ritong Lu

This dissertation project examines how the privatization of state-owned enterprises (SOEs) affects the degree of capital controls in the emerging and developing countries. It tests the proposition that major waves of privatization weaken the strength of traditional SOEs, and thus reduce the likelihood of using capital controls. As a significant part of the "insider" interests that benefit from the *status quo*, traditional SOEs usually enjoy preferential treatment thanks to state influence in financial regulation. In particular, they may have easier or even guaranteed access to credits under strict capital controls, and thus would be expected to oppose any reforms that might affect their rent-seeking activities, including capital market liberalization. In addition, traditional SOEs are likely to fight even harder against liberalization of capital outflows rather than inflows, because of potential benefits from increasing foreign investments and the fear of domestic capital flight, and their resistance is likely to be more effective in state-directed market economies (SMEs) than in other types of market economies. The empirical section includes two parts. The first part conducts quantitative analysis using annual panel data of emerging and developing countries from 1995 to 2015; the second part consists of three case studies, with one intensive case study of China and two supplementary case studies of India and Brazil.

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List of Abbreviations

CSS *Country SOE Shares*

BNDES Banco Nacional de Desenvolvimento Economico e Social (National Bank for Economic and Social Development)

BRICs Brazil Russia India and China

CBI Central Bank Independence

CMEs coordinated market economies

CPC Communist Party of China

CPE Comparative Political Economy

GDP gross domestic product

HMEs Hierarchical market economies

IFC International Finance Corporation

IMF International Monetary Fund

IPE International Political Economy

LMEs liberal market economies

MNCs multinational corporations

MTNL Mahanagar Telephone Nigam Ltd (Metropolitan Telephone Corporation)

OECD Organization for Economic Cooperation and Development

POEs privately-owned enterprises

PPI Privatization Participation in Infrastructure

SASAC State-owned Assets Supervision and Administration Commission

SMEs state-directed market economies

SOEs state-owned enterprises

TRAI Telecommunication Regulatory Authority of India

US United States

VoC Varieties of Capitalism

VSNL Videsh Sanchar Nigam Ltd (International Communications Corporation)

Chapter 1

Introduction

The world has experienced unprecedented level of financial integration in the last few decades of 20th century. The magnitude of cross-border financial assets holdings grew from under 50% of world gross domestic product (GDP) in the 1970s to over 300% in the early 2000s. There was a dramatic opening of national economies to external forces during this period of time (Simmons and Elkins, 2004). But as shown in Figure 1.1, interestingly the trend peaked in early 2000s before being reversed and started to show mixed signs with higher level of variance over the years. There has been more diverging views on globalization across countries, and states have opted to choose different paths of financial liberalization in accordance with their own agendas (Furceri, Loungani and Ostry, 2019; Angelico and Oliveira, 2020). The puzzle this dissertation project is interested in examining is the variation of the degrees of capital controls, i.e., why some states are financially more liberalized than others. Emphasis will be placed on the perspective of domestic interest groups, specifically the cleavage of interest between SOEs and privately owned enterprises (POEs), as the existing literature has often overlooked the important factor of firm ownership in determining policy preferences among interest groups.

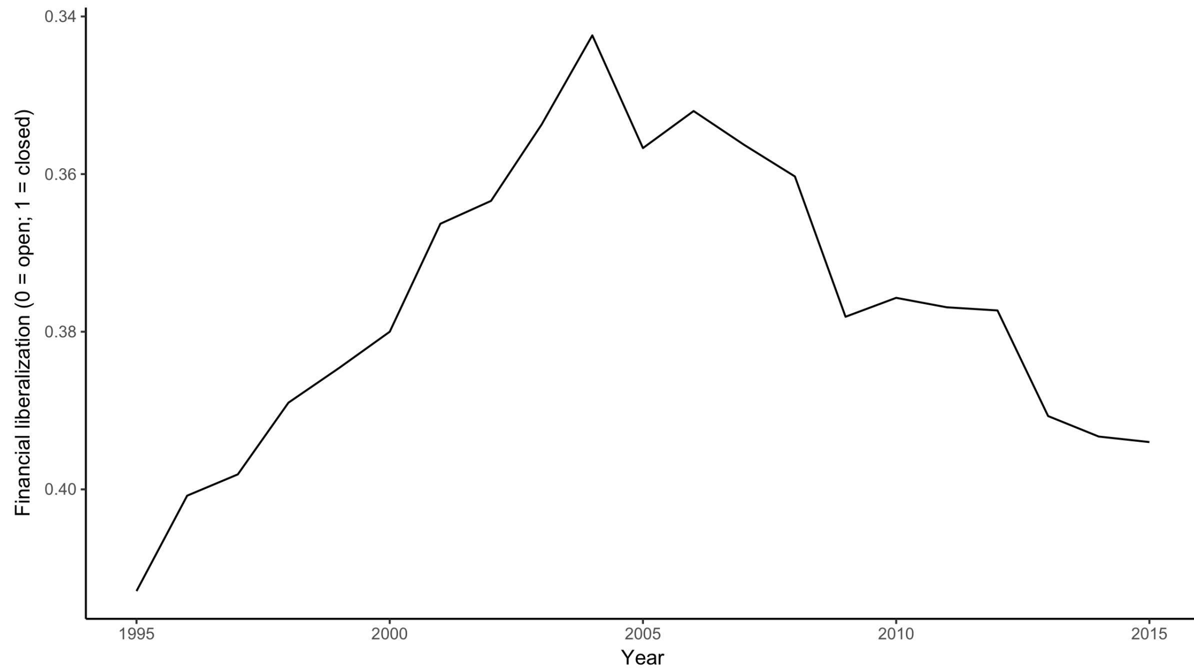

Figure 1.1: Fernández et al. (2016)'s new dataset of capital controls (average for 100 countries)

Studies on SOEs have mostly remained in the field of comparative political economy (CPE) and focus on domestic policy making without making the connections between the preferences of SOEs and the international policy outcome of capital-account opening. Scholarly works that have focused on capital controls and financial liberalization are largely from the field of international political economy (IPE). Although many in the IPE literature have studied the distributional consequences of international economic policies from the perspective of domestic coalition, they often fail to acknowledge the importance of SOEs as a critical domestic interest group. This dissertation project seeks to bridge this gap by highlighting the role of SOEs in determining the level of capital controls among emerging and developing countries, and contributes to the understanding of the policy preferences of these powerful newly emerged mixed-ownership SOEs and their institutional ties with the governments, which in turn might help explain the mixed signs observed in the recent world trend of financial integration.

It is important to understand the linkage between SOEs and capital-account opening, especially the preferences of these newly emerged mixed-ownership SOEs and the policy outcome of partial instead of full financial liberalization. Instead of an open-and-shut case, the emerging and developing countries are experimenting with the technique of carefully designed controls for the rate of capital flows. The conflicts of economic interests and business negotiations related to capital-account opening between countries might become more complicated and issue-specific. Understanding the domestic side policy considerations is a prerequisite for successful international financial cooperation.

SOEs are expected to prefer higher level of capital controls and stronger state influence over the financial sector to ensure their preferential treatment including concessional lending in the competition over capital vis-à-vis POEs. Despite the trend of privatization that weakens the presence of SOEs worldwide, the degree of privatization has varied across countries and helps explain the variation in the use of capital controls among states. In addition, the impact of SOEs on financial liberalization may be even stronger in the case of controls on capital outflows than capital inflows, because of higher stakes of interest in the former. At the institutional level, the varying contexts of state-market interaction also affects the influence of SOEs over financial policy making. The impact of SOEs on financial opening would be stronger in countries with more elements of interventionist state policies in economic activities, given the stronger ties between SOEs and the government and more favorable institutional frameworks for SOEs in these countries. The study of SOEs and capital controls in countries characterized with different types of state-market interaction is of great significance to make feasible policy suggestions based on how domestic interest groups are embedded in different institutional contexts.

Another important motivation for this research project derive from the fact that links between domestic preferences and policy outcomes in the emerging and developing world remain understudied compared to the OECD countries, and broad macro-level variables

alone cannot explain the variation of state behavior faced with the same international events (e.g., the Washington Consensus or the global financial crises): the impact is mediated through domestic factors. By looking into the role SOEs have played in determining the degree of financial openness, this project seeks to shed some lights on the larger theoretical questions of how privatization may drive financial liberalization, and why have the modest public-private cooperation model of privatization and partial financial liberalization become the new fashion among the largest emerging countries including China, India, and Brazil. Given that most developed countries especially the OECD countries have liberalized their financial markets and there is no observable variation in the dependent variable of capital controls, the scope of this project will be limited to the emerging and developing countries with higher variation in the level of capital controls.

1.1 Capital Controls

Developed countries in general have lower level of capital controls than developing countries. For example, members of the Organization for Economic Cooperation and Development (OECD), a forum of countries with high-income economies and a very high Human Development Index (HDI) describing themselves as committed to democracy and the market economy, have maintained no capital controls. The OECD Codes of Liberalization are one of OECD's most important legal instruments, being a signatory to which is one of the prerequisites for joining the Organization (Blundell-Wignall and Roulet, 2014). In a first wave, US, Canada, Germany, Switzerland and Great Britain abolished capital controls in the 1970s; most other advanced countries followed in 1980s and early 1990s. In the emerging and developing countries, many governments decided or were coerced into following the advanced economics by abandoning capital controls in the same period, whereas the largest emerging countries such as China and India have

maintained a “wall” of strict capital control (Boughton, 2001; Helleiner and Pickel, 2005; Klein, 2012).

Since the early 2000s, some developing countries that had liberalized their capital-accounts began to reintroduce controls, and this retrenchment increased after the onset of the 2008 global financial crisis (Klein, 2012; Chamon and Garcia, 2016). Among the largest emerging economies, the so-called BRICs countries of China, India, Brazil, and Russia, both China and India announced their intention to liberalize their capital-accounts in the past few years, but the prospect remains controversial regarding the extent of liberalization achieved so far, how far it might go, and what factors may determine the liberalization process. The world has a huge stake in China and India integrating their finances into global markets without disruptive spillovers to the global financial system (Hooley et al., 2013; Stanley, 2017). A stronger correlation between domestic and oversea stock market for example might occur after deeper financial integration of the largest emerging markets of China and India, which in turn affects the benefits reaped from international diversification portfolio for investors (Bhullar, 2019). Both Russia and Brazil have made significant progress of lifting capital controls in the past few decades, but have experienced ups and downs in the use of capital controls lately.

Studies of financial liberalization often stress that the 2008 global financial crisis changed things quite dramatically. Capital flows to the emerging-market economies peaked at $680 billion in 2007 and turned negative at the onset of the 2008 global financial crisis, then they rebounded and receded again after the US (United States) sovereign debt downgrade in 2011, when the credit ratings of the US federal government was reduced from AAA/outstanding to AA+/excellent. The flow continued to swing wildly, leaving emerging-market policy makers wondering whether they can put in place policies during the inflows phase that will soften the blow when flows subsequently recede (Ghosh, Ostry and Qureshi, 2018). Capital controls have been reintroduced as a

legitimate policy tool as part of a tighter macro-regulatory framework for many countries to reduce vulnerabilities to crisis in the contemporary era (Ülgen, 2016). Some scholars suggest the movement toward more open capital markets not only has stopped, but may also have reversed for the first time since the late 1970s (Grabel, 2015; Perri, 2017).

Other observers have questioned the drastic transformative effect of 2008 and present evidence of continuity. Kaltenbrunner (2016) suggest that the capital controls observed are often temporary, and does not indicate a fundamental shift of attitudes towards managing crisis. Helleiner (2014) refers to the unsatisfying post-2008 reform of global financial governance as the *status quo* crisis, and attributes the stagnancy to the underlying unchanging configuration of power and politics among and within the influential states, especially the overwhelming structural power of the US. Akyüz (2017) also suggest that despite the recurrent global financial crisis, the trend of financial liberalization has continued and even accelerated in the new millennium. Almost all emerging and developing countries are now vulnerable to financial shocks irrespective of their balance-of-payments, external debt, net foreign assets and international reserve positions. This is a matter for concern since the multilateral system still lacks mechanisms for orderly resolution of financial crises with international dimensions. Bekaert and Mehl (2019) argue that global financial market integration follows a "swoosh" shape – i.e. high pre-1913, still higher post-1990, low in the interwar period, and find no evidence of financial globalization reversing since the Great Recession based on a factor model of monthly equity returns that measure the *de facto* financial market integration.

Both sides of the stories might be true if we differentiate between *de jure* versus *de facto* capital controls. *De jure* capital controls comprise rules, taxes, or fees associated with financial transactions that discriminate between domestic residents and nonresidents (Ostry et al., 2011; Klein, 2012). The measures of *de jure* measures of capital controls are mostly derived from the binary variables in the IMF's *Annual Report on Exchange*

Arrangements and Restrictions (AREAER)[1]. *De facto* measures of capital controls are often based on the Law of One Price (LOP), and exploit observable phenomena resulting from increased capital mobility, such as the magnitude of gross capital flows, share of domestic equities that are available for foreign purchase (Edison and Warnock, 2003), decreasing correlations between savings and investment (Feldstein and Horioka, 1979), and convergence between external and domestic interest rates, foreign exchange forwards rates, and bond yields (Dooley, Mathieson and Rojas-Suarez, 1997; Ma and McCauley, 2014). Among them, Lane and Milesi-Ferretti (2007) offer what many scholars regard as the most useful *de facto* measure of a country's exposure to international finance, by using the ratio of the sum of international assets and liabilities to GDP as the indicator for *de facto* capital controls. Higher ratio suggests higher level of financial integration between the domestic financial market and the world and lower level of capital controls.

The world trend of financial liberalization in the 21st century looks more continuous rather than transformative after the 2008 financial crisis if we look at *de facto* capital controls rather than *de jure* capital controls, since in reality, the degree of enforcement of the controls has considerable influence on the "controlled" nature of transactions, and observed capital flows often exceed the extent of mobility legally allowed (Ma and McCauley, 2014). It seems that scholars arguing for the continuity of international financial integration are more concerned about the macro-level phenomenon of increasing cross-border capital flows in practice as measured by the level of *de facto* capital controls; whereas critics highlighting the reversal of financial liberalization trend are talking about the reintroducing and retaining of *de jure* capital controls as a useful policy tool in many emerging and developing countries aiming at protecting themselves from external financial shocks. Although *de jure* capital controls sometimes fail to achieve the expected level

[1] An alternative source is the OECD Codes of Liberalization of Capital Movements and Current Invisible Operations. It is less frequently used because of limited scope, and because most of the advanced countries included removed capital controls long ago.

of effectiveness, interest groups including those newly merged mixed-ownership SOEs often prefer the existence of at least some level of state control over the capital-account rather than a full liberalization, given their benefits under state financial repression. For the purpose of this dissertation project, I will focus on *de jure* instead of *de facto* capital controls because the former is more pertinent in understanding the linkage between SOEs and capital-account opening.

1.2 SOEs around the World

SOEs are formally defined as firms whose controlling shareholder is a central or subnational government. In the context of this dissertation, two types of SOEs are classified: 1) traditional SOEs where the state maintains full ownership and control; 2) mixed ownership SOEs where the private sector is invited to become shareholders but the state remains the controlling interest by owning a significant portion of the voting shares. Although some observations anticipated that SOEs would fade away after the breakup of the Soviet Union in early 1990s due to inefficiency and lack of competitiveness, it seems not to have been the case (Bruton et al., 2015). As Figure 1.2 shows, the privatization of SOEs went from an iconoclastic policy idea in Margaret Thatcher's 1979 British election manifesto to a major element of economic policy in both developed and developing countries over the course of around twenty years before the turn of the century (Brune, Garrett and Kogut, 2004). Since 2000s, however, new dynamics have emerged, as many SOEs may have survived and thrived in part because they have evolved to become a type of hybrid organization (Inoue, Lazzarini and Musacchio, 2013; Bruton et al., 2015). New modest public-private cooperation models of privatization have gained an upper hand over the rapid trend of privatization seen in the late last century. In this model, the state invites private investors to become shareholders of SOEs with or without management

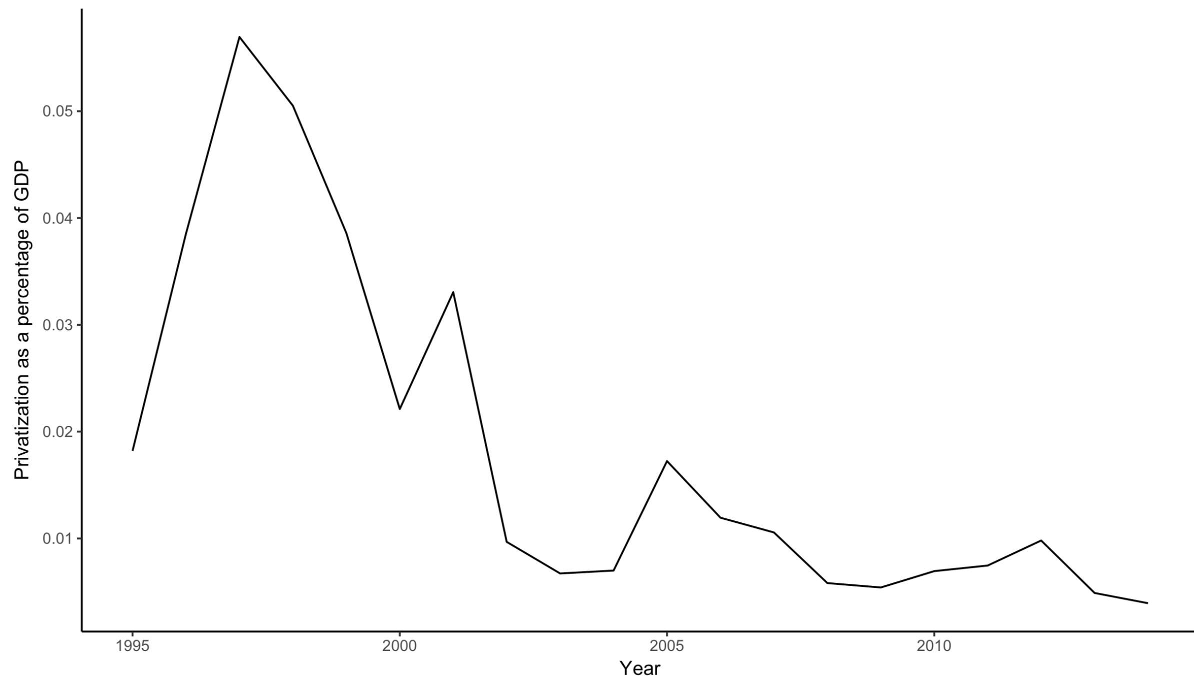

Figure 1.2: Privatization trend based on the World Bank's *Private Participation in Infrastructure (PPI)* database (average for 59 emerging and developing countries)

roles. Traditional SOEs where the state has full ownership and control are being transformed into new mixed ownership SOEs. Some of the most profitable central SOEs have been retrofitted for the market era and become strikingly resilient after being exposed to competition and endowed with elements of modern corporate governance (Musacchio and Lazzarini, 2014; Chatterjee, 2017). Rakhman (2017) finds empirical evidence that the financial performance of partially privatized SOEs has become at least as good as that of private firms and sometimes even higher in the past decade.

Based on an estimation in 2011, SOEs generate approximately one tenth of world GDP and represent approximately 20% of global equity market value (Economist, 2012). Of the 2000 largest companies in the world, 204 (10%) are SOEs where the state is the ultimate owner (i.e., the state holds more than 50% of a company's share) (Kowalski et al., 2013). The combined sales of the 204 SOEs amounted to USD 3.6 trillion in 2011,

equivalent to almost 6% of world GDP. China has the highest number of SOEs in the list (70), followed by India (30), Russia (9), the United Arab Emirates (9) and Malaysia (8). In terms of SOEs influence at the country level, *Country SOE Shares* (*CSS*), an index computed as equally weighted averages of SOEs shares of sales, assets and market values among each country's top ten companies is created by Kowalski et al. (2013) as one of the indicators. The ten countries with the highest *CSS* in 2011 were China (95.9), the United Arab Emirates (88.4), Russia (81.1), Indonesia (69.2), Malaysia (68), Saudi Arabia (66.8), India (58.9), Brazil (49.9), Norway (47.7) and Thailand (37.4) (Kowalski et al., 2013). Wu (2019) provides another updated estimation based on the number of SOEs in the top ten companies globally from 2000 to 2015, and suggests that the presence of SOEs continue to rise from 2011 onward, with half of the ten largest companies in the world being SOEs in 2015.

According to the International Finance Corporation (IFC, a World Bank group)'s report in 2018, SOEs account for 20% of investment, 5% of employment, and up to 40% of domestic output in countries around the world (IFC, 2018) . Despite intensive privatization, governments continue to partially own and operate national commercial enterprises in key industries. These newly emerged mixed-ownership SOEs play an important role in delivering critical services in key economic sectors, including utilities, finance, and natural resources. Their presence in high-income countries, in major emerging-market economies, and in many low- and middle-income countries has endured and expanded. The way SOEs are used as a means to correct market failure despite the risk of being subject to political interference in this era is worth noting. The problems that arise from the conflict of interests between the government as the controlling shareholder and as the corporate regulator call for reconceptualization and reform of corporate governance (Bank, 2014; Lim, 2020). The fact that many newly emerged mixed-ownership SOEs now rank among the world's largest companies, investors, and capital market players makes

it ever more important to study and understand their preferences and the mechanisms of how SOEs influence governmental decision-making including financial policy changes. The stakes are extremely high, since operational deficiencies and political manipulation of SOEs could disrupt service provision, creating negative impacts for citizens, businesses, and potentially entire economies (IFC, 2018).

1.3 Outline of Chapters

This dissertation consists of eight chapters. The present chapter is an introduction to the project. It first introduces the main argument and the motivation for this project, then explains the concepts of capital controls in terms of definitions, classifications, and changing trends, before moving on to describing varying types and sizes of SOEs across the world.

Chapter 2 reviews the existing literature. In the political economy literature, domestic political divisions are mostly drawn along the line of class (factors of production) or industry; this project, however, will focus on the cleavage of interest based on the ownership of enterprises, i.e., SOEs versus POEs, because ownership matters in a significant way and has been overlooked and understudied. Besides, unlike in OECD countries, state presence remains significant in business management in the emerging and developing countries, and in some cases, state intervention has even increased in recent years (Kowalski et al., 2013; Musacchio and Lazzarini, 2014). At the institutional level, the Varieties of Capitalism (VoC) literature suggests that the general institutional context of how states interact with markets matters and this is an important aspect for this dissertation project (Hall and Soskice, 2001; Thelen, 2012). The privatization literature addresses the differences between SOEs and POEs but is more focused on the economic side (for example, the differences in their performances) and domestic policies; whereas

this project will instead bring in a more political economic perspective, and will discuss the distributional impact of international financial integration policies for these two groups.

Chapter 3 develops an argument explaining the variation of the degrees of capital controls among developing countries and derives the main hypotheses. First, privatization lowers the chance of having capital controls (hypothesis #1). SOEs benefit from capital controls, because it helps ensure that SOEs have easier and guaranteed access to below market interest rate financing, and strict financial regulations in general provide a number of other policy tools that might be useful to assist SOEs in times of need. Both full and partial privatization, however, weakens traditional SOEs politically. Under full privatization, traditional SOEs are sold off and turned into POEs; under partial privatization, they are transformed into mixed-ownership SOEs by incorporating preferences and interests of the private sector. Privatization thereby lowers market concentration level, improves efficiency and performance, and helps reduce SOEs' resistance to lifting capital controls. Second, the impact of privatization on capital controls works differently between capital inflows and outflows and is stronger in the latter (hypothesis #2). The potential benefits from capital inflows (e.g., the increased access to foreign investors and lenders that helps reduce firms' financial constraints) might be able to partially offset the cost of capital-account liberalization for SOEs; whereas the stakes of interest is extremely high in the case of capital outflows because possible domestic capital flight after financial opening is supposed to severely undermine the lending privileges for SOEs. Third, the resistance from SOEs is more influential and effective in countries with more concrete and everlasting legacies of an interventionist state (hypothesis #3). SOEs are expected to have stronger power if accompanied with institutional frameworks where they can directly contact and make policy demands with the government, and their political influence might be counterbalanced by the significant presence of foreign capital, which

sometimes follow the retreating of an interventionist state.

Chapter 4 outlines the research design. The empirical section of this dissertation includes both large-N quantitative analysis based on panel data and small-N case studies. The former quantitative part performs tests for correlation between privatization and the degree of capital controls using fixed-effects model and conducts difference-in-means tests between high privatizers and low privatizers, thereby providing empirical evidence for the first two hypotheses. The latter qualitative part details the causal mechanism(s) of the theory, and provides empirical evidence for all three hypotheses. China is selected as a critical case for intensive examination including content analysis, interviews and field work because of its significant number and strength of SOEs, high level of capital controls, and a strong state with a direct role in economic management. India and Brazil are selected as supplementary cases where evidence is mainly drawn from secondary sources to form comparisons with China, since these countries also have a large number of SOEs, and other similar characteristics with China such as large economic size and rapid rate of growth. Among the three countries, India is relatively more similar to China than Brazil. The variation between India and Brazil on the dimension of the state role in economic intervention (with India having a relatively more interventionist government and Brazil having less) allows for investigation of the impact of different types of market economies on the effectiveness of SOEs' resistance. The rationale for selecting the three cases is to see to what extent is China's case replicable in India, and how does the context of a less interventionist state in Brazil affects SOEs' influence to capital controls.

Chapter 5 discusses findings based on panel analysis. A statistically significant negative correlation is found between privatization and the likelihood of using capital controls based on a panel of 59 emerging and developing countries from a period of 1995 to 2015. In addition, democracies, countries with more independent central banks, and richer countries also have a lower chance of having capital controls. The correlation is also

found to be statistically more significant if the dependent variable is controls of capital outflows alone compared to the aggregated level of capital flows and controls of capital inflows. In addition, evidence from difference-in-means tests shows that the high privatizers (presumably with stronger presence of SOEs to start with) have an overall higher levels of capital controls compared to the low privatizers. But as the presence of their SOEs falls with privatization, the high privatizers see a drop in their levels of capital controls over the years whereas the low privatizers actually has a slight increase in their levels of capital controls. This suggests that for countries to achieve the policy outcome of reducing capital controls, it may have to consistently privatize for a continued period of time until the presence of SOEs diminishes under a certain level. Further tests that differentiate between controls of capital outflows and inflows again indicate that the observed difference in means between high and low privatizers is largely driven by the data of outflows rather than inflows controls, thereby supporting the argument that SOEs' resistance to capital controls in stronger in the case of controls of capital outflows than inflows because of higher stakes of interest in the former.

Chapter 6 presents findings from the intensive case study of China and explains how China fits into the theory. It traces the trajectories of both the independent and dependent variable in China for the past few decades, and provides empirical evidence for all the three hypotheses. A careful review of relevant official government documents suggest that privatization comes before capital-account liberalization and is considered as a necessary step to be accomplished before the policy initiative of lifting capital controls in China. China is pursuing a modest public-private cooperation model of privatization that prevents privatization from going further and driving financial liberalization as predicted by the theory. The story of how SOEs stand in the way of furthering capital account opening in China helps provide empirical evidence for H1. In the meantime, it details the mechanism of how privatization affects the likelihood of using capital con-

trols by altering the preferences of critical interest groups. Specifically, the privatization project of Wasu in the Chinese telecommunication industry is carefully examined as a model with rich details of how this process works. The second section on capital inflows versus outflows explains how China's case relates to H2. Throughout the qualitative interviews, government officers, financial sector managers, financial journalists, SOEs and POEs managers all seem to assume that once the gate is open, Chinese investors will be eager to transfer their financial assets abroad. The fear of losing domestic capital and potential economic political turmoil is considered as the major incentive to move slowly and gradually down the path of financial liberalization. In contrast, a general favorable and welcoming attitude is associated with capital inflows throughout the observations. The third section on SOEs and institutional embeddedness provides qualitative evidence for how interests are aggregated in a typical SME of China, thereby providing empirical evidence for H3. China has an institutional environment more favorable to SOEs largely because of significant leftovers from an interventionist state after liberalization reform.

Chapter 7 discusses India and Brazil to form comparison with China. India turns out to be very similar to China, where SOEs receive preferential treatment with the help of strict capital controls and the institutional legacy of "licence Raj" is in favor of SOEs. Privatization in India also comes before capital-account liberalization, and a consolidated domestic financial sector is considered as a necessary condition to be met before undertaking the more risky choice of lifting capital controls. Like China, India also employs a modest public-private cooperation model of privatization and has a very gradual path of financial liberalization. But the Indian government has a relatively more pro-business stand compared with China and has given more control to the private sector during privatization, which might help explain the relatively more consistent path of capital-account opening seen in India.

Brazil started out in a similar political economic setting as India and China but

with different dynamics occurred along the way. Evidence shows that Brazilian SOEs have a significantly higher chance of being selected as "national champions" that receive profound governmental support, and privatization in Brazil also follows a modest public-private cooperation model as China and India do. But unlike China and India, Brazil has driven much further away from its interventionist policies in the past and becomes much more dependent on foreign capital. Compared to the scenarios of China and India where the preferences of SOEs have largely been reflected in the actual policy outcome of capital-account opening with the help of institutional leftovers from interventionist state policies, SOEs in Brazil are not as influential and powerful. Brazil does not retain a state-led regulatory system as we see in China and India that directly ties SOEs' preferences to the state and more importantly, the profound presence of MNCs and foreign lenders have been able to offset the impact of SOEs. Instead of a gradual path of financial opening as seen in China and India, the capital-account in Brazil is much more open than the other two, and it has experienced ups and downs along with world economic crisis.

Chapter 8 concludes and discusses policy implications for this project. This dissertation contributes the existing literature by highlighting the important but overlooked variable of firm ownership in determining domestic cleavage of interest. In addition, it differentiates controls of capital outflows and capital inflows to disaggregate the concept of capital controls, which helps reveal the nuances of policy considerations for different types of controls. The role of institutional context is also carefully examined to better understand the mechanism how privatization affects financial liberalization, as the political power of SOEs differs across countries depending on how institutionally embedded and closely connected they are to the government. The findings of this dissertation suggest that the privatization of SOEs might be a necessary condition for financial liberalization in the developing world. Full financial liberalization may be delayed while partial financial liberalization becomes more common in the meantime. State capitalism and partial

liberalization led by the major emerging countries including China, India and Brazil could become a norm shared across the developing world. The study is also relevant for the developed world, since it is possible that a giant private sector could act as both the owner and regulator in more mature market economies, just as the state acts as both the owner and regulator in emerging markets. These gigantic private firms regardless of country origins receive preferential treatment not because of a strong state, but rather a weaker state. In the absence of sufficiently effective regulatory institutions, they may be able to oppose any reforms that threaten their interests and safeguard the *status quo* through their greater lobbying power.

An appendix is provided at the end that lists the countries used in the sample for quantitative analysis and the professional information of the interviewees as part of the case study on China.

Chapter 2

Literature Review

2.1 Capital Controls

Capital controls comprise rules, taxes, or fees associated with financial transactions that discriminate between domestic residents and nonresidents (Ostry et al., 2011; Klein, 2012). Other terms that have been used to describe the restriction on cross-border capital flows other than capital controls include capital-account regulations, capital-account management, and capital flow management techniques (Ocampo and Palma, 2008; Ostry et al., 2011; Fritz and Prates, 2014). In theory, capital controls do not target either foreign nationals operating onshore (e.g. local subsidiaries of foreign banks) or the operations of nationals operating offshore; they are targeted at cross-border operations (Kaltenbrunner, 2016).

Capital controls cover a wide range of financial activities and have been classified into different categories in the literature. Administrative capital controls include prohibitions on foreign borrowing or lending, quantitative limits on these transactions, or a requirement that such transactions receive prior government approval; they also tend to be long-standing controls that cover a broad range of assets. Market-based capital controls

often involve taxes on cross-border capital transactions, differential bank reserve requirements for resident and non-resident accounts, or a requirement that some proportion of capital inflows be deposited in a non-interest-bearing account at a central bank (an unremunerated reserve requirement), which effectively serves as a tax on inflows; they are sometimes referred as "gates" to enable an economy to benefit from international capital, but may swing shut in the face of unwanted appreciation or a destabilizing asset market boom, and usually are targeted towards particular categories of assets (Klein, 2012). Others have distinguished between long-term capital controls and those that are implemented as temporary counter-cyclical tools, controls on capital outflows and those on inflows, and static controls which authorities do not modify in response to changes in circumstances and dynamic regulations that can be activated or changed as circumstances warranted (Grabel, 2012; Fritz and Prates, 2014; Kaltenbrunner, 2016; Achsani, Irawan et al., 2018).

In that respect the focus of this dissertation is on the differentiation between controls on outflows and inflows. Controls on outflows target outgoing domestic capital looking for investment and diversifying opportunities overseas; whereas controls on inflows aims at incoming foreign capital as investors or lenders to domestic economic activities. Empirically as Figure 2.1 show, countries have overall higher levels of controls in the outflows than inflows. Although the correlation between capital inflows and outflows have been rapidly increasing as the world gets more financial integrated, such correlation is much higher in more advanced countries (Davis and Van Wincoop, 2018). Emerging countries and developing countries are more likely to have higher controls of capital outflows than inflows, given their status of being relatively more capital scarce and stronger desire for foreign investment and fear of capital flight compared to the developed countries.

At the level of theoretical debates, liberal economists argue that capital controls impede efficient allocation of financial resources. In fact, the dominant view of capital

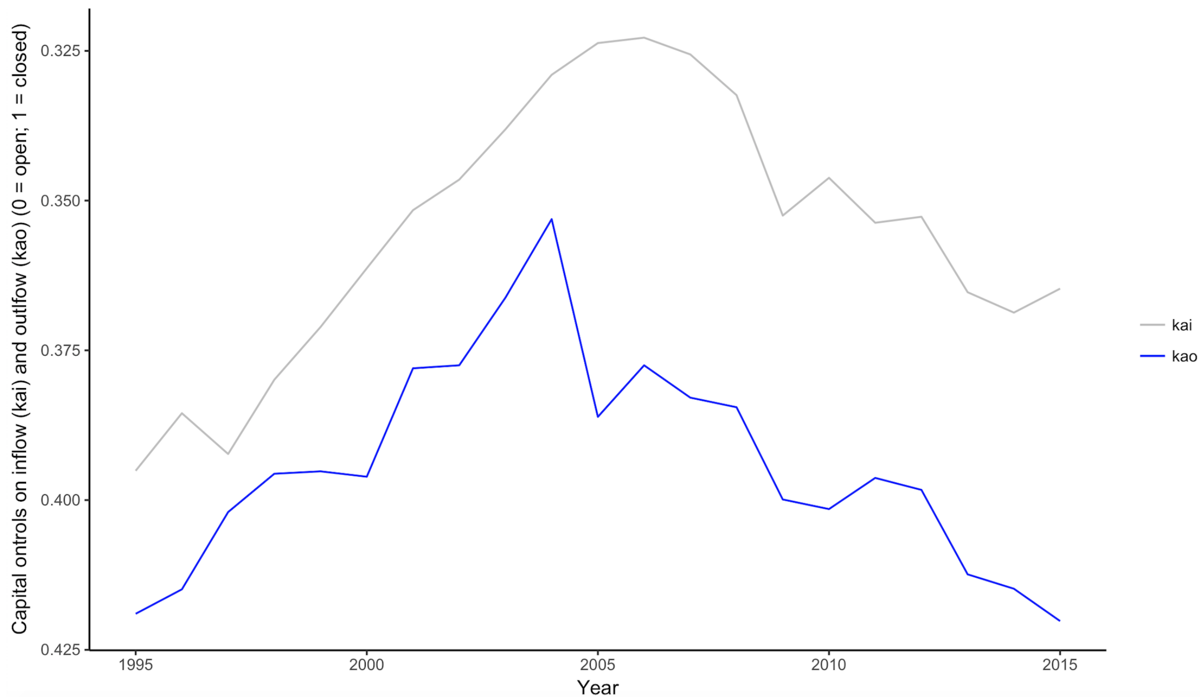

Figure 2.1: Fernández et al. (2016)'s new dataset of capital controls for inflows and outflows (average for 100 countries)

controls before the 2008 financial crisis was that they reduce the supply of capital, raise the cost of financing, increase financial constraints for domestic firms that are denied direct access to international capital markets, reduce the discipline of markets on decision-making, and increase the risk of corruption (Edwards and Ostry, 1992; Blundell-Wignall and Roulet, 2014). A country is generally assumed to benefit from allowing the free flow of assets across its borders, and this is thought to be especially true of middle-income emerging-market economies, because they have an abundance of funding opportunities relative to domestically generated savings. International asset diversification could also benefit savers in these countries, since their domestic productive activities tend to be concentrated within a limited range of industries. capital-account liberalization in emerging economies might also help transfer financial know-how that could spur development in their rudimentary capital markets (Klein, 2012).

Besides, capital flows have become so immense and sophisticated that they seem virtually impossible for nation-states to regulate. The structural power of global financial markets, and the ability of foreign investors to have veto-power over national regulation by threatening to withdraw their capital, has tilted national institutions and ideologies to shift in favor of capital-account liberalization. Those sectors that benefited most from capital flows became relatively stronger and supported political parties that endorsed the deregulation of the capital-account (Goodman and Pauly, 1993; Cohen, 1998; Gallagher, 2014).

These prevailing views came under critical review after the 1998 Asian financial crisis and especially during the 2008 financial crisis. Despite the modest intellectual progress toward more favorable views of capital controls that began after the Asian crisis, controls before 2008 remained an exceptional and contested measure that were thought to achieve desirable outcomes only when particular preconditions were in place. Since the global crisis, controls on outflows and especially on inflows are not just tolerated, but are in many cases understood as a vital tool of prudential financial management that help address capital volatility (Jeanne, 2012; Rey, 2015; Eichengreen and Rose, 2014).

Critics argue that capital controls have been successfully "rebranded" during the recent global financial crisis. Formerly denigrated as a policy tool of the weak and misguided, capital controls have now been normalized as a tool of prudential financial management, even within the corridors of the International Monetary Fund (IMF), which until recently held a long-standing position against restrictions on international financial transactions (Fernández, Rebucci and Uribe, 2015; Grabel, 2015). The IMF's crisis-induced research on controls culminated in a December 2012 report of the Executive Board, which the IMF terms "the institutional view." The report makes clear that inflows and outflows surges may induce instability, and countries should not consider capital liberalization prematurely. Other major points made include the idea that temporary

inflows controls and even outflows controls may be warranted during turbulence, that countries retain the right under Article VI to put controls in place, and that the IMF's new, more permissive stance on controls may conflict with and be subsumed by trade and other agreements. It is also worth noting that the institutional view of the IMF emphasizes continued effort to domesticate the use of controls, now referred as "capital flow management" techniques: controls should be targeted, transparent, and temporary, and should not discriminate against foreign investors (Ostry et al., 2011; Grabel, 2015; IMF, 2012)

Many most recent publications also raise concerns over the desirability of financial liberalization and discuss the legitimacy, necessity, and possible benefits of tighter controls of capital flows especially among the more vulnerable developing countries to help them contend with large and volatile capital flows (Kaltenbrunner, 2016; Heathcote and Perri, 2016; Lee, Lin and Zeng, 2016; Ülgen, 2016; Ghosh, Ostry and Qureshi, 2018). Ülgen (2016) suggests that when financial markets are liberalized and private-interests related self-regulation replaces public macro-prudential supervision, the financial system undergoes institutional deadlock and the ensuing confusion is transformed into a market gridlock. Therefore, systemic stability calls for a tighter macro-regulatory framework to remove the domination of speculative finance over economic decisions and activities. Lee, Lin and Zeng (2016) provides empirical evidence for the negative impact of financial liberalization on the likelihood of currency/systemic banking crises. Kaltenbrunner (2016) suggests that emerging and developing countries should be encouraged to establish permanent, comprehensive and institutionalized administrative capital-account regulations to help develop their domestic economies and financial systems and foster national savings, given the inherent instability of international financial markets and the structural subordination of emerging and developing countries. They also differentiate capital controls from macroprudential regulations despite some inevitable overlaps, as the latter

does not discriminate against agents based on their residence and aims at reining in the excesses rather than fundamentally altering the course of privately-driven market behavior, and they have gained wide acceptance and prevalence after the 2008 global financial crisis. Heathcote and Perri (2016) provide evidence for the welfare gains from imposing unilateral capital controls in a standard two country international macro model, and argues that under all plausible model parameterizations, countries can benefit at the expense of their trading partners by imposing taxes on international lending and borrowing, as it generates favorable changes in the dynamics of equilibrium interest rates and the terms of trade.

2.2 Domestic Preferences

The existing scholarly literature has offered both domestic-level and macro-level analyses of capital-account liberalization. From the perspective of domestic preferences, scholars often focus on the distributional effects of capital controls. Classical IPE literature argued that capital controls affect capital and labor differently. Increased mobility of capital favors the owners of capital in the sense that they can now diversify country-specific risk and avoid taxes and regulations by moving assets across borders, but workers may lose given that their specialized skills are more "specific" within the borders of the country and immobile across borders (Alesina and Tabellini, 1989; Frieden, 1991; Rodrik, 1997). Furceri and Loungani (2015) provide empirical evidence that capital-account liberalization tends to increase inequality and reduce the labor share of income in the short and medium term.

Most recently, firm-level cleavages have started to draw more scholarly attention, including size, market structure, and ownership. In terms of size, Friedman (2005) argues that globalization has granted more equal opportunities for smaller corporations and

made the world "flat." Others however, are more skeptical and present evidence of increasing consolidation across major industries through mergers and acquisitions (M&A); this is making competition even more difficult for latecomers especially smaller firms in the emerging and developing countries (Nolan, Jin and Chunhang, 2007; Nolan and Zhang, 2010). Although these discussions address firm-level cleavages at the global level and discuss globalization in general, the implication for domestic preference formation regarding capital-account liberalization is clear. Lifting capital controls might benefit small domestic firms by providing access to credits from foreign markets that were previously restricted, thereby leveling the playing field vis-a-vis large firms, following Friedman (2005)'s insight.

Laeven (2003) and Forbes (2007) find that large firms tend to be less financially constrained than smaller firms before liberalization and are less likely to experience a reduction in financial constraints afterward. Not only do large firms benefit less from liberalization, they may even experience an increase in financial constraints after financial liberalizations because in many emerging and developing countries, large firms often have access to preferential credit during the period before financial liberalization. This form of favoritism is likely to decrease after financial liberalization. But as Nolan, Jin and Chunhang (2007) and Nolan and Zhang (2010) mention, it is also possible that large firms grow even larger and become more competitive after liberalization.

In terms of market structure, Broz and Werfel (2014) identify domestic cleavage based on the market structure of industries. They differentiate high pass-through industries from low pass-through industries, where pass-through refers to the elasticity of import and export prices to changes in the real exchange-rate. Pass-through tends to be highest in industries where firms produce homogeneous goods (e.g., basic metal products, minerals, textiles) and compete mainly on price, and lowest in industries that produce differentiated and specialized goods with few substitutes and compete on quality and

reputation rather than simply on price. Thus, high pass-through industries are more likely to petition for protectionist policies during periods of currency appreciation, because they compete mainly on price, and their competitiveness is more adversely affected by currency appreciation, whereas low pass-through industries are better insulated from the effects of exchange-rate fluctuations, since demand is relatively inelastic and product differentiation prevents domestic goods from being close substitutes for foreign goods.

Broz and Werfel (2014)'s study is relevant to the issue of capital-account opening despite its focus on trade, since capital-account policies affect the real exchange-rate and the trade balance and can sometimes be used to achieve the same outcomes as trade protectionism (Jeanne, 2012). Leiteritz (2012) also distinguishes domestic cleavages of interest based on whether and how firms are affected by exchange-rate volatility. He argues that sustainable capital-account liberalization presupposes that business-government relations privilege the interests of economic sectors that depend on the unfettered flow of international capital and are largely unaffected by exchange-rate volatility (e.g., large business and financial sector) over the interests of exporters of non-traditional goods (small business) worried about exchange-rate appreciation in the context of capital-account openness.

In terms of ownership, Harrison, Love and McMillan (2004) find that restrictions on capital-account transactions tend to increase firms' financing constraints, and these financial constraints are greater for firms that are domestically-owned as compared with those with either foreign ownership or assets, because the latter have easier access to the international financial market. The study also finds that increased FDI is associated with reduced financing constraints for firms,

Some combine multiple dimensions. Khanna and Yafeh (2007) propose of the highly concentrated and large-size diversified business groups (consisting of independent firms across industries) that are ubiquitous in the emerging-markets. Johnson and Mitton

(2003) study the distributional effects of capital controls and relate that to cronyism. Using data from Malaysia before and after the imposition of capital controls in the 1998 financial crisis, their study shows that in the initial phase of the crisis (from July 1997 to August 1998), roughly 9% of the estimated $60 billion loss in market value for politically connected firms (defined as firms that have officers or controlling shareholders with close relationships with key government officials could be attributed to the fall in the expected value of their connections. With the imposition of capital controls in September 1998, about 32% of the estimated $5 billion gain in market value for firms connected to the prime minister could be attributed to the increase in the value of their connections. In other words, capital controls created a screen for cronyism and favored privileged firms with political connections. Johnson (2009) speaks of oligarchies consisting of emerging-market governments and private-sector allies, and argue for the necessity of reforms to solve their economic problems caused by elites' risky investment decisions under the backups from the government.

Weymouth (2016) highlights the cleavage between an alliance of rent-preserving incumbent producers and affiliated labor groups (termed "insiders"), and a pro-competition coalition of consumers, unorganized workers, and new entrepreneurs ("outsiders"). Insider firms that are able to charge a price that exceeds marginal cost (a monopoly price) without inducing new firms to enter the market have a higher degree of market power; they are therefore more likely to oppose the enforcement of competition policies that impede their rents. But Weymouth uses the time-invariant cross-national variable of the degree of market concentration to measure the independent variable of the level of rent-preserving alliance in the hazard model he employs by the year 2002. Although he uses a time-varying proxy of value-added in manufacturing as a percent of GDP to conduct robustness check, the approach is far from satisfying given how market concentration levels could have changed over the years. Although these studies often assume interest-group

preferences as either pro-liberalization or anti-competition, they have clear implications for capital-account opening since it is a major part of liberalization and pro-competition reform.

Bunte (2019)'s book *Raise the Debt: How Developing Countries Choose Their Creditors* combines the comparative politics approach with IPE methods by studying the distributional consequences of governments' borrowing decisions and establishing the linkage between the strength of domestic societal coalition and the policy outcome of government choice of loan offers. It seeks to explain how governments choose among competing loan offers from for example China, the US, or the IMF. Citizens have preferences across creditors and politicians are concerned about electoral effects of their choice of creditors. The varying types of dominant domestic interests ranging from corporatist coalition in Ecuador to capital coalition in Columbia to consumer coalition in Peru helps explain why Ecuador has historically chosen BRICs loans, Columbia traditionally prefers private creditors, and Peru has favored Western creditors.

Yoo (2018) focus on the structure of the domestic financial sector in determining the distributional consequences of opening the capital account, and finds that only when the financial sector is diffuse does capital account liberalization lead to reforms in entry barriers, directed credit programs, and banking sector supervision, which extends to improved access to credit for private firms and households. When the financial sector is highly concentrated, capital account liberalization actually leads to a decrease in loans to private firms and households and an increase in loans to governments and SOEs.

Ding et al. (2020) and Larrain and Stumpner (2017) study the mechanism of how capital account liberalization reduces firms' financial constraints, and Ding et al. (2020) examines the distributional consequences of financial liberalization based on the level of financial constraints for firms. Ding et al. (2020) examine the valuation effect of capital account liberalization based on evidence from the Chinese stock market and find

that the market has an overall positive response to the capital account liberalization announcements. But firms with more severe financing constraints earn higher returns than their counterparts, and this implies that the market expects capital account liberalization to provide overseas financing opportunities for firms, especially those with financing constraints.

2.3 Domestic Institutions

From the perspective of domestic institutions, scholars often put capital controls in the context of the unholy trinity (Cohen, 2000), thereby linking capital controls to the choice of exchange-rate regime and the extent of autonomous monetary policy. The unholy trinity principle suggests that policymakers of a country may pursue only two out of three policy directions simultaneously: capital mobility, an autonomous monetary policy, and a fixed exchange-rate policy. Scholars argue that capital controls are more likely to be imposed when the central-bank is not independent, and when the exchange-rate is fixed (Alesina, Grilli and Milesi-Ferrett, 1993; Grilli and Milesi-Ferretti, 1995; Leblang, 1997). The level of central-bank independence (CBI) indicates the level of state repression of the financial sector: a subordinate central bank implies a strong political government with a relatively free hand over monetary policy. Other closely related institutional factors examined include the level of centralization of the state, the number of veto-player parties in government, partisanship, and regime type (Kastner and Rector, 2003; Quinn, 1997).

Another group of literature have studied the impact of the quality of domestic institutional environment on the policy outcome of financial liberalization, and suggest that the establishment of proper regulatory institutions appear to be important prerequisite for successful financial liberalization (Demirgüç-Kunt and Detragiache, 1999; Klein and Olivei, 2008; Chinzara, Lahiri and Chen, 2017; Elkhuizen et al., 2018). Demirgüç-Kunt

and Detragiache (1999) argue that a weak institutional environment based on the measures of the rule of law, level of corruption, law enforcement, bureaucratic efficiency, and the absence of proper regulation and supervision is associated with higher likelihood of financial crisis. Klein and Olivei (2008) raise question on the desirability of opening up the capital-account given the observed failure of capital-account liberalization to promote financial deepening among developing countries. Chinzara, Lahiri and Chen (2017) find that financial reforms are associated with improvements in within-sector, but not between-sector allocation of capital and imply that reforms that improve the quality of economic institutions may be an important step to bring the expected economic take-off after financial liberalization. Elkhuizen et al. (2018) suggest that social capital presented in the form of interpersonal trust, information sharing, and social norms may substitute for formal institutions as a prerequisite for effective financial liberalization policies.

The VoC literature combines multiple dimensions of domestic institutions in the study of state-business relationship. The original VoC framework established by Hall and Soskice (2001) is firm-centered. Companies are considered as the crucial actors during technological change and international competition but they are also institutionally embedded. Financial system is one of the four institutional domains (with the other three domains being industrial relations, education and training systems, and the inter-company system) that define firms' incentives and constraints. Two major institutional frameworks are identified to organize capitalist economic relations largely based on observations of relatively mature market economies including the western Europe and the US: liberal market economies (LMEs), coordinated market economies (CMEs) (Hall and Soskice, 2001).

In LMEs and CMEs, state role is either *laissez-faire* ("let market actors do") as in LMEs, or *faire avec* ("do with market actors") as in CMEs. In LMEs, market plays the dominant role in coordinating economic behavior (for example, through price signals),

and the state remains an arm's-length enforcer of contracts. In CMEs, economic behavior is strategically coordinated to a larger extent through non-market mechanisms including negotiation, bargaining, and collaboration. Although in CMEs the state plays a relatively more "active" rather than "minimum" role, there are certain constraints and the state is expected to coordinate industrial, financial, and inter-corporate relationships without taking an independent role. In neither scenario is the state supposed to *faire* ("do in place of the market") (Hall and Soskice, 2001; Schmidt, 2009).

Building on Hall and Soskice (2001)'s LMEs versus CMEs juxtaposition, a new generation of VoC scholars have offered alternative taxonomies largely based on their observations of the relatively less mature market economies in Eastern and Southern Europe, Asia, Latin America, and Africa, thereby combining the development studies and VoC literature. Of particular interest to this dissertation project is the categorization of state-directed market economies (SMEs)(Schmidt, 2009; Thelen, 2012) and dependent market economies (DMEs) (Nolke and Vliegenthart, 2009; Nölke, 2018).

SMEs are often characterized with a centralized government, high level of state capacity, and a financial system heavily under state influence (Wade, 1990; Woo-Cumings, 1999; Nölke et al., 2015). They are plan-rational capitalist development states, which differs from plan-irrational state (as in communist regimes) in which both ownership and management remained in the hands of the state, and differs from free market state where there is no plan and private control coincided with private ownership (Woo-Cumings, 1999). In SMEs, it is possible and sometimes desirable for the state to cross certain "boundaries" of intervention for the sake of growth. The corresponding institutional arrangements include a centralized and autonomous bureaucracy aimed at plan-rational capitalist development, high level of state capacity and effectiveness in allocating resources to long-term investment such as infrastructure, an active industrial policy that favors and strengthens selected industries, and a financial system heavily under state

influence (Wade, 1990; Woo-Cumings, 1999). The theoretical roots are non-orthodox economic theories such as developmental economics and developmental state literature that stresses the role of the state as the primary engineer of development (Wade, 1992).

More recently, Nölke (2012) and Nölke (2018) use the term of state-permeated market economies to highlight the commonalities of capitalism in the largest emerging countries. The central coordination mechanism in state-permeated market economies is the dense collaboration between public authorities and major domestic enterprises. Informal personal relations based on common values and shared social backgrounds is a major mode of social coordination that supports such public-private cooperation. Here, national capital often outweigh transnational actors in corporate governance. The financial system is often dominated by state-owned banks and internally pooled capital and less reliant on foreign investors. Another central feature of state-permeated market economies is having a large domestic market. The focus is on the national control of economic development, which is considered to be indispensable in order to avoid colonization by, or dependency on, outside forces.

As latecomers with regard to the development of their capitalist systems, the emerging markets need foreign economic inputs in order to modernize. China and India have reacted to this challenged by protecting their companies to develop domestically before exposed to international market competition. The dependent economies of East Central Europe, namely, the Visegrád States (Czech Republic, Hungary, Poland and Slovakia), have embraced economic integration in order to modernize their economies and create employment. Brazil is an emerging economy that lies somewhere in-between (Nölke, 2018). Alternatively, terms such as state-enhanced capitalism (Schmidt, 2003) and mixed-market economy (Hancké, Rhodes and Thatcher, 2009) are used to classify market economies where the level of state intervention in economic management falls between what has been described in SMEs and that of CMEs/LMEs.

In DMEs, support from international actors such as MNCs and international financial institutions such as the IMF is of crucial importance for any politicians/parties to rule. The state caters to the requirements of foreign capital and structures labor and financial markets accordingly (Nolke and Vliegenthart, 2009). For DMEs, they have embraced foreign economic integration and invited both FDI and global financial markets. The central economic coordination mechanism in DMEs is the dependency on the hierarchies in MNCs that are headquartered abroad. DMEs are more strongly dominated by FDI than any other type of capitalism. Almost all strategic sectors, including the most advanced production lines and the financial sector, are usually controlled by foreign companies. These economies have a rather limited degree of economic sovereignty and are rather dependent on decisions that are taken elsewhere in the world (Nölke, 2018). (Schneider, 2013) uses the alternative term of Hierarchical Market Economies (HMEs) to emphasize how MNCs and diversified domestic groups with both domestic and foreign ownership have managed to maintain hierarchically structured relations based on observations of Latin America and some part of East Asia.

Some most recent VoC literature has developed more accurate categorizations of capitalist market economies based on regional expertise and specific sectors at the expense of parsimony. Drahokoupil and Myant (2015) distinguish five varieties of capitalism, FDI-based, Peripheral Market Economies, Order States, Oligarchic or Clientilistic, and Remittance or Aid-based, in the transition economies of post-Soviet states based on product complexity, type of production networks, and integration through finance. Carney (2016) categorized East Asian countries as either Family Market Economies or State Market Economies based on whether dominant businesses are state-owned or family-owned. Rougier and Combarnous (2017) specify four distinctive models, the Globalization-Friendly, Resource-Dependent Statist, Informal(Weak State) and Hybrid-Idiosyncratic in addition to the original LMEs versus CMEs dichotomy, based on the

seven sectors of institutional governance including labour and production relations, education and training, product market and competition, social protection, finance and credit market, agriculture, and environmental regulation models.

For macro-level analysis, scholars have focused more on the effect of capital controls on macro-level economic and financial indicators such as GDP growth, the real exchange-rate, foreign reserve accumulation, inflation, financial volatility, etc., instead of the other way around (Klein and Olivei, 2008; Jeanne, 2012; Klein, 2012; Blundell-Wignall and Roulet, 2014; Chamon and Garcia, 2016). The issue of whether capital controls are contracyclical and succeed in mitigating sudden surges and withdrawal of capital is of particular interest to more recent studies, given the reintroduction of capital controls in some emerging countries that had previously abolished capital controls, such as Brazil and South Korea (Gallagher, 2014; Fernández, Rebucci and Uribe, 2015; Forbes et al., 2016).

Gallagher (2014) raises a theory of "countervailing monetary power" that amends the capital-mobility hypothesis (which suggests that the structural power of global financial markets is an absolute constraint for states, especially in emerging-markets), such that at the national level emerging and developing countries were able to countervail political pressure and sophisticated global capital markets in order to manage financial stability in the post-crisis period from 2009 to 2012. Fernández, Rebucci and Uribe (2015), however, find empirical evidence that policymakers do not change capital controls over the business cycle, and on average, controls on capital inflows or outflows are virtually unchanged during macroeconomic booms or busts. Forbes et al. (2016) investigate the externalities of capital controls. Implementing capital controls have signaling effect and might induce changes in investors' expectations about future policies, thus leading to a "bubble-thy-neighbor" effect, as inflows might be diverted to neighboring countries after a country implements controls thereby aggregating risks of bubbles and overheating in its neighbors.

Macro-level analyses that focus on explaining capital-market liberalization largely fall under the rubric of policy diffusion theories, although the term diffusion was not used in some of the earliest work. Simmons, Dobbin and Garrett (2006) argue that governments adopt new policies not in isolation but in response to what their counterparts in other countries are doing. Four distinct mechanisms through which interdependent decision-making may take place are suggested: coercion, competition, learning, and emulation.

Coercion may involve many forms including the manipulation of economic costs and benefits. Goodman and Pauly (1993) illustrate this mechanism by arguing that the economic costs of capital controls outweighed their benefits in the new world economy. Under the mechanism of competition, Bartolini and Drazen (1997) focus on competitive pressures on the deregulation movement under increased capital mobility. Under the mechanism of emulation, Chwieroth (2009) and Weymouth and Macpherson (2012) study the shared beliefs of free trade and liberalization that contribute to trade and capital market liberalization. An example of the mechanism of learning is Sobel (1994)'s article that argues that economic policy changes that occurred earlier may serve as examples and would constrain the range of choices for latecomers. More recently, Steinberg, Nelson and Nguyen (2018) argues that democracy is only positively associated with capital account openness when proximate countries maintain open capital markets. The policy choices from neighboring countries have an impact on the domestic support for capital account liberalization, as an open global financial system increases societal support for capital account liberalization and incentivizes democratic leaders to liberalize.

2.4 Privatization

Studies of SOEs and privatization are relatively more limited compared to scholarly work on capital-account liberalization, and scholars have mostly been writing from their

expertise of certain regions without establishing systemic theoretical frameworks. Many existing studies focus on the historical waves of privatization in developed countries. Köthenbürger et al. (2006) and Palcic and Reeves (2011) present details of privatization experiences in Europe and provide evaluations of the varying effects of privatization on social and economic outcomes across European countries. Schwartzberg (2018)'s book is largely written from the perspective of privatization in the US and present analyses of the contemporary debates over privatization.

Supports of privatization highlight the issues of SOEs performance, efficiency, and accountability (Kowalski et al., 2013; Musacchio and Lazzarini, 2014; Obinger, Schmitt and Traub, 2016; Schwartzberg, 2018). In most economic theories, privatization is expected to increase productivity, efficiency, and output, since SOEs are often not as well-performing as POEs. SOEs managers usually lack high-powered incentives and proper monitoring either from boards of directors or from the market, and they are often poorly selected, based on political and administrative rather than economic criteria. The social objectives of SOEs such as maximizing employment and opening unprofitable plants in poor areas often conflict with profitability; besides, politicians sometimes use SOEs for their personal gain or to benefit politically connected capitalists, and managers are less concerned about performance, as they enjoy low level of financial and budget constraints and know that they will be bailed out if necessary (Brune, Garrett and Kogut, 2004; Clarke and Pitelis, 2005; Schwartzberg, 2018). Policy makers and privatization experts have agreed that it is critical to "get privatization right," and a most recent step-by-step guide is published by the OECD (2019) to prepare policy makers for a well-planned and executed transaction when transferring state-owned assets and/or governmentally provided services to the private sector, by drawing on the internationally agreed OECD guidelines on corporate governance of SOEs and decades' worth of national experience across both OECD and partner economies.

Critics of privatization raise the question of whether market-based solutions can really solve social problems, and is this the intention of government social policy (Dunlop, 2019)? Many are concerned that, given private actors' self-interest and profit seeking motives, the privatization of important public functions is likely to lead to morally objectionable social outcomes (Cordelli, 2019). Nowak (2016) examines privatization from a human rights perspective and asks whether states, by outsourcing to the private sector many services with a direct impact on human rights – education, health, social security, water, personal liberty, personal security, equality – abdicate their responsibilities to uphold human rights. Some observers from development studies see SOEs as a way to correct market failure and promote development beyond what is possible under free markets, and argue that governments should be encouraged to help SOEs develop new capabilities, either by reducing financing constraints, by reducing the costs of research and development, or by coordinating resources and firms to pursue new projects with high spill-overs for the economy (Musacchio and Lazzarini, 2014).

Clarke and Pitelis (2005) and Stiglitz (2008) provide comprehensive overview of privatization process around the world including both advanced countries and the developing world. As Stiglitz (2008) mentions, the privatization of large SOEs is one of the most radical policy developments of the last quarter century. Right-wing governments have privatized in an effort to decrease the size of government, while left-wing governments have privatized either to compensate for the failures of SOEs or to generate revenues. In this way, privatization has spread from Europe to Latin America, from Asia to Africa, reaching its zenith with Central and Eastern Europe's transition from socialism to capitalism. In many countries state ownership has been an important tool in bringing cheap water, energy, and transport to poorer segments of the population. In other instances, it has sponsored aggressive cutbacks, corruption, and cronyism. One surprising trend uncovered in Stiglitz (2008)'s book is that partial privatization tends to be more widespread

than one might think, especially among the emerging and developing countries.

Relatively fewer scholars have been writing on the on-going process of privatization, or the so-called public-private cooperation model of partial privatization in emerging and developing countries, and have discussed the implication of partial privatization for financial liberalization compared to the study of privatization in developed countries. For developing countries, the primary reasons for privatization include serious budget deficits, high foreign debt, high dependence on international agencies such as the World Bank and IMF, and limits on economic modernization (Clarke and Pitelis, 2005). International financial institutions and their conditional lending based on structural adjustments are also considered to have contributed to privatization in developing countries. Brune, Garrett and Kogut (2004) examine the impact of IMF lending on privatization and argue that countries that borrowed from the IMF subsequently privatized more assets (in terms of revenues and the number of transactions), since investors are willing to pay more for privatized assets in countries that owe the IMF money (and hence are subject to the policy conditions attached to the loans). The reason for this is that investors view IMF conditionality as a signal of credible policy reform. Lim (2020) examines the rise of the model of partial privatization in Asia, and suggest that having the government as the controlling shareholder of the SOEs poses two key problems, namely, conflicts of interest between the government as the controlling shareholder and as the corporate regulator, as well as political interference and extractions of benefits of control by the government. One of the central challenges in the modern era is whether and if so how the corporate governance mechanisms should be remodeled to promote sustainability and development in an environment that is characterized by governments as controlling shareholders and possible governmental interference.

A few works have touched the linkage between privatization and capital market development. Research on early privatization suggests that firm and sector performance

improve only when privatization is coupled with the creation of truly competitive markets (Vickers and Yarrow, 1988). Many cross-national studies find that while privatization improves performance at the firm level (Galal, 1994; Megginson and Netter, 2001), the benefits of privatization depend as well on the level of capital market development. When capital markets are liquid and have strong investor protection, the benefits of privatization and private ownership tend to be substantial; whereas in the absence of well-functioning capital market, private companies are not unambiguously superior to SOEs (Bortolotti, Fantini and Siniscalco, 2004; Musacchio and Lazzarini, 2014).

A branch of literature on the BRICs countries has studied SOEs and the phenomenon of partial privatization largely from domestic perspective (Mishra and Lateef Syed Mohammed, 1994; Musacchio and Lazzarini, 2014; Chatterjee, 2017; Liu et al., 2019). Mishra and Lateef Syed Mohammed (1994) suggest that India has followed the path of a "mixed economy" which thrives on the co-existence of public and private sectors. Liu et al. (2019) argues that ownership structure plays a major role in China's national economy, SOE reform is pivotal to stimulating general economic reform and development in order for China to achieve a smooth transition to a mature market economy. Musacchio and Lazzarini (2014) analyzes the rise of new species of state capitalism in which governments interact with private investors either as majority or minority shareholders in publicly-traded corporations or as financial backers of purely private firms (the so-called "national champions") in Brazil. They also argue that the longstanding debate over whether private ownership is superior or inferior to state capitalism has become irrelevant, since private ownership is now mingled with state capital on a global scale. Chatterjee (2017) suggest that SOEs in contemporary India have become state-market hybrids and marked the rise of "state capitalism 2.0," which replaces the first-generation of state capitalism characterized by detailed planning and overt protectionism, and emphasizes public-private collaboration.

2.5 Discussion

This chapter first reviewed the debates over the desirability of capital controls in last two decades or so after the 1998 Asian financial crisis and 2008 global financial crisis, before moving on to an overview of the relevant literature that study the variation of capital controls across countries as well as changing trend of capital controls over the years from the perspective of domestic preferences. Most existing literature that focuses on explaining capital controls from the perspective of domestic interest has overlooked the factor of firm ownership as an important explanatory variable, although the stakes of studying and understanding SOEs are high. State presence remains significant in business management in the emerging and developing countries, and in some cases, new generations of state capitalism have emerged in recent years. This is partly due to fact that the majority of literature on financial integration often has a broader research scope by focusing on the international dimension, whereas scholarly works interested in SOEs are mostly written from the perspective of domestic political economy. This dissertation attempts to bridge this gap in the literature, by adopting an approach based on cleavage of interest based on firm ownership and seeks to extend the growing body of IPE literature that emphasize firm-level cleavage.

The most important insight from scholarly works on institutions and financial integration is that impact of SOEs on financial policy making will be better understood if we take the general context of state-market relations into consideration. They also provide justifications for the use of political regimes and central bank Independence as control variables for this project, as these institutions matter in affecting the likelihood of using capital controls. It is also acknowledged in the literature that macro-level factors such as external influence including conditional lending from IMF and financial policies from neighboring or competing countries also matter in determining the likelihood of using

capital controls. This dissertation will control for the macro-level factor of IMF lending and the general level of economic openness for a country, but focus on the domestic side of the story. This project aims to explain more specifically *the variation of state behavior faced with the same trend at the world level*, to examine *why some states implement strict capital controls whereas others implement partial controls or no controls*, and to identify the potential barriers for financial liberalization at the domestic level.

Existing studies of privatization focus on addressing the economic and moral debates over the desirability of privatization, but do not sufficiently examine the political side of the story. Scholars rarely link the competition between SOEs and POEs to the policy outcome of international financial integration. This project will instead bring in a more political economic perspective, and will discusses the distributional impact of international financial integration policies for these two critical domestic interest groups. It will emphasize enterprise ownership, link ownership structure to particular policy preferences for capital controls, provide empirical evidence based on panel statistical analysis, and reveal the causal mechanisms of how the differences in the distributional consequences of capital-account opening between SOEs and POEs determine their preferences, which in turn affect the policy outcome of capital account opening through case studies of China, India and Brazil.

Chapter 3

Theory

The present chapter develops a theory that explains the variation of the degrees of capital controls among developing countries and derives the main hypotheses. It will start with a discussion of the various ways that the state attempts to influence the market through ownership and shareholding in enterprises, then identifies the cleavage of interest between SOEs and POEs, by demonstrating the different distributional consequences they are faced with after capital-account liberalizations. The use of capital controls helps ensure that SOEs have easier and guaranteed access to credits, and SOEs have a much higher stake in fighting against financial liberalization than POEs. Both full and partial privatization, however, weakens traditional SOEs politically. Under full privatization, traditional SOEs are sold off and turned into POEs; under partial privatization, they are transformed into mixed-ownership SOEs by incorporating preferences and interests of the private sector. Privatization thereby lowers market concentration level, improves efficiency and performance, and helps offset SOEs' resistance to lifting capital controls.

3.1 SOEs versus POEs

In the more traditional form of SOEs, the state has full control and ownership and manage SOEs as extensions of the public bureaucracy; enterprises are left with limited autonomy, and the decision-making process is non-transparent. But new forms of mixed ownership SOEs where the state invites private investors to become shareholders but still acts as a controlling shareholder have become increasingly common in the emerging and developing countries. In a first scenario the government lists traditional SOEs on stock exchanges but holds more than 50% of a firm's shares. This is a form of partial privatization in which the state retains control while attracting minority private investors. These publicly traded SOEs have higher level of financial autonomy and transparency than traditional SOEs, and tend to have professional management, a board of directors with some independent members and with short tenures, and financial reports audited by professional accounting firms. In a second scenario, governments exercise their control as majority investors using state-owned holding companies, and form a pyramidal structure of ownership where the government is a majority owner in a company that then holds majority equity positions in other companies (Musacchio and Lazzarini, 2014). In both cases, the government is the controlling interest with enough voting stock shares to prevail in any stockholders' motion.

Musacchio and Lazzarini (2014) also describes a third scenario of how states attempt to influence corporations in emerging economies. It is referred as the model of state as a minority shareholder, where the state is no longer formally the controlling interest, but still has some influence over corporate decision-making in POEs. The state either directly holds residual shares in partially privatized firms or uses state-owned holding companies to hold minority stakes in a variety of firms controlled by private investors. States might also use development banks, sovereign wealth funds, and other state-controlled

funds to invest in private companies. In this more nuanced form of state influence over corporations, private actors manage the companies that the government wants to support financially; political intervention may be minimal compared to mixed-ownership SOEs where the state has the ultimate say in corporate decision-making (Musacchio and Lazzarini, 2014).

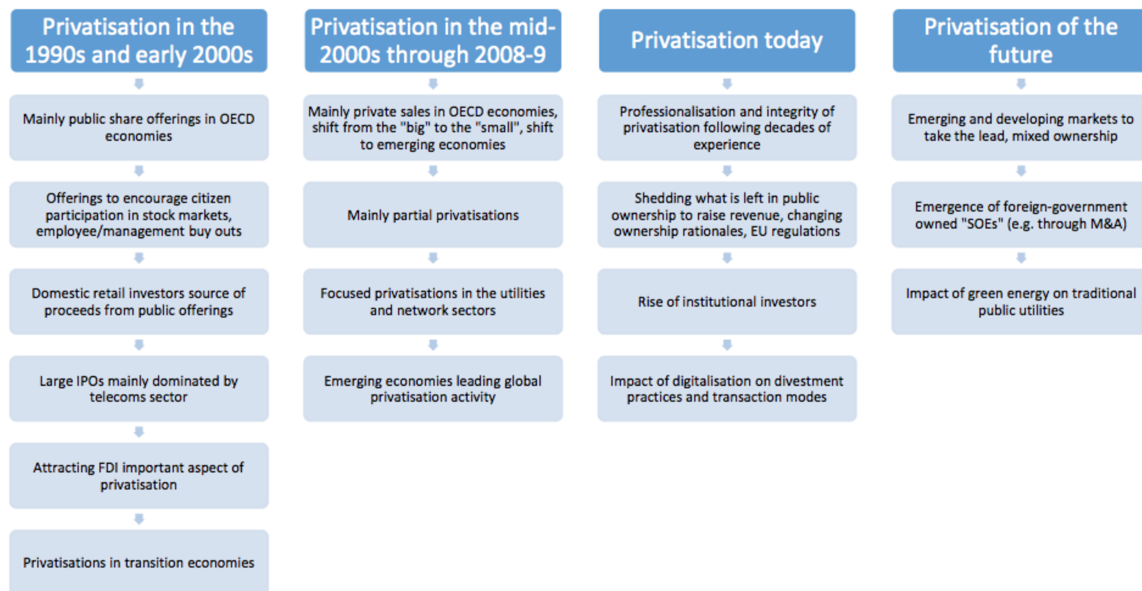

Table 3.1: Changing Paradigms of Privatization (OECD, 2019)

As Table3.1 shows, SOEs are more prevalent in emerging and developing countries as compared with the OECD countries in contemporary era, and emerging economies are now leading global privatization activities. The public enterprise sector in the OECD countries has become significantly smaller over time; The volume of private sales in OECD economies have shifted from "big" to "small" and the remaining SOEs are formally regulated according to the same rules of corporate governance that apply to POEs. Many emerging and developing countries, however, increasingly use state ownership to promote developmental or other strategic goals. This has been labeled as the rise of a second-generation state capitalism or crony capitalism in the emerging world (Economist,

2012; Chatterjee, 2017). Political connections enjoyed by business groups facilitate rent seeking and are often used to restrict market entry and competition. SOEs represent an ultimate form of political connection in the sense that the government is both the owner/shareholder and regulator. The government may create an uneven-playing field that favors SOEs over private firms through direct or indirect preferential treatments (Forbes, 2007; Capobianco and Christiansen, 2011). Possible policy measures include direct subsidies, concessionary financing, state-backed guarantees, preferential regulatory treatment, exemptions from antitrust enforcement or bankruptcy rules, and market entry restrictions for non-SOEs. (Kowalski et al., 2013).

Of particular concern to the policy outcome of capital controls is the instrument of concessionary financing and credit guarantees. SOEs may enjoy loans that come directly from governments or may be provided via state-controlled financial institutions at below-market interest rates. They might also enjoy an advantage in the competition for capital vis-à-vis their privately owned rivals because of explicit or implicit state guarantees. Exemptions from antitrust and bankruptcy rules in some cases also add to market confidence in SOEs and make it completely rational for lenders to prefer to lend to the SOEs (Capobianco and Christiansen, 2011). Enterprises in the developing world are often faced with severe financial constraints and find it difficult to get the credits needed to start business or financing for corporate expansion. The primary means of financing is through bank loans, given the prevalence of underdeveloped financial market and the difficulty to issue bonds and to be listed in the stock market. But these financial constraints are much more severe for POEs than SOEs, since most SOEs are privileged groups that have more reliable access to credits from banks controlled by the state or heavily under state influence. At a minimum, they may be in a relatively better position and favored by banks in competing for credits. This helps reduce risk and ensure profits regardless of business performance. Except for a small number of large-size POEs that

have either successfully built strong political connections with the state, or become business groups with mixed ownership of both national and foreign capital, most POEs have to compete for limited funding opportunities based on performance, and often turn to the informal/shadow banking system unregulated by the government.

Such an effect is stronger in the emerging and developing countries because of their underdeveloped internal financial markets, where capital is relatively scarce and the competition for capital is more fierce compared to developed countries where capital is more abundant (Musacchio and Lazzarini, 2014). This indicates an even higher degree of advantage enjoyed by SOEs in the emerging and developing countries as compared with OECD countries, since in these countries the immature domestic financial sector is typically more under state influence, and external financing is also less of an option to offset such effects due to their higher level of exchange restrictions. The scope of this dissertation is constrained to the emerging and developing countries to have more observable variations in the dependent variable of controls of capital flows, but future research projects might consider looking at historical evidence from OECD countries before their capital market liberalization when many SOEs were present.

As Table 3.2 shows, financial liberalization tends to reduce the advantages enjoyed by = SOEs in the competition for capital vis-a-vis POEs. In theory, full financial liberalization leads to the convergence between domestic and international interest rates, because capital will be free to move to places where interest rates are higher seeking better returns, thereby bringing the relatively high interest down toward an equilibrium. Although in reality the financial market is not perfect and the convergence of interests rates will not necessarily be complete, the state's capacity to intervene in allocating credits and manipulating interest rates will be much weaker with an open capital-account. The access to foreign financial market after liberalization will also be more likely to reduce financial constraints for POEs than SOEs because POEs often outperform SOEs and

	SOEs	POEs
Under Capital Controls	Reliable access to credit offered by banking system heavily under state influence	Discriminated by the formal banking system and government regulation
	High likelihood of obtaining below-market interest rates on loans	Severe financial constraints
	Other preferential treatments backed by strong state capacity in economic intervention	Informal banking often becomes an option
After liberalization	Market gets more veto power through the threat of capital withdrawal; state capacity for economic intervention becomes smaller	Increased access to foreign financial market, and often favored by foreign investors because of better performance
	The advantages under capital controls are weakened and might suffer from more financial constrains	Financial constraints significantly reduced
	*Note: might also benefit from increased capital inflow	

Table 3.2: Distributional Consequences for SOE and POEs after Financial Liberalization

suffer more from severe financial constraints under capital controls. Other forms of preferential treatment such as subsidies, preferential regulatory treatment, exemptions from antitrust enforcement or bankruptcy rules, and market entry restrictions for non-SOEs are also likely to be indirectly affected and become less effective after liberalization, since the market has an increasing veto-power through the threat of withdrawal of capital, and the overall role of the state in economic management is becoming smaller.

As a significant part of entrenched interests, SOEs may be expected fight hard against any reforms that introduce market competition, weaken state capacity in economic intervention, and threaten their rent-seeking capabilities (Johnson, 2009), including capital-account liberalization. Among various forms of SOEs, traditional SOEs are more likely to resist financial liberalization than mixed-ownership SOEs or POEs where the state is a minority shareholder, because traditional SOEs are usually less efficient, not so well-

performing, and rely more on state support in terms of financing and other preferential treatment to ensure profits; whereas mixed-ownership SOEs rely less on the government and are more subject to market monitoring because of the incentive to please their private shareholders. For POEs where the state is a minority shareholder with minimum political intervention, the incentive to resist financial liberalization is likely to be even lower because their advantage under capital controls is smaller and they benefit relatively less from restrictions. Besides, their private shareholders have more say in corporate management, and some of these private investors might have a preference for pro-competition reforms and lifting capital controls because of their stake in other POEs seeking for a more level playing ground in the competition for capital with SOEs.

3.2 Hypotheses

It follows that both full and partial privatization of SOEs is likely to weaken the political influence of SOEs and increase the likelihood of financial liberalization. In the scenario of full privatization, most SOEs are transformed into POEs, and their preferences are expected to change accordingly after the private sector takes control. The few remaining SOEs are regulated under non-preferential rules. Although the preferences of the private sector are more heterogeneous depending on firm size and sector, it is important to note that full privatization of SOEs weakens one major source of opposition to capital-account opening (i.e., SOEs) and makes capital-account opening more likely.

In the case of partial privatization, traditional SOEs are transformed into new forms of SOEs characterized by public-private partnership. SOEs are not necessarily retreating from the economy but rather are reformed in a way that is more compatible with market discipline. More competition is introduced in industries with high levels of market concentration and previously dominated by traditional SOEs, and higher efficiency and

performance often comes along with the partial privatization process. The new forms of mixed-ownership SOEs and a group of POEs where the state is the minority shareholder can be expected to be relatively more willing to embrace financial liberalization than traditional SOEs. In general, resistance to financial reform may be expected to become weaker after privatization. This suggests the following hypothesis:

Hypothesis 1: *The more the presence of SOEs is reduced by privatization, the more capital controls are likely to be reduced.*

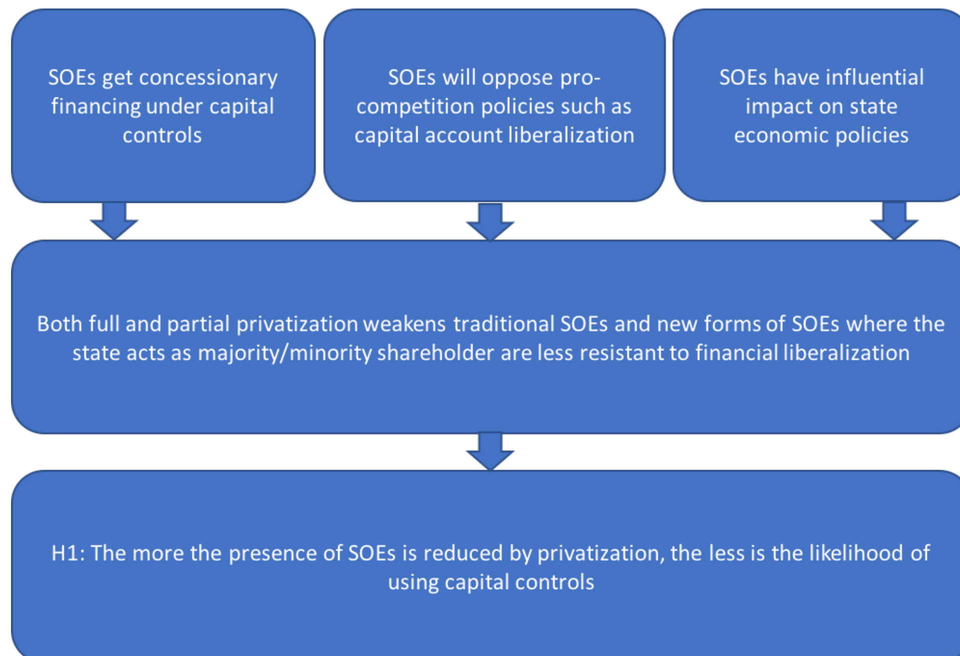

Table 3.3: Assumptions in Hypothesis 1

Liberalization of capital markets involves loosening restrictions on both capital outflows and inflows. There are two main categories of controls on inflows, including *purchase of financial assets locally by non-residents*, and *sales or issue of financial assets abroad by residents*, and two main categories of controls on outflows, which are *purchase of financial assets abroad by residents*, and *sales or issue of financial assets locally by non-residents*. The correlation between inflows controls and outflows controls tends to

be high, though different across asset categories (Fernández et al., 2016). The correlation between inflows and outflows controls suggests that a state that has restriction on inflows also tends to restrict outflows. It is unlikely, for example, that the state would be able to open/encourage inflows while strictly restrict outflows thereby locking capital inside the border, since foreign investors will anticipate the risk of not being able to pull capital back and thus choose not to invest in countries with strict controls on outflows in the first place. It is also unlikely to strictly restrict inflows while allowing for free outflows given the fear of losing investments. But it is worth noting that at the aggregate level, the world has seen higher likelihood of outflow controls than inflow controls as has been shown in Figure 2.1 in the previous chapter. Inflows in the form of direct investment are often favored and less restricted than inflows of more short-term investments, such as derivatives and money market products, since short-term investments are often more liquid and can be moved more easily, causing volatility, fluctuation and financial instability. It is thus necessary to differentiate between inflows and outflows controls or even different asset categories to detail the nuances and different implications for this project.

After controls on outflows are eased, domestic investors including affluent households and firms (mostly POEs) would reasonably look for opportunities to diversify their assets by depositing in foreign banks and investing in foreign financial products such as equities, bonds, money market instruments, derivatives, and real estate, since capital controls significantly dampen cross-border portfolio asset holdings (Bayoumi, Ohnsorge et al., 2013). The impact of lifting controls on outflows is likely to be even stronger when the domestic saving is high, and a great amount of previously "locked" domestic capital is now freed to seek diversification abroad. It is important to note that although following this line of argument, SOEs might also have the incentive of diversification, they are often privileged to do so under capital controls with special governmental approval; besides, even after liberalization, SOEs are not as free as POEs to make foreign investments,

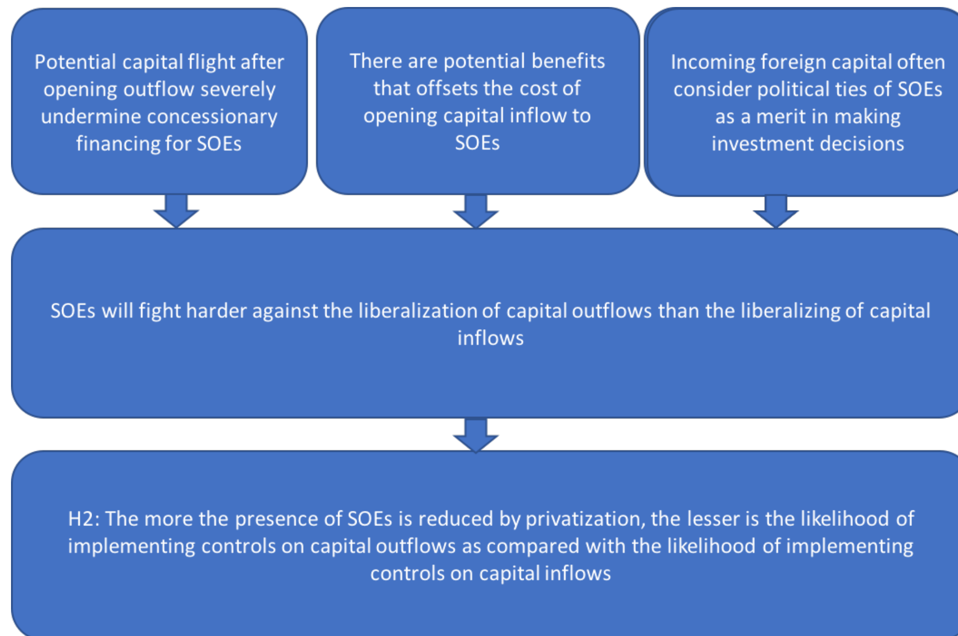

Table 3.4: Assumptions in Hypothesis 2

since the governments might have strategic geopolitical goals other than being purely driven by profit maximization. In other words, SOEs' motivation for diversification is not expected to translate into lobbying for lifting controls on outflows.

After the removal of capital controls on outflows, the policy instruments of concessionary financing and government guarantees would be significantly weakened. Domestic capital will no longer remain in state-controlled banks and can be expected instead to seek higher interest rates abroad, which in turn would be expected to lead to a convergence of domestic interest rates and external interest rates in the longer run. It would thus become much more difficult for the government and domestic banks to offer below-market interest-rate loans to SOEs. Other forms of favorable treatment are also likely to be indirectly undermined after liberalization, since domestic capital is now able to make the threat of leaving the country if unsatisfied with state policies, thereby constraining the state's ability to discriminate in favor SOEs.

As for inflows, advantages enjoyed by SOEs are also weakened in several dimensions by

liberalization. Restrictions on capital inflows in general tend to increase firms' financing constraints as firms will have limited access to international financing as a result of strict controls on capital inflows such as FDI (Love and McMillan, 2004); however, SOEs are less financially constrained than POEs under controls of capital inflows due to state-backed preferential financing. It follows that POEs would benefit more than SOEs from lifting controls on capital inflows, since POEs are likely to experience a significant reduction of financing constraints after liberalization, by issuing equities, bonds, and other financial products that foreign investors can purchase, or by attracting foreign direct investment. Besides, POEs are more likely to attract foreign investment than SOEs after liberalization because 1) SOEs are relatively more restricted in terms of foreign ownership shares; 2) POEs in general promise better performance than SOEs in terms of productivity and efficiency; and 3) POEs might suffer less from political intervention and the risk of appropriation. In sum, POEs are likely to become better positioned in competing with SOEs after lifting restrictions on both capital outflows and inflows.

Although foreign investors might be more interested in making investments in the private sector, it is worth noting that SOEs might also benefit from incoming capital (although to a lesser extent as compared with POEs), and this introduces some offsetting effect in the case of capital inflows compared to the more straightforward case of capital outflows. It is possible that some foreign investors might take into consideration the value of political connections and state-ownership. They might prefer investing in SOEs or at least state-backed corporations in the hope of sharing rents with the government if they are allowed to do so. Because of this countervailing effect, the impact of loosening capital inflows on SOEs might be less clear than the scenario of capital outflows. It follows that SOEs would be expected to fight harder against the liberalization of capital outflows than that of capital inflows. This leads to my second hypothesis:

Hypothesis 2: *The more the presence of SOEs is reduced by privatization, the lower is*

the likelihood of implementing controls on capital outflows as compared with the likelihood of implementing controls on capital inflows.

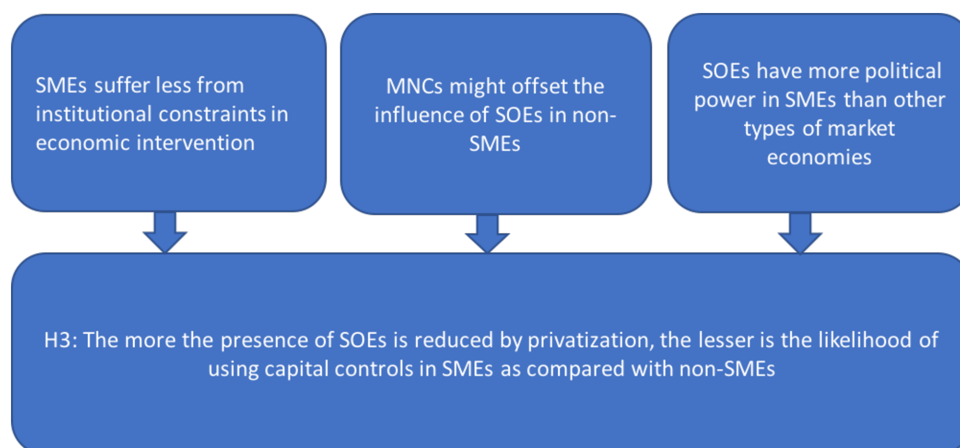

Table 3.5: Assumptions in Hypothesis 3

As the VoC literature suggests, the institutional constraints on using capital controls might differ in SMEs as compared with LMEs/CMEs/DMEs and other hybrid types of market economies. SMEs suffer less from institutional constraints to state intervention in economic policies. Many SMEs have sets of well-established regulatory frameworks that build close ties between SOEs and the government. Besides, many senior executives of SOEs often have experiences of serving as government officials in charge of industrial relations, corporate governance, financial regulations, etc. The inter-personal tie between SOEs and the government is strong and serves as another major mechanism of coordination. SOEs are much more embedded in the government in SMEs than in other types of market economies. These existing institutions make it easier for the state to supervise SOEs, and provide SOEs with a unique platform where they can directly make political demands and communicate their needs with the state. POEs and foreign capital find it struggling to access policy makers and make political demands. One alternative approach is to join and become a shareholder of mixed-ownership SOEs during privatization waves.

In non-SMEs, however, the state plays a relatively less predominant role and the

sentiment of nationalist economic development is weaker. The institutional framework that ties SOEs to the government found in SMEs is largely absent in non-SMEs. Foreign capital and multinational corporations (MNCs) may have similar or sometimes even better access to policy makers as SOEs. It is not any more difficult for foreign businesses to formally or informally influence policy making (e.g., through bribery) than SOEs in non-SMEs. In many DMEs, foreign capital often have greater political influence than domestic SOEs and POEs because of their dominance in strategic sectors including infrastructure and finance (Nölke, 2018). Alliances have been built between foreign capital and domestic elite capitalists (Evans, 1979). Unlike in SMEs, where the phenomenon of newly emerged mixed-ownership SOEs reflects the growing desire of POEs and foreign capital to gain access to central and local policy makers, in non-SMEs especially DMEs, mixed-ownership enterprises are often products of reciprocity. The alliances building between foreign capital and domestic elites helps secure rent-seeking activities of the corporate sector. MNCs and diversified business groups with both domestic and foreign ownership sometimes have become main actors that manage economic activities through the means of hierarchical relationships (Schneider, 2013).

The preferences for a more liberal financial account may come from external actors, namely, the apex of the business group or the corporate headquarters of the MNCs in the home country. Through hierarchical corporate governance, these preferences are taken into consideration and aggregated into domestic policy making. In non-SMEs, the greater veto-power of MNCs and foreign capital in policy making and their pro-liberalization preference help offset the influence of SOEs. It follows that the impact of privatization on capital controls varies depending on the larger context of the state's role in economic management. The resistance of SOEs to financial liberalization is more likely to be effective in SMEs, and the impact of privatization on the likelihood of using capital controls is likely to be more significant in SMEs than in non-SMEs. This leads

to my third hypothesis:

Hypothesis 3: *The more the presence of SOEs is reduced by privatization, the less is the likelihood of using capital controls in SMEs as compared with non-SMEs.*

Chapter 4

Research Design

To test my hypotheses, this dissertation employs mixed methods: both a large-N statistical analysis and three case studies. The statistical analysis and case studies will complement each other: The large-N statistical analysis is useful to test my first two hypotheses based on a large number of observations; case studies will examine the historical process of how privatization affects financial liberalization and will contribute to detailing the causal mechanisms of my theory, and provide empirical evidence in support of all three hypotheses especially the third hypothesis.

4.1 Large-N Statistical Analysis

4.1.1 Dependent Variable

To measure the dependent variable of capital controls, I use a recently published dataset from the IMF (Fernández et al., 2016) that is being updated every year. It records whether a state has laws and regulations on cross-border capital flows. This dataset offers information of restrictions on both capital inflows and outflows in 10 categories of assets for 100 countries since 1995, and it has been updated to 2017 so far. The

ten asset categories are money market, bonds, equities, collective investment securities (such as mutual funds and investment trusts), derivatives, financial credits, commercial credits, and guarantees (including sureties and financial backup facilities), real estate, and direct investment [1]. The dataset is based on the IMF's *Annual Report on Exchange Arrangements and Restrictions*, which has included a binary variable indicating whether a country imposes controls on payments for capital transactions by residents since 1967. In 1996, it made an important augmentation by providing binary indicators across subcategories of capital transactions and by differentiating between outflows and inflows. For each transaction subcategory, a distinction is made between restrictions on inflows and outflows, and between transactions by residents and by nonresidents.

<table>
<tr><td rowspan="4">Average restrictions on capital flow for equity</td><td rowspan="2">Average restrictions on equity outflow</td><td>Purchase abroad by residents</td></tr>
<tr><td>Sales or issue locally by nonresidents</td></tr>
<tr><td rowspan="2">Average restrictions on equity inflow</td><td>Purchase locally by nonresidents</td></tr>
<tr><td>Sales or issue abroad by residents</td></tr>
</table>

Table 4.1: Measurement of Equity Flows Restrictions in Fernández et al. (2016)'s Database

For example, as is shown in Table 4.1, under the asset category of equity, there are seven variables in total. Variable eq refers to the average equity restrictions and is calculated as the average between eqo (equity outflows restrictions) and eqi (equity inflows restrictions). eqo is calculated as average of eq_slin (the sale or issue locally by nonresidents), and eq_pabr (purchase abroad by residents); eqi is calculated as the average of eq_plbn (purchase locally by nonresidents) and eq_siar (sales or issue abroad

[1] Although the degree of disaggregation varies across the assets because of data availability.

by residents). All these details make it possible to disaggregate the general concept of capital controls, especially in differentiating inflows and outflows and provide a more nuanced and complete picture of what is going on.

There have been debates over the measurement of capital controls between *de jure* versus *de facto* capital controls: *de jure* measures are mostly derived from the binary variables in the IMF's *Annual Report on Exchange Arrangements and Restriction (AREAER)*. The major imperfections of measurement derived from the *AREAER* are 1) it does not allow for measurement of capital controls' intensity, coverage, and their gradual liberalization or intensification; and 2) it captures more the regulatory restrictions on capital-account transactions than the actual degree of financial integration. Alternatively, Chinn and Ito (2008) take the first principal component of the *AREAER* summary, and create a KAOPEN index measuring a country's level of financial openness. It is derived from four on-off variables of controls: current account transaction, capital-account transaction, the existence of multiple exchange rates, and the requirements of surrendering export proceeds (repatriation). Quinn (1997) and Quinn and Toyoda (2008) build indices that reflect the intensity of controls based on the narrative information of the *AREAER* reports. Each country receives a value between 0 and 2 in increments of 0.5 (i.e., 0, 0.5, 1.5, 2), depending on the extent of the restrictions (e.g., existence of approval requirements and frequency of approval). The index, however, does not distinguish between controls on capital inflows and outflows.

4.1.2 Independent Variable

To operationalize the independent variable of the presence of SOEs, I use the World Bank's Privatization Participation in Infrastructure (PPI) database, and measure the presence of SOEs at the country level based on the proxy of the level of private partic-

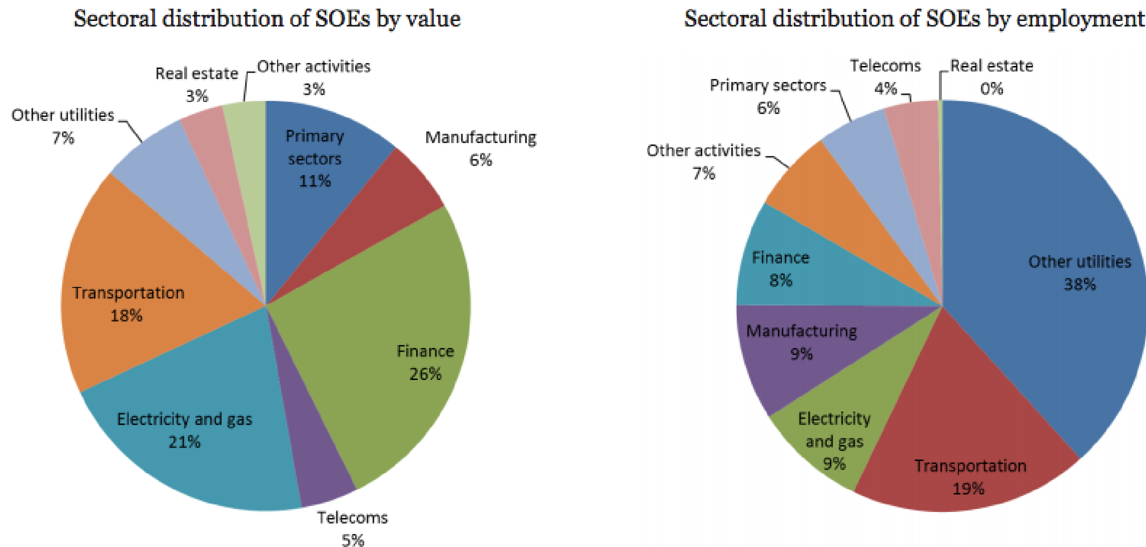

Figure 4.1: Sector Distribution of SOEs by Value and Employment among OECD and Partner Countries(Kane and Christiansen, 2014)

ipation in infrastructure. Higher level of private participation in infrastructure indicate relatively smaller presence (and political influence) of SOEs. The PPI database is a leading source of private participation in infrastructure trends in emerging and developing countries, covering over 6,400 infrastructure projects in the energy, telecommunications, transport, and water and sewage sectors in 139 developing countries. Projects include management or lease contracts, concessions, greenfield projects, and divestitures. Infrastructure industries are considered strategically important fields traditionally occupied by state capital. In fact, SOEs accounted for more than half of all infrastructure project commitments in emerging market economies and low-income developing countries in 2017 as Figure 4.1 shows. In terms of the sectoral distribution of SOEs, as Figure 4.2 shows, the electricity and gas, transportation, telecommunications and other utilities sectors account for 51% of all SOEs by value and 70% by employment among OECD and major emerging countries. Finance is the largest individual sector, at 26% of SOEs by value (Kane and Christiansen, 2014).

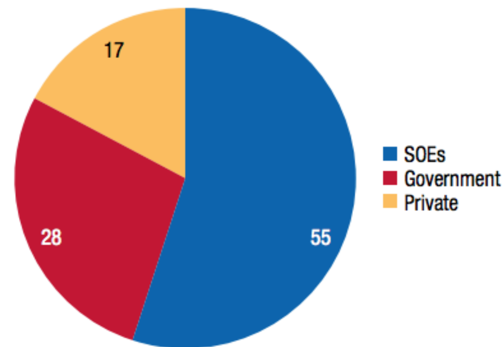

Figure 4.2: SOEs' Share of Infrastructure Investments in Emerging and Developing Countries as Percentage of Total investment Value in 2017 from World Bank data (IMF, 2020)

The original PPI database is organized by project instead of country-year. Given that my unit of analysis is a country in a given year, I chose to reorganize the data in a panel form that includes a dummy variable of privatization to indicate whether a country in a given year privatizes or not. I first collapse all of 6,400 projects and organize them by country and year. Then I code the privatization dummy as 1 if a country have at least one infrastructure project with private participation in a given year. Similarly, the privatization dummy equals 0 if there is no infrastructure project with private participation recorded for a country in a given year. For each country in a given year, the value of the privatization dummy is either 1 or 0. Although the range of privatization dummy is from 0 to 1, the years that a country have privatized in the time period covered in the sample range from 0 to 21. Over the 21-year period of time from 1995 to 2015, some countries have privatized every year for 21 years, while some have no records of infrastructure projects with private participation according to the PPI database.

It is important to note that the PPI database records total investment (e.g., expenditures on facility expansion, divestiture revenues, licence fees, etc.) in infrastructure projects with private participation, not private investment alone. Projects are considered to have private participation if a private company or investor bears a share of the

project's operating risk. In other words, a private sponsor is at least partially responsible for operating cost and associated risks. This could be by either having the rights to operate alone or in association with a public entity or owning an equity share in the project. A private sponsor is defined as a company controlled and majority owned by private parties. SOEs or their subsidiaries are considered private investors only in projects located in foreign countries. Partially divested state-owned enterprises or their subsidiaries that remain majority owned by government entities are not considered private sponsors in their own countries. One of the major criteria for a project to be included in the database is that private parties have at least a 20% participation in the project contract, except for divestitures which are included with at least 5% of equity owned by private parties. The PPI database does not record information on public investment in infrastructure projects, because it would require not only collecting public investment data disaggregated at sector level for each developing country but also having a common methodology for developing economies on what and how data are collected. But currently, most countries do not report data on public investment disaggregated at the sector level nor do they use similar methodologies to collect public investment data.

Admittedly, using the privatization dummy variable approach may not perfectly capture the variation in the extent of privatization across years (i.e., countries might privatize more in some years than the others), since it only indicates whether country privatize or not in a given year. One possible approach to ameliorate this problem is to create a continuous variable of investment, which combines the investment amount of each privatization project as a percentage of GDP for a country in a given year. But the variable of investment turns out to be less useful than the dummy variable of privatization, since the database records contractual arrangements for public infrastructure projects in which private parties assume operating risks, but are not limited to projects that are entirely privately owned, financed or operated. Some have public participation as well. In other

words, the variable of investment reflects total project investments encompassing the shares attributable to both the private and the public parties. It is a variable that mixes public and private investment without separating one from another.

Another approach to examine the impact of the degree of privatization on capital controls is to differentiate high privatizers and low privatizers based on the continuous variable of years of privatization, which ranges from 0 to 21 during the twenty-one-year period of time from 1995 to 2015 as has been mentioned above. My sample of countries are divided into two groups based on the median years of privatization (i.e., 12): high privatizers and low privatizers. High privatizers have privatized for 12 years or more in the past two decades or so, whereas low privatizers have privatized for less than 12 years during the same period of time. A list of the countries identified as high privatizers and low privatizers in my sample are provided in the appendix A. The categorization of two sub-groups of high and low privatizations allow difference-in-means tests on the average level of capital controls as well as the average change in the capital controls between them, and helps reveal the impact of the degree of privatization on capital market liberalization. More nuanced dynamics related to the extent of privatization will also be examined in the follow-up case studies of China, India and Brazil.

In the academic literature, few scholars have attempted to create relevant indicators of the presence or strength of SOEs. Kowalski et al. (2013) have constructed an indicator of *Country SOE Shares (CSS)* as explained earlier, but it only calculates *CSS* for OECD and major emerging countries and for only one year (2011). Obinger, Schmitt and Traub (2016) have created an "index of public entrepreneurship", measured by the revenues of departmental agencies, public corporations, and state companies as a proportion of GDP in a given country and year, but their data only cover rich democracies, i.e., 20 OECD countries from 1980 to 2007. Theoretically, one of the best approaches to measure the presence of SOEs is to investigate firm-level data that contains ownership information,

and calculate the state share of all enterprises as a percentage of GDP of each country. But firm-level data are often not freely open to the public because of sensitive information related to equity return, and information is collected from business registries and commercialized.

This dissertation project have employed the alternative approach of measuring the presence of SOEs based on the extent of privatization, as more privatization suggests decreasing presence of SOEs. The World Bank's Privatization Database provides information on privatization transactions of at least US$1 million in developing countries from 2000 to 2008. Prior to this effort the most comprehensive information could be found in the World Bank's Privatization Transactions database, which covered the years 1988 through 1999; the difference is that the Privatization Transactions database also includes privatization transactions of less than US$1 million. But a major issue with both of these sources is the limited coverage of time, and there are no further updates planned; though new dynamics might have emerged after the 2008 financial crisis, they are not captured in the data. The attribution/citation of the World Bank's Privatization Database however does include two major parts that continue to be updated. The first is the PPI data that has been described above. The second is the Privatization Barometer Index. It is less useful for this project, given that it is restricted to developed countries, and only tracks the performance (total return) of shares of privatized companies that are listed for trading in domestic stock markets of the enlarged European Union.

4.1.3 Control Variables

To control for domestic institutions, I use the Polity IV score to measure the type of political regime, and the widely-used Cukierman, Webb and Neyapti (CWN) index of central bank independence to measure CBI from an updated CBI data for 144 countries

from 1972 to 2015 by Bodea and Hicks. To control for macro-level factors and external influence, I use the World Bank's data on the sum of a country's exports and imports as a share of that country's GDP to control as a proxy for economic openness, and the World Bank's data on a country's total debt service as a percentage of exports of goods, services and primary income to measure the level of indebtedness to external lenders. Finally, I also include GDP per capital from the World Development Indicator to capture the general impact of economic development on capital controls. These five control variables are included because of their widely acknowledged relevance to the dependent variable of capital controls based on the literature review.

The measurement of political regime is necessarily controversial because democracy is a complex concept difficult to measure and aggregate, and there is no single index that offers a satisfactory response to all three challenges of conceptualization, measurement, and aggregation. Even the strongest indices suffer from weaknesses of some importance (Munck and Verkuilen, 2002). Two of the mostly widely used indicators in scholarly work are the Freedom House and Polity IV scores. The Freedom House score is less useful for this project since it emphasizes participation and its definition of democracy includes a wide array of attributes such as socioeconomic rights, freedom from gross socioeconomic inequalities, property rights, and freedom from war, which are relatively less relevant to this project. In contrast, the Polity IV Project uses a minimalist definition, and polity is largely defined as a subset of a class of authority patterns, which is more appropriate for this project, since it focuses on political economy rather than sociological aspects.

The Polity IV continues the Polity research tradition of coding authority characteristics of states in the world system for purposes of comparative, quantitative analysis. The dataset covers all major, independent states in the global system over the period 1800-2015. The Polity conceptual scheme is unique in that it examines concomitant qualities of democratic and autocratic authority in governing institutions, rather than

discreet and mutually exclusive forms of governance. This perspective envisions a spectrum of governing authority that spans from fully institutionalized autocracies through mixed, or incoherent, authority regimes (termed "anocracies") to fully institutionalized democracies. The "Polity Score" captures this regime authority spectrum on a 21-point scale ranging from -10 (hereditary monarchy) to +10 (consolidated democracy).

The CWN index of CBI is used since it provides a relatively comprehensive list of attributes to build the index and specific coding rules. The index is based on four components: 1) the appointment procedures for the head of the central bank such as terms of office and dismissal; 2) monetary policy formation process and the resolution of conflict between the central bank and the executive branch of government; 3) the prioritization of an explicit policy target such as price stability, stable banking system, or full employment; 4) rules limiting lending to government. Then it provides detailed coding rulings under each subcategory of these four aspects (16 different legal variables in total) on a scale of 0 (lowest level of independence) to 1 (highest level of independence). The codes are set so that a higher number indicates a stronger mandate and greater autonomy for the central bank to pursue price stability (Cukierman, Web and Neyapti, 1992).

Democracies are often linked to amelioration of rent seeking among incumbent insiders such as SOEs. Higher level of central bank independence often indicates less state influence on the financial sector and is linked with capital-account liberalization. Given the difficulty to categorize each country based on the type of capitalism identified in the VoC literature since many "mixed" cases exist, CBI also serves as a proxy for SMEs in the quantitative investigation, as SMEs tend to have a repressive financial sector and lower level of CBI. But since financial repression is only one of the many features that characterizes SMEs, and the interpretive implications of the level of CBI and the types of capitalism are quite different, I will discuss the impact of the contextual factor of state

role in economic management more in detail in the case studies.

As the commitment to economic liberalization might be able to drive both privatization and capital account opening, I also include the share of an economy's GDP that is made up of trade to control for the impact of economic openness following Rodrik (1998)'s definition. It is possible that more open economies with higher amount of trade might have a higher likelihood of privatization and financial liberalization. The correlation between privatization and capital controls might become spurious if they disappear after including the variable of economic openness in the regression analysis. But if the regression model survives after including the variable of economic openness, it is likely that the weakening political influence of SOEs as a result of privatization has an independent impact on capital account opening.

Another possible alternative explanation is external influence. It is possible that external actors such as IMF have contributed to both higher level of privatization and less likelihood of using capital controls. I include the variable of external debt to control for the impact of external lenders. It is measured by the total debt service to exports of goods, services and primary income. Total debt service is the sum of principal repayments and interest actually paid in currency, goods, or services on long-term debt, interest paid on short-term debt, and repayments (repurchases and charges) to the IMF. The government might agree to make economic adjustment including privatization and lifting capital controls to meet the conditions to borrow from the external lenders. If the regression analysis survives after controlling for the external influence, it would strengthen the argument that privatization drives capital account opening by weakening the resistance from SOEs.

4.2 Case Studies

This dissertation conducts one in-depth case study on China and two less intensive case studies on Brazil and India to form a basis for comparative analysis. This non-symmetrical design of a series of case studies is appropriate for this project because it is better than a single case study [2] and it is not feasible to do intensive field work in all three countries because of the limit of resources and my language abilities.

The most important reason for selecting China as my target for an intensive case study is that it is a critical case with significant presence of SOEs and high levels of capital controls. It has experienced several major waves of privatization in the past few decades, and has made several announcements related to liberalizing its capital-account since 2007, although the actual timeline is uncertain. A close examination of China will be able to detail at least one of the causal mechanisms of how the privatization of SOEs reduces the likelihood of using capital controls. Besides, the issue of how domestic interest group affects policy making in China has drawn a great amount of scholarly attention but remain unclear and understudied because of limited data access. An intensive case study of China in this dissertation will contribute to this line of scholarly work by providing detailed qualitative data, and help outsiders understand how policy changes occur and what role domestic interest groups play in China. My linguistic ability in Chinese and social connections also makes it more reasonable for me to choose China as my case for in-depth analysis.

It is difficult to find a good match for the case of China, given the country's large economic size, unprecedented rate of sustained economic growth, and capitalism with Chinese characteristics. The rationale for selecting India and Brazil as supplementary

[2] given the many reasons of doubting single case study, for example, measurement in a single case is difficult and not perfectly reliable; social reality is not reasonably reacted as being produced by deterministic processes, so random error would appear even if measurement were perfect (King, Keohane and Verba, 1994)

cases is to find the best available matches for China: first, the comparison between China and the other two controls for the size of the economy. This matters since larger economies might have more room to implement capital controls thanks to their large domestic market, whereas small economies are more dependent on the world market and often left with fewer choices but liberalization (Katzenstein, 1985). Second, relevant factors such as the income level and growth rate (e.g., higher GDP per capita is correlated with lower likelihood of using capital controls) of China, India, and Brazil have been largely similar. All three belong to the same category of middle-income group and BRICs countries. In terms of SOEs presence, all three have substantial number of SOEs and are among the ten countries with the highest *CSS* in 2011. Finally, for the use of capital controls, China and India have in general maintained a high level of capital controls, whereas Brazil has ups and downs in the use of capital controls in the last two decades. A summary of similarities and differences between the three cases is provided in Table 4.2.

Between India and Brazil, India is relatively more similar to China in terms of region and state-market relationship, since both China and India are Asian countries, and both are SMEs where the state governs (in the case of China) or at least tries to govern the market (in the case of India). It follows that the case study of India is to see the possibility of replication of China's experience in a most similar case. Although political regime types are different between China and India, they are still a good match for this project, since states are more constrained in economic intervention in democracies, and we expect democratic institutions to mitigate the resistance of SOEs to financial liberalization. So if we find evidence that SOEs in the democratic India affects capital controls in a largely similar way as in autocratic China, then we might be able to strengthen the theory by claiming that it also applies to democracies where it is expected to be less applicable.

Since Brazil is often categorized as a typical dependent state, where the state has a limited role in economic management because of predominant influence of foreign capital,

the case study of Brazil is to see whether and how the contextual variable of state role in economic intervention mitigates the resistance of SOEs to financial liberalization, or whether in a typical non-SME, the influence of SOEs will be offset by other forces such as foreign lenders/investors and MNCs.

Table 4.2: Comparison Between China, India, and Brazil

Variable	China	India	Brazil
Large economic size	✓	✓	✓
Middle income group countries	✓	✓	✓
High growth rate	✓	✓	✓
SMEs	✓	✓	✗
Substantial number of SOEs	✓	✓	✓
High levels of capital controls	✓	✓	✗

As has been mentioned, it would be ideal to conduct in-depth case studies of all three countries, and detail the causal mechanisms of how privatization affects capital-account opening in each one of them to form a solid comparative analysis. But given limits of funding and time, I only investigated the case of China through content analysis and interviews in the original language. For the data of India and Brazil, I gathered information from secondary sources and literature reviews written in English. I did several rounds of literature review starting with most recent news articles to get a flavor of what is going on, what issues matter, and who are the major actors. Then I investigated into scholarly literature related to privatization and capital controls in these two countries to form a more in-depth understanding of their situations as compared to China.

4.2.1 Content Analysis

It is a widely-known fact that Chinese politics are obscure: central policymakers rarely reveal their true intentions/motivations behind each move of market reform; the actual timelines and upcoming steps are subject to frequent change of mind (at least

from a non-domestic perspective); the lack of freedom of speech and expansive use of propaganda makes it even harder to obtain truly meaningful data. Besides, access to top-level government officers is extremely difficult if not impossible. To address these issues, I use a) content analysis to look at the written records of top Chinese policy-makers' speeches and interpretations of these speeches and conduct b) interviews with both central and local level of government officials in the area of financial policy making.

To be more specific, I looked over government documents such as 1) relevant statements on financial reform and privatization from keynote reports from the 12th to the 19th Communist Party of China (CPC) National Congress covering the period of 1982 to 2017. CPC National Representatives Congress is a party congress that is held every five years. In the past two decades, the National Congress of the CPC has been pivotal at least as a symbolic part of leadership changes. The reason for starting from the 12th CPC congress is that China's opening and reform started around the late 1970s to early 1980s. In each Congress, the President of the CPC would make a keynote report, which served as the guideline for policy-making in the next five years. The reports are often around 30000 words and written in similar formalities with different wordings in each subsection covering major political, economic, social, and security issues. 2) official government documents from China's State-owned Assets Supervision and Administration Commission (SASAC) of the State Council. SASAC is a special commission of the People's Republic of China, directly under the State Council. It was founded in 2003 through the consolidation of various other industry-specific ministries (Starr, 1997). As part of economic reform, nearly half of all SOEs were sold off in the form of equity. SASAC is responsible for managing the remaining SOEs, including appointing top executives and approving any mergers or sales of equity or assets, as well as drafting laws related to SOEs. The documents to be reviewed include SASAC's official annual report published since 2008, which includes general information on major political performance during

that year, and the SASAC monthly journal *State-owned Assets Report* published since 2014 that contains both news related to SOEs reform and analytical articles related to lessons learned in the past and directions for future. 3) official annual report on financial reform from the People's Bank of China published since 2001. The purpose of reading these official documents is to provide an accurate timeline of China's progress in privatization and financial liberalization, and discuss the nuances of when, how, and why the official attitudes shift back and forth.

In addition, I continue to follow news articles from mainstream Chinese media and scholarly work from domestic Chinese scholars, since news and academic literature serve as domestic interpretations of policy-making at the central level in China. News sources include articles related to the topics of SOE reform and capital-account opening from the on-line platform of one of China's major mainstream media Xinhua Net[3]. Content analysis based on recent domestic news articles will be particularly useful in providing an up-to-date picture of China's ongoing policy movement. For scholarly work from domestic Chinese scholars, I go through related papers from cnki.net database, which is the largest academic database in China and covers scholarly works back to the 1970s and 1980s.

4.2.2 Interviews

Interviews with experts and policymakers are an effective way to collect data and form an in-depth understanding of whether and how privatization of Chinese SOEs affects the process of financial liberalization. The fact that China is an authoritarian regime and elites' opinions might matter more than the public also makes it more reasonable to gather evidence from top-down elite perspective. Thus, government officers and policy experts are the targeted population for conducting interviews. For this project, I interviewed

[3]www.news.cn

government officers in relevant departments, SOEs managers, POEs managers, banks, experts and media workers in the issue area of privatization and financial reform[4]. The language used in these interviews is Chinese, as most of my interviewees do not speak fluent English and often most sensitive information can only be obtained in a context of speaking in one's mother tongue. The purpose of doing interviews was to provide qualitative data for analysis, as interviewees are expected to share their professional experience related to on-going privatization projects, credits allocation between SOEs and POEs in the banking sector, and financial regulation.

For interviewee selection, randomization is not going to be superior than intentional selection given the small-N. Snow-ball techniques was used to recruit interviewees besides my initial contact in Yongjia County (Wenzhou, Zhejiang Province) and Beijing, as market reforms are still considered as a sensitive topic and direct contact might not work as well as referral. Frequent follow-ups with my interviewees and field visits and observations also helped contribute to the reliability and validity of my findings. Specifically, interviewees included insiders/participants such as former official of SASAC in Wenzhou, director of Yongjia Wasu group as a representative of SOEs managers, managers of local banks in Yongjia, manager of Suifeng Paper Mill as a representative of the POEs, and governmental officials in the Yongjia financial reform office, and outsiders/observers such as journalists in the field of economic and financial issues in Wenzhou. A complete list of my interviewees is provided in the appendix. The ongoing privatization project of Wasu group in the industry of telecommunication (a typical industry often dominated by SOEs around the world) will be a critical case for this project to help reveal micro-level details of what actually happens to SOEs over time and how that links to the policy outcome of changes in the use of capital controls.

[4] A list of my interviewees and time of interview is provided in the appendix

Chapter 5

Panel Analysis

For my quantitative analysis, I start with fixed effects models to perform an analysis based on a panel of 59 developing countries from 1995 to 2015. The 59 countries are selected based on data availability after cross-checking the data sources of my independent and dependent variables[1] The list of countries included is provided in the appendix A. Fixed effects regression is considered as particularly useful for panel analysis, because it restricts comparisons to within-unit variation, thereby controlling for time-unvarying omitted variables across countries. These omitted variables can be correlated with the observed independent variable of privatization. By comparing countries to themselves in different time periods, the fixed-effect model helps improve the causal inferences based on repeated observation of the same unit (i.e., country) over a sufficiently long period of time. A fixed effects regression consists in subtracting the time mean from each variable in the model and then estimating the resulting transformed model by Ordinary Least Squares.

The independent variable used in the fixed effects model is the privatization dummy

[1] For the independent variable of SOEs presence, the PPI dataset I use covers 139 developing countries from 1990 to 2015, for the dependent variable of capital controls, the IMF dataset covers 100 countries including developed and developing countries over the period of 1995 to 2017.

coded as either 1 or 0 for a country in a given year in the database. It is lagged by 1 and 3 years respectively to capture the impact of privatization in the previous years on the policy outcome of capital controls. If the association between privatization and higher likelihood of using capital controls holds when the privatization dummy is lagged by both 1 and 3 years, we can be more confident that the results support our expectations. For many emerging and developing countries, privatization is an on-going process. The weakening of SOEs is gradual and the realignment of domestic interest coalition over the use of capital controls takes time. The dependent variable is the level of capital controls based on the average of inflow controls and inflow controls of a country in a given year. The five control variables used are central bank independence, Polity4 score, external debt, log (GDP percapita), and economic openness. Multiple models with different specifications are tested as robustness checks to see whether the models survive with different sets of control variables.

Then in the second part, as has been described in the research design, I first divided the countries in my sample into two groups based on the median of the number of years of privatization across the twenty-one-year period of time. Then I do comparative tests on their means of capital controls and changes of capital controls as compared to five years ago to see whether these two groups significantly differ from one another. Unlike in the fixed-effects models, the independent variable in the second part of means-of-difference tests is years of privatization instead of the privatization dummy (although the former is constructed based on the latter). The dependent variables are first the level of capital controls as in the fixed-effects model, and second, the level of changes of capital controls as compared to five years ago (which is also constructed based on the original dependent variable of capital controls).

The years of privatization from 1995 to 2015 for countries in my sample might range from 0 to 21 because the time period covers 21 years. The median years of privatization

for all countries is 12. The first group of countries, classified as high privatizers, have infrastructure projects with private participation recorded in 12 years or more from 1995 to 2015. Low privatizers countries have privatized for less than 12 years during the same period of time. A list of countries classified as high or low privatizers is provided in the appendix A. Means-of-difference tests are conducted on the average level of capital controls as well as the average change in the capital controls as compared to five years ago across these two groups of countries. The time range of five years are used because the change of policies that involve financial opening is often gradual and takes time. Looking at the level of capital controls as compared to last year might not be as helpful as looking at how the level of capital controls has changed as compared to five years ago. The comparison in average changes of capital controls between high and low privatizers is particularly useful because it helps control for unit-level heterogeneity. It is possible that country-level variables associated with high/low levels of privatization (such as stages of economic development, or political regimes) might help explain the differences in the average level of capital controls between high and low privatizers. The comparison between the average change of capital controls between high and low privatizers however helps control for these country-level variables, because countries are compared to themselves five years ago when calculating the changes of capital controls.

5.1 Fixed-effects Regression Results

Table 5.1 presents the summary of descriptive data used in the fixed-effects regressions. The average level of capital controls is 0.51 from a level of 0 to 1 (with 0 indicating no controls, and 1 indicating strict restrictions). This suggests that most emerging and developing countries have capital controls. The average restrictions of capital outflows (0.54) is 0.07 higher than the average restrictions of capital inflows (0.47). The mean for

the dummy variable of privatization lagged by one year is 0.55 and the means for privatization lagged by three years is 0.56. Both of them are slightly higher than the arithmetic mean of 0.5, suggesting that privatization is likely (rather than unlikely) among emerging and developing countries.

Table 5.1: Summary Statistics of Variables in Fixed-effects Regression

Statistic	N	Mean	St. Dev.	Min	Max
Capital controls	1,239	0.51	0.35	0.00	1.00
Outflow restrictions	1,237	0.54	0.39	0.00	1.00
Inflows restrictions	1,239	0.47	0.34	0.00	1.00
Privatization (lagged by one year)	1,180	0.55	0.50	0	1
Privatization (lagged by three year)	1,062	0.56	0.50	0	1
Polity score	1,095	3.91	5.93	−9	10
log (GDP per capita)	1,071	3.54	3.49	2.04	4.23
Central bank independence	1,036	0.55	0.21	0.11	0.95
Economic openness	1,212	131.88	334.60	0.17	2015
External debt	1,065	16.74	12.92	0.38	116.56

Table 5.2 shows fixed-effects results for Hypothesis 1. The results in Model 1/2/3 suggest that if a country privatizes in a given year, it has a higher likelihood to lessening its use of capital controls in the following year. In other words, privatization in the previous year is associated with capital-account liberalization this year, and the correlation is highly statistically significant. As a country privatizes more and its SOEs get weaker and resist less against lifting capital controls, the level of financial liberalization increases, holding other conditions (i.e., central bank independence, level of political freedom, debt to external lenders, economic development, and economic openness) as constant.

Other findings are that as the level of central bank independence in a country increases, it is less likely to have restrictions on capital flows; as political freedom increases, the likelihood of using capital controls decreases. The variable of log (GDP per capita)

Table 5.2: Effect of Privatization Dummy in the Previous Year on Capital Controls, Fixed Effects Regression

	Dependent variable:		
	Capital controls		
	(1)	(2)	(3)
Lagged privatization (1 yr)	−0.025***	−0.026***	−0.023**
	(0.009)	(0.009)	(0.010)
Central Bank Independence	−0.183***	−0.205***	−0.212***
	(0.043)	(0.039)	(0.045)
Polity4 score	−0.004**	−0.005***	−0.006***
	(0.002)	(0.002)	(0.002)
External debt	0.001	0.001*	0.001*
	(0.0004)	(0.0004)	(0.0004)
log(GDP per capita)	−0.017*		−0.005
	(0.009)		(0.009)
Economic openness	−0.0003	−0.0003	
	(0.0003)	(0.0003)	
Observations	784	822	802
R^2	0.080	0.070	0.074
Adjusted R^2	0.018	0.010	0.015
F Statistic	10.613*** (df = 6; 734)	11.658*** (df = 5; 771)	12.082*** (df = 5; 753)
Note:			*p<0.1; **p<0.05; ***p<0.01

Table 5.3: Effect of Privatization Dummy Three Years Ago on Capital Controls, Fixed Effects Regression

	Dependent variable:		
	Capital controls		
	(1)	(2)	(3)
Lagged privatization (3 yrs)	−0.023***	−0.025***	−0.022**
	(0.009)	(0.008)	(0.009)
Central Bank Independence	−0.209***	−0.209***	−0.246***
	(0.049)	(0.044)	(0.051)
Polity4 score	−0.005**	−0.005***	−0.007***
	(0.002)	(0.002)	(0.002)
External debt	0.001**	0.001*	0.001*
	(0.0004)	(0.0004)	(0.0004)
log(GDP percapita)	−0.005		0.007
	(0.008)		(0.008)
Economic openness	−0.0002	−0.0001	
	(0.0003)	(0.0003)	
Observations	709	743	724
R^2	0.067	0.062	0.069
Adjusted R^2	-0.002	-0.006	0.003
F Statistic	7.896*** (df = 6; 659)	9.151*** (df = 5; 692)	10.021*** (df = 5; 675)
Note:			*p<0.1; **p<0.05; ***p<0.01

turns out to be only statistically significant in Model 1 (which includes all variables) and suggests that richer countries might have lower level capital controls in general, but the association often disappears with different sets of model specifications. These findings are not surprising. As existing studies have suggested, the use of capital controls is a policy tool associated with heavy state influence over the financial sector. A country with higher level of financial repression is also likely to have a central bank that is not independent. Democracies are also less likely to impose capital controls and they often have higher level of political freedom and relatively higher level of economic development.

Interestingly, the level of external debt to turns out to be statistically significant in affecting the level of capital controls in models that excludes the control variable of economic openness or GDP per capita (i.e., Model 2 and 3), possibly because the variable of external debt is correlated with GDP per capital and economic openness: more open economies with higher trade volume and richer countries borrow less from the external lenders. The results on the variable of external debt suggest that in accordance with the existing theories, external influence such as the level of indebtedness also plays a role in determining whether a country imposes capital controls. The more a country is indebted to external lenders, the less likely would the country impose capital controls. International lenders such as the IMF often requires structural adjustment that a country must adhere to in order to secure a loan, including reducing government spending, opening to free trade, financial liberalization and so on. Higher level of indebtedness might increase the possibility of lifting capital controls and capital-account opening for borrowing countries. But the level of statistical significance is not high (with a p value between 0.05 and 0.1). It is unlikely that external influence such as IMF conditionality has contributed to both higher level of privatization and lower level of capital controls in a country as some critics have pointed out, since the association between privatization and less likelihood of using capital controls in the following year still holds after adding the control of external

debt. If external influence from the international lenders is driving both privatization and capital-account opening and there is no independent impact of privatization on financial liberalization, we would expect the correlation between the independent variable and dependant variable to vanish after adding the control of external debt, which serves as a proxy for external influence.

Surprisingly, the variable of economic openness is not statistically significant across different model specifications, although theoretically, we might expect that economically more liberal and more open countries with higher amount of GDP that is made up of trade would also have higher level of financial liberalization. The results suggest that financial liberalization does not necessary follow trade liberalization and they are not correlated. Countries with high volume of trade are not more likely to open their financial account than countries with low amount of trade. Different considerations exist in analyzing trade liberalization versus financial liberalization. In addition, since the correlation between privatization and capital controls still exists after controlling for economic openness. it is unlikely that economic openness has driven both privatization and capital-account opening, or that the correlation found between privatization and financial liberalization is because more liberal countries tend to have both.

Table 5.3 shows fixed-effects results when the independent variable of privatization dummy is lagged by three years instead of one year. The results are largely similar to the models when the privatization dummy is lagged by 1 year. Privatization three years earlier in a given country is associated with higher likelihood of lifting capital controls this year. This implies that privatization not only has an impact on the policy outcome of capital-account liberalization in the next year, but also the next three years. In accordance with our expectations, both privatization in the previous year and privatization three years earlier have impact on the use of capital controls, thereby providing supporting evidence for my first hypothesis. For the control variables, external debt turns

out to be significantly correlated with the use of capital controls across all three models after the switch of lagging privatization for three years. The variables of log (GDP per capita) and economic openness do not have a statistically significant impact on the level of capital controls.

Table 5.4: Effect of Privatization Dummy in the Previous Year on Outflow Controls, Fixed Effects Regression

	Dependent variable:		
	Outflow controls		
	(1)	(2)	(3)
Lagged privatization (1 yr)	−0.033***	−0.030***	−0.030**
	(0.011)	(0.011)	(0.012)
Central Bank Independence	−0.190***	−0.225***	−0.223***
	(0.053)	(0.047)	(0.055)
Polity4 score	−0.001	−0.001	−0.003
	(0.002)	(0.002)	(0.002)
External debt	0.001**	0.001**	0.001*
	(0.001)	(0.0005)	(0.001)
log(GDP percapita)	−0.013		0.002
	(0.011)		(0.011)
Economic openness	−0.0001	−0.0002	
	(0.0004)	(0.0004)	
Observations	784	822	802
R^2	0.049	0.048	0.043
Adjusted R^2	-0.015	-0.014	-0.018
F Statistic	6.278*** (df = 6; 734)	7.774*** (df = 5; 771)	6.815*** (df = 5; 753)
Note:			*p<0.1; **p<0.05; ***p<0.01

Table 5.4 and Table 5.5 present results for the effect of the privatizations dummy in the previous year/three years earlier on the use of capital outflow controls. The association between lagged privatization and outflows is highly significant. They are largely similar

Table 5.5: Effect of Privatization Dummy in Three Years Ago on Outflow Controls, Fixed Effects Regression

	Dependent variable:		
	Outflow controls		
	(1)	(2)	(3)
Lagged privatization (3 yrs)	−0.032***	−0.030***	−0.030***
	(0.011)	(0.010)	(0.011)
Central Bank Independence	−0.252***	−0.266***	−0.295***
	(0.060)	(0.054)	(0.063)
Polity4 score	−0.001	−0.001	−0.004*
	(0.002)	(0.002)	(0.002)
External debt	0.001**	0.001**	0.001*
	(0.001)	(0.0005)	(0.001)
log(GDP percapita)	−0.001		0.013
	(0.010)		(0.010)
Economic openness	−0.0002	−0.0001	
	(0.0004)	(0.0004)	
Observations	709	743	724
R^2	0.049	0.052	0.048
Adjusted R^2	-0.021	-0.017	-0.020
F Statistic	5.695*** (df = 6; 659)	7.536*** (df = 5; 692)	6.812*** (df = 5; 675)
Note:			*p<0.1; **p<0.05; ***p<0.01

to the previous fixed-effects regression where the dependent variable is capital controls in general, except that control variable of political freedom turns out to be less statistically insignificant. It is only significant in Model 3 from Table 5.5 when the privatization dummy is lagged three years and the model specification does not include the control of economic openness.

Table 5.6 and Table 5.7 present results for the effect of the privatizations dummy in the previous year/three years earlier on the the use of capital inflow controls. Here the level of statistical significance between privatization and capital controls significantly drops after the dependent variable is switched to the use of inflow controls alone. When privatization is lagged by one year, it is associated with inflow controls in Model 1/2 in Table 5.6, but the significance disappears in Model 3 after the model specification excludes the control of economic openness. In Model 1/2, the p value in the case of inflow controls is also much smaller than the case of outflow controls. When privatization is lagged by three years, the association between privatization and inflow controls is only significant in Model 2 in Table 5.7 where the control variable of log (GDP per capita) is excluded from the model specification. For the control variables, interestingly, political freedom seems to be only associated with inflow controls whereas external debt is only associated with outflow controls. In accordance with my expectation, I find evidence that the impact of privatization on the likelihood of imposing capital controls is more significant in the case of outflow controls than inflow controls.

As has been explained, there are potential benefits from incoming capital and investment for domestic SOEs, and they tend to fight less against the lifting of restrictions on capital inflows. Besides, a major motivation for domestic SOEs to fight hard against the lifting of outflow controls is the fear of domestic capital flight, which might severely impact state capacity in guaranteeing low interest-rate loans and other forms of preferential treatments for SOEs. The different results between the case of outflow and inflow con-

trols also suggests that the states differentiate restrictions of capital inflow and outflow based on separate policy considerations and under different levels of domestic pressure. It is not just winners and losers from the general use of capital control, but the sub-category of inflows and outflows. Further research should make such distinction when talking about capital controls, as there might be more interesting findings along this line of distinguishing between the two.

I have also conducted fixed-effects model analysis on the investment variable, but the results suggest that there is no significant correlation between the amount of privatization investment as a percentage of GDP and the likelihood of using capital controls, possibly because the investment variable does not differentiate between public and private shares in the investment of privatization projects, as I mention before. It also suggests that the overall size of public-private cooperation deals is not associated with the level of using capital control; it is the ownership change from privatization that matters.

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Table 5.6: Effect of Privatization Dummy in the Previous Year on Inflow Controls, Fixed Effects Regression

	Dependent variable:		
	Inflow controls		
	(1)	(2)	(3)
Lagged privatization (1 yr)	−0.017*	−0.021**	−0.015
	(0.010)	(0.009)	(0.010)
Central Bank Independence	−0.176***	−0.186***	−0.200***
	(0.045)	(0.042)	(0.046)
Polity score	−0.008***	−0.008***	−0.009***
	(0.002)	(0.002)	(0.002)
External debt	0.0004	0.0005	0.001
	(0.0004)	(0.0004)	(0.0004)
log(GDP percapita)	−0.021**		−0.013
	(0.009)		(0.009)
Economic Openness	−0.0004	−0.001	
	(0.0004)	(0.0003)	
Observations	784	822	802
R^2	0.097	0.075	0.093
Adjusted R^2	0.037	0.015	0.036
F Statistic	13.121*** (df = 6; 734)	12.528*** (df = 5; 771)	15.519*** (df = 5; 753)
Note:			*p<0.1; **p<0.05; ***p<0.01

Table 5.7: Effect of Privatization Dummy in Three Years Ago on Outflow Controls, Fixed Effects Regression

	Dependent variable:		
	Inflow controls		
	(1)	(2)	(3)
Lagged privatization (3 yrs)	−0.014	−0.019**	−0.014
	(0.009)	(0.009)	(0.009)
Central Bank Independence	−0.162***	−0.151***	−0.193***
	(0.052)	(0.048)	(0.053)
Polity4 score	−0.008***	−0.009***	−0.011***
	(0.002)	(0.002)	(0.002)
External debt	0.001	0.001	0.001
	(0.0004)	(0.0004)	(0.0004)
log(GDP percapita)	−0.010		−0.001
	(0.009)		(0.009)
Economic openness	−0.0002	−0.0002	
	(0.0003)	(0.0003)	
Observations	709	743	724
R^2	0.071	0.057	0.076
Adjusted R^2	0.002	-0.012	0.010
F Statistic	8.415*** (df = 6; 659)	8.299*** (df = 5; 692)	11.093*** (df = 5; 675)
Note:			*p<0.1; **p<0.05; ***p<0.01

5.2 Difference-in-Means Test Results

Although fixed-effects model addresses within-unit variation and allows for meaningful statistical tests on the relation between privatization and capital-account liberalization, it does not tell much about how the intensity of privatization affects a country's financial liberalization policies. To address this issue and investigate the impact of the degree of privatization on capital controls, I further divide my sample into two groups based on the median of the number of years of privatization (i.e., 12) across the twenty-one-year period of time: the high privatizers and low privatizers. As has been explained in the beginning of this chapter, across the twenty-one-year time period for my data, some countries have been consistently privatizing every year, whereas some only have occasional privatization deals. Those that have privatization deals for twelve years or more across a twenty-year period of time are identified as high privatizers, and those that have privatization deal for less than twelve years across a twenty-period period of time are identified as low privatizers. Then I conducted means-of-difference tests on the average level of capital controls as well as the average change in the capital controls (compared to five years ago) across these two groups of countries. The results of the means-of-difference tests are shown in Table 5.8.

Table 5.8: How Years of Privatization affect Average Capital Controls and Changes of Capital Controls between High and Low Privatizers, Means-of-Difference Tests

	Country × years	Capital controls	Change of capital controls
Low privatizers	481	0.474	0.013
High privatizers	661	0.529	-0.011
Mean difference		-0.055***	0.024**
t-Value		-2.633	2.433

Note: *p<0.1; **p<0.05; ***p<0.01

The average level of capital controls from a scale of 0 (no capital control) to 1 (strict

capital controls) among low privatizers is 0.474, and the average level of capital controls among the high privatizers is 0.529, and such difference is highly statistically significant. High privatizers actually have an overall higher level of capital controls than low privatizers. The implications for my theory is that either high privatizers have greater amount of SOEs to start with, or that they are simply more willing to privatize than low privatizers. According to the case studies of China, India and Brazil as will be discussed in later chapters, it seems to be former, i.e., high privatizers also have higher SOEs to start with, and they often also have higher levels of capital controls.

But interestingly, although the average change in the level of capital controls every five years for high privatizers is a decrease of 0.011, the average level of change in capital controls every five years for low privatizers is an increase of 0.013. Again, the means of difference tests show that the differences in the changing trend of capital controls between the high privatizers and low privatizers are highly statistically significant. This suggests that high privatizers see a gradual drop in their level of capital controls over the years as the presence of their SOEs falls, whereas low privatizers actually has a slight increase in their level of capital controls. This implies that for countries to achieve the policy outcome of reducing capital controls, it may have to consistently privatize for a continued period of time until its presence of SOEs diminishes under a certain level. Unsustainable privatization might even see an increasing level of capital controls in the short-run, as we see in the numerous examples of reform reversal and policy backfire where liberal reformers are replaced by even more conservative party leaders. I also tested for different threshold (i.e., somewhere just up the median, or below the median of twelve years of privatization over the twenty-one-year period of time) to differentiate between high and low privatizers as robustness checks, and the results consistently show that there is significant difference between high and low privatizers in both their average level of capital controls and their average change of capital controls every five years.

To test my second hypothesis that the impact of privatization affects the restrictions on capital outflows more significantly than the case of capital inflows, I also look at whether and how the degree of privatization (measured by the years of privatization) affects the restrictions on inflows and outflows differently. I did means-of-difference tests between the high privatizers and low privatizers first on their overall level of capital outflows restrictions and change of capital outflows restrictions, then on their overall inflows restrictions and change of their capital inflows restrictions. The results are presented in Table 5.9 and Table 5.10.

Table 5.9: How Years of Privatization affect Average Outflow Controls and Changes of Outflow Controls between High and Low Privatizers, Means-of-Difference Tests

	Country × years	Outflow Control	Change of Outflow Controls
Low privatizers	481	0.516	0.027
High privatizers	661	0.563	-0.006
Mean difference		-0.047**	0.033***
t-Value		-1.969	2.846
Note:			*p<0.1; **p<0.05; ***p<0.01

Table 5.10: How Years of Privatization affect Average Inflow Controls and Changes of Inflow Controls between High and Low Privatizers, Means-of-Difference Tests

	Country × years	Inflows Controls	Change of Inflows Controls
Low privatizers	481	0.429	0.002
High privatizers	661	0.491	-0.015
Mean difference		-0.062**	0.017
t-Value		-2.222	1.483
Note:			*p<0.1; **p<0.05; ***p<0.01

As Table 5.9 shows, the average level of capital outflows restrictions for low privatizers is 0.516 from a scale of 0 (no controls) to 1(strict controls), whereas for high privatizers, it is 0.563. The means of difference tests show that such differences are highly statistically

significant. When it comes to the change in outflow restricts for every five years, low privatizers actually have an increase of 0.027 in their means of outflows restrictions, and high privatizers see a decrease of 0.006 in their means of outflows restrictions. And such difference is highly statistically significant too. This suggests that stronger SOEs' presence among high privatizers is associated with lower level of capital outflow restrictions, and as these SOEs get weaker over time with intensive and consistent privatization, the level of capital outflow restrictions start to fall.

As for the case of capital inflows restrictions, however, the impact of privatization on capital-account liberalization is not as straightforward as the case of capital outflows restriction. As Table 5.10 shows, the average level of capital inflows restrictions for low privatizers is 0.429 from a scale of 0 to 1, whereas the average level of capital inflows restrictions for high privatizers is 0.491. High privatizers have a significantly higher level of restrictions for capital inflows than low privatizers. This again indicates that the greater presence of SOEs among high privatizers is associated with higher level of capital inflows restrictions. But when it comes to the level of change for capital inflows restrictions for every five years, there is actually no significant difference between the high privatizers and low privatizers. This implies stronger presence of SOEs among high privatizers is associated with more strict control in capital inflows, but as these SOEs privatize over time, this does not have the same dramatic impact on reducing capital inflows restrictions as we see in the case of capital outflows. As stated in the theory section, one major possible explanation is that in the case of capital inflows, there are certain benefits from attracting foreign investment that offsets the SOEs' resistance to capital controls.

As for the third hypothesis, there is no comprehensive dataset that accurately measures whether a country is a SME or dependent state, which is not surprising because the role of the state in economic intervention involves aspects from industrial to mone-

tary and fiscal policies, and this makes it too complex a variable to measure. Through qualitative comparison of my cases, we will see that the resistance of SOEs is much more effective in typical SMEs (China and India) than in a non-SME (Brazil).

5.2.1 Discussions and Limitations

These statistical findings demonstrate that SOEs' presence and privatization are associated with the policy outcome of using capital controls, thereby laying the foundation for doing qualitative work. Stronger SOEs are indeed associated with more strict capital controls, and as SOEs privatize consistently over time and becomes weaker, the level of capital controls especially the capital outflow controls decrease accordingly; whereas in the case of capital inflows controls, things are a bit more complicated because of SOEs' possible benefit from increasing foreign investment, which offsets its resistant impact on lifting capital controls.

It is important to note that privatization is not randomly assigned to countries in my sample. This raises several concerns for estimating the impact of privatization on financial liberalization. First, countries that have lifted capital controls might decide to privatize and improve efficiency and performance because their domestic sector especially the financial sector is faced with more fierce competition after international financial integration. If this is the case, then privatization might be endogenous to financial liberalization. Any relationship between privatization and capital controls might be flowing from latter to the former. To address the endogeneity problem, I have lagged privatization by 1 and 3 years in both cases, and the correlation survives. This suggests opening capital account is associated with privatization that have happened in the previous years, thereby strengthening my argument. But admittedly, the non-random assignment of the independent variable may still affect the causal inference of the model

results. Empirically, privatization does not always come before financial integration. As will be discussed in detail in the part of case studies, privatization has preceded financial liberalization in China and India, but not in Brazil. Factors such as the institutional legacies and from the past and external actors help contribute to the different scenarios across the three countries.

Second, the likelihood of lifting capital controls might be based on other observable variables that are themselves correlated with the probability of privatization. Countries might decide to open their capital accounts because they are committed to economic liberalization and market reform, or because they are more indebted to external lenders and feel obligated to follow the their policy suggestions to improve financial openness, or simply because they feel ready after achieving higher level of economic development and transition to become democratic regimes. If these variables are omitted from the models, the models and results would be biased. To limit the bias from omitted variables, I have included five controls commonly used in the IPE literature that studies capital control, including central bank independence, political freedom, external debt, GDP per capita, and economic openness.

But one notable limitation is that the variable of economic openness might not be able to accurately reflect a country's commitment to economic liberalization and the extent of market reform that has been achieved. Market reform often comes in different packages and proceeds by stages. Trade liberalization is often only one part of a larger policy reform. The level of trade as a percentage of GDP serves as a proxy a country's latent commitment to economic liberalization and turns out to be statistically insignificant in the fixed-effects model results, but we would expect market reform to have played a more important role in influencing privatization and capital account opening. As we will see in the qualitative studies part on China, Indian, and Brazil, the mechanisms of how market reform has affected both privatization and financial liberalization and how privatization

and the weakening of SOEs pave the pave the way for capital-account opening may co-exist with each other. The field studies of China in particular present nuances and details on the market reform, SOEs privatization, and financial sector consolidation. They strengthen the argument by providing ample evidence that SOEs are standing in the way of further liberalization of the capital-account, and privatization needs to be achieved to a certain extent before liberalizing the capital account.

Another possible selection bias results from the structure of the PPI data. As has been mentioned, Public investment in infrastructure projects is excluded in the PPI data, as it only records infrastructure projects with private participation. The independent variable of privatization is coded as 1 if a country has private participation in infrastructure in a given year according to the records, and 0 otherwise. The extent of privatization is allowed to either increase (when coded as 1) or remain the same (when coded as 0) but may not decrease. In reality, it is possible that countries might expand the public sector by for example, launching new infrastructure projects entirely funded by the public sector, signaling an expansion of the public sector. In this case, the private sector shrinks and the extent of privatization actually decreases. Although the PPI data set does allow the variation of privatization across the countries over the years, it may be biased because it excludes the cases of decreasing privatization. But the impact should be minimal because empirically, privatization and public-private cooperation has become a world trend for the past few decades. It may have halted but the reversal of privatization has been relatively rare.

Another possible confounding variable is firm size, since SOEs are typically also large, and it is possible that the cleavage between SOEs and POEs is capturing the cleavage between large and medium/small size firms. But it is also worth noting that large SOEs are mostly owned by the central government whereas at the sub-national level such as provinces and cities, SOEs owned or controlled by local government are not necessarily

larger than POEs. Managing these small SOEs often becomes an administrative burden for the local governments. Moreover, SOEs do not necessarily get smaller after privatization, it is the state share that becomes smaller. In the case of full privatization, traditional SOEs are turned into POEs, whereas in the case of partial privatization, traditional SOEs are transformed to be operated and managed more like POEs subject to consumers preferences and market shareholders. The sales of these new mixed-ownership enterprises might even go up after privatization while the number of employees might decrease as efficiency improves. POEs are also not necessarily smaller than SOEs, if we consider large mixed-ownership business groups with both national and foreign shareholder as will be discussed in the case study of Brazil.

Chapter 6

China

6.1 Introduction

This chapter explains how the case of China fits into my theory. It traces the trajectories of both the independent and dependent variable in China for the past few decades, and provides empirical evidence for all the three hypotheses. In the meantime, it details the mechanism of how privatization affects the likelihood of using capital controls by altering the preferences of critical interest groups.

The first section on privatization and capital-account opening reviews the history and most recent changes of these two reform projects. The story of how SOEs stand in the way of furthering capital account opening in China helps provide empirical evidence for H1. In contrast to other countries in the large-N data, China is not one of those countries where the accomplishment of large-scale privatization has successfully driven financial liberalization. The story of China shows that SOEs were dominant historically and continue to be exceptionally powerful and not favoring change nowadays. They are privatized at an extremely slow pace. China is pursuing a modest public-private cooperation model of privatization that prevents privatization from going further and driving

financial liberalization as predicted by the theory. According to domestic interpretation, the incentive of this modest model is to bring everyone on board and create a win-win situation[1]. A plausible interpretation is that the current approach is the only feasible and implementable path forward. SOEs' privatization is not possible when it interferes with the interest of core SOEs leaders and the state itself. This is a top-down approach coming from political leadership instead of the market force.

The discussion of the privatization of Wasu in the telecommunication industry presents details of an on-going pilot project that exemplifies how traditional SOEs preferences are changing when being transformed into new mixed-ownership SOEs. Privatization in China is designed to transform SOEs instead of weakening them. But during this process, many traditional SOEs have been weakened, and new mixed ownership SOEs have been empowered. The state often remains as the largest shareholder for these mixed ownership SOEs, but the private sector is also a minority shareholder. These mixed-ownership SOEs have been created in the contemporary era following market rules. Mixed-ownership SOEs might have a preference for partial financial opening that lie in between the traditional SOEs and the private sector, but presumably much closer to the preference of traditional SOEs in the spectrum in the case of China. As a result, the capital account is opening only slightly and is nowhere near full liberalization. China's privatization has been going on so gradually for a long time that its impact on furthering capital-account opening seems to have just begun and remains at an initial stage.

The second section on capital inflows versus outflows explains how China's case relates to H2. Empirically, China slightly loosened its controls of capital inflows for three years in the end of the 1980s. During the same period of time, controls of capital outflows remained strictly maintained except a very slight reduction in 1999. In China's recent attempts to open capital-account in the 2010s, controls of capital outflows and inflows

[1]Source: interviews with SOEs managers and government officers

were raised and loosened simultaneously without the differentiation observed in the late 1980s. But throughout the qualitative interviews, the sense is that most critical domestic actors are fearful of losing domestic capital after opening the gate to invest abroad. Government officers, financial sector managers, financial journalists, SOEs and POEs managers all seem to assume that once the gate is open, Chinese investors will be eager to transfer their financial assets abroad. The scenario of domestic capital flight is expected to cause financial chaos and economic volatility that are unacceptable by the central government of China. The fear of losing domestic capital and potential economic political turmoil is considered as the major incentive to move slowly and gradually down the path of financial liberalization. In contrast, a general favorable and welcoming attitude is observed when interviewees talked about capital inflows. There are ample evidence that China is attempting to establish more favorable conditions to attract foreign investors and welcome foreign banks. The dramatic contrast of attitudes between lifting controls of capital outflows and inflows among domestic actors helps provide supporting evidence for H2. SOEs might fight harder against lifting controls of capital outflows because domestic capital is expected to flee abroad after the outgoing gate is open, which in turn undermines the state capacity to discriminate between SOEs and POEs and offer concessional financing to the former.

The third section on SOEs and institutional embeddedness provides qualitative evidence for how interests are aggregated in a typical SME like China, thereby providing empirical evidence for H3. SOEs in SMEs are particularly powerful in fighting against capital-account opening because they benefit from the existing institutions. The strong presence of SOEs in China has two critical components: 1) exceedingly large size; 2) political influence thanks to their extremely close institutional linkages to the state. China's legacy of interventionist institutions enables SOEs and helps them effectively influence policy making. The political economic institutions in China are designed to empower the

state under the CPC's rule. A solid and comprehensive framework of regulation is established to supervise economic activities and provide platforms for political interventions if needed; in the meantime, the interaction between regulators and those being regulated provide a mechanism for domestic preference aggregation.

But not every regulatory framework works similarly. The regulatory framework for SOEs is well-established and builds strong ties between SOEs and their regulators. On the one hand, SOEs may easily express their preferences and make their voices heard at each administrative level through the existing institutional platforms; on the other hand, this framework enhances SOEs' loyalty to the state and ensures that they will efficiently follow the lead from the state when economic interventions are needed. Non-financial SOEs are even more connected to the policy maker than financial SOEs, because the former has the same owner and regulator. The conflict of interests between different government entities might be less of a problem for non-financial SOEs than financial SOEs. For POEs, the regulatory framework is much more loose and informal. The platforms where they can express concerns and demands are more societal instead of official and lacks authority and power. Many of them have seized the opportunity to become a shareholder of mixed-ownership SOEs during the process of privatization and obtained greater political influence. In a SME, it seems that the best way to ensure profitability for businesses is to build and maintain strong ties with the government. The voices of SOEs find it much easier to reach central policy making than POEs in China through the country's economic political institutional design. The impact of SOEs and their resistance to financial opening are stronger and more effective in China because of their embeddedness in the state-led political economic institutions compared to non-SMEs. As privatization gets stuck in this modest public-private cooperation and state-dominated mixed ownership model, the capital account remains largely closed in China. Policy makers may not agree to open up the capital account unless the impact of SOEs,

especially these powerful central non-financial SOEs in strategic sectors, is retreating to a significantly lower level.

6.2 Privatization and Capital Account Opening

6.2.1 From 1978 to the Present

The world news have reported Chinese politics as extremely difficult to interpret. But if we look from inside-out and try "decipher" its messages in its own rules under its original context, there are traces to be found and we may even find that it actually claims what it intends to do and report progress and failure as things go on and make adjustments. New policy tools and pilot reform arrangements are devised and tested to gain experience and learn the lessons before moving on to larger policy change. In general, China is consistently pursuing the tricky task of promoting economic reform and strengthening political rule at the same time since the 1978 reform and opening up.

Comparatively speaking, the reform of SOEs and privatization have come earlier, been going on much longer, and going further and deeper than liberalizing the capital-account in China. Successful privatization of SOEs seems to have become a prerequisite to capital-account opening. It is widely acknowledged by various parties of interest that SOEs enjoy borrowing privileges compared to POEs. Lifting capital controls might be leveling the playground between SOEs and POEs in their competition for loans. The extremely slow and gradual approach of privatization in the form of public-private cooperation and mixed-ownership firms might help explain the even slower progress of financial liberalization in China. This provides empirical evidence for H1, which suggests the progress of privatization and the political strength of SOEs affects the likelihood of using capital controls.

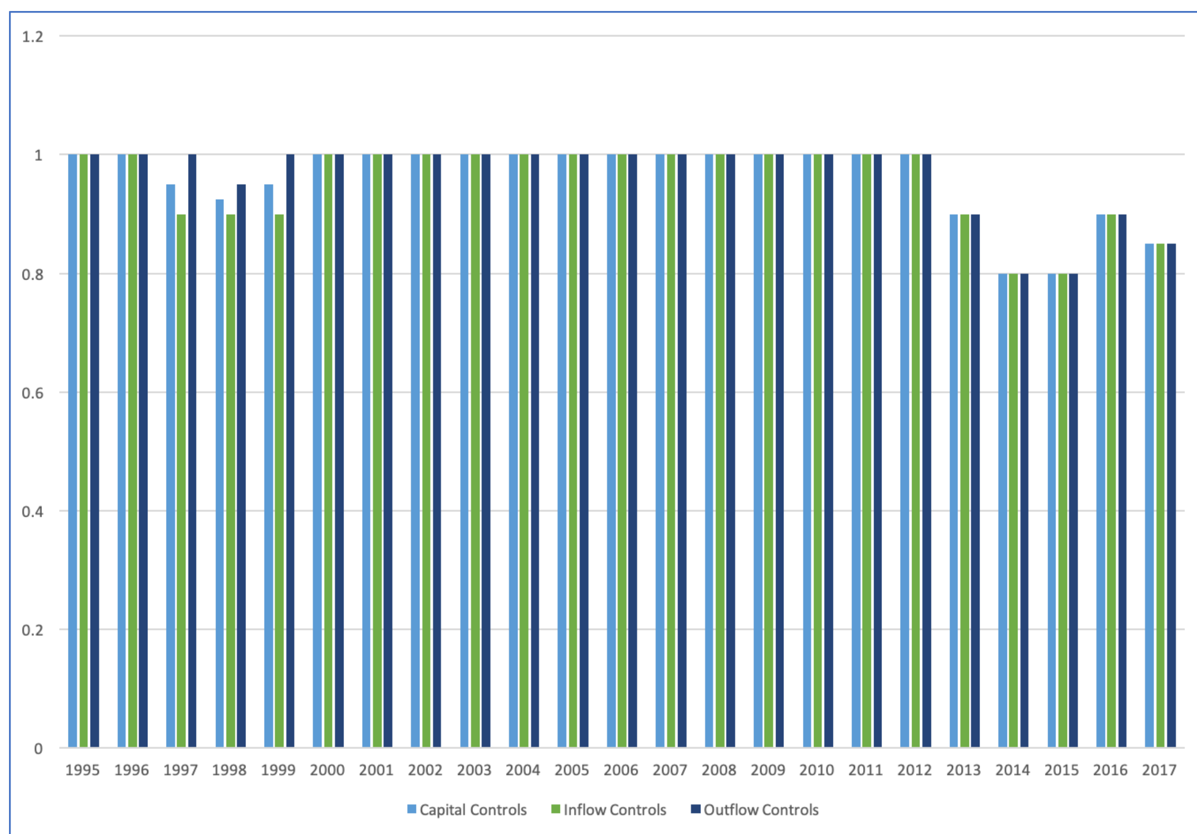

Figure 6.1: China's capital controls from 1995 to 2017 (Fernández et al., 2016)

As Figure 6.2.1 shows, China has maintained very tight capital controls since the civil warn. It slightly loosened the control of capital inflows by 10% during the 1998 Asian Financial Crisis, and quickly restored its extremely strict capital controls in both capital inflows and outflows in the 2000s. Since 2013, a new trend began to emerge. Both controls of capital inflows and outflows were loosened by 10% from the most strict level of controls in the year of 2013 [2], and then dropped by another 10% in the year of 2014 and 2015 before going up again in 2016 and dropping again in 2017. This suggests that "achieving full RMB convertibility in capital-account", or the lift of capital controls and liberalizing the capital-account was once tested, but later delayed or even off the table

[2] According to Fernández et al. (2016)'s measurement, China's level of capital controls dropped from the most strict level of 1 to around 0.9 in 2013

for now, and consensus has not been reached at the national level.

According to the series of keynote reports from CPC[3], the topic of "interest rate liberalization" was only first raised in the 16th report in 2003, whereas the topic of "gradually opening capital-account" was introduced in the 17th report in 2007 for the first time, and "achieving full RMB convertibility in capital-account" was mentioned in the 18th report in 2012. In the 19th report released in 2017, however, the document goes back to stressing "interest rate and exchange rate marketization reform" without emphasizing "capital-account opening." These subtle changes of wording confirms that the policy initiative of capital-account opening and financial liberalization was met with resistance and setbacks during the 2010s. Some initial trial policy changes starting in 2013 have been reversed, as the CPC de-emphasized "capital account liberalization" in its keynote reports in 2017 after it was introduced a few years earlier.

In contrast, the issue of privatization appeared much earlier in these keynote reports compared to financial liberalization. The topic of privatization has remain in these keynote reports since the beginning in the late 1970s and it is brought up in a manner of higher level of consistency and certainty without going back and forth as in the topic of capital-account opening and RMB convertibility. There is a notable increase in the appreciation for private business sector and decreased support for the SOEs, and the differential treatment between SOEs and POEs is de-emphasized over time. In the 16th keynote report published in 2003, it is stated that SOEs needs major support because they control the critical part of the national economy and plays a critical role in national

[3] As has been mentioned before, CPC National Representatives Congress is a party congress that is held every five years. In each Congress, the President of CPC would make a keynote report, which serve as the guideline for policy-making in the next five years. These reports have been established to coordinate policy efforts of reform. They have been written in a similar structure in the past few decades, and minor changes of wording and adjectives in subsections often suggest changes of policy focus in corresponding areas. Each report has a subsection on economic institutions and market reform that describes the party's policy attitudes towards SOEs and POEs, and another subsection on the opening-up where guidelines on financial liberalization can be found.

economic development; in the 19th report coming out in 2017, the newest wording is to "further reform of SOEs and develop mixed ownership economy." It seems that the party wants to send out a welcome gesture to the private sector as it becomes more profitable, efficient, and has grown much stronger over time and become an increasingly important part of the economy. These messages serve to reassure the private sector's confidence in its sense of belonging and keep up its motivations. A relatively higher level of consensus has been reached in the policies related to privatization compared to capital-account liberalization, and it is not something as debatable as financial liberalization. It is as if China is doing policy experiments before making major policy changes, and privatization has experienced many more trials than capital-account opening.

Historically, SOEs in China was established based on the confiscation of gigantic private capital, for example, the wealth from the four big families that begin with the Chinese surnames Chiang, Soong, Kung, and Chen and have close ties with the *Kuomintang* of China (Chinese Nationalist Party), and restructuring of various other forms of private capital after the CPC won the civil war and took over since 1949. SOEs were the one and only official form of corporate governance for the economies and businesses in the first couple of decades since the People's Republic of China was established in 1949. The CPC undertook the role of rebuilding the economy, provided employment and a wide range of social services such as education, medical care, and retirement protection. As G.W., one of my interviewees from the banking sector mentions, "loans and financial support was once exclusive to SOEs in the past. It remained so until the 1980s; POEs did not have a chance, and it was not allowed to lend to them."

Since the economic reform and opening-up policies began in 1978, China's SOEs have undergone a long process of gradual and progressive transformation. Many inefficient and smaller SOEs have been closed down, merged or sold, and the resulting unemployment and restructuring issues were painful. But many large SOEs in key and strategic sectors

have been transformed into more profitable modern economic entities with appropriate corporate governance structures, many of which have mixed ownership but the state remains the largest shareholder. Although lending to POEs are now allowed and even encouraged, the interest rate is much higher compared to the lending to SOEs because it is considered more risky. Every interviewee ranging from the SOEs and POEs to the government and financial sector acknowledges and is fully aware of the lending privileges and other forms of preferential treatments enjoyed by SOEs in China. Reasons mentioned include the relatively lower risk of lending to SOEs both economically and politically. Economically, SOEs are less likely to ever go bankrupt thanks to government bailouts. The interest rate for SOEs might be lower but it is much safer. Politically, as G.W., my interviewee from the banking sector says, "you would not be held accountable and lose your job even if you don't get the money back from the lending. But if you make the call to lend to a seemingly promising and highly profitable POE and it fails, then your career might be jeopardized. Besides, banks are also part of the state, and it ought to lend to state-owned businesses."

It seems that every party of interest understands the relatively lower performance and profitability issues of SOEs, but the banking sector is still wiling to lend to them mostly because of their back-ups from the state. SOEs are confident and not wary of financing when faced with their lenders regardless of their performances. For POEs, financing is a big headache and they struggle when trying to convince their creditors and even if they get loans, it is much more costly because of higher interest rate, and such issue is even more severe for smaller POEs. Alternatively, many turn to informal lending and raise funds from their friends, relatives, and other investors in their social networks according to interviews with POEs managers and local journalists. The government has initiated policy guidelines to provide more financial support for POEs especially smaller ones, but in general acquiesce to SOEs' huge appetite for low interest rate loans.

According to the most recent official reports published by the central SASAC, a new series of guidelines on SOEs reform from the state council of the People's Republic of China were established since 2015. These guidelines makes it explicit that the state is no longer the administrative supervisor of SOEs; instead, the state is an investor and should therefore take responsibilities and exercise its rights as a shareholder. Boundaries have to be drawn when the state tries to regulate: it is to regulate its asset and capital, but not the companies[4]. In January 2020, guidelines on leadership and management were introduced: traditional forms of permanent positions employment were to be replaced by modern contracts and performance-based jobs[5]. In addition, a Share Incentive Plan was introduced in approximately 30% of listed SOEs controlled by the central SASAC, and the percentage was to be increased[6].

A review of Chinese scholarly work and media reports on the two issue areas of privatization and capital-account opening suggest similar findings. The attitude towards privatization among scholars is non-controversial and supportive. Some observers and scholars express concerns over the slow progress of privatizing SOEs and provide policy suggestions on how to accelerate the reform (Sheng, 2015; UIE, 2011)[7]. The discussions of capital-account opening however started much later and the debates are much more fierce. The research topic of RMB convertibility and capital-account opening first emerged at the end of 1980s (Hu, 1989*b*), and a wave of debates followed in the 1990s (Zhou, 1989; Xu, 1989; Hu, 1989*a*). The attitudes towards financial liberalization became much more positive after the major policy change of achieving RMB full convertibility under the current account in the mid 1990s (Jiang, 1994; Hu and Cheng, 1996). The majority of literature echoes the state voice and finds empirical support for the merit of gradually

[4] http://www.sasac.gov.cn/n2588035/n2588320/n2588340/c12857285/content.html

[5] http://www.sasac.gov.cn/n2588035/n2588320/n2588340/c14922936/content.html

[6] http://www.sasac.gov.cn/n2588035/n2588320/n2588340/c14735075/content.html

[7] UIE stands for Unirule Institute of Economics (*tianze yanjiuyuan*), a think tank specializing on political economic policy research based in Beijing

opening up capital-account (He, 1999; Yu, 2010; Peng, Chen and Tan, 2015). Only a few exceptional works argue for accelerating full capital-account convertibility as it is a prerequisite for RMB convertibility and necessary step to reduce excessive dependence on the dollar (Zhao and Song, 2009; Wang, 2009; Li, 2014),. The reason for not rushing into full convertibility of capital-account, as some scholars suggest, is China should wait until certain issues are resolved(Yu, 2011; Zhou, 2009). SOEs reform is one of them to help reduce non-performing loans for banks; others include that the Central Bank and other government institutions needs downsizing to reduce financial burdens, and the domestic financial sector needs to grow more competent and be able to provide better financial assets. All of these domestic reforms needs time (Huang, 1998; Li and Ding, 2014; Cao and Hao, 2016). The online platform of Xinhua.net, China's most powerful and leading media institution has a record of more than 2000 news articles under the keyword search of "SOEs" reform, but only around 100 articles with the keyword of "capital-account opening." The general attitudes remain positive and rosy when it comes to SOEs reform and privatization. The articles on capital-account opening however have a more cautious and vigilant attitudes, and are often wary of negative consequences and financial chaos.

Unlike the issue area of privatization where there are more specific guidelines and policy instructions at the official level, capital-account opening and financial liberalization remain in the domain of academic and media discussion. This again confirms that privatization goes first in China. Financial liberalization may or may not come later depending on how successful privatization has been implemented, how resilient these large SOEs considered as national champions have become and ready to compete without protection, and how strong the private sector has actually grown both economically and politically.

There is ample evidence that China is promoting a more market-oriented modern corporate governance among its SOEs to avoid further loss of state capital and improve

profits. But there is also evidence that the privatization of SOEs reform is taking a very gradual and slow approach. The Chinese government is not willing to fully give up the control of its large SOEs yet. It is practicing to distance itself from the role of direct management but remain as a major shareholder of SOEs. By taking it step-by-step, the CPC wants to have the flexibility to determine the pace of reform, make necessary adjustments if unexpected outcomes come along the way, and be extremely wary of possible threat to its political survival. It is not departing from its current political economic regulation system as a typical SME where the state has built a consolidated framework for political intervention in economic activities. For example, the CPC has party branches (*dangzhibu*) in every major SOEs, and the appointment and career path of leaders of these party branches are subject to judgement from the upper level. Many of these party branches secretaries have also served as civil servants and government officials at some point of their career path. Political rules instead of market rules applies when it comes to the issue area of party branches management, and these branches provide a straightforward institutional channel for political interference when needed.

China has been promoting SOEs reform for a long time since the late 1970s. But interestingly, these official guidelines that illustrate the boundaries of regulation, introduce contract-based jobs in replacement of permanent positions, and encourage Share Incentive Plan only come this year in 2020. This provides another piece of evidence that China is seeking an extremely gradual and slow approach of privatization, presumably under a lot of pressure from SOEs. As T.Z. from the China Banking Regulatory Commission says, "we want change; in fact a lot of people want to go further. But the pressure is huge when you ask people to speed up the change, be more hardworking and efficient, let go of the old times when you are paid less but also work less. And the most difficult part is when you must make the decision to have someone lose his/her job." SOEs want protection against free competition, enjoys the privileges of lending and various other forms

of financial advantages. They want their preferential treatments to continue, and would not want to go through the painful process of upgrade to modern corporate governance if not forced to. SOEs managers and executives need to make sure that they have at least some personal gains after privatization is accomplished.

Interestingly and ironically, the market reform and SOEs privatization are implemented in the form of political instructions from the upper level. The incentive of becoming more profitable and avoiding further loss of state capital actually comes from the possibility of political promotion or fear of jeopardizing one's career path in the current political regime in China. As Y.L. (a manager of SOEs) mentioned in the interview, the incentive of the current wave of privatization is to "bring the private sector into the game: they are responsible for bringing funds and resources, they may share the profits, but they are not allowed to lead or rule." In the end of 2020, the Chinese government turned its back on Jack Ma, founder of Alibaba and the richest businessman in China. Observers have considered it as part of the political move to prevent the "disorderly expansion of capital" following President Xi's rule that prioritizes servility and loyalty above everything else (Li, 2020). This provides another piece of anecdotal evidence for China's nuanced stand on private businesses as stated above. Privatization has been going on in China from a top-down approach. Although it has privatized every year in the past 20 years or so, the pace is extremely slow. The interests and preferences of SOEs have been altered so gradually that its impact on reducing capital controls have only come very recently and remain at a minimum level.

6.2.2 The Privatization Project of Wasu in the Telecommunication Industry

Having looked over the macro-level picture of privatization and capital-account liberalization in China, it is useful and interesting to look closer into the details of how a specific privatization project is actually carried out, what does a "mixed ownership" firm look like and how does it work, who are the key actors and what are their preferences, how do their preferences turn into actual policy outcomes, and what are some of the major issues along the way. Such an investigation helps reveal (at least one of) the causal mechanisms of my theory, i.e., how privatization weakens traditional SOEs and promotes new forms of public-private cooperation and paves the way for furthering the open-up of the capital-account.

The industry of telecommunication is one of the major infrastructure industries traditionally owned by the state (others include energy, transportation, finance and natural resources). In this industry, corporations provide cables and networks as well as internet services to billions of homes across the domestic market in China. There are four major companies in this industry: China Mobile, China Unicom, China Telecom, and Wasu. Wasu is a latecomer, as it is a pilot program that aims to separate the "broadcasting and TV function" and the "network function" of the original broadcasting and TV (*guangdian*) system, and make the latter (i.e., the network company of Wasu) more profitable and competitive in the telecommunication industry, whereas maintaining the more political function of those TV stations.

This new pilot model of Wasu is carried out in Zhejiang Province in the southeast coast of China, a home to many other pilot market reform projects thanks to its advanced economic development level, relatively strong private sector, and well-established sense of business among the public. In Zhejiang, market force is relatively more embraced and

residents in Zhejiang are relatively more open to pro-market reforms, which makes it an appropriate test field to see the impact of market reform at the local level before it reaches the national ground.

The initial insight of this project is "marketization", i.e., "to improve efficiency, be responsible for one's own earnings and loss, and incomes of employees will be based on performance rather than the old way of same for all", as the manager of Yongjia Wasu said in one of my interviews. "So earnings will vary and differ from each other within the same level/tile in the job, and those who work more can earn more. In the meantime, those that want to contribute and those with talents can get more income, whereas the old staff can be persuaded into doing something else. In general, motivations will get stimulated."

It is also worth noting though just as many other reform projects in China, such a "marketization" process is partial, or that the market is not employed as the major mechanism of resource allocation free from political interference and constraints. For example, censorship is another important responsibility for these network companies, so that the content from the internet will be more "positive" with less focus on violent and sexual materials and any discussions on politically sensitive topics can be detected.

It seems that every market reform step that the Chinese government takes is carefully designed not to undermine political control while embracing the merit of market forces. The major issue to be addressed for this pilot project, according to the manager of Yongjia Wasu, is that unlike China Telecom, Unicom, and China Mobile, there is no centralized regulatory system in the original broadcasting and TV (*guangdian*) system: every province, city and county has its own stations (and now their own Wasu companies at different administrative level). Accordingly, there is no centralized management across the nation for something that separate from its original system. Since Wasu is a new player that represents the network function separated from the original broadcasting

and TV (*guangdian*) system, a new political web with centralized management must be created at the same time to keep these new forms of business within the reach of the central government.

In terms of actual implementation, other than the old fashioned direct administrative way which might trigger resistance in an era after forty years of opening up, the new fashion is to play by the rule of the shares of ownership: you have more shares, you have more authority over decision-making. Merger and acquisition becomes the major method to create such a political web of regulatory system for Wasu, and there are certain market-based rules to be followed. For example, one has to be larger in market value than the other if it is going to become the prime party of decision-making after merger and acquisition is accomplished; it also has to pay off the debts if it wants to acquire another, and if they have to borrow money to pay off debts, then the lenders (often from the private sector) sometimes end up with some shares in the new company too. There is anecdotal evidence that Qiang Cang, the founder of Zhejiang Wasu, was so ambitious that he initially sought to acquire the national-level broadcasting and TV station, which might have become a symbolic movement of how mixed-ownership firms get the upper hand over the traditional SOEs/government institutions if such a merger and acquisition had worked out.

Another experimental design of this privatization project is how it employs different shares of ownership to bring in each party of interest including the government, POEs, and individual private investors. For example, Wasu Co. Ltd consists of Wasu group as the major shareholder and Wasu at each city/county level as minority shareholders, and the shareholders of Wasu group includes the Zhejiang broadcasting and TV station, Zhejiang Daily, and Hangzhou broadcasting and TV station. Wasu media is another sub-firm of Wasu group that has been listed in the stock market for public trading and invites individual shareholders, and it also has private shares from the Ali group, the

largest and perhaps strongest private group in China.

"Mixed ownership" firms are purposefully designed in a sophisticated way that allows POEs to contribute money and share profits with the state on the condition that they do not take management and regulatory roles. As Y.L., my interviewee from Wasu mention, "they cannot send people in, or participate in decision-making, but they have the right to know." Despite such a discriminatory treatment with no critical role in decision-making, POEs are keen to join in driven by both economic incentive and the pursuit of political power. Economically, given the monopolistic status of those traditionally state-owned industries, POEs find it attractive and to get a share of these previously inaccessible state businesses. Since the economic pie has doubled or even tripled as China's economy grow, even a slice of it seems lucrative enough. Politically, as has been mentioned before, POEs do not have an institutionalized regulatory framework that reports their preferences and interests to central policy making, and becoming a part of these mixed ownership firms brings them closer to the central policy making, and might be a good (if not only) alternative way for them to achieve political influence.

China's privatization works in the form of public-private cooperation and mixed ownership model because it is still considered as a win-win situation for all, though not an equal one. The state needs funding resources, and the private sector wants a share of state business and stronger political ties with the government. And to make the economic pie even bigger, going public and accessing funding through the stock market becomes another viable and attractive option that is supposed to bring everyone in. Even for the general public and individual investors, they may get a slight share of the profits from state businesses by investing in SOEs through the stock market. Another interesting incentive often overlooked in this scenario is that going public is a strategy of rapid accumulation of wealth for those original shareholders, some of which might be relatives and offsprings of the party leaders. In fact, SOEs leaders at the local level also want a

share of the pie for themselves, and according to one of my interviewee, some of the Wasu leaders at the local level have made a collective request to lend their own money and become one of the original shareholders of local Wasu companies but got disapproved in the end. Although evidence at the central level is rare, these local requests also helps us understand what is going on at the central government level. Investing in SOEs listed in the stock market and becoming a shareholder is highly thought of and sought after among individual investors, especially those with stronger political connections and access.

In other words, privatization is happening in China not just because market is considered as a good supplement (if not superior) to direct state management of the economy, but because it is taking a pragmatic path and designed in a mixed manner to bring as many actors on board as possible, just as any other reform projects that have been consistently and successfully implemented. The benefits are distributed unequally, with the party leaders gaining disproportionately more than the other actors of POEs and the general public, but the domestic pressure to go forward is much less than other reform projects that have not come up with a practical design such as opening the capital-account, Privatization is desired by most people, as they have at least some gains from it.

But once things get ongoing, sometimes the market might get the upper hand and affect other issue areas of reform in an unexpected way. The investigation of the Wasu project clarifies the mechanism of how traditional SOEs are weakened and transformed into new forms of firms with mixed ownership and possibly changed preference for capital-account liberalization. A newcomer like Wasu with shares from almost all major actors in the contemporary era, some of which have become powerful economically but not yet politically, is likely to have different preferences with the original player of the broadcasting and TV stations, or the other major telecommunication firms such as China Telecom, China Unicom, and China Mobile, since they have experiences of following market rules

since the beginning from the practice of merger and acquisition, and they have incorporated a much wider range of shareholders including POEs and individual investors who have a higher stake in reducing capital-account restrictions than traditional SOEs.

These new forms of mixed ownership firms also have a better chance to make demands and achieve their preferred policy outcomes than POEs, because they now have an assigned supervisor, the SASAC at each administrative level from local to the central government, or "an ear that listens" in the government. In China, it seems that interest group must have someone in the government that they closely interact with to make their voices heard. Through both formal interactions of constant meetings and reports and informal mechanisms of dinners and phone calls, interest groups explain their situations, express their concerns, and make demands to the government (usually a specific department) that directly supervise/regulate them. Through the power struggles during the process of merger and acquisition when creating these mixed ownership firms, different segment of domestic interest in China conflict and converge with each other. As a shareholder, POEs naturally seeks more power during the process of arguing over the issue of who gets more say over decision-making after the merger and acquisition is accomplished, and are increasingly making their voices heard. But again, most POEs remain as minority shareholder in these mixed-ownership firms. A small number of exceptional successful POEs might be able to have a louder voice, but overall there is limited room to express their demands for financial liberalization and capital-account opening. For China to accelerate its financial reform and continue its efforts to open the capital account, the private sector might need to become a more critical and influential actor within these mixed-ownership firms. The stagnation of China's financial liberalization and its setbacks in the 2010s might have things to do with the extremely moderate reform of privatization in the form of public-private cooperation and mixed-ownership firms as the field observations present.

6.3 Capital Inflows versus Outflows

As Figure 6.1 in the previous section has shown, China slightly reduced its extremely strict controls of capital inflows by 10% from the most strict level of control in 1997, 1998 and 1999 [8]. The changes in the controls of capital outflows were however relatively much more mild during this period of time. It remained at the highest level in 1998 when controls of inflows started to slightly decrease, dropped by 5% in the following year of 1999, and went back to the highest level of controls in the next year of 2000. A plausible interpretation of this short-term adjustment of capital controls is China's response to the Asian financial crisis that hit in the late 1990s. In most part of Asia, both residents and non-resident investors ran from the country. Capital flowed out and currencies in the region collapsed. Strict capital controls have helped insulate the Chinese economy during the crisis, as residents were faced with limits on transfers abroad and non-residents required government permission to invest onshore. When capital inflows to China declined somewhat following the 1998 Asian crisis, the government slightly loosened its controls of capital inflows. For example, it extended preferential treatment to FDI in energy, transportation, and infrastructure industries (Hung, 2008) in response to the crisis. For capital outflows, the controls were largely intact with a very mild relaxation in 1999 to better shield the economy from the market crash abroad. As observed in this round of capital controls adjustment in the late 1990s, China seems to be relatively more willing to open the gate for incoming capital flows as compared with the more vigilant and cautious approach when it comes to opening the gate for outgoing capital.

Both controls of capital inflows and outflows were restored to the most strict level through 2000s. Since early 2010s, a new round of trials to open the capital account

[8] The actual change is from 1 to 0.9, with 1 indicating the most strict level of control and 0 indicating non controls according to Fernández et al. (2016)'s measurement

started and experienced ups and downs. Unlike the previous short-term adjustment of capital controls driven by external shocks of financial crisis, China's most recent attempt to gradually lift capital controls is more internally driven and serve as a critical step of market reform. Controls of capital inflows and outflows are not differentiated with each other as in the previous short-term adjustment. During this most recent wave of capital-account opening, capital controls are treated in general with controls of inflows and outflows rising and dropping at the same time according to the quantitative data. But qualitative data obtained through field observations and interviews with critical domestic actors helps reveal the nuances and subtle differences between the rationale to loosen controls of capital outflows and inflows in China.

When asked about the trend and future prospect of China's financial liberalization and capital-account opening, most interviewees acknowledged the gradual relaxation of capital account over the years they have been working in their professions. One mostly mentioned reasoning for the trend is to attract foreign investment and introduce competition from foreign capital, thereby upgrading the domestic economic financial system. As G.W. from a local branch of People's Bank of China mentions, "in the beginning, foreign capital is only allowed to participate and become a minority shareholder in joint venture. We did not have the market infrastructure and feared competition. Then the shares foreign capital are allowed to own started to increase as domestic business gets stronger and more mature. Now foreign business including foreign banks may run their own branches with sole ownership, but only in a handful of largest first-tier cities." C.Y. works as a local financial journalist and shares his most recent observations on China's treatment of foreign capital. "Lately China has taken steps to protect the legal rights of foreign business. In 2019, an updated version of *Foreign Investment Law of the People's Republic of China* was established to replace the original three sets of laws related to foreign business management. The original versions of law are not longer suitable for

the modern era. China wants to send out a signal to foreign investors. It is not just providing economic inventive, but also legal and institutional support."

The critical differences between the original and updated version of foreign investment laws include for example, a non-discriminatory treatment between "selected" foreign businesses and domestic investors, protection of intellectual property rights and commercial secrets of foreign business, and equal treatment of domestic and foreign investors in government procurement. It is worth noting that the list of "selected" foreign business has also been expanded in 2019. For example, it is no longer required for foreign investors to become a part of a joint venture with Chinese investors to invest in oil and gas industries. The cap for foreign ownership in the financial industries of futures, securities and insurance will be completely lifted starting in 2021.

Throughout the interviews, the attitudes are generally positive when discussing capital-account liberalization in terms of lifting controls for capital inflows. It seems most interviewees assume open the gate for incoming capital helps attract foreign investors and helps domestic economy. Partial opening is presumably preferred over complete opening, as it allows the state to discourage foreign investment in certain strategic industries, whereas encourage foreign capital to enter in industries in need such as high-tech or infrastructure in less developed regions. In the discussion of capital-account opening in terms of lifting controls for capital outflows, however, the attitudes become more mixed among interviewees and overall more vigilant.

Both Z.M. and T.Z. from China's Banking Regulatory Commission highlighted the shock of 2015, when China lost one trillion dollars in foreign reserve over one year after the policy trial to start opening the capital account in 2013. This provides another piece of evidence to justify for the fear of capital flight after loosening capital controls in China. As G.W. mentions, based on his experience working in the banking sector, there is no actual timetable for capital-account opening from what he has heard from the guidelines

and numerous conferences and meetings with policy makers from above. "If anything, the guideline is once one step is ready, you go for that step. Opening capital account is still considered as a double-edged sword and RMB is not ready to compete with dollar yet." The anticipation of domestic capital flight seems to be a major concern that prevents the lift of controls for capital outflows. Currently, China's approach in terms of loosening controls of outflows seems to be differentiating between selected industries/firms and the general public, thereby remaining in control. According to G.W., the state is encouraging large domestic banks to build branches around the world and invest abroad. But the state also sets requirements on the projects to be invested. For example, it limits the investment options to what the government deemed as "high-quality" industries such as modern technology. But for the general public, free investment abroad is not possible in the near future.

In general, financial stability is repeated stressed as the priority in the attempt to opening the capital-account as part of a larger financial reform. Whereas opening the gate for capital inflows are more associated with the benefits of incoming foreign investment, allowing capital outflows are often linked with the fear of capital flight and unstable financial system. The anticipation of losing control over the financial sector is widely shared among critical domestic actors. The observations in China provide evidence for the widely-shared anticipation of losing large amount of domestic capital after lifting controls of capital outflows. This helps clarify the reasoning why SOEs might have a stronger incentive to resist opening the gate for outgoing capital than incoming capital as suggested in H2, as SOEs are fearful of losing their preferential treatment after the state loses control over the financial sector.

6.4 SOEs and Institutional Embeddedness

China has a legacy of institutions historically designed for the state to directly manage the economy from the time of planned economy. Some institutions have taken new forms in the contemporary era, but still provides a convenient platform where SOEs can effectively make political demands. For POEs, they were historically historically weak and distant from the state, and as they grow stronger over time with China's reform and open up, their loose regulatory framework has not been updated and strengthened accordingly. As a typical SME, China's unique regulatory framework where the SOEs are deeply embedded in the existing institutions adds to the political influence of SOEs as compared to POEs. The way how SOEs are embedded in China's regulatory institutions provides evidence for the role institutions play in affecting SOEs' resistance to financial liberalization. As H3 suggest, SOEs are even more politically powerful in SMEs because the existing institutions are often more favorable to SOEs than POEs. SOEs find it much easier than POEs to express their political demands thanks to their closer ties and more frequent interactions with policy makers. Among SOEs, the ties between non-financial SOEs and the state are even closer than the connections between financial SOEs and the state. For non-financial SOEs, the same governmental department plays as both the shareholder and regulator. For financial SOEs, their primary shareholder is often the Ministry/Department of Finance whereas their regulation lies in the hands of the central/local financial regulatory systems. The possible conflicts of interest between different governmental departments might make it relatively more struggling for financial SOEs to make collective demands than non-financial SOEs.

SASAC (State-owned Assets Supervision and Administration commission) was established in 2003 to manage the remaining large SOEs after the first major wave of privatization in the 1980s and 1990s, most of which are now concentrated in non-competitive

industries that restricts private entries. The establishment of SASAC signals the accomplishment of the first wave of privatization. The state has retreated from industries it considers as relatively non-strategic during this wave of privatization. These non-strategic industries are referred as "competitive industries (*jingzhengxing hangye*)" by local officials since they allow for private capital entries and encourage open competition. The state has chosen to remain in a few key sectors where SOEs still dominate, and local officials refer to these key sectors as "non-competitive industries (*feijingzhengxing hangye*)" because they do not allow or encourage competition from the private sector.

State assets are classified into three major categories in China: 1) commercial corporations and state-owned businesses; 2) non-profit organizations, 3) natural resources. As shown in Table 6.1, depending on how SOEs are regulated, there are two major types of SOEs: 1) central SOEs (or *yangqi*) owned and regulated by the central government, and 2) local SOEs owned and regulated by the local government at the provincial, city, or county level. The primary shareholder of central SOEs consist of two major institutions: the SASAC, and the Ministry of Finance. SOEs whose primary shareholder is the SASAC are often referred as the national champions in strategic industries and infrastructure including military, oil, steel, electricity, telecommunication, transportation, construction, high tech, etc.

As of 2017 SASAC' companies had a combined assets of more than 50 trillion yuan (US$7.6 trillion), making it the largest economic entity in the world (South China Morning Post, 2017). 32% of the total assets (16.2 trillion yuan) are from central SOEs, and the remaining 68% (34.1 trillion yuan) are from local SOEs according to SASAC's official website [9]. The most recent records from March 2020 show that there are currently 97 central SOEs under the supervision of SASAC. This suggests that central SOEs controlled by SASAC is a band of titans with an average size of over 160 billion yuan (US$23 billion)

[9] http://www.sasac.gov.cn/n2588025/n2588164/n4437287/c9732858/content.html.

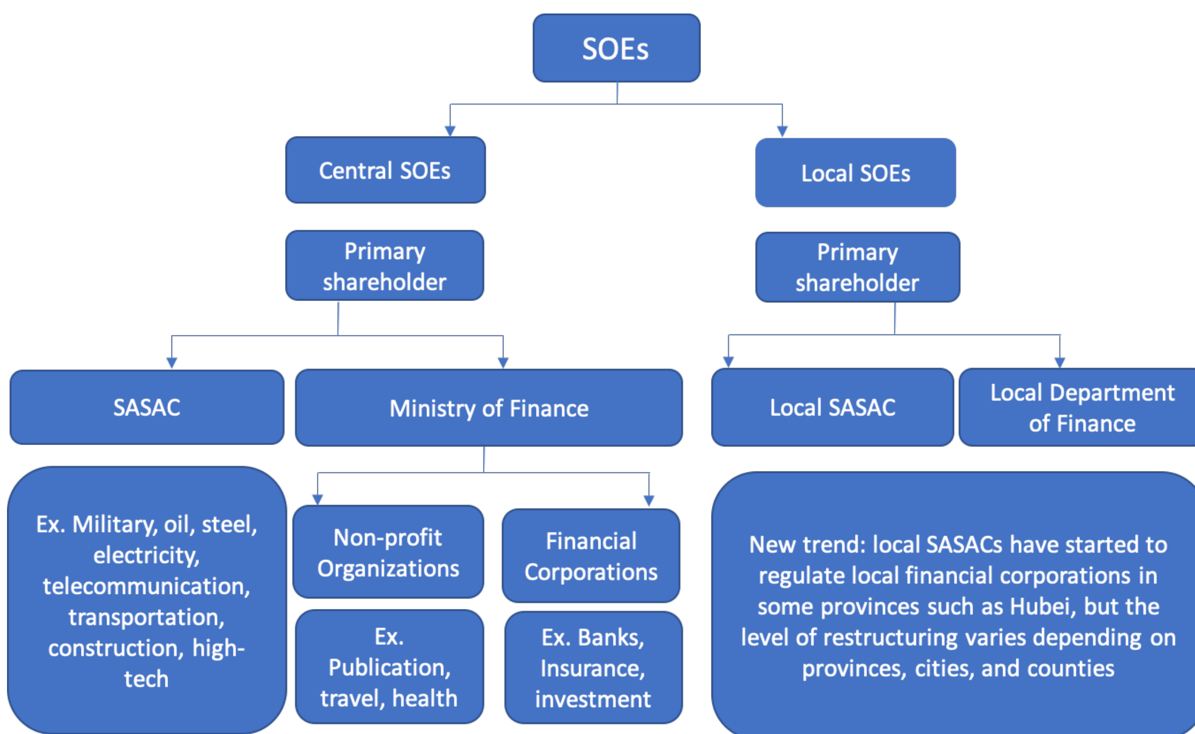

Table 6.1: How SOEs are regulated in China

in assets. Central SOEs whose primary shareholder is the Ministry of Finance consist of non-profit organizations, many of which are affiliated entities of the government and operated in a way similar to public services, and financial corporations including banks, insurance companies, and investment funds. There are 23 central SOEs in the financial sector as of 2019.

The primary shareholder of local SOEs consist of local SASAC, and local department of finance. But the regulatory framework varies depending on the number and size of local SOEs. In places where SOEs have become a much smaller component of the local economy, local SASAC might become a auxiliary unit of the local department of finance; in places where SOEs accounts for a significant portion of the economy, local SASAC run and operate more independently. In some cases, local SOEs only report to their upper-level parent companies, and their parent companies are then subject to supervision from

SASAC from the corresponding level[10].

The combined assets of both central and local SOEs in the financial sector are 16.2 trillion yuan (US$ 2.38 trillion). It is important to note that China regulatory framework differentiate non-financial SOEs from financial SOEs, and separate sets of rules apply. Central SASAC is not responsible for the supervision of central SOEs in the financial sector, as illustrated in Table 6.1. In general, SASAC is responsible for supervising non-financial SOEs, but the regulation of SOEs in the financial sector is more complicated. Although the Ministry or local Departments of Finance serve as the primary shareholders of these SOEs, the regulation of SOEs in the financial sector remain in the hands of the financial regulatory system consisting of *yihangsanhui*: the People's Bank of China, and China Banking/Insurance/Securities Regulatory Commissions as well as their sub-units at the local level. This suggests that for non-financial SOEs, their ties with the state are extremely close as SASAC is both the primary shareholder and their regulator. For financial SOEs, their primary shareholder is the Ministry/local Departments of Finance but their regulator is the financial regulatory system of *yihangsanhui*. The ties between financial SOEs and the state are not as close as non-financial SOEs, since there might be conflicts of interest between different government entities. As my interviewees from China Banking Regulatory Commission mention, the Ministry and local Departments of Finance often prioritize economic development and prefer higher leverages of lending and other forms financial support for the economy; whereas the financial regulatory system of *yihangsanhui* might prefer smaller leverages in financial lending to control systemic risk level.

In a typical SME such as China, preferences from interest groups are often expressed and consolidated through their regulators and supervisors because of their frequent interactions and familiarity with each other. According to interviews with local SASAC

[10]Source: from interviews with government officials from SASAC and SOEs leaders

leaders, SASAC is responsible for critical appointments of management teams for SOEs, and highly respected among them. Conversely, SASAC is well aware of the issues faced with SOEs and their policy preferences, and naturally represent SOEs' interest when participating in policy making at each administrative level. Similarly, the financial regulatory system of *yihangsanhui* at each administrative level knows the concerns of banks, insurance and security companies and naturally represents their interests or at least have these interests in mind in financial policy making.

Both non-financial SOEs and financial SOEs have well-established connections with the government in the form of formal institutions, and it seems that ties between non-financial SOEs and the government are even stronger than in the case of financial SOEs. As Y.L., a SOE manager mentions, "SOEs have a direct impact on policy making as they have someone to go to at each administrative level, and their concerns expressed at the lower administrative level will be reported to the higher level until their demands are brought up to the central government level." In China's political economic regime where the state takes the lead in policy changes and market reform, power is concentrated in the hands of central government, and policy debates often happen at the top level. For interest groups to influence policy making, they have to find ways to have their voices heard by the central government.

For POEs, formal ties with the government are much weaker, and the regulatory framework for POEs is immature and not fully institutionalized as will be explained below. When asked about how POEs make their policy demands to the government, the answers from my interviewees suggest that POEs do not have a direct supervisor within the government as in the case of SOEs and SASAC, and their approach of expressing concerns and preferences is more civil and indirect. "POEs do not have a specific department within the government that is responsible to take care of their concerns and address their issues. Instead, it is issue specific: if their issue relates to land, then they go to the

Bureau of Land, and if it relates to the environment, then the Bureau of Environmental Protection, or if it is about product management, then the Bureau of Economic Information, etc.," as X.S., one interviewee working in the POEs mentions. Y.L., another interviewee working as a SOE manager and government officer adds that "if the industry is large in economic size and significant, there might be industry associations where POEs can express their preferences and concerns. But it is more civil and unofficial. Local governments will first go through the issues to determine whether they are significant enough to be reported to the upper level because of limited resources to handle every single concern. Another possible platform is the business associations consisting of senior executives from each industry. But technically it is under the administration of the United Front Work Department, a party organization that manages relationships with and attempts to influence elite individuals."

In other words, some POEs may turn to the coalition with other POEs in the same industry to express policy preferences, and there is a chance that their preferences may reach the higher-level governance but not guaranteed. A few extremely large POEs might rely on their boss to express concerns and needs through the platform of business associations, but the effectiveness of such mechanism largely depends on individual political ties. In general, it is much more difficult for POEs to have their voices reach top-level policy debates and they have a much smaller chance of influencing policy making compared to SOEs. Because of the limited access to an "ear" in the government for POEs, many tend to find alternative ways to build stronger ties with the state such as becoming a part of mixed ownership firms and gain access to policymakers.

6.5 Summary and Discussion

Both privatization and financial liberalization are taking an extremely slow and cautious approach with a lot of limitations. China is a typical example pursuing a gradual model of privatization in the form of public-private cooperation and mixed-ownership SOEs. The modest and incomplete progress of privatization helps explain why the policy initiative of capital-account liberalization has stagnated and gone back and forth in the 2010s. If there were any protesters in China, they would not like capital controls to be lifted until privatization had been achieved. Relatively speaking, SOEs have a stronger incentive to fight against lifting controls of capital outflows, because it is connected with capital flight and financial instability, and may threat state control over the financial sector according to domestic observations. Lifting controls of capital inflows however is met with milder resistance as its implications are not as negative and often associated with increased incoming foreign investment among key domestic players. One major reason that contributes to the scenario of China is that it is a typical SME that heavily relies on SOEs' loyalty in economic interventions. The solid regulatory framework intended to strengthen state leadership in economic activities provides SOEs with an easily accessible political platforms where they can express their preferences and influence state policies.

Some critics have questioned whether the correlation between privatization and capital-account opening found in the large-N analysis actually reflects a larger reform project that is taking place. Others have raised the issue of the direction of influence between the independent variable and dependent variable: does privatization drive capital-account opening, or is it the other way around? The section on privatization and capital account opening in this chapter presents China' scenario of reform where the project of privatization has come much earlier and was implemented more successfully than the policy initiative of capital-account opening. It has privatized gradually and consistently every

year in the past 25 years. Experiences were gained along the way and the model of privatization is updated accordingly. Every reform project seems to be faced with its own unique issues and challenges that determine its pace of going forward. At least in the case of China, privatization and capital-account opening do not come together simultaneously as part of a larger reform package. Evidence shows that privatization comes before financial liberalization in China, and paves the way for the latter by transforming traditional SOEs' preferences and reducing their resistance, instead of the other way around.

The observations from China also helps providing supporting evidence for the presumptions made in the theory. As indicated, interviews with relevant actors ranging from government officials to SOEs/POEs managers and banks in China provide ample evidence for the preferential treatment that SOEs receive from the state. SOEs have a history of being the state's favorite whereas POEs were historically excluded from receiving bank loans, and often have to turn to informal lending based on personal ties and social networks. The borrowing privileges of SOEs have not been diminished in the modern era, and continues to provide a most important financial support for sustaining their businesses. As SOEs benefit from the *status quo* of financial repression that guarantees their advantageous financial status compared to the POEs, they have a strong incentive to block financial liberalization and capital-account opening as the theory suggests.

Chapter 7

India and Brazil

7.1 Introduction

Case studies of India and Brazil helps provide additional supporting evidence for H1 and H2, and are especially useful for detailing the mechanism in H3, which argues that the impact of SOEs on capital controls varies depending on the larger context of the state's role in economic management. In general, the experience of how privatization goes and affects financial openness in China is more replicable in India than in Brazil. India is institutionally more similar to China. Both countries may be classified as SMEs. Brazil however has transitioned from the historical interventionist state to a non-SME accompanied with foreign capital predominance. The institutional differences of how SOEs are connected to the state helps explain the different path of privatization and capital-account opening in India and Brazil as compared to China.

Like China, the path of India provides another example in which privatization comes before and presumably drives financial opening instead of the other way around as H1 suggests. It is again not like what we have seen in the 1980s when significant waves of privatization have successfully driven capital-account opening, but a story of how

the modest public-private cooperation model of privatization paves way for gradually opening capital account but prevents full financial liberalization. The section on the privatization of telecommunication industry in India provides a parallel comparison with China's local privatization project in the same industry. The process of how traditional SOEs are transformed into resilient and powerful mixed-ownership SOEs with modern corporate governance and altered preferences for partial observed in China is also present in India. In both China and India, capital inflows are relatively more welcome than capital outflows. Empirically, India has slightly more strict controls on capital outflows than capital inflows in the attempt to open capital-account since early 2000s. This is in accordance with the expectation that SOEs will fight harder against the lifting of capital outflows controls than the capital inflows controls, and helps providing another piece of supporting evidence for H2 of the theory.

The comparative analysis of how SOEs and POEs are institutionally embeddeded between China and India helps provide solid evidence for H3. The institutional similarities and subtle differences between India and China helps explain why India has pursued a very similar approach of gradual approach of privatization and capital-account opening like China, but goes relatively further down the road as a latecomer. In both countries, the history of direct political intervention in economic activities matters. The leftovers of policy tools from the past provides SOEs with a friendly institutional framework that connects them to policymakers as well as a convenient platform where they can directly make political demands. This path-dependent effect helps explain why newly emerged mixed-ownership SOEs have remained influential after several decades of liberalization reform in both China and India.

But unlike China where the state is extremely reluctant to step back and remain dominant in the mixed public-private cooperation after privatization, the role of the Indian government has declined further accompanied with a stronger pro-business stand.

The private sector seems to have become part of the pro-reform coalition and gained more control after the 1991 reform in India. Compared to China, India has achieved relatively higher level of public-private cooperation. In China, the institutional elements that characterize a typical SME have been largely kept after market reform. India however has fewer residuals left from its command-and-control era and institutionalized new cooperative relationships between the state and the private sector. The preference of POEs are better incorporated into the policy outcome of financial opening in India. This helps explain why India has been able to pursue a more consistent approach in gradually opening its capital-account than China.

In Brazil, modest public-private cooperation mode of privatization has also prevented the capital account from being fully liberalized as has been observed in China and India, especially if we look at the trend of capital outflows controls, thereby providing evidence for H1 and H2. Empirically, there is a more significant difference between the level of controls between capital outflows and inflows in Brazil than in China and India. The controls of capital outflows have been in general relatively more strict and experienced less volatility than controls of capital inflows. In all three countries, there was a history of strong state intervention in economic policies and there are still traces left after market reform. SOEs have started out strong and have privileges compared to POEs, and such privileges are maintained or better implemented under capital control. After privatization, SOEs became slightly weaker and were transformed into mixed ownership firms with both public and private operation, and these mixed ownership firms often have a higher stake in reducing capital controls and liberalizing the financial sector than the traditional SOEs. But institutions from a state-led economic developmental model were retained to a larger extent in China and India compared to Brazil, providing a more favorable institutional environmental for SOEs in making policy efforts in China and India than Brazil. As predicted by H3, financial liberalization goes further in Brazil largely because Brazil

has transitioned to becoming a non-SME and has minimum leftovers from interventionist state regime that would have empowered SOEs in making effective political demands.

Unlike China and India where privatization came before financial liberalization, in Brazil, privatization and financial opening have happened more or less at the same period of time in the 1990s. In fact, regulations on foreign capital were gradually loosened and foreign lenders were allowed and had played an important role in acquiring state-owned assets during privatization, as well as lending for POEs who aim at the acquisition. This helps pave the way for domestic financial reform and modernization of the banking sector, and prepare Brazil for increased opening in the early 2000s. The case of Brazil presents an example for the mechanism of "second image reversed (Gourevitch, 1978)," or how international factors may affect domestic interest formation.

Compared to China and India's gradual and pragmatic path of privatization and financial liberalization, Brazil has gone faster and deeper, as SOEs' resistance to financial opening is relatively less effective. It seems that Brazil has been able to get away from the proposition that privatization has to be achieved to a certain extent before capital account may be opened, because Brazilian SOEs are not as politically powerful as Chinese and Indian SOEs in the first place. The relatively loose institutional connection between SOEs and the state in Brazil has made it a relatively level playing field for SOEs, POEs and foreign capital to compete for political influence. The institutional linkages through which SOEs obtain political power observed in China and India are not found in Brazil. Instead, foreign capital seems to have gained stronger political voice because of more abundant economic resources and other historical factors such as Latin American debt crisis in the 1980s. The integration of foreign capital into Brazilian political economy helps offset SOEs' resistance to opening capital-account in Brazil.

7.2 India

7.2.1 Privatization and Financial Liberalization

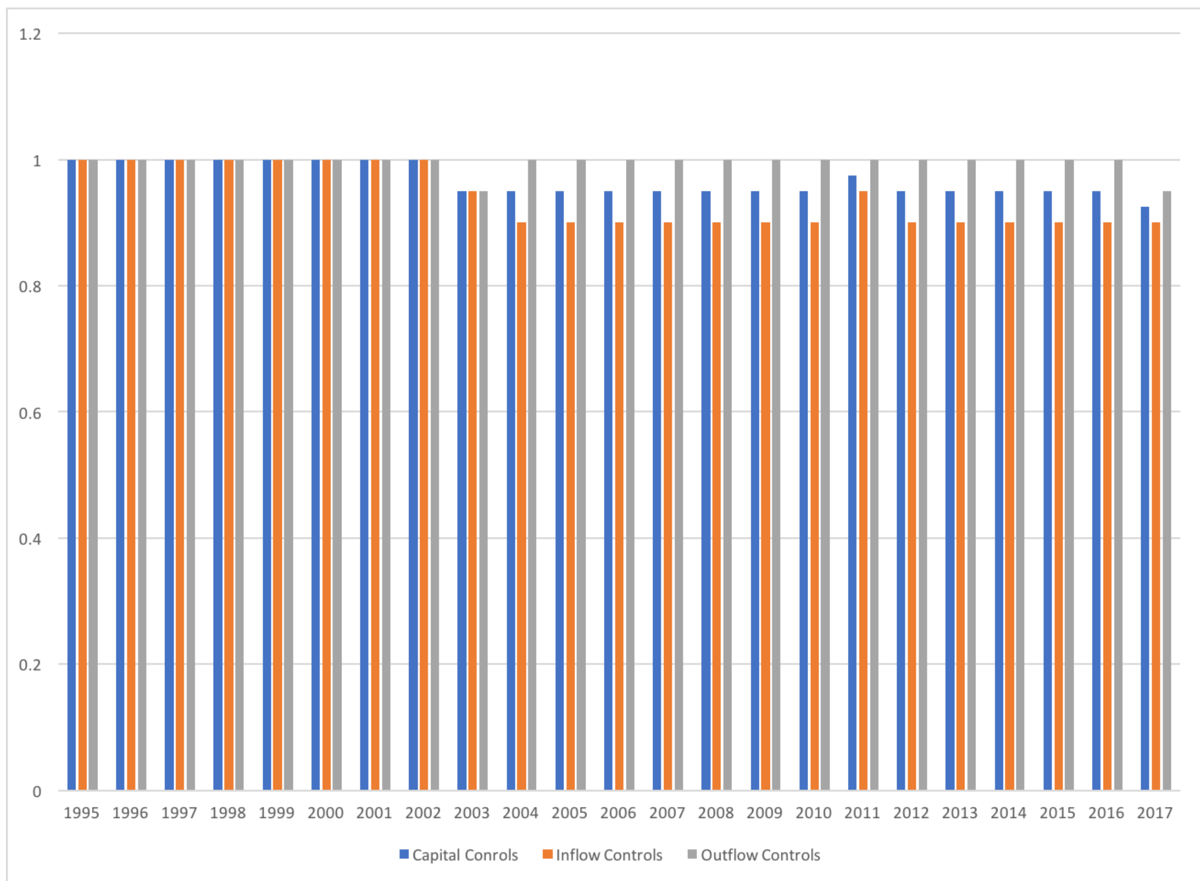

Figure 7.1: India's capital controls from 1995 to 2017 (Fernández et al., 2016)

As shown in Figure 7.1, India has taken a similar gradual path of opening its capital-account like China. But India's timeline to open capital-account started one decade earlier and have been implemented in a more steady and continuous manner without significant backfires as has been observed in China. The financial sector in India was tightly controlled through the 1990s. Since then, India initiated financial market reforms that focus on the removal of structural bottlenecks, introduction of new players and instruments, free pricing of financial assets, relaxation of quantitative restrictions,

improvement in trading, clearing and settlement practices and greater transparency (Mohan, 2005). Starting in the beginning of the 21st century, the Reserve Bank of India has taken what it calls a calibrated approach to cautiously liberalizing the capital-account step-by-step, with certain types of flows and particular classes of economic agents being prioritized in the process of liberalization before moving on to other more risky categories (Reddy, 2011). The gate of capital flows has remained open by around 10% at the level of 0.9 from a scale of 1 to 0 (with 1 indicating most strict controls and 0 indicating no controls) through 2000s and 2010s with slightly more strict controls of capital outflows than inflows. The more or less same pattern were kept during this period of time with very mild adjustment in 2011 and 2017.

According to Prasad (2009), India has moved slowly and steadily towards capital-account convertibility, and reversing the trend is not a viable option. The capital-account in India has become more open and restrictions on both inflows and outflows have been eased significantly over time. Government control nevertheless is maintained on many types of flows; some of them are as modest as registration requirements on foreign investors but some others are as onerous as virtually keeping foreign investors out of the government debt market. These elements are part of a strategy of cautious and calibrated capital-account liberalization that has served India well in reducing its vulnerability to crises and allowing more time for domestic reform.

Like China, it is agreed that domestic reforms and significant progress of privatization have to be accomplished to a certain extent before India fully opens its capital-account to reduce its vulnerability to crises. (Prasad, 2009). According to the 2006 report of the Committee on Fuller Capital-Account Convertibility, "it must be ensured that different market segments are not only well developed, but also well integrated before making a move towards fuller capital-account convertibility"(Sinha and Pradhan, 2008). Indian scholars also suggest that "a more resilient domestic market where economic entities are

familiar with and subject to the discipline of the market other than commands and orders is to be built before moving on to the next step of financial opening (Chatterjee, 2017)." Successful restructuring of SOEs in the form of public-private cooperation under modern corporate governance seems to be one of the critical issues to be addressed before fully opening the gate for incoming and outgoing capital flows, as many of these traditional SOEs were inefficient and considered as a major financial liability in the past.

Historically, establishing businesses and accessing funding were much easier for SOEs than POEs in India. In fact, eighteen industries were reserved for investment by public-sector enterprises only, before being pruned down to a list of eight industries during the 1991 reform. Like China, SOEs in India have privileged access for financing as well as other forms of preferential treatments. The issue of concealed subsidies in the operations of public enterprises and the pricing mechanisms are being flagged by academicians for attention (Reddy, 1990). As Mohan (2018) mentions, the higher industrial growth of the 1980s in India was brought with higher public-sector investments. Other anecdotal evidences of such privileges are also commonly found in scholarly work on India. For example, although the Unit Trust of India, a major public sector mutual fund, did not officially enjoy a government guarantee, it was widely perceived as having one because its top management was appointed by the government. The Trust had to be bailed out once in 1998, when its net asset value fell below the declared redemption price of the units, and again in 2001, when the problem recurred (Ahluwalia, 2002).

Like China, privatization in India has started earlier and been going on longer than capital-account opening. According to Mohan (2018), policy guidelines for the 1991 reform state that "the government will ensure that the public sector plays its rightful role in the evolving socio-economic scenario of the country. The government will ensure that the public sector is run on business lines as envisaged in the Industrial Policy Resolution of 1956 and would continue to innovate and lead in strategic areas of national impor-

tance. In the 1950s and 1960s, the principal instrument for controlling the commanding heights of the economy was investment in the capital of key industries. Today, the state has other instruments of intervention, particularly fiscal and monetary instruments. The state also commands the bulk of the nation's savings. Banks and financial institutions are under state control. Where state intervention is necessary, these instruments will prove more effective and decisive (pp.42)." There is a clear shift from the traditional central-planning command-and-control style of state intervention in businesses and a turn to more indirect intervening strategies through fiscal and monetary adjustments that alter financial incentives. But the strategic importance of SOEs remain acknowledged and presumably maintained through advantageous financing through state-controlled financial sector, instead of direct policy command and industry access restrictions as in earlier times. During the 1990s, the government moved away from the "commanding heights" philosophy of the 1950s, and the new industrial policy paved the way for disinvestment in public-sector companies through the public floatation of shares, as private investment were allowed in these areas previously reserved for SOEs. The guidelines also suggest that action would be taken on low-performance public sector enterprises so that they could be closed down after due process. To enable this, a social security mechanism would be created to protect the interests of workers likely to be affected by such rehabilitation packages.

But as Chatterjee (2017) mentions, despite three decades of privatization, the public sector's contribution to the Indian economy remains crucial. Liberalization has come without a consistent reduction in the public sector's contribution to GDP, and privatization has been extremely slow. Public sector banks and state-led term-lending institutions also continue to play a major role, as shown by both their lending patterns and overexposure to non-performing loans in key sectors such as power and infrastructure. Empirically, 6 of India's 10 largest firms by sales were still central SOEs in 2015, down only marginally

from 8 in 1982. Some of the best central SOEs have been retrofitted for the market era and become strikingly resilient after being exposed to competition and endowed with at least some elements of corporate governance. As Chatterjee (2017) put it, "the most successful central SOEs institutionalize a pragmatic variant of liberalization, in which public versus private ownership matters less than ideas of managerial efficiency and market discipline (pp.85)". They indicate a new, entrepreneurial, corporatized mode of state activism in the context of increased competition, which is distinct from both the SOEs of the planning-era dirigiste state and the Washington Consensus template of liberalization.

The privatization strategies and guidelines in India sounds very similar to the public-private cooperation model of privatization as described in the case of China, where traditional SOEs are being transformed into new mixed-ownership SOEs under modern corporate governance. The interests of the private sector might be different from the government and SOEs, but their preferences are aggregated through the mechanism of shareholding following market rules for corporate governance. These newly emerged mixed-ownership SOEs often incorporate preferences of the private sector and become more market-oriented and more similar to POEs than traditional SOEs, but still prefers a state-steered economy where the policy tools of political intervention in economic activities such as capital controls are maintained to stay on top of liberalization.

But compared to China where POEs often remain excluded from decision-making since the 1978 reform, the relationship between private businesses and the government in India has made a more significant turn towards increased control for the private sector. According to Das (2018)'s narrative, the first real sign of change in the relationship between the government and business came in 1983, when Rajiv Gandhi (then general secretary of the Congress), called the Association of Indian Engineering Industry, the predecessor of the Confederation of Indian Industry, to brief him and other political leaders and senior officials in a closed-door, several-hour long session on "industrial

development" issues. "This was very different from the previous format of written representations by business with usually no response from the governments, and meetings and calls on ministers and officials were largely protocol and infructuous. These changes were institutionalized during the 1991-96 period, when the business sector and the government worked as one team on domestic- and foreign-policy issues. There were dialogue, engagement, consultation, sharing of views, travelling with the prime minister abroad — Davos, Vietnam, Singapore, etc. It was a new phenomenon and not a one-off effort, and much credit has to go to the officials who were comfortable interacting with business without, in any way, being compromised (pp.225)."

Private businesses in India have built relatively stronger coalitions and more cooperative relationships with the government in the form of shared control during privatization waves. The government of India seems to have gone slightly further in the pursuit of a mixed economy in which both public and private sectors are permitted to operate through the idea of "joint sector": a combination of joint ownership, joint control and professional management. It is a pattern wherein the government, through its Industrial Development Corporation, holds 26% of equity capital, the private sector partner holds 25% and the remaining 49% is meant for the public. Foreign equity participation up to 49% was also permitted in case of a joint venture between an Indian and a foreign firm. (Mishra and Lateef Syed Mohammed, 1994). This is different from the Chinese approach of privatization that excludes the private sector from management roles and rarely allows foreign acquisition of SOEs. Moreover, the private sector is allowed to actually compete with SOEs in many industries with entry restrictions in India (for example, telecommunication industry as to be discussed below); whereas in China, the private sector is only allowed to become a private stakeholder that brings funds and resources in mixed-ownership SOEs, and the "competition" being encouraged is in fact among those newly emerged SOEs and traditional SOEs instead of between SOEs and POEs.

The Case of Telecommunication Industry

Similar to the case of the privatization project of Wasu in China. the telecommunication industry in India went through carefully designed reconfiguration process to promote competition following market rules. But India has gone relatively further in welcoming private competition. Telecommunications in India started as a state monopoly during the mid 1980s. Telecommunication services were provided by the Department of Telecommunication before being separated out through the establishment of two public sector enterprises: the Videsh Sanchar Nigam Ltd (International Communications Corporation or VSNL) and Mahanagar Telephone Nigam Ltd (Metropolitan Telephone Corporation, or MTNL) (Sinha, 1996).

In the early 1990s, the telecommunications sector was liberalized and private sector participation was permitted through a gradual process. First, the telecommunication equipment manufacturing sector was deregulated. Then the government allowed private players to provide value added services such as paging services. In 1994, it was recognized that existing government resources would not be sufficient to achieve telecommunication growth and therefore private investment would be allowed to bridge the resource gap especially in areas such as basic services. Accordingly, private sector participation was allowed in basic services. As the government was unable to keep up with the demand for telephone connections, coupled with the fact that there was a waiting list for telephones, the government open the industry to the private sector. It introduced the Cellular Mobile Telephone Service license and the Basic Telecommunication Service license, which allowed private players to provide telecommunication services. The government then simplified the licensing regime and introduced the Unified Access Service license, combining the two licenses and therefore allowing Unified Access Service licensees to provide both services under the ambit of one license. Subsequently, the government introduced the

unified license where a single license consolidated 12 categories of services. An applicant could apply for the unified license along with authorisation for any one or more of the 12 categories of services. With this, the government also separated the license from spectrum, which now must be independently acquired (Ravindranath, Reddy and Parikh, 2019).

In the meantime, the government also divested itself of its regulatory role by creating an independent regulatory body, followed by divestiture of a direct operational role through SOEs. The Telecommunication Regulatory Authority of India (TRAI) was established in 1997 in India in order to separate the service-providing function of publicly owned telecommunication enterprises and policy-making function, both of which were initially within the Department of Telecommunications. TRAI was established as an independent regulatory authority for the telecommunication sector with clearly defined functions, powers and responsibilities to encourage competition and ensure a level playing field, but is not entrusted with functions relating to licensing, standard setting and allocating spectrum, which are in the domain of the Indian government through the Department of Telecommunication. A refinement in the regulatory framework occurred in 2000 when an amendment of the TRAI Act split the regulatory and adjudicatory functions by establishing a specialized statutory dispute settlement mechanism. Nevertheless, the government retains policy-making and licensing functions and its standard-setting role, and determines the allocation of spectrum (Prasad, 2008).

Unlike China where the private sector is keen to join in and become a shareholder in those mixed-ownership SOEs during privatization, it is often doubtful whether the divestiture of the Indian government would successfully attract the requisite private capital. Private investors seems to be less enthusiastic in becoming a minority shareholder in the mixed-ownership SOEs in Indian. VSNL, one of the largest public telecommunication service corporations separated from the government, for instance, had twice had to

postpone global share offerings because of the lack of investor interest in the mid-1990s (Sinha, 1996). Another example is the case of Air India, a most recent ongoing movement of privatization that often occur in the front page of media and draws public attention. The Indian government failed to receive a single bid when it first offered to sell a stake in Air India in May 2018. A key concern among potential investors was the level of management control they would have post purchasing a stake with the government retaining a 24% stake and all attendant shareholder rights available to it under law, instead of opting to remain as a minority financial investor (Mishra, 2019).

These examples help provide empirical evidence that India has given more control to the private sector compared to China. Privatization in both China and India has been going on gradually and following a step-by-step protocol. But India has achieved relatively greater progress towards privatization and made more significant progress in empowering the private sector. This helps explain the very gradual path of financial opening for both countries and why China is going even slower and being more unstable in financial liberalization than India, thereby providing support for H1.

7.2.2 Outflows versus Inflows

Compared to China, India conforms more to the proposition suggested in H2 that controls of capital inflows are more likely to be loosened than controls of capital outflows, as the former are relatively more welcome among the domestic sector and met with milder resistance from SOEs than the latter. As shown in Figure 7.1 at the beginning of this section, India started to loosen both controls of capital outflows and inflows by 5% in 2003, but reversed the controls of capital outflows back to the most strict level while further reducing the controls of capital inflows by 5% in the following year of 2004. Overall, the same pattern of slightly more strict controls of capital outflows than inflows

was maintained in India for around 14 years until 2017, when capital outflows controls started to drop by 5% from its highest level again.

As Reddy (2000) and Jadhav (2005) mention, a clear distinction is made between controls of capital inflows and outflows in India, with asymmetrical treatment from the control angle for inflows (less restricted), outflows associated with inflows (free) and other outflows (more restricted). As the capital-account opening gradually moves on, the Indian rupee has been made convertible for foreign investors looking for long-term investment. However, restriction on capital outflows involving residents continue. A sense of relatively more welcoming attitude to incoming foreign capital than outgoing domestic capital observed in China is also present in India. The series of 1991 New Industrial Policy statements has a subsection on FDI that notes the change of attitudes towards foreign investment in the early 1990s. The government made it explicit in the statements that foreign investment and technology collaboration would be welcomed to obtain higher technology, to increase exports, and to expand the production base. This is considered as a major departure from previous thinking and practice, where foreign investment was at best tolerated, a far cry from being welcomed. Specifically, it was decided to provide approval for direct foreign investment up to 51% of foreign equity in a specified list of industries (Mohan, 2018).

As has been observed in China, incoming foreign capital is associated in India with stimulating domestic economic growth and bringing advanced technology, whereas free flow of outgoing domestic capital is often met with concerns over potential economic and financial chaos because of potential capital flight. According to Jadhav (2005), the major issues with respect to liberalization of capital outflows include lifting of controls on convertibility of domestic assets by residents, the dollarization of domestic assets, and internationalization of local currency. While some measures are being taken to liberalize overseas investment, particularly in the recent years, the stance on dollarization

and internationalization of the rupee has been quite conservative, based on appropriate prudential consideration for ensuring financial stability. Both India and China have been more cautious in the attempt to open the gate for outgoing capital that involves residents. The fear of losing control over domestic financial sector after lifting controls of capital outflows observed in both countries provide evidence for the presumption made in H2, i.e., SOEs have a higher stake in fighting against opening the gate for capital outflow because they anticipate that their preferential treatments will go away after state financial repression is undermined.

7.2.3 SOEs/POEs, License Raj, and Institutional Embeddedness

Like China, India has a legacy of "command and control" mode of direct political intervention in economic policies, where large SOEs have been the historical hallmark of state influence in the economy (Chatterjee, 2017; Mehta, 2018). Public enterprises in India are regarded as an extended arm closely connected to governmental institutions, and their employees are treated as if they were civil servants within the governmental system just as in China. India had a set of Industrial Licensing Policies including the Industries Development and Regulations Act 1956, the Monopolies Act, the Monopolies and Trade Practices Commission and a host of other legislative and policy measures to limit the freedom of POEs to grow from the late 1940s to early 1990s (Das, 2018). This discriminatory regulatory system commonly referred as "license Raj" was established to restrict the private sector from entering key industries and serves to ensure that the public sector occupied the commanding heights of the economy. As a result, the public sector was totally dominant in a number of lucrative industries such as railways, telecommunications, banking, insurance, electricity, gas, water supply, petroleum, external trade, airlines, mining, and quarrying (Reddy, 1990) before the 1991 reform of "New Economic

Policy", which is similar to China's "Reform and Open-up" in 1978. Both of them attempted to depart from the institutional legacy of direct state intervention in economic policies and look to the discipline of the market for resource allocation and achieve a new balance between the state and the market.

Prior to the sweeping industrial policy reforms of 1991, the establishment and operation of an industrial enterprise in India required approval from the central government at almost every step. For example, before making an investment, an entrepreneur had to obtain an 'in principle' approval from the Ministry of Industry. The granting of this approval resulted in the issuance of a "Letter of Intent", which usually included a requirement for a phased manufacturing program aimed at progressive indigenization of the manufacturing process. Armed with this "Letter of Intent", the entrepreneur could then tie up other requirements for setting up the project. If he needed to import capital goods, he had to obtain a capital goods import license from the Chief Controller of Imports and Exports, in the Ministry of Commerce. The approval for the import, however, was given by a committee set up in the Ministry of Industry. In order to raise funds for the project, if an entrepreneur wanted to go to the capital market, he needed separate approval from the Controller of Capital Issues in the Ministry of Finance, etc. Once everything was tied up and the unit was about to go into production, the entrepreneur had to go back to the Ministry of Industry for an Industrial license, and then approach the government-owned development finance institutions for funding (Mohan, 2018).

This looks like a more elaborate and formal version of the current regulatory system for POEs in China, where private businesses have to make policy demands based on each individual issue area and go to separate government departments asking for approval. Such a system of detailed physical controls is interpreted by Indian scholars as the private-sector arm of the command economy (Mohan, 2018). The desire is to run a command system in the private sector based on quantitative and physical controls, since

the instruments of an indicative fiscal system are too indirect for administrators who were trained in and more used to the command economy system.

Both governments of China and India are not interested in entirely relinquishing political control in economic affairs. But for India, it kept some of the leftovers of policy tools from "license Raj" and attempted to steer the direction of market reform through the gradual relaxation of licensing policies as we see in the case of telecommunication industry deregulation. In China, the CPC has established institutional designs such as party branches (*dangzhibu*) in every major SOEs including those newly emerged mixed-ownership ones not just to stay in control, but also strengthen political rule. The regulatory framework inherited from interventionist policies in the past in both countries has provided SOEs with a favorable institutional environment and helped maintain strong connections between SOE and policy makers. SOEs are institutionally embedded and politically powerful in both China and India. Their resistance to lifting capital controls helps explain the slow progress towards capital-account opening in both countries. But the level of embeddedness between SOEs and the state seems to be even higher in China than in India based on observations. Accordingly, it is more difficult for China to overcome the opposition from SOEs and move on with the policy initiative of capital-account opening than India.

For POEs, their institutional ties with the government are relatively stronger in India than in China. Since 1990s, the private sector in India has been able to gradually institutionalize its cooperation relationships with the government. The democratic regime in India also helps provide relatively more open access to policy makers for POEs as compared to China. The loose and underdeveloped regulatory institutional framework for POEs in China has left private businesses with few other options but to becoming part of these mixed-ownership firms in order to gain access and influence policy outcomes. Despite the discriminatory treatment, becoming a minority "insider" with political ties with

the state is still considered as superior to being an "outsider" in the institutional context of China. In India, however, POEs may turn to alternative mechanisms to lobby for preferred policy outcomes and approach policy makers through democratic institutions. Becoming an investor of mixed-ownership SOEs is therefore a less attractive option for private businesses in India because of the limited control.

The private sector in India has been able to grow and obtain greater political influence through actual competition with SOEs as illustrated in the reform of telecommunication industry. Privatization in India has gone relatively further and empowered the private sector by sharing control. The public-private cooperation model of privatization in China nevertheless is still characterized by state dominance and private participation. India has been able to push privatization and financial liberalization forward thanks to the weakening connections between SOEs and the state accompanied with growing cooperative institutions between POEs and the state during deregulation. In China, however, the process of how privatization drives financial opening falls behind, as the linkages between the private sector and the government remain under-established and incomparable to the intimacy between SOEs and political leaders. The institutional reform in China has achieved minimum progress in deregulation as compared to India because of the overwhelming political agenda to strengthen authoritarian rule.

7.2.4 Summary and Discussion

Both China and India have a similar background of a central-planning model of economic development before switching to pragmatic market reform. In both countries, privatization has been going on slowly for the past few decades and is still ongoing, and its impact on furthering capital-account opening has only become more evident in recent years. China's experience of how SOEs resists capital-account opening and privatization

paves the way for financial liberalization is very much replicable in India, but India has gone relatively further than China despite being a latecomer. Public-private cooperation has been implemented more successfully with more private control in India. Capital-account started to slightly open one decade earlier in India in the early 21st century compared to China, and has continued in a cautious and calibrated path without ups and downs as we see in the case of China. India has also turned out to be a case that provides solid support of H2, as the pattern of more strict controls over capital outflows than inflows is observed over the years in capital-account opening.

One major reason that contributes to the subtle differences in these two scenarios is that China has maintained more institutions that characterize a SME than India after market reforms. China has devised new policy tools based on its traditional party-led political interventions in economic activities, one of which is the well-established regulatory system of SOEs that maintains extremely close ties between SOEs and the state; whereas in India, it has driven relatively further away from its command-and-control era and maintained fewer leftovers of policy tools after demolishing the notorious system of license Raj. The institutional reform to reduce political intervention in economic activities has been achieved to a larger extent in India and given more control for the private sector, levelling the play field between SOEs and POEs. But full liberalization is unaccomplished in neither China nor India because the newly emerged mixed-ownership SOEs remain powerful in both countries, and they often have a preference for partial financial opening where the state maintains the policy tools to steer the direction and keep the pace of opening in control.

In response to the criticism that external force might be driving both privatization and financial liberalization and helps the correlation found between the two based on large-N data, it is also worth noting that external force is not a major factor in facilitating capital-account opening in either China or India. A few Indian scholars briefly mention

the influence of the IMF and the World Bank in pushing for the reform, but emphasized domestic interest as the primary explanatory variable for the policy outcome of capital-account opening (Mohan, 2018). Among scholarly work on China, external influence is rarely mentioned to have affected financial policy making in my interviews and considered as secondary compared to domestic factors. The case of India also evidence for the preferential treatment SOEs enjoy in addition to China, thereby strengthening the key presumptions made in all three hypotheses.

7.3 Brazil

7.3.1 Privatization and Financial Opening

As Figure 7.2 shows, Brazil liberalized its capital flows regimes gradually starting from the early 1990s, culminating in a fairly open capital-account by the mid-2000s in the run-up to just before the global financial crisis in 2008. Since then, capital controls were reintroduced and relaxed as a policy tool to signal the government's larger intentions and sensibilities to foreign investors (Jinjarak, Noy and Zheng, 2013). Compared to China and India, the capital-account started to open much earlier in Brazil, and financial liberalization has gone much further and deeper down the road. The path of financial opening in Brazil looks quite different from China and India, as it presented a pattern much more integrated with the world. Brazil immediately introduced capital controls after the 2008 financial crisis, and quickly lifted some of them when circumstances stabilized. Brazil is generally much more open than China and India, but unlike some other fully open economies in the region of Latin American with no restrictions of capital flows at all, capital controls remain an important policy tool in mitigating possible negative impact that world economic trend might impose on the domestic political economy in

Figure 7.2: Brazil's Capital Controls from 1995 to 2017 (Fernández, Rebucci and Uribe, 2015)

Brazil, although it may not be as effective as is expected to be (Jinjarak, Noy and Zheng, 2013).

A notable difference between Brazil and China and India resides in the level of modernization and consolidation of the domestic financial sector. In both China and India, one major factor cited for the delay of financial opening is the unpreparedness of the domestic sector especially the banking industries. In Brazil, the banking crisis resulted from the 1994 Mexican crisis contagion provided a one-time set of opportunities to establish functioning banking systems with the help of foreign investors (Fernando de Paula, 2011). As Jinjarak, Noy and Zheng (2013) mention, few industries were so modernized as the banking industry in Brazil. In fact, private institutions supplied more credit than

public institutions for the first time since 1999. After acquiring banks previously owned by provincial state governments, foreign banks managed to increase their operations by riding on the waves of privatization from 1990s to the early 2000s. Unlike China and India, domestic reform including the privatization of SOEs has gone further in Brazil and comes together with financial liberalization.

Brazil also has a history of direct state intervention in economic policies in the 1950s just like China and India. All of these three countries have a huge public sector to start with in the 1960s to 70s because of interventionist state policies. As Rapoza (2018) put it, within the Americas, no country has more SOEs than Brazil, making it Latin America's China. Brazil's developmental model between mid 1960s to mid 1980s is based on what Evans (1979) called the "triple alliance" between SOEs, MNCs and local private monopolies. It involved both a continuation and a rupture with parts of the previous nationalist-populist model. Under a series of military regimes, the state continued to play a major role in the economy by protecting local strategic national institutions (e.g., banking, capital goods, and petroleum) and subsidizing industrial projects(Petras and Veltmeyer, 2003). In the meantime, state regulations were loosened to allow a greater influx of foreign capital. Starting in the late 1980s and early 1990s, Brazil went through major liberalization reforms, which is comparable to China's "Reform and Opening Up" in 1978 and India "New Economic Policy" in 1991. Although it has talked a great deal about privatization since the mid 1980s, Brazil only began to make noticeable changes under President Collor (1990-1992), Franco (1993-1994), and the progress accelerated after Cardoso (1995-2003) took office (Armijo and Jha, 1997; Petras and Veltmeyer, 2003).

Similar to China and India, one of the most important transformations of the development strategies in Brazil after the 1990s reform was the restructuring of the way the state invests in and runs corporations (Musacchio and Lazzarini, 2016). Instead of

the old system where the government owned and operated hundreds of SOEs and dozens of state-owned banks, controlled prices, and directed subsidized credits to a large number of national firms, the government opened up many sectors to foreign competition, privatized most SOEs, and let most domestic prices to be determined by market forces. In this process of transformation, however, the Brazilian state kept ownership of some of the most important SOEs in sectors deemed by the government as "strategic", and used its remaining banks, especially the Banco Nacional de Desenvolvimento Economico e Social (BNDES; National Bank for Economic and Social Development), to support the so-called private and state-owned firms'"national champions."

In a first model where the governments kept majority ownership and control of firms, they privatized a good share of their capital and attracted private investors to share the risks and rewards of sectors such as electricity, water and sewage, and oil and gas, which is very similar to China's dominant privatization strategy of bringing resources of funds from the private sector without giving them management roles. In a second model, the Brazilian government private a large share of the equity of the companies it owned, but retaining minority equity positions in a variety of firms using state-controlled developmental banks such as the BNDES. It provided capital to firms through equity and loans from its investment arm, and often outsourced the management of these mixed-ownership firms to the private sector (Musacchio and Lazzarini, 2016).

By 2014, there were 47 SOEs still controlled by the federal government (from a maximum of close to 250 *circa* 1980), with $626 billion dollars in total assets. State-level SOEs totaled 49 under direct control by the state governments, with total assets worth $66 billion (from a level of around 400 in the late 1970s). According to Musacchio and Lazzarini (2014)'s estimate, Brazilian governments at the federal and state levels controlled more than $757 billion dollars in total assets, representing approximately 33% of GDP. During the transformation, the state also improved the governance of many of

its firms using the advances in corporate governance and transparency that large private firms have adopted after the 1980s.

To be listed in public stock in international stock market for example is meant to force firms such as Petrobras (Brazil's national oil company with over 60% state direct and indirect ownership) to publish audited financials quarterly and adhering to general accepted accounting principles, and opened it up to the scrutiny and monitoring of rating agencies and large mutual and pension funds from all around the world. But this does not indicate the lack of political interventions in the management of SOEs. There are ample evidence that large SOEs in Brazil have a higher likelihood of being selected as "national champions" and receive preferential lending from state-controlled banks. Petrobras, for example, holds the largest share of almost 40% of the BNDES loans distributed to a sample of publicly listed firms in 2009 (Musacchio and Lazzarini, 2016). The Brazilian approach of privatization is similar to China and India as it also follows a modest public-private cooperation model of privatization where traditional SOEs are transformed into mixed-ownership firms with modern corporate governance. The state is stepping back but not retreating to fully relinquish control.

The remaining mixed-ownership SOEs after liberalization have aligned with the left and nationalist leftover in Brazilian state apparatus, and continued to lobby for at least some level of state control in the capital-account. It helps ensure their subsidies and preferential lending as well as reducing the country's vulnerabilities to economic shocks. This helps explain the ups and downs in the use of capital controls in Brazil recently, as the government attempted to counter the impact of world economic cycles and provide at least some protection for the domestic sector and favored SOEs during crisis, and reopened the financial account when conditions improve.

POEs in Brazil, especially large business groups with mixed ownership of both national and foreign capital, has also been growing significantly thanks to back-ups from

the state during privatization. As has been mentioned before, India has been slightly more pro-business during and after liberalization reforms compared to China. In Brazil, the pro-business stand of the government is significantly stronger than the other two. The transformations of SOEs provided an opportunity for capital accumulation through the acquisition of state-owned assets. The deals are lucrative as state assets are often underpriced. To further encourage the participation from the private sector during privatization projects, the state also created financial instruments such as the "privatization currencies", i.e., securities issued before the launching of national privatization programs or created to be exchanged during the privatization process. According to Carvalho (2001), this mode of payment was the most widely used during privatization during the 1990s and it attracts private participate because of the high discount that these securities had on the aftermarket. In addition, the increase in the international supply of credits through deregulated financial market during the same period of time provides another source of funding for POEs aimed at the acquisitions, and creates a growing entanglement between private economic groups, SOEs, financial capital from both pension/investment funds at public banks and oversea lenders.

As seen in China and India, the public-private cooperation model of privatization prevents capital-account from fully opening, because the newly emerged mixed-ownership firms often prefer a partial opening after incorporating the interest of both traditional SOEs and non-public interests including both domestic and foreign private businesses, thereby providing support for H1 in the case of Brazil. However, both privatization and financial liberalization have moved on faster and gone deeper in Brazil as compared to China and India. Brazilian SOEs are not as closely connected to the state and have not been able to achieve the level of political influence as seen in China and India. It is no more difficult for foreign capital and domestic private businesses to access policy makers and make political demands than SOEs in Brazil. The preference of both foreign and

domestic private businesses for opening capital-account has been better incorporated and helps offset the resistance of SOEs to facilitate financial opening.

Role of Foreign Capital

One major difference of privatization in Brazil as compared to China and India is the much more significant role that multinational capital and oversea lenders play during the transformation, which might help explain why privatization remain a much more controversial topic in Brazil compared to the other two. Privatization is acknowledged to be a necessary element of market reform in both China and India; it takes an extremely slow path and is carefully designed in a pragmatic manner to bring everyone on board thereby minimizing opposition. In Brazil, however, privatization has remained a dirty word for a long period of time until most recently, and significant privatization projects are often met with public opposition and protests. As Rapoza (2018) put it, soon as Bolsonaro (the current President of Brazil) puts one of those national corporate brands up for sale, protesters from the labor unions take to the streets. In contrast to China and India, most Brazilian SOEs in infrastructure sectors were considered to have been reasonably efficient and profitable through the 1970s, until the central government finances deteriorated rapidly from about 1979, and were exacerbated by the Latin American debt crisis, which hit Brazil in late 1982. Since then, Brazilian economic development depended exclusively on government indebtedness, and Brazilian economy became dependent on foreign lenders. Privatization emerged as an alternative to solve problems related to governmental debt, but selling the family jewels to pay off oversea bankers and lower government overhead doesn't sit well with the public (Dias, Teles and Pilatti, 2018).

There is also a national sentiment in Brazil that associates privatization with foreign takeovers and believes that Brazil is being sold out and privatization threatens national sovereignty and endangers the quality of public services (Petras and Veltmeyer, 2003;

Sims, 2017). Besides, the political scandals that involves how SOEs are used as an important mechanism for corruption and political patronage for politicians seeking influence are adding to the public concern. "More and more Brazilians are having a hard time believing that reforms which would put state assets back in the hands of the private enterprises accused of making corrupt deals with the government would be a good thing (Sims, 2017)." As Petras and Veltmeyer (2003) mention, before Cardoso (president of Brazil from 1995 to 2003), the traditional political formulas of political influence and corruption that characterize Brazilian politics greased the wheel for national development, for example, via state contracts to private builders to develop infrastructure. Under Cardoso, however, corruption had a different meaning and served to facilitate vote buying to secure the sale of the most lucrative Brazilian enterprises to foreign capital. To enhance foreign investors' confidence, the incorporation of officials favorable to foreign banks and firms must be ensured.

Foreign capital and MNCs have a longer history and more profound foot of in Brazilian political economy compared to China and India. As has been mentioned, state regulations were loosened to allow a greater inflows of foreign capital even before the major liberalization reforms in the late 1980s and early 1990s in Brazil. According to Petras and Veltmeyer (2003)'s narrative, large-scale, long-term entry of foreign capital was allowed in a host of manufacturing sectors, particularly in automobiles, and it is seen as a "partner" of national capital, stimulating national manufacturing via regulations that specified an increasing percentage of national components in assembly plants of overseas subsidiaries.

From 1985 to 1994, the three presidents before Cardoso (Sarney, Collor, and Franco) had all engaged in piecemeal privatizations and made small inroads towards financial liberalization. But these efforts were not able to overcome the opposition of the burgeoning popular movements and the deeply entrenched nationalist forces in the state apparatus,

and all of them retained certain reservations for a full opening of Brazil for foreign investment. With Cardoso's election in 1994, however, it marked the massive breakthrough of foreign capital over the weakening barriers of state regulation and nationalist and leftist political opposition. As Petras and Veltmeyer (2003) put it, "overseas capital and bankers had finally secured a president capable of uprooting the fundamental state institutions and policies that promoted long-term, large-scale national development (pp.9)."

The Cardoso regime gave free rein to foreign capital in buying out and running firms in the strategic sectors of the economy in an unprecedented level, including energy, transport, chemical, and major banks. In the 1990s, foreign control and ownership of basic industries increased substantially as did foreign influence over public policy. By 1998, 36.3% of the 500 largest private firms and the fifty largest SOEs had come under foreign ownership and control (up from 31% in 1990), and the percentage continued to rise in the 2000s (Petras and Veltmeyer, 2003). The current account deficits the reappeared in 2008 and continued to rise in the 2010s have been financed by foreign capital inflows. Brazil's international reserve has grown by 673.4 % between 2003 and 2012, reaching the amount of US$ 379 million in 2012 (Earp and Bastian, 2017). The prolonged conflict, tension and coexistence between powerful national or state economic sectors and giant MNCs were resolved by the Cardoso regime in favor of the latter (Petras and Veltmeyer, 2003).

7.3.2 Outflows versus Inflows

Interestingly, the path of capital-account opening in Brazil has been relatively more gradual and stable and looks more similar to China and India than if we look at controls of capital outflows only. As Figure 7.2 from the previous section shows, controls of capital outflows in Brazil slightly went up by 20% during late 1990s and started to gradually

fall by 10% in the beginning of 2000s before another sharp fall by 35% in late 2000s. It started to go up by 15% in 2009 and remained relatively high around 0.7 to 0.8 (on a scale of 0 to 1, with 0 indicating no controls and 1 indicating strict controls) in the 2010s. In general, the gate of capital outflows has remained more closed than open in the past 25 years except the three years of 2006, 2007 and 2008. Even in these three years, the gate is still 40% closed instead of being fully open.

Controls of capital inflows however have more fluctuations and a higher variance over the years. They gradually increased by around 10% in the late 1990s before dropping slightly by 5% in the beginning of 21st century. Then there was a very sharp 70% fall in 2002 and capital inflows controls have remained in a minimum level during most of the 2000s before rising again in 2009 after the 2008 global financial crisis. In 2010s, controls of capital inflows have remained at a level in-between the 1990s and 2000s, i.e., around 20% lower than the former the and 20% higher than the latter. Since 21st century, the overall level of capital inflows controls was lower than that of outflows during except the three years of 2009, 2010 and 2010.

In Brazil, the remaining large SOEs after privatization helps explain the overall strict controls of capital outflows over the last two to three decades and the pattern of generally more strict controls of capital outflows than inflows since 2000s. As H2 suggests, SOEs have a higher stake in the policy outcome of capital outflows controls because of the fear of undermined state financial repression after anticipated domestic capital flight that involves residents. According to Goldfajn and Minella (2005), during the financial liberalization wave in 2000s, the public opinion still associates transfers abroad with illicit or anti-patriotic practices. Similar to China and India, a relatively more concerned view is associated with outgoing capital than incoming capital. But the association between SOEs's resistance and the level of controls of capital outflows in Brazil is not as evident as in China and India, possibly because the policy preference of Brazilian SOEs is not as

incorporated into actual policy outcome as in China and India.

In the case of capital inflows controls, in addition to the relatively lower stake for SOEs to resist opening up because of potential benefit, it seems that the policy preference of SOEs is very much offset by the preference of foreign investors and lenders. Foreign capital often has a higher stake in the case of opening the gate for capital inflows, as it seeks to reduce costs related to foreign transaction or entry in industries previously restricted to domestic investors. In Brazil, a much more welcoming attitude to foreign capital is observed compared to China and India. The trend of capital inflows controls therefore largely reflects the policy efforts of foreign capital instead of SOEs. Foreign capital has been able to push the gate for incoming capital to stay open since early 2000s. During the reversal trend following the 2008 global financial crisis, a 2% tax on fixed-income and equity inflows was reintroduced in October 2009 with further widening its application the next month. The tax was later increased to 6% in two stages (in October 2010); but then reduced back down to 2% in January 2011 (Jinjarak, Noy and Zheng, 2013). As the impact of crisis slowly faded over the years, the gate for incoming capital started to gradually open again.

7.3.3 The Lack of Institutional Embeddedness of SOEs

The significant presence of foreign capital that characterize Brazilian political economy helps explain why Brazil has moved much further towards capital-account opening than China and India. In addition to making direct political demands to open the gate for capital flows in Brazil, foreign capital also indirectly accelerates the progress of financial opening by facilitating privatization in Brazil as a major investor in acquiring SOEs. Besides historical factors, foreign capital has been able to play a much more important role in Brazil than in China and India because the institutional context of Brazil as a

non-SMEs differs from that of China and India. The scenario of how privatization and financial liberalization have happened simultaneously in Brazil is attributable to the lack of institutional embedded of SOEs and their relatively weaker political power as compared to China and India. As H3 suggest, the political efforts made by SOEs to oppose capital-account opening are more effective in SMEs such as China and India than in non-SMEs such as Brazil.

As a country with a significant portion of remaining mixed-ownership SOEs that prefers a gradual opening under control, we would expect Brazil to be less financially open than it really is and have a path of gradual and stable financial opening relatively more similar to China and India. The context of Brazilian state as a non-SME helps explain why the significant presence of SOEs is associated with an unstable semi-open capital-account in Brazil, instead of a gradual path of financial opening as in China and India. Unlike the scenarios of China and India where the preferences of SOEs have largely been reflected in the actual policy outcome of capital-account opening with the help of institutional leftovers from an interventionist state, SOEs in Brazil are not as influential and powerful. The Brazilian government has driven much further away from its interventionist past and become much more dependent on foreign capital compared to China and India. It does not retain a state-led regulatory system as we see in China and India that directly ties SOEs' preferences to the state. More importantly, the profound presence of MNCs and foreign lenders has been able to offset the impact of SOEs in Brazil, as they are not underprivileged by the existing institutions as in the case of China and India.

The lobbying efforts made by SOEs in Brazil may not be as effective as that in China and India. Unlike China and India where the leftover institutions from interventionist state remain strong and provides SOEs with a direct and convenient platform to make political demands, i.e., the well-established regulatory system in China and the reformed

system of "license Raj" in India, there is no such a counterpart in Brazil. The official institutional mechanism that connects SOEs to the state is rarely mentioned among the literature of Brazilian political economy. Instead, what frequently comes up is the informal political influence and corruption. SOEs in Brazil has a more difficult time influencing financial policy making as compared to China and India due to the lack of elaborate regulatory institutions that often characterize SMEs. Brazil is a state with significant decline of state role in economic management after liberalization and have much fewer leftovers from the previous interventionist state regime than China and India.

Moreover, despite the remaining powerful mixed-ownership SOEs preferring partial opening, the interests of MNCs and foreign lenders often get the upper hand and have found a way of influencing domestic policy making by being integrated into and becoming an important part of domestic interest through lending or shareholding, a mechanism referred as the "second image reversed" by Gourevitch (1978). The foreign capital often prefer a more open capital-account that allows free inflows and outflows of capital and reduces the cost, for example, by lowering taxes involving foreign transactions. The lack of elaborate regulatory institutions for SOEs helps explain the deeper penetration of foreign capital as well as the overall higher level of financial openness in Brazil compared to China and India. Instead of a gradual path of financial opening as we see in China and India, the capital-account in Brazil is therefore much more open than the other two, and it has experienced ups and downs along with world economic crisis as a result of more in-depth financial integration.

7.3.4 Summary and Discussion

Similar to China and India's modest public-private cooperation model of privatization, traditional SOEs in Brazil were also transformed into mixed-ownership SOEs under

modern corporate governance, and presumably with an altered preference for partial financial opening after incorporating the private sector. The story of Brazil is much closer to the scenario of how successful privatization and significant declining of SOEs leads to the opening of a country's financial account in the 1980s and early 1990s. Privatization in Brazil is still on-going and follows a modest model of public-private cooperation that transforms instead of significantly weakening SOEs. The pattern of capital outflows controls in Brazil is relatively more similar to China and India than the trend of capital inflows controls. In addition to providing evidence for the higher stake of SOEs to resist opening the gate for outgoing capital, this illustrates how the preference of foreign capital has been able to offset the influence of SOEs in non-SMEs.

One criticism for this dissertation's argument is that whether the theory of how SOEs stand in the way of financial liberalization only applies to typical SMEs. The case of Brazil suggest that in a typical non-SME, SOEs remain large after ownership change and this is associated with a partial financial opening with at least some level of state control instead of a full liberalization of the capital-account. It provides good supplementary evidence for the theory, and serves as an example of how the theory may play out in different institutional contexts. SOEs in Brazil are institutionally less connected to the state and politically less powerful compared to the case of typical SMEs such as China and India. This provides evidence for the mechanism that helps explain why the resistance of SOEs to financial opening is less effective in non-SMEs compared to SMEs as suggested in H3. The scenario of Brazil also adds evidence to the establishment of a new norm that prefers partial opening among emerging countries, where the state is unwilling to entirely forgo capital controls as a useful policy tool in response to world economic chaos

Chapter 8

Conclusion

This dissertation examines two of the three major trend of liberalization: privatization and financial liberalization. The third trend of political liberalization is controlled for in the large-N statistical analysis and discussed in the form of institutional context in case studies. It raises the question of why are some states financially more liberalized than others, and offers a test of an important but often overlooked variable in the existing literature on international financial integration, i.e., firm ownership. The domestic cleavage of interest is identified between SOEs and POEs. SOEs benefit more than POEs from state financial repression and heavy state influence in the financial sector including the use of capital controls, as they have easier access to below-market interest-rates credits and other forms of preferential treatment. The expected distributional consequences of financial liberalization are less promising for SOEs than POEs, since POEs are usually more efficient, have better performance, and often favored by foreign investors and lenders. States where SOEs have been significantly weakened in relative terms by privatization therefore have a higher likelihood of lifting capital controls, as the resistance of SOEs to financial liberalization weakens.

By differentiating controls of capital outflows and capital inflows, this project also

contributes to disaggregating the general concept of capital controls and helps understand the different mechanisms and policy considerations between the two. SOEs have more concerns over lifting controls of capital outflows, as they anticipate weakened state capacity in influencing loan allocations and other forms of discriminatory financial policies after domestic capital flight. The potential benefit from increased access to foreign capital after liberalization might partially offset the cost for SOEs. The resistance of SOEs to lifting capital controls is therefore more significant in the case of controls of capital outflows than inflows. The empirical section of statistical analysis provides both fixed-effects regression and difference-in-means test results in support of the theory, and suggest that domestic institutions such as regime type and central bank independence also help explain the variation of state behavior in financial integration.

This project also examines the role of the larger institutional context of state-market interactions in determining the effectiveness of SOEs' resistance to capital account opening. It extends the VoC literature by providing qualitative data from comparative analysis of China, India and Brazil. As another SME, India presents a very similar story to China. The slightly stronger private sector in India helps explain its relatively more consistent path of capital-account opening. In Brazil, a non-SME where the state is less influential in its economic activities, the resistance of SOEs to financial liberalization is less effective due to the lack of regulatory institutions similar to those observed in China and India.In typical SMEs such as China and India, where institutional legacies of interventionist state policies in economic activities remain concrete after market reform, the impact of SOEs' resistance to financial liberalization has been more significant. In non-SMEs such as Brazil, where the state has driven further from nationalist development policies in the past with rarely any institutional leftovers, foreign capital has been able to build deeper roots and become significant shareholder of mixed-ownership SOEs and POEs. Their preference for an open capital account helps explain why Brazil has made greater

progress towards financial opening than China and India despite the similar approach of public-private cooperation model of privatization in all three countries.

SOEs in Brazil are in a relatively level playing ground, as compared with POEs and foreign businesses, in accessing and influencing policy makers. The market reforms in both China and India are carefully designed to avoid major conflicts with opposing interest groups; each step taken is small, the pace is extremely slow, and the progress remain initial. Brazil has experienced more variants in the direction of market reforms as it goes back and forth because of changing domestic coalitions and realignments of interests. The state has retreated much further in Brazil compared to India and China, because of the lessons learnt from inflation, indebtedness and crisis in Latin America. Those historical experiences pave the way for foreign capital penetration, and allow the establishment of an intimate relationship between foreign businesses and the state, a phenomenon that characterizes Brazil but not China and India. The mechanisms and platforms existing in Brazil that connects foreign businesses to policy makers are built through the history of debt crises in Brazil. In China and India, however, politics is about access and neither country has experienced debt crisis. Unlike Brazil, a newly constructed way of lobbying that brings foreign capital much closer to policy making does not open up in China and India. After SOEs are privatized in Brazil, managers are often bought off and easily become managers of the newly emerged mixed-ownership firms or MNCs.

While the nationalist development policies and corresponding institutions remain strong in China, and are largely retained in India, the state in Brazil no longer assumes the leading role in promoting economic growth, and what comes instead is an intertwined force of local and international capitalists that brings development. The "internationalized and directly international sector of the economy is expected by the state to assume the leading role of agent of national development. Whether they want it or not, they

are expected to do so (Rocha, 1994). Unlike the highly-institutionalized regulatory system observed in China and India where both capital and labor are under state control, regulation in Brazil is relatively loose and capital of both domestic and foreign origin in Brazil is not as repressed as labor. Since the state is relatively weak in the face of market force in non-SMEs such as Brazil, large capitalists therefore often have an upper hand in gaining political access and obtaining favorable policy outcomes compared to other interests. Institutional contexts seem to have played a significant role in explaining the different ways SOEs interact and influence financial policy makers across China, India, and Brazil.

Admittedly, the small-N case studies suffer from the issue of external validity. It is possible that what has happened in China, India, and Brazil in privatization and financial opening might not be generalizable to the rest of the world. But the comparison between these three cases provides solid evidence in support for many presumptions made in all three hypotheses across three different countries in varying regions of the world and contrasting institutional contexts including SMEs and non-SMEs. For example, the preferential treatments SOEs enjoy thanks to state influence in the financial sector are observed across all three cases; domestic interests including SOEs in all three countries tend to link the lift of controls of capital outflows with capital flight, and are relatively more tolerating if not embracing incoming capital.

The cases of China and India have been more supportive to the theory than Brazil, since privatization is observed to have driven financial opening in both China and India, whereas in Brazil, such pattern is not as evident. However, the contrast between Brazil and the other two helps reveal interesting findings on the contextual factor of political economic institutions. The reason why Brazil has departed from the proposition that privatization has to come before financial opening is that Brazilian SOEs are not as institutionally embedded and politically powerful in spite of their large size. This gives

room for the rise of foreign capital and other large domestic private businesses in the competition for political influence. The comparison between Brazil and the other two countries helps clarify some of the causal mechanisms of how privatization affects the capital-account opening. The effectiveness of this process depends on how closely SOEs are institutionally connected to the government and how easily they can access political leaders. Future researchers might find it useful to combine the theory with the different classification of state-market interaction from VoC literature, and see how the varying degree of institutional embeddedness of SOEs affects the way privatization drives financial opening.

Although external validity is limited because of the small number of case studies, the details and nuances revealed in these three cases provide many policy implications for the emerging and developing countries as well as the rest of the world. First, for the developing world *per se*, the privatization of SOEs might be a necessary condition for financial liberalization. SOEs often lags in efficiency, and may resist any forms of liberalization that introduce competition. Given the relatively larger number and smaller size of private business companies in the developing world, it might take some time for them to grow through M&A or public-private partnership and acquire sufficient political clout to compete with the influence of SOEs. It follows that full financial liberalization may be delayed in the developing world while partial financial liberalization becomes more common in the meantime.

Second, although the scope of this research project is on SOEs in emerging and developing countries, the causal mechanism is relevant for the concentration of market power for private companies in the developed world as well. A giant private sector could act as both the owner and regulator in the mature economies, just as the state acts as both the owner and regulator in emerging markets; POEs could successfully oppose any reforms that allow the entry of new competitors through their greater lobbying power.

These giant private firms receive preferential treatment not because of a strong state, but rather a weak state. As has been observed in Brazil, when the state role retreats in economic management, the market force comes in. Large capitalists regardless of country origin are sometimes in a position unbridled by regulations. Their close ties with policy makers in developed countries might become equally concerning to those between SOEs and the state as more commonly seen in developing countries. Policy makers might need a more balanced approach to tackle issues related with the most advantageous domestic interest groups depending on their institutional contexts of state-market interaction. In SMEs, the findings imply that the elaborate institutions that ties SOEs to the state might need a reform targeted at downsizing; in non-SMEs, is might be necessary to build more established regulatory institutions to solve social economic problems resulted from overly expanding capital.

Third, state capitalism, or partial liberalization led by BRICs could become a norm shared among the developing world. Diffusion, particularly policy learning, might help explain the policy convergence towards retaining the role of state in corporate governance and partial liberalization in emerging and developing countries. They have learnt from the past that undesirable consequences might occur after capital-account liberalization, and financial opening has different distributional implications for the domestic sector. Policy makers have attempted to implement financial liberalization in a manner that mitigates the possible negative impact through carefully designed restrictions of certain types of flows. It is necessary for countries across the world to get prepared for a world where financial integration is being restructured with more complex and specific capital controls that reflects the interests of different domestic actors. Instead of an open-and-shut case, the emerging and developing countries are experimenting with the technique of multiple locks for the different parts of the gate for capital flows. It is possible that the conflicts of economic interests and business negotiations related to capital-account open-

ing between countries might become more complicated and issue-specific. Understanding the domestic side policy considerations is a prerequisite for successful cooperation in the area of financial affairs.

Appendix A

Country list

The 59 emerging and developing countries included in the sample for statistical analysis are Algeria, Angola, Argentina, Bangladesh, Bolivia, Brazil, Bulgaria, Burkina Faso, Chile, China, Colombia, Costa Rica, Cote d'Ivoire, Dominican Republic, Ecuador, Egypt, El Salvador, Ethiopia, Georgia, Ghana, Guatemala, India, Indonesia, Iran, Islamic Republic of Jamaica, Kazakhstan, Kenya, Kyrgyz Republic, Lebanon, Malaysia, Mauritius, Mexico, Moldova, Morocco, Myanmar, Nicaragua, Nigeria, Pakistan, Panama, Paraguay, Peru, Philippines, Romania, South Africa, Sri Lanka, Swaziland, Tanzania, Thailand, Togo, Tunisia, Turkey, Uganda, Ukraine, Uruguay, Uzbekistan, Venezuela, Vietnam, Zambia.

A.0.1 High privatizers

Argentina, Bangladesh, Brazil, Chile, China, Colombia, Costa Rica, Dominican Republic, Georgia, Ghana, Guatemala, India, Indonesia, Kenya, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Panama, Peru, Philippines, Romania, South Africa, Sri Lanka, Tanzania, Thailand, Turkey, Ukraine, Uruguay, Vietnam.

A.0.2 Low privatizers

Angola, Algeria, Bolivia, Bulgaria, Burkina Faso, Cote d'Ivoire, Ecuador, Egypt, El Salvador, Ethiopia, Hungary, Iran, Islamic Republic of Jamaica, Kazakhstan, Kyrgyz Republic, Lebanon, Mauritius, Moldova, Myanmar, Nicaragua, Paraguay, Swaziland, Togo, Tunisia, Uganda, Uzbekistan, Venezuela, Zambia

Appendix B

Interviewee list

1. Dr Z.M: Government officer from the Bureau of Policy Research, China Banking Regulatory Commission (Beijing). Date of virtual Interview: June 22, 2020.

2. Dr T.Z: Research Associate for National Institution of Finance and Development/Director of the Policy and Regulation Center, Jingdong Digital and Technology Policy Research (Beijing). Date of Virtual Interview: June 22, 2020.

3. J.S: Manager from local Rural Commercial Bank (Yongjia). Date of Virtual Interview: March 17, 2020

4. G.W: Former Government Officer from the local People's Bank of China (Wenzhou). Date of Virtual Interview: March 13, 2020

5. Y.C: Government Officer from local State-owned Assets and Administration Commission (Wenzhou). Date of Virtual Interview: March, 9, 2020

6. Y.L.: SOE manager from Wasu (Yongjia). Date of Virtual Interviews: July 17, 2019 and August 2, 2019.

7. X.S: POE manager from Suifeng Paper (Yongjia). Date of Virtual Interview: July 10, 2019
8. C.Y: Senior Financial Journalist from Wenzhou Daily (Wenzhou). Date of Virtual Interviews: Oct 27, 2020

   (Note: Interviewee names are provided in the initials for confidentiality.)

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