THE DIVERSITY OF CONVERGENCE:

STATE AUTHORITY, ECONOMIC GOVERNANCE AND THE POLITICS OF SECURITIES FINANCE IN CHINA AND INDIA

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THE DIVERSITY OF CONVERGENCE:
STATE AUTHORITY, ECONOMIC GOVERNANCE AND
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This dissertation explains contrasting patterns of financial reform in China and India. It focuses on "securitization" – the structural shift from credit-based finance (banking) to securities-based finance (stocks and bonds) – as a politically consequential phenomenon in comparative and international political economy.

The analysis revises common theories of the developmental state – theories derived from Gerschenkron's emphasis on directed-credit and the state's role in capital formation – in light of securitization's growing global importance in the last twenty years. Contrasting responses to securitization are explained using international and domestic variables including the profile of a country's exposure to the world economy, the distributional coalition supporting the state and the prevailing structure of property rights.

At a theoretical level, the dissertation highlights the political consequences of securitization for state authority in the economy, arguing that directed-credit; 1) enhanced state discretion in the management of distributional coalitions; 2) facilitated the perpetuity of poorly specified property rights; and 3) mitigated the consequences of the country's position with respect to external trade and investment.

Empirically, the research presented here demonstrates that China and India responded differently to the process of securitization, contrary to the expectations of globalization theories that identify finance as a domain in which international forces

favoring convergence should be strongest. The thesis also shows that, in contrast to the scholarly depiction of China's authoritarian system as superior to India's democracy in the reform process, in the area of finance, Indian and Chinese reform patterns are mirror images: reform *with* substantive change in India, reform *without* substantive change in China.

Finally, most scholars viewed China's massive foreign exchange reserves and world-topping volumes of foreign direct investment as signs of economic strength. This thesis suggests the opposite: that these signs indicate Chinese vulnerability is derived from an "affliction of abundance." India, however, made a virtue of its weakness, exploiting the "advantages of adversity." With little foreign direct investment, few exports, and (until recently) scant hard currency reserves, India chose to develop world-class securities markets and a rich tapestry of securities governance institutions in order to better mobilize and direct corporate finance and attract hard currency through foreign portfolio investment.

BIOGRAPHICAL SKETCH

Matthew C.J. Rudolph graduated with Honors in Political Science and Art History from Swarthmore College. Before seeking a Doctoral degree at Cornell, he worked in Washington, D.C. at the Henry L. Stimson Center. There, Matthew's worked focused on conflict avoidance in South Asia. He has lived, studied and worked in South Asia and Greater China for over eight years.

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Chapter One

GLOBAL SCRIPT, LOCAL ENACTMENT: THE DRAGON AND ELEPHANT ON THE WAY TO GLOBALIZATION

I. Increasing Assets: the contemporary life of securities finance

Cab drivers call it the "share bazaar," and will convey a passenger as close as the thronging traffic permits. Crowding up and around its vast flanks are shoeshine boys, snack kiosks, and vendors of share applications (who will, for a fee, fill out the applications – different prices for handwritten or typed). Banks with doors half open are guarded by desultory *chowkidars* (security guards) drinking tea. The traffic in and out, as well as around the building, is incessant and raucous. Despite the fact that it is one of the tallest buildings on the south Bombay skyline, situated on hugely valuable property, it can be accessed only by way of labyrinthine small lanes. This is the Bombay Stock Exchange, India's best-known securities exchange.

In Shanghai's glittering new *Pudong* financial district, rising majestically between a manicured empty greensward and a wide yet often empty boulevard, stands the Shanghai Stock Exchange. Inside and out, it is disconcertingly still, soporific. In the solitude of the foyer, a footfall is deafening. The exchange building itself is a huge chrome and steel affair shaped like a square doughnut, with a vast empty space in the middle.

These renderings of the different social geographies and built environments in which the Chinese and Indian securities exchanges exist, evoke themes that distinguish the two countries' patterns of securities finance. Observers often view China as a surging dragon, a vigorous economy with a dynamic reform agenda. India

is viewed less favorably, as a plodding elephant, a sluggish economy, and a listless reformer. Contrary to these common characterizations, I argue in what follows that, when we look at the area of securities finance in stocks and bonds, the dragon is less fierce than often believed and the elephant more nimble.

Where will China and India be tomorrow? Two prominent political economists, one Chinese and one Indian, reason that "the answer will be determined in large measure by how well both countries utilize their resources, and on this score, India is doing a superior job" (Huang and Khanna 2003, 80). Table 1-1 summarizes the conventional wisdom circa 2002 on this question, highlighting the one clear area of difference: finance. The haphazard, heterodox, confused, and yet organic constituents of the first tableau rendered above presents an apt evocation of the Indian pattern. The rational, orderly, formally impressive, yet ultimately hollow constituents of the second tableau present an equally apt evocation of the Chinese pattern.

Table 1-1:
A Scorecard for the Dragon and the Elephant

Contrasting Patterns of Financial Governance	
China	India
Dynamic economy Dynamic reformer	Sluggish economy Sluggish reformer
Underperforms Compared To: India Other Chinese Sectors	Overperforms Compared To: China Other Indian Sectors

Beginning in the early 1990s, both countries faced a common exogenous stimulus in the form of the global securities finance trend. The two shared a common legacy of directed-credit developmentalist financial systems. However, their profiles of exposure to the international economy, their coalition politics, and their property rights structures were different. Based on documentary, quantitative, and interview-based evidence collected during twenty months of field research from 1997 through 2001, this thesis draws conclusions about how these three variables help elucidate the politics of securitization in China and India and how they help explain the differing patterns that emerged in their governance of securities finance.

In the 1970s and 80s, technological innovation and market expansion made securities finance using stocks and bonds cheaper, more reliable, and more prevalent. At the same time, securities finance not only became socially more acceptable globally, it came to be seen as a necessary element in the common global financial reform trend and a desirable, if not obligatory, attribute of a sovereign national market participating in the global economy. In the 1990s, facilitated by these earlier changes and buoyed by a boom in information technologies, a U.S.-led securities investment *Zeitgeist* seemed to infect much of the rest of the world, triggering a new and rapid expansion of securities finance. In many countries, American capital markets were considered, in the words of one prominent Indian financier, the "nirvana of financial development."[1] The decade-long American expansion did much to spread the "cult of equity" and the craze for stock markets. As one longtime observer of such trends

[1] Author's interview, New Delhi, 2000, #22. There is often a confusing degree of imprecision among journalists, and often even among political scientists and economists, in the discussion of "capital markets." The term is often incorrectly used as a synonym for securities markets. The first analytical advantage of focusing on securities is the avoidance of this imprecision. Capital markets do include securities, but they refer to the organized markets and institutions dealing in long-term instruments (typically with a maturity exceeding one year). In addition to stocks and bonds, the capital market includes term loans, mortgages (which can be, and now often are, securitized), and even term deposits. Commercial paper and certificates of deposit (CDs) are exceptions to rule in this general "long-term" definition (Wai and Patrick 1973).

remarked, this set the stage for worldwide rivalry of capitalist models – "stock market capitalism versus welfare capitalism" (Dore 2000). In the process, American securities finance and its watchdog, the Securities and Exchange Commission (SEC), were in many quarters valorized, emerging as perceived global standards which governments and market participants elsewhere often sought to emulate, and against which the progress of securities finance development and regulation were often measured.

In 1997 and 1998, as financial crisis roiled much of Asia, official promoters of caution, gradualism, and market insulation in Chinese and Indian financial policy no doubt felt vindicated when a former top U.S. financial official concluded that "one of the principal causes of the Asian crisis" was the fact that "financial liberalization was undertaken in countries that didn't have the infrastructure to support it."[2] In March of 2000, the decade-long bull run on American stock markets ended. Then in December 2001 came the collapse of the American energy giant Enron Corporation. It was a financial debacle with a significant securities finance component, and a body blow to the American "variety" of capitalism. Indeed, during congressional hearings on the matter, a U.S. senator upbraided Kenneth Lay, former chairman of Enron, complaining that Lay had "failed not just Enron, but America." Lamented the legislator, "we tried to go into emerging markets and talk about the wonderful things capitalism has done for our country. Mr. Lay, I believe you bear a great deal of the responsibility for shaking the confidence of us being able to export capitalism" (Considered 2002). Following Enron's collapse, Chinese securities regulators quickly shelved plans to require audits of Chinese firms by foreign accounting firms such as Arthur Anderson (disgraced and fatally damaged by the Enron fiasco). Indians

[2] The official quoted is someone who should know: Ricki Helfer, former chair of the U.S. Federal Deposit Insurance Corporation (Kristof and Sanger 1999).

angered by Enron's 1990s machinations in a major energy infrastructure investment there also enjoyed a moment of *Schadenfreude*.

The unfolding of Enron and other securities-related corporate scandals in the U.S., together with the recently-burst stock market bubble, began to reveal how the 1990s expansion in securities finance had instigated a shift in the politics of securities finance from one of interest group politics (Stigler 1971) to one of popular politics. Contenders on American hustings are now presented with yet another economic issue in electoral politics: the "wealth" created by popular, broad-based securities finance. According to one prominent political columnist, "whereas in the 1970s and 1980s unemployment and inflation were the key indicators of economic performance to the public, the White House has come to believe that the stock market is now the key barometer" (Lizza 2003). Asserting that "there is a new number, and it is wealth," one seasoned lobbyist and economic policy strategist argued that this new "wealth effect" is poised to join the ensemble of key broad-based economic electoral issues.[3]

Summarizing his discussions with officials about the situation confronting the incumbent U.S. administration in a post-bubble, post-Enron era in which as many as two-thirds of voters own stock, another important observer of economic policy explained that this was "the first sustained period of economic weakness since mutual funds and 401(k) retirement plans[4] made investing part of everyday life across the income spectrum, and some White House officials are concerned that there is no playbook for responding to anxiety among the mass investor class" (Stevenson 2002).[5] The 1990s seem to have introduced a new dimension to electoral politics – investor

[3] This was tax policy activist and Republican consultant Grover Norquist, quoted in (Lizza 2003).
[4] These are tax-preferred, specially regulated securities investment funds for retirement in the U.S.
[5] In 2002-2003 the Republican Party did manage to devise one political "play" for the era of securities finance. They introduced a tax cut on the dividends companies pay to their shareholders, and one Republican Party strategist commented with glee that in opposing this dividend tax cut, the Democratic Party had been successfully portrayed as "enemies of the investor class" (Lizza 2003).

confidence – and a new interest group, the "investor class." Although securities finance in China and India in the 1990s was not broad-based in this way, and the politics of securities finance occurs largely among powerful groups like state and coalition actors, the investor class in these two countries is likely to reach proportions over the next decade or two that will have the potential to impact popular politics.

These are key liniments of the global context in which securities finance has emerged in developing and transitional economies in recent decades. However, a more provocative way to frame the analysis of Chinese and Indian securities finance that follows is to consider the American circumstances of the mid-1960s. At that time, more than thirty years after the Great Crash of 1929, much of the American general public and almost all economic experts considered U.S. stock markets to be a dangerous casino-like "playground for speculators" (Bernstein 1990). The public remembered when presidents of the New York Stock Exchange didn't just resign over outsized pay packages (as President and Chairman Richard Grasso did in September, 2003). Within memory of many Americans still living in the 1960s, NYSE chair Richard Whitney, husband to Gertrude Vanderbilt Whitney and brother of J.P. Morgan Bank Chairman George Whitney, had been jailed for stealing from the exchange's pension fund. As late as the early 1970s, more than a few Americans even recalled the great Wall Street banker J.P. Morgan Sr. himself being pilloried in congressional hearings. Yet, it wasn't until 1975 that the Securities and Exchange Commission broke up the self-enriching commission system long enjoyed by securities brokers and Congress imposed the unifying and cost-reducing National Market System, putting in place a market design intended to foster growth and competition in securities trading. Not until the 1970s did mutual funds and index funds[6] finally bring easy

[6] An index fund is a mutual fund that seeks to produce the same investment performance as a specific stock or bond index such as the Dow Jones Industrial Average in the U.S. To achieve this intended

diversification of stocks at low costs, helping investors confront risk and complexity in the market for U.S. securities.

This detour into U.S. financial history is a valuable caveat when analyzing recent development in Chinese and Indian securities finance. It puts in global and historic perspective the seeming riot of these countries' financial conditions at the turn of the millennium. Remembering Richard Whitney is important when we consider the ignominious exits of various Bombay and Shanghai Stock Exchange presidents.[7] The vilification of the likes of J.P. Morgan helps put in context the recent treatment of such erstwhile Indian financial heroes as now-disgraced Global Trust Bank President Ramesh Gelli and former chairman P.S. Subramanyam of the massive state-run mutual fund UTI – as well as billionaire Chinese businessman Zhou Zhengyi.

II. Convergence, Diversity, and State Authority

Global technology, global markets, and global society are homogenizing forces. They act as external stimuli on the way countries organize their economic and political institutions. Some argue that these forces encourage convergence, meaning that, in the words of political scientist Suzanne Berger, "competition, imitation, diffusion or best practices, trade, and capital mobility naturally operate to produce convergence across nations in the structures of production and in the relations among economy, society, and state" (Berger 1996, 1). Together with domestically driven adjustments in many countries around the world, the impact of these global forces has

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result (often referred to as "passive management"), an index fund manager maintains a portfolio of all (or a representative sample of) the securities in the index.

[7] In India, Bombay Stock Exchange Presidents Anand Rathi and JC Parekh left under clouds in 2000 and 1998 respectively. For detailed discussion of the dismissal of Shanghai and Shenzhen exchange leadership, see chapter 6.

led to changes in the state's role in the economy, particularly in developing and transitional economies (DTEs).

Yet, researchers still struggle to understand how these global forces – techno-market and social – influence domestic economic governance. For students of politics, a particularly important question is how the intrusion of these forces in formerly autarkic countries, where commerce and finance were once organized by government planning, affects the exercise of state authority in the economy. How and to what extent is economic action embedded in state and other social institutions? In this way, the analysis presented here carries forward Polanyi's preoccupation with what he called the "embeddedness" of markets and the "double movement" or symbiotic tension of socio-political reaction to market expansion (Polanyi 1957). *Global forces may explain convergence in market outcomes, but they are indeterminate in explaining political and governance outcomes.* This analysis also extends the growing interest in the varieties of capitalism. In identifying distinct patterns among the sectoral trends in Chinese and Indian economic governance, the arguments presented here should help in thinking about the various "futures" or possible "varieties" of Asian capitalism now emerging in these two major developing and transitional economies (Hall and Soskice 2001; Schmidt 2003).

To sharpen the focus of this inquiry, I look to the domain of finance in formerly planned economies. Specifically, I examine the politics and governance of "marketizing" finance in two of the world's largest DTEs, a process that extends the depersonalization and calculation of capitalism to the financial arena. This process as a whole is abstract and not easily grasped. I address the questions it raises by comparing the local enactment in China and India of one particular and prominent manifestation of global techno-market and social forces: *securitization.*

Securities finance is an area of financial marketization with broad linkages to, and implications for, the rest of the financial sector and the real economy. Claims on the value-creating "stock" assets that constitute firms are embodied in shares of equity often referred to as "shares of stock." Claims on "flow" assets, including firms' and governments' revenue streams, are embodied in debt obligations such as bonds. Both are packaged into standardized, anonymous, tradable "instruments" known collectively as securities. Securities such as stocks and bonds are thus instruments for commodifying the equity and credit funds offered to firms or governments.[8]

But the implications of "securitization" go beyond its technical meaning. It is an important dimension of a global modernization process. "Commodification" – that is, treating an object or relationship not as social or political but as purely commercial – evokes a disembodied dynamic. Securitization is a macro-form of commodification: the creation and trading of claims on a society's most productive assets, like firms and tax revenues, including the social relations within and among those assets. Commodification evokes "disembedding," where embedding refers to the rooting of financial relations in social or political institutions. Direct investment and bank loans are alternative, non-commodified sources of finance.[9] For someone exploring the marketization of finance in an effort to comprehend the comparative political sociology of globalization and of state authority in development and transition, key questions include how formerly *dirigiste* states respond to the global and local

[8] There is no equity investment in governments, only in the firms controlled by governments "on behalf of" their citizens.

[9] The everyday vocabulary of finance unconsciously recognizes this. As discussed below, political and financial economists tacitly internalize this fundamental distinction in the logic of their analytic categories. An outsider might be puzzled to hear that they contrast "bank-based" financial systems (dominated by banks) with "market-based" financial systems (dominated by securities), with the clear implication that securities finance is more "marketized" than is bank finance (Demirguc-Kunt and Levine 2001; Zysman 1983).

expansion of "securitized" finance, as well as how those responses shape the governance of securities finance.

Comparing the recent experience of securitization in India and China reveals contrasting outcomes. In the early 1990s, as the global tide of securities finance gathered momentum and both China and India began to securitize in earnest, their prevailing financial governance regimes were comparable. Large, organized industry in both countries operated in similar milieus of directed-credit finance based on central grants and loans from state-controlled banks or long-term lending institutions. By the end of the decade, however, distinct new regimes governing securities finance emerged from this common directed-credit legacy, and were discernible in the two countries. It is the politics of these two regimes that I will analyze and explain.

Governance regime is a term used by economic sociologists in characterizing the ensemble of actors, institutions, and social relations that "govern" a given sector of the economy. It includes structures of hierarchy-like state institutions and organizations or firms, and zones of relatively horizontal interaction like markets, the media, associations, and networks. The regime governing securities finance in a country – the securities governance regime (SGR) – is the dependent variable in the analysis that follows.

The Chinese and Indian securities governance regimes developed very differently from one another, and differently from the general reform and governance trends in each country more broadly. Tracing how the new SGR reshaped the form but not the function of financial power in China's marketizing state socialism helps us understand the curious circumstances of that country's "Potemkin stock markets"[10] –

[10] Naughton (1998) first compared this showcase feature of China's markets to "Potemkin Villages," which were named after Russian Empress Katherine the Great's renowned political-military advisor. Potemkin (1739-1781) is credited (apocryphally) with arranging sham villages that presented to the Empress a façade of thriving orderliness, obscuring a very different reality. In the heyday of Soviet and

financial reform *without* real financial change. Tracing how the new Indian SGR reshaped both form and function of financial power as that country moved from plan to market in the 1990s helps explain one of the most fundamental transformations in modern Indian political economy.

There is still some disagreement over whether, and/or the degree to which, the forces of globalization are causing irreversible convergence in policy institutions through the relative disempowerment of the state in favor of markets, capital-rich actors, or neo-classical economic ideas (Kurzer 1993; Milner 1998; Weiss 1998). To date, the international political economy (IPE) and comparative political economy (CPE) literatures make clear that there are trends toward both convergence and national diversity in countries around the world (Berger 1996; Laurence 2001; Vogel 1996; Wade 1996). But the proponents of convergence arguments have yet to stipulate what kind of convergence is expected. Do they expect the convergence of various countries' development trajectories toward some infinite intersection point on the horizon at which market and regulatory institutions of all nations will become formally and substantively alike? Or does convergence mean greater similarity (formal and/or functional) across national market and regulatory institutions, even while significant diversity persists? While we cannot know the future, looking for variation in securities governance regimes in two of the world's largest economies should contribute to our understanding of this issue.

The results of the China-India comparison on securities governance presented here offer evidence for the latter expectation: diversity *amid* convergence; convergence – meaning greater similarity, but not intersection – in many formal elements of finance stipulated by the global securitization script; and diversity in the

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Chinese state-socialism, "model" towns were presented in domestic and international propaganda, purportedly demonstrating the advantages of communist economic and social organization.

local enactment of that script's spirit and underlying functions. There may be a secular long-term trend toward convergence, but there is growing agreement among political economists and political sociologists that the global convergence trend is: a) long enough that diverse, medium-term equilibria along the way are both durable and important; b) indeterminate in its ultimate destination point (some "final" common universal form of market institutions); and c) almost certainly not toward a single, common intersecting equilibrium point in regulatory and market structures (Berger 1996, 4). The evidence presented in this thesis supports this view, demonstrating that the Chinese and Indian trajectories in securities finance are not likely to intersect, and that distinct, diverse, relatively stable medium-term equilibrium outcomes were reached during the first fifteen years of reform.

I argue that despite some formal signs of convergence, the responses to securitization in India and China are very different. Based on numerous interviews with officials and experts in both countries, and drawing on government documents, statistics, press coverage, and local secondary sources gathered over the course of twenty months of field research, I present a political explanation for these contrasting outcomes. The dual imprint of variable international exposure and historically provided domestic forces has produced distinct securities governance regimes in each country.

The combined effect of these techno-market and social dynamics is a global securitization "script."[11] Along with certain technologies and expanding exchange practices, the script also prescribes certain actors (such as issuers of securities and investors in securities), certain institutions (such as securities exchanges, securities regulators, or mutual funds), and certain behaviors (corporatization of firms, public

[11] The conceptualization of a taken-for-granted intersubjective script, and of the norms, practices, and material conditions associated with the enactment of such a script, are elaborated in Meyer et al (1997), and Finnemore (1996).

offerings of enterprise equity, privatization, mergers and acquisitions, and bond-based public and private finance). The script thus encompasses a common set of stimuli. However, the actual performance of this script's plot – its enactment – is not predetermined. It is the result of the politics shaping the configuration of state, market, and civil society. That configuration yields a country's particular securities governance regime. Countries respond differently to the common stimuli of the *script, enacting* that script in distinct ways. This local enactment is based on variation in the dual imprint of each country's relationship to the international economy: its profile of international economic exposure, on the one hand, and its domestic coalition politics and property rights politics on the other. Global script, local enactment.

To be sure, global forces exert formidable pressure for policy and institutional conformity in the form of technological innovations (diminishing transaction costs), expanding markets (increasing opportunity costs), and proliferating social standards and norms of behavior (shaping goals and identities). Yet, the political incentives to adopt convergent policies are mediated by each country's specific profile of exposure to the international economy. Differences in these profiles across countries lead to variation in the political incentives for policy making and institution building. Facing a particular set of such incentives, a country's securities governance regime will be influenced by how the central state acts on them in interaction with domestic coalition politics and the structure of domestic property rights institutions.

Based on my analysis of the development of these two countries' governance of securities finance, I also argue that state authority in the economy is not, as some have argued, retreating.[12] Rather, the nature of state authority is being transformed. Understanding authoritative relations between the state and the economy requires

[12] For a clear statement of this argument, see Nee (1989), Woo (1999), and Strange (1996). For arguments to the contrary that differ from the one presented here, see (1998) and especially Wade (1996).

attending as much to *how* state power is exercised, as to *how much* of that power exists. The following analysis therefore emphasizes not the *quantum,* but the *character* of state authority in the economy. This emphasis reveals how state power is exercised through different patterns of securities governance in China and India. Changes in the nature of state authority with respect to securities finance involve not only a diminution of state power, but also a shift in the mix of two ideal-type modes of state-economy relations – *distributive intervention* and *procedural supervision* – or the distinction between the tutelary and the regulatory state.

III. Securitization

Securities finance involves the creation, circulation, and use of stocks, bonds, and other tradable financial claims. *Securitization* has a number of meanings.[13] In this study, I define it in two ways. First, it is the creation of claims on productive assets that are divisible, uniform, and tradable. They can be claims on equity (stocks) or debt (bonds). Securitization also refers to the shift in a country's "financial structure," as the ratio of securities in the financial system increases relative to loans mediated by banks or bank-like institutions. At a first order of approximation, this helps us distinguish between what political scientist John Zyman called "bank-based" and "market-based" (meaning securities-based) financial systems (1983).[14]

[13] There are other narrow, specialized uses of the term among financial services sub-sectors.

[14] Demirguc-Kunt and Levine devised a "financial structure index" based on combined measures of banks-versus-securities (equities) finance, aggregating indicators of size (market capitalization vs. bank assets), activity (equity trading volume vs. bank credit), and efficiency (equity trading costs vs. bank overhead costs). Some countries demonstrate the usefulness of the index by their counterintuitive index rankings. For example, countries such as the Philippines are classified as "market-based," not because of well-developed securities finance, but because they have poorly developed banking systems (Hutchcroft 1998). Another important exception is Korea. Generally considered a "bank-based" system (Park 1993), Korea is classified here as "market-based" because it has very active, highly efficiency equity markets, and because, as in India, there is a large role for what the database calls "non-bank finance" (Demirguc-Kunt and Levine 2001 120).

Securities finance is highly formulaic. The standard "script" is familiar.[15] There are two types of instruments, bonds and stocks. These instruments are most often traded on an exchange. Corporate securities have a standard hierarchy of claims.[16] However, the essential point of this thesis is that the formulaic script nevertheless allows for variable "enactment" of its details.[17] The securitization script is dynamic yet teleological. According to the view of many mainstream financial economists, as securitization proceeds, a country's political economy will shift from bank-based finance to competitive, securitized capital markets. The convergent trajectory of this teleology is imagined to be leading toward the Anglo-American model. [18]

IV. A Puzzling Contrast in Responses to Securitization

In the early 1990s, when China and India undertook securities reform in earnest, their financial systems initially shared a comparable structure of financial governance dominated by directed credit. Yet, a decade later, Indian securities finance exhibited a high degree of substantive market and regulatory reform, both relative to other sectors and factors within India, and relative to China and other DTEs. By

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[15] The terms "script" and "enactment" are common terms of art in the economic and political sociology. A "script" is an intersubjective set of expectations about the actors and practices appropriate to a given field of social action. In dealing with complex social interactions in different fields of human endeavor, economic sociologists conceive of actors as using readily available scripts, often provided by governments or professionals, to structure their interactions (DiMaggio and Powell 1983; Jepperson 1991). See footnote 17 below. Also, see chapter 1, footnote 4.

[16] Bondholders have first claims on a firm's assets in the event of bankruptcy, but have no direct voice in the firm's governance. Holders of equity have only residual claims on bankrupted firms, but are entitled to dividends and (in the securitization script) a voice in corporate governance.

[17] "Enactment" refers to the execution of that script and the adaptation and learning that occurs in the course of that execution (Abolafia and Kilduff 1988; Weick 1987).

[18] In over seventy interviews with Chinese officials and experts, only a few had thought about this long-term consequence of securitization. Some argued that the Anglo-American model was a good outcome because, they reasoned, a more bank-based system would lead to higher industrial concentration (Cheabol or Keiretsu-like groupings), Author's various interviews, 10/1999 to 10/2001.

contrast, Chinese securities finance displayed a high degree of superficial convergence with global norms in the technical infrastructure of securities finance, but a low degree of substantive market and regulatory reform – both relative to other sectors and factors within China, and relative to India and other DTEs. Table 1-2 provides a selected summary of reform outcomes in various sectors in the two countries.

These different patterns involved distinctly identifiable regimes for the creation, circulation, and use of securities, with China developing a pattern I call *discretionary involution,* while India developed, to use a similar idiom, a pattern of *constrained evolution*.

In the China of the late 1990s, the social, market, and regulatory contexts for products, services, and transport were vigorous and broad in scope. For this reason, China has often been viewed as an effective economic reformer. Yet, by the end of the decade, despite the attention given to the large capitalization of China's stock market (Asia's third largest) and the quality of its securities trading and settlement systems, the governance of securities finance had not evolved; it had involuted. Involution here means that the governance regime that emerged in securities finance was not vigorous and broad in scope, unlike the regimes in a number of other Chinese sectors, and that the old modes of financial governance that had characterized the directed-credit system were reproduced within the realm of securities finance.

Table 1-2:
Sectoral Variation in Reform Outcomes

	Substantive Governance Regime Change	Minimal Governance Regime Change
China	Agriculture Transport Manufacturing/Product Markets Power	Banks ***Securities***
India	***Securities***	Power Transport Telecom Petrochemicals

Following an initial burst of reform that dismantled the licensing system and encouraged competition in the early 1990s, reform in India's real (that is, non-financial) economy has been moderate, and in areas of organized labor and infrastructure has been quite slow. For this reason, India has been considered a mediocre reformer. But the pace and scope of reform in securities finance has been remarkable, with many observers calling it the most significant area of change in an otherwise tepid reform agenda. The scope of securities activities, the vigor of competition, the changed role of the state, and the participation of civil society (particularly associations and the media) have all been significant in securities finance. This is evolution, in contrast to China's involution.

V. The Dual Imprint Explanation

The explanation offered here for the variation in Chinese and Indian securities governance regimes uses what I call a dual imprint analysis. At each level (international and domestic) of this dual imprint analysis, China and India were mirror opposites, as Table 1-3 shows. At the international level, China's abundant inward foreign direct investment (FDI) and robust export-led growth produced a benign profile in that country's external macroeconomic juncture. This contrasted starkly with India's scarcity of FDI and anemic exports, producing a precarious profile. Precariousness in the balance of payments plus scarcity in the flow of capital equaled jeopardy for the Indian central state.

At the domestic level, in the realm of securities finance, the central Chinese state was constrained by other state actors in what I call the "intramural" dominant political coalition, and by the rigidity of state-socialist property rights. However, in India, the central state enjoyed relative autonomy from the dominant political coalition

and room to maneuver within the flexibility of its inherited Nehruvian "mixed-economy" property rights regime.

In this analysis, domestic politics are dominated by struggles within the dominant coalition over the property-rights implications of securitization. The domestic-level process is a fundamentally political one because by revealing, specifying, and enabling the exchange of property rights, securitization at a minimum puts pressure on, and at maximum fundamentally challenges, the prevailing definitions of property rights and the arrangements for their allocation in the organized economy. The politics of securitization are thus a struggle over those two issues. This struggle involves political contestation and institutional transformation. Its outcome is shaped by the configuration of each country's dominant political coalition and by the inherited institutions that define the property rights of the productive assets that are being securitized.

Table 1-3: The Explanation

	China	India
International Juncture	**I.** **Enabled** by *benign abundance* • benign balance of payments position • abundant capital • abundant foreign exchange	**II.** **Constrained** by *precarious scarcity* • precarious balance of payments position • scarce capital • scarce foreign exchange
Domestic Conditions	**III.** **Constrained** by • state dependence on *intramural* distributional coalition • rigid state-socialist property rights	**IV.** **Enabled** by • state autonomy from *tripartite* distributional coalition • flexible mixed-economy property rights

Where the Chinese central-state-elite was enabled by the benign abundance of its external macroeconomic conditions, it took advantage of those conditions, adjusting to the constraints imposed by the dominant intramural political coalition of other state actors and by the rigid structure of state-socialist property rights. This yielded China's *discretionary involution* pattern of securities governance. In contrast, where the Indian central-state-elite was constrained by the precarious scarcity of its external macroeconomic conditions, it was obliged to accommodate those constraints by exploiting its relative autonomy from the dominant political coalition and its margin to maneuver within the flexibility of inherited Nehruvian mixed-economy property rights. This yielded India's *constrained evolution* pattern of securities governance.

VI. Some Contending Explanations

As noted above, both India and China began the decade with similar developmental, state-led directed credit systems of finance. But by the end of the 1990s, the two were displaying evidence of variation in their responses to the conformity-inducing power of global techno-market and social forces. Local enactment of the increasingly shared global securitization script was not the same. What might explain this variation?

Within the existing corpus of social science theory, the possible explanations for these different securities governance regime outcomes in China and India may be divided into two general groups: those emphasizing international factors, and those emphasizing domestic factors. As mentioned above, on the international side, some of the arguments for how global forces shape domestic institutional development and policy change in DTEs, including economic governance regimes, emphasize the role of international markets, technological change, and an emergent world society. Other international or systemic explanations for domestic governance structures emphasize ideas or the interests of powerful global actors such as transnational corporations and hegemonic states like the United States. Among domestically focused explanations, arguments about relative state autonomy and/or differences in regime type are most commonly invoked to explain variation in national policy institutions or economic governance structures.

Many of these factors emphasized in the contemporary IPE and CPE literatures do indeed influence the securities governance regime outcomes in China and India. The merits of these arguments and their limitations in explaining the Chinese and Indian cases at hand are discussed further in chapter 3. However, the analysis I propose here offers a simple and more comprehensive explanation based on three

easily identified variables (one international, and two domestic): 1) the profile of external exposure; 2) the relative autonomy of the central-state-elite vis-à-vis the dominant coalition; and 3) the constraints imposed by the inherited structure of property rights.

Two important monographs have recently staked out the theoretical and empirical poles of the debate over the internationalization of finance and the domestic politics of financial governance. Examining the IPE and CPE of financial governance in Great Britain and Japan over the last two decades, Steven Vogel and Edward Laurence disagree over both the policy outcomes and the process behind changes in domestic financial governance prompted by the forces of financial globalization (Laurence 2001; Vogel 1996).[19] With respect to outcomes in the area of financial governance, Vogel finds divergent responses in the two cases, while Laurence finds convergence. Examining the key actors and processes driving institutional change, Vogel argues that it was governments, not interest groups – Laurence's favored actors – that drove change. Vogel believes it is the ideational "orientation" and institutional "organization" within the state that explains the different outcomes he sees in British and Japanese regimes of financial governance. By contrast, Laurence views the actual or potential threat of "exit" by mobile capital as driving the process of convergence in the two countries' institutions of financial governance.

The crux of their disagreement over outcomes can be explained by the distinction drawn by Vogel, between "liberalization" and "deregulation." Liberalization involves the introduction of competition and increasing privatization.

[19] Laurence's explanation relies on the mobility of capital when he argues the threat of "exit" leads to policies that favor the holders of mobile assets. This limits the generalizability of his thesis, excluding the many developing countries with closed capital accounts, including China and India. Vogel's ideational and organizational explanation is more portable. For arguments about capital mobility with more relevance to DTEs, see Winters (1996).

Deregulation involves the reduction of governments' instruments of distributive intervention in the economy. The two authors are not asking exactly the same question. Laurence blurs the boundary between liberalization and deregulation, measuring reform with reference to market changes. He therefore identifies convergence and similar outcomes in the Japanese and British cases when he observes significant *liberalization* in both countries. Vogel seeks to explain not only market outcomes, but also regulatory reform, identifying a "re-regulatory" option in which the common trajectory of liberalization in market outcomes does not exhaust the scope of his dependent variable, which includes institutional and organizational outcomes as well as market outcomes.

Comparing these two monographs helps locate the current study of financial change in India and China within this ongoing debate among students of IPE and CPE. The Britain-Japan comparison among OECD cases is not unlike the India-China comparison among DTEs, and a lesson can be drawn from these studies for the current work. Global market forces may explain convergence in market outcomes, but they are indeterminate in explaining political and governance outcomes. Consequently, when the scope of the dependent variable is expanded to include political as well as market outcomes, the case for convergence is harder to make. Furthermore, the Vogel-Laurence debate demonstrates that only by taking the whole economic governance regime (and not just market outcomes) as the dependent variable, is it possible to adequately explore the important issue of transformations in the nature of state-economy authority relations.[20]

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[20] Research on "marketization as state-building" is still under-developed. After Ikenberry's initial salvo (1988), Fligstein's work on "markets as politics" (1996; Fligstein 2001), and Padgett's research on the "co-evolution" of states and markets (Padgett) have now firmly established this as a promising research agenda. Vogel's work on finance and telecommunications sectors was valuable for OECD cases (1996). Chaudhury addressed some Middle-Eastern cases (1997), David Woodruff the Russian case (1999), and Lu Xiaobo has begun looking at the PRC case (1997). The most comprehensive conceptualization and

The key difference between Vogel's and Laurence's lines of argument is the emphasis put on the role of global market forces: Do global forces act to impose conformity with a standard set of micro- and macro-economic structures of organization and governance (Laurence)? Or do they form a common stimulus to which states and other social actors respond in different ways (Vogel)? Because global techno-market and social forces (the *global script*) are indeterminate in explaining specific institutional outcomes (*local enactment*) at the domestic level, I agree with Vogel that these forces should be treated as stimuli provoking distinct national responses. For this reason, we must look elsewhere for explanations of variation in governance regime patterns. Proceeding from Vogel's insight, I therefore argue that the way countries respond to the stimuli of global forces depends on the nature of their junctures with the international economy. These can vary broadly, creating different incentive structures for powerful actors within those countries, particularly the central-state-elite.

VII. Explaining Securitization Using the Dual Imprint Approach

This exploration of the securitization process in DTEs is a new contribution to the study of both international political economy (IPE) and comparative political economy (CPE). These fields have not paid adequate empirical and conceptual attention to the marketization of finance associated with the growth of non-banking finance in general, and securitization in particular. Furthermore, while finance is often considered the most internationalized of economic sectors or factors, the politics and institutions of finance have generally been taken as an independent variable – a factor explaining other outcomes – not as something itself to be explained. The increasing

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empirical exploration to date is Schamis' exploration of the issue in Latin American and East European cases (2002, particularly Chapter Eight).

use of securities in finance, both within countries and across borders, has been one of the most dramatic changes in this expansion of global finance, particularly in the last twenty years (Sobel 1999). Securitization, wrote political scientist Ethan Kapstein in one of the earliest discussion of this issue among OECD countries, was eroding the longstanding "distinction between lending and underwriting," thus blurring the distinction between commercial and investment banking (1989, 325).[21] Yet, since Kapstein's article, few published books or articles have specifically addressed the international or comparative political economy of securitization in general, and in DTEs in particular.

A. Comparative and International Political Sociology of Financial Change

Research on the *politics* of financial policy in DTEs continues to be scant for a number of reasons. First, research, policy-practice, and popular discourse are dominated by a focus on the debate over finance and economic performance (Levine 1997; Rajan and Zingales 1998). The selective focus on how financial structures contribute to overall welfare, and the impediments to allocative efficiency, tend to crowd out other non-economic questions such as the political causes and consequences of financial change. Second, the increasing complexity of financial transactions and technologies tends to deter non-experts from attending to the political and social dynamics of financial policies and practices. Finally, the decade of securitization's most rapid global expansion coincided with, and indeed was strongly inspired by, the ICE (information, communication, and entertainment)-driven supercharged American bull market of the 1990s. In this context, the irresistible specter of comparison with U.S. financial markets limited the contemplation of alternative objectives for, and

[21] "Underwriting" here refers to the issuance of securities, not bank loans.

approaches to, financial organization. The post-2000 decline of the U.S. stock market, followed by the Enron-initiated parade of corporate scandals in the U.S. and elsewhere, opened analytic space for a more sober and open-ended (that is, less teleological) analysis of securitization and the organization of financial governance.

This neglect is serious for macro-concerns in political sociology and political economy. Understanding the politics of securitization in financial change is important because, at the broadest level of interest to students of politics, finance is crucial to how authority and power are exercised in any economy. Finance is a form of capital. Proprietary rights such as the ownership or "bonding" conferred by corporate shares and bonds are also a form of capital. By virtue of their fungibility, securities encompass both of these properties. Securities are thus the ultimate capitalist institution. We cannot understand varieties of capitalism without understanding variation in the way securities finance is governed in different polities. Furthermore, until recently, there has been a similar neglect of the "rise of the regulatory state" in DTEs. The analysis of securitization and financial governance offered here revises our understanding of market regulation and state-economy relations. In the tradition of Polanyi, this comparative analysis of securities finance in China and India explores how shifts in the exercise of state authority in the economy – from distributive intervention to procedural supervision – present a challenge to the neo-classical economic conception of state-economy relations as broadly zero-sum.[22]

The neglect is also serious at the meso-level of research, for without an understanding of the securitization process, it is difficult to make sense of many important changes taking place in DTEs around the world.[23] Specifically,

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[22] Nee (1989) states the clearly the neo-classical view. Szelenyi (1996) responds with a perspective inspired by Polanyi's "double movement" argument, and a case for the importance of sectoral variation in state-economy relations.

[23] The variety of countries where this process is important could, in principle, include the whole universe of DTEs, as well as mature capitalist economies. However, it is perhaps most relevant to

understanding the politics of securitization in DTEs is valuable for comprehending other key areas of contemporary research in these countries, including privatization, industrial organization and the conduct of economic adjustment, firm-level organization (including "corporate governance"), and the degrees of economic inequality and volatility.

B. The Asset-Class/Financial-Position Matrix

But understanding the politics of securitization in DTEs is not easy. The recent rate of financial change in developing countries has been rapid. The protean character of the actors and institutions in transitional economies further complicates the task. Part of the framework I present here is specifically designed to address these challenges and to help clarify the implications of securitization, general and specific, enumerated in the previous paragraph. This part of the framework – the asset-class/financial-position matrix – is a new approach I use to analyze the process of political contestation that influences securities governance. The matrix, displayed in its simplest form in Table 1-4, relies on the highly formulaic distinction in securities finance between, on the one hand, the different asset-classes of equity (stocks) and debt (bonds), and on the other hand, the different financial positions created by the structural distinction between those who issue securities (issuers) and those who invest in them (investors). That is, what is the financial position of a given financial actor with respect to a security? This is similar to other analyses in political economy and

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formerly planned DTEs that possess large industrial, commercial, and financial enterprises that could form the basis of an independent national securities market that would be economically viable on its own. Good examples include Brazil, Russia, and Korea. For a discussion of countries that wish to have securities markets despite a small industrial and financial base, see Lavelle (1999).

economic sociology that derive expectations from the distinction between seller and buyer, or between producer and consumer.

Issuer-investor relations are important in determining the kind of capitalism a given polity will produce. The matrix helps identify the "what, who, and where" of securities finance. The matrix is thus a simple idea that helps categorize varieties of

Table 1-4:
The Asset-Class/Financial-Positions Matrix:
Analyzing the Domestic Politics of Securitization

	Issuers	Investors
Equity	**I** **• Enterprise Finance** **• Wealth Capitalization** **• Privatization**	**II** **• Shareholder Rights** **• Industrial Organization**
Debt	**III** **• Enterprise Finance** **• Public/Fiscal Finance** **• Monetary Policy**	**IV** **• Bankruptcy/Creditor Rights** **•Interest Rates/Fixed Returns**

capitalism. As the Table shows, the matrix helps to identify and map many of the issues that influence the character of a capitalist economy, including *inter alia* external enterprise finance, privatization, mergers and acquisitions, and bond-based public and private finance. It offers a new way of analyzing variation in the authority structures and social relations that govern securities' finance and productive assets (from tax revenues, to factories, to telephone receivables) in any country. This matrix contributes to the overall framework I use to explain the differing political responses to securitization that are shaping the Chinese and Indian varieties of Asian capitalism.

The overall framework I use supplies guidance for a structured-focused comparison that can be used to conduct a process-tracing analysis of the politics of securitization across case studies. It involves a two-level analysis that explicitly links theoretical and empirical concerns central to contemporary international political economy literature with those at the core of the comparative political economy literature. From IPE, I borrow a cognizance of the relative power of domestic and international forces, and a focus on how countries' connections to the international economic and social systems affect domestic political outcomes.[24] Analytically, I draw on a venerable tradition in IPE research that relies on varying national responses to common exogenous stimuli as a comparative framework.[25] In this case, the stimulus was the expansion of global finance in general, and securitized finance in particular, during the late 1980s and early 1990s. I also look to parts of the IPE tradition in considering the relative importance of a country's juncture with the world economy as an explanatory variable.[26]

I link these IPE considerations with two factors central to many comparative politics analyses: distributive coalitions and property rights.[27] Furthermore, in focusing

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[24] For this I draw on Katzenstein (1985) and Meyer (Meyer 1980).

[25] The key empirical works in this lineage are Katzenstein (1985) and Gourevitch (1986). Conceptually, Frieden and Rogowski (1996) and Garrett and Lange (1996) did much to clarify and formalize this tradition. The schema presented in Chapter 2 summarizing my argument is a modification for securitization of Garrett and Lange's modeling of this tradition.

[26] Key works that pioneered this approach are Gerschenkron (1962 (1951)), Kurth (1979), Skocpol, and Chaudhry (1989).

[27] For an overview of comparative politics schools and methods, see Philippe C. Schmitter's article, "Comparative Politics," in Joel Krieger et al, eds. (1993). On political coalitions, the *locus classicus* is Olson (1982). Research on the political sociology of Indian economic policy and institutions by Bardhan (1984), Rudolph and Rudolph (1987), and Herring (1999) have relied heavily on the structure of distributive coalitions as an explanatory variable. With China's opening in the 1980s, the scope of coalition analysis expanded from the factional bases of economic policies and institutions, to include explanations that used more general "corporatist" or particularistic interests (involving provinces, ministries, sectors, and the military) in the work of Lieberthal and Oksenberg (1988), Shirk (1993), and Zweig (2002). Contemporary empirical research on the comparative politics of property rights is a relatively recent phenomenon drawing on the experiences of developing and transitional economies in the 1980s and 1990s. See Weimer (1997) and Murrell (2001). China has received some of this attention (Oi and Walder 1999), but India practically none (Austin 1999). This new research attention to property rights in comparative politics has its roots in the economic history of Douglass North (1990).

on the institutions of economic governance, I engage the key comparative politics theme of state authority in analyzing the *quality,* not just the *quantum,* of state power. This is an organic result of analytically locating the state within an ensemble of components, including the market and civil society, which govern economic action. I thereby address what is considered by two eminent surveyors of the field to be the major lacuna in research on the comparative and international political economy of finance. Political scientist Stephan Haggard and economist Chung H. Lee lamented that studies have "not bothered to ask whether financial market policy was in fact a result of political pressures or whether it sprang from economic constraints or the projects of state officials." The failure to treat financial institutions as outcomes is responsible for a major blind spot in contemporary research in the comparative and international political sociology of finance: "The inability to account for variations across countries in terms of the extent or nature of government intervention in financial markets" (Haggard and Lee 1993, 8-9). This framework begins to address this failure by taking the institutions of financial governance themselves as outcomes to be explained. It presents a unified two-level analysis (international and domestic) that includes a new way of unpacking the "what" and the "where" in the domestic politics of securities finance: the asset-class/financial-position matrix.

VIII. The Rest of the Argument in Brief

In chapter 2, I evaluate the process of securitization in light of existing arguments about the relationship between the state and financial structure.[28] This leads

[28] These arguments are part of an identifiable corpus of IPE and CPE research on finance, backwardness, and "developmental states." The lineage began with Gerschenkron (1962 (1951)), was

to some suggestions for a revised and more coherent analytic framework for the study of the state and finance in the political economy of late development, incorporating the advent of securitization as a politically consequential phenomenon.

This revised framework is the core of chapter 3. It is the dual imprint framework that links the elite politics of a country's external economic exposure to domestic coalition dynamics and property rights structure using the asset-class/financial-position matrix (AC/FP matrix) shown in Table 1-4. While the dual imprint framework bridges the international-domestic divide, the AC/FP matrix is a novel tool for analyzing the "what and where" in the political sociology of securitized finance in any country. That chapter begins by carefully defining economic governance regimes – the outcomes to be explained in this thesis. It then briefly discusses how those outcomes were coded. Before concluding, I place the dual imprint explanation that I offer in the context of other possible explanations. I then conclude chapter 3 with a discussion of research and method-related issues.

Chapter 4 deals with comparisons and antecedents. To begin, the chapter describes the use of financial control by developmental states. It considers why and how the model of *dirigiste* socialism came to rely on financial control in the economy and society. The discussion is a critique and modification of Kornai's stylized model of the socialist. The case is made that China and India are nevertheless comparable cases based on the similar political and developmental logic of centrally controlled finance and directed-credit. Chapter 4 then outlines and compares the landscapes of Chinese and Indian financial prior to the 1990s. Neither country started from scratch with securitization in the early 1990s. During the post-Independence years, the Indian

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extended in general IPE terms by Gourevitch (1978), and elaborated with reference to specific CPE cases in Asia, Europe, and Latin America by Johnson (1982), Zysman (1983), Amsden (1989), Wade (1990), Maxfield (1990), and Woo-Cumings (Woo 1991). Recently, the research agenda has been revived with a general treatment from Woo-Cumings (1999) and Boyer (2000), and CPE cases from Vogel (1996) and Dore (2000).

state had colonized or marginalized securities finance; and during the 1980s, China initiated a haphazard set of experiments. Identifying the key elements of these antecedents is essential to understanding the politics of securities finance during the securitization boom of the 1990s. Circumstances across some components of the governance regime – including the state and market – are surveyed. This is an important preface to the analysis of incentives analyzed in chapter 5 and the outcomes explained in chapters 6 and 7.

At the international juncture, how do we trace the molding of central-state-elite preferences by the country's profile of external economic exposure? This requires a historical and sociological analysis of the events, conditions, ideas, and institutions that constitute the preference-formation relationship between that elite and the profile of external exposure. Such an analysis is the subject of chapter 5. It draws on external macro-economic data, intensive interviews, a range of press reports, and other expert opinion and secondary material.

Chapter 6 draws on a comparative case study of stock exchange development.[29] At the domestic level, how do we trace the formulation of central-state-elites' strategies to satisfy the preferences identified in chapter 5? For that, we need a framework to analyze how they pursue their preferences in interaction with the dominant political coalition and the prevailing structure of property-rights. I offer such a framework in the asset-class/financial-position matrix. Chapter 6 focuses on unpacking and deciphering the politics of equity finance in the two cases. It examines the top row of the AC/FP matrix – the equity asset-class – demonstrating how the interests and actions of issuers and investors (in the field of equity assets) are mediated by coalition dynamics and property rights structures in their influence on state

[29] In later versions it will include similar case comparisons of mutual funds, brokers, shareholder/investor rights, corporate governance, and industrial organization (which I define to include the equity securities implications of and for competition, mergers and acquisition).

strategies and the securities governance regimes they produce strongly. Chapter 7 does much the same thing for bonds.

In conclusion, I address two particular extensions of the framework and concepts introduced in the previous seven chapters. First, I explain how the politics of debt, that is, bonds, could be analyzed using the asset-class/financial-position matrix. This has particular relevance for the development of what financial policy experts call "credit culture," which some consider to be a polite reference to *rentier* power. Management of enterprise failure, bankruptcy, and the degree of assistance creditors can expect from the state are crucial in shaping the business climate of any country and the character of its capitalist institutions. The right of sub-national political units to use bond finance, and the power of the central government to use bond finance both for the central fisc and for the management of monetary policy, all shape the nature of center-local or federal relations in any country. Second, based on the political challenges of securitized finance discussed in chapter 2, I explore the transformation of state authority in the economy. This section elaborates on the conceptual distinction between distributive intervention and procedural supervision and how state authority can vary across economic sectors and factors. Finally, I conclude the analysis with a consideration of how the contrasting Chinese and Indian experiences of the 1990s hold surprising implications for the future: China's seeming advantages and strong economic performance may undermine its future, while India's disadvantages and poor economic performance perhaps hold out unexpected promise.

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Chapter Two

LATE DEVELOPMENT, SECURITIZATION, AND STATE AUTHORITY

As early as the mid-18th century, Montesquieu identified the challenge of securitization for state authority when discussing how political coercion led to the creation of the earliest securities. In Book XXI of the *Spirit of the Laws,* he explained the medieval European invention of bills of exchange, the first known tradable securities. "We owe…to the avarice of rulers," wrote the French baron, "the establishment of a contrivance (bills of exchange) which somehow lifts commerce right out of their grip. Since that time, the rulers have been compelled to govern with greater wisdom than they themselves might have intended" (Montesquieu et al. 1989 (1748)). Here we have one of the earliest analyses of the power of financial mobility and capital's "structural power" vis-à-vis the state (Gill and Law 1989; Winters 1994).

The inherent "marketness" of securities-based finance relative to banking renders the hierarchical character of state intervention in securities finance both more transparent and more difficult. Securitization therefore has political effects, and as such becomes both an instrument and an object of political contestation. This highlights one of the puzzles that this thesis addresses. Why, to use Montesquieu's word, were the Indians and Chinese differentially "compelled" with regard to securities finance? How was the Chinese central-state-elite able to "hack" this attribute of securities finance that "compelled" so many other states, including the one in New Delhi, to "govern with greater wisdom than they would otherwise have intended"? To address these empirical questions, it is useful to understand what securitization is, what is at stake economically, sociologically, and politically in the process of

securitization, and finally how it came to developing and transitional economies (DTEs).

The spread of securities finance is one part of the increasingly popular, yet still controversial central idea of late capitalism: that wherever possible, allocation of economic factors should be determined in the market. Securitization is a highly formulaic process associated with the application of this principle. Understanding how states respond to the spread of securitization and to the need to regulate securities finance requires 1) an understanding of the internal logic of securitization's formulaic doctrine, and 2) an understanding of the political consequences of that doctrine's application to the distinct structures of particular developmental states' political economies. This chapter addresses each of these requirements in order.

The chapter introduces the reader to securitization, frames it in the history of developing and transitional economies, and highlights its implications for domestic politics and state authority in DTEs. The first section defines securitization and discusses the theoretical and conceptual terrain in which it fits, emphasizing its commodifying properties. The next section discusses the progress and potential effects of securitization in those countries of the developed world where it where it has progressed the furthest. Section three outlines the role of finance in "developmental states." This is important for understanding how securitization might affect political action and state authority in countries like China and India, which are prominent descendants of the "developmental state" lineage. Finally, the last two sections examine, in conceptual terms, how securitization affects the political control of finance and, by implication, economic action in the organized sector of an economy.

I. The Process of Securitization

Financial globalization includes at least four ongoing changes in the international economy that alter the "decision environments" and affect the "alternatives and incentives" faced by investors and issuers (that is, those raising funds). These changes, in political scientist Andrew Sobel's apt phrasing, "fundamentally transform the international financial environment" (Sobel 1999, 1). This transformation has been wrought by a tripartite combination of technological, market, and sociological factors. They include: 1) Capital's increasing international mobility; 2) The participation of a growing number of states in global financial markets (particularly formerly socialist and/or autarkic states); and 3) The spread of formal securities finance institutions and practices (such as stock exchanges, the creation of companies limited by shares, and the use of bond finance) as common attributes of the modern nation-state and an internationally sanctioned set of norms. Together, the previous three changes are driving a fourth summary change: growing "securitization."

In this study, I adopt a broad definition of "securitization" based on the vernacular usage of the term among financial service providers and non-financial academic political economists. This definition has two parts. First, in broadest terms, securitization is the process whereby large portions of societies' productive assets located in the organized economy are commodified at the highest possible level. Claims on the value-creating assets that constitute firms are embodied in shares of equity, commonly called stock. Claims on flow assets, including firms' and governments' revenue streams, are embodied in debt obligations such as bonds and stocks. Both types of asset bundles are packaged into standardized, divisible, uniform, anonymous, tradable "instruments," and made available for exchange. These are

commonly referred to as securities.[1] This first part of securitization involves two steps. First, corporate or public funds are raised when securitized claims such as stocks or bonds are "issued" to investors, in what is called the "primary market." Second, these securitized claims circulate in a "secondary market" as they are traded among individuals or on a stock exchange.

A common indicator of securitization defined in this way is the market value of all stocks or bonds – referred to as "market capitalization" – as a percentage of a country's productive output (GDP). Figure 2-1 shows the *size* of securitization for equity securities (stocks) in a range of countries. Highly securitized countries like the United States, the United Kingdom, and Singapore have market capitalizations well above 100 percent of GDP. Countries that have only just begun to securitize, such as Poland, have capitalizations under 20 percent. Figure 2-1 makes clear that, with the exception of Japan, almost all countries' levels of securitization increased in the 1990s.[2] In the U.S. and other economies relying heavily on securities, debt finance through bonds (which includes government and corporate debt) is even greater than through stocks. U.S. bond market capitalization is more than twice its GDP. Compare that to India, where bond market capitalization is not quite half of GDP. Or consider China, where it is a minuscule 2 to 4 percent.[3]

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[1] This definition, which emphasizes "the emergence of intangibles as commodities," would also include the multitude of financial futures, options, and swaps that embody claims on stocks, bonds, or revenue streams (Sobel 1994). Though trade in these *derivative instruments* ("derivatives" for short) now dwarfs the trade in "real" securities, they are not addressed directly in this study.

[2] These data are from the World Bank's World Development Indicators 2002 (Bank 2002b). China's negotiable market capitalization is included because more than two-thirds of China's equity is held idle under state control and does not trade. These data are from the (Commission 2001).

[3] China's small debt market capitalization is explained by the fact that most of the debt is hidden away in that country's (technically insolvent) state-run banking system (Lardy 1998). For U.S. markets, see the Bond Market Association of America (2003); for China, see the CSRC Yearbook (2001); and for India, see Tahir (2003).

Securitization also refers to change in a country's "financial structure" (Demirguc-Kunt and Levine 1999).[4] As formerly planned economies have marketized their financial systems, there has been a shift in the balance of their financial structures. In this process, the role of mediated lending by banks and long-term credit institutions diminishes relative to the role of "securitized" finance provided directly by investors to issuers of stocks and bonds. Analyses of financial structure commonly distinguish between "bank-based" systems dominated by "mediating" lending institutions like commercial banks or long-term credit institutions, and "market-based" systems that include a large share of "direct" or "unmediated" securitized finance (Zysman 1983).

The equally infelicitous term "disintermediation" is also used to refer to this process, because it involves cutting out the role of commercial banks as "mediators" who stand between savers and borrowers, shouldering the default risk that borrowers may not repay their loans, and charging a fee (in the form of the spread between interest rates on deposits and loans). Securitized finance is "disintermediated" because investors incur this financial risk themselves when they buy stocks or bonds from issuers (Goodhart 1987).[5] Increasing securitization or disintermediation worldwide is slowly eroding the traditional distinction between commercial and investment banking.

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[4] This is a macro-economic definition of "financial structure" not to be confused with the firm level of use of the term, referring to the right-hand side of a corporate balance sheet.

[5] This terminology is mildly disingenuous because in the real-world practice of securitized finance, investment banks (what Europeans call "merchant banks") actually "mediate" between issuers and investors, often bearing significant amounts of financial risk (referred to as "underwriting risk"), and charging accordingly.

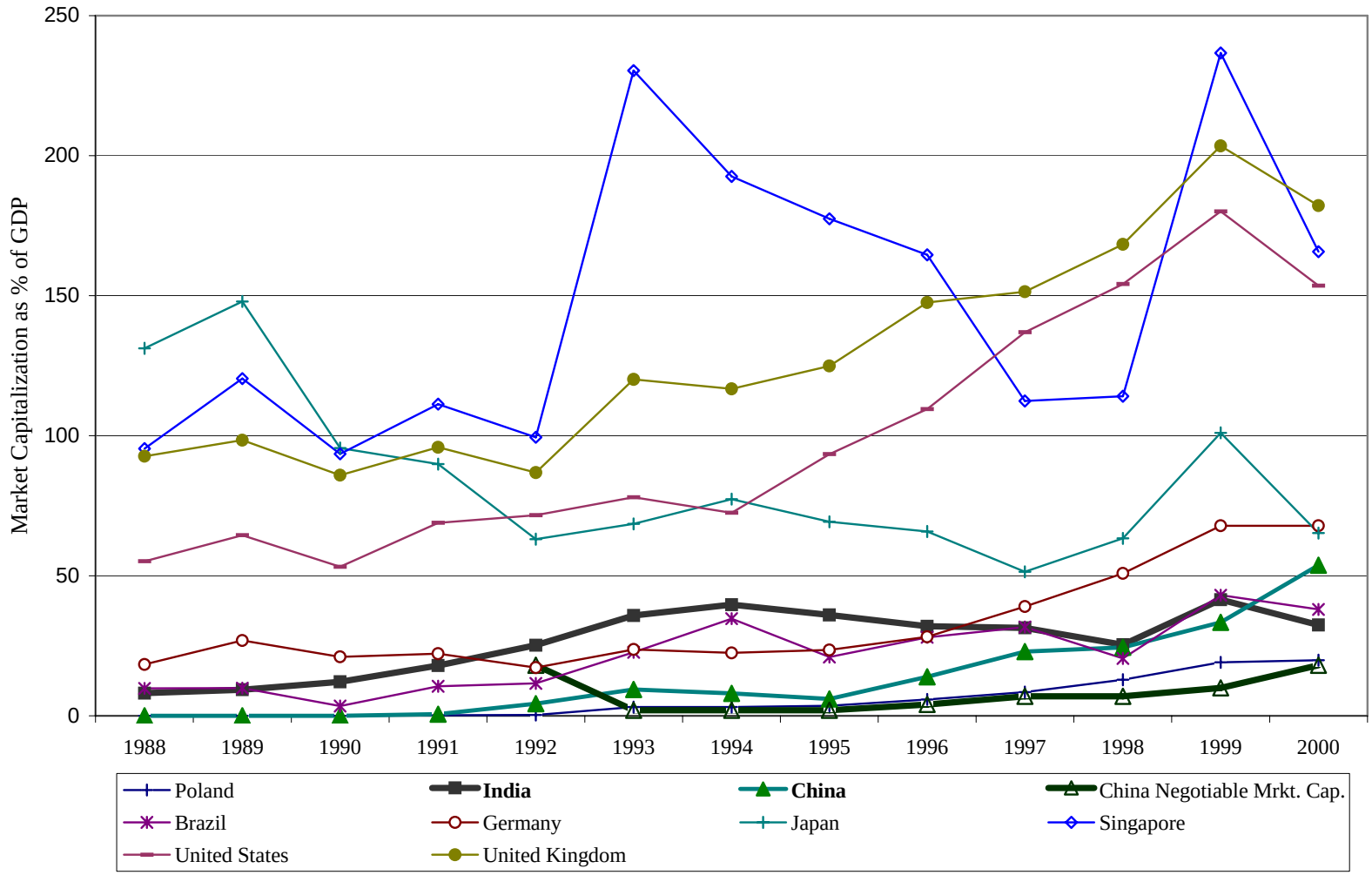

Figure 2-1: The Size of Securitization (stock market capitalization as a percentage of GDP)
World Bank, 2002. China Securities Regulatory Commission, 2002.

There are a number of indicators for financial structure that measure the size, activity, and efficiency of bank finance relative to securities finance. Table 2-1 displays the results of a composite indicator of "financial structure." Developing and developed country categories are presented separately, ranking countries from least to most bank-based and from least to most market-based within each country-category of development.

Table 2-1:
Country Classification of Financial Structure[6]

	Developing and Transitional Economies	Developed Economies
Bank-based financial systems	Egypt Indonesia China[7] India	Italy Japan France Germany
Market-based financial systems	Peru Brazil Mexico Philippines	Great Britain Singapore United States Switzerland

Confirming the first-order indicator of securitization based on market capitalization presented in Table 2-1, the United States, the United Kingdom and Singapore appear as "market-based," highly securitized financial systems. Germany, France, and Japan are considered typical examples of bank-based systems among developed countries (Allen and Gale 2001). Brazil is the case most often cited as an example of "market-based" finance among developing countries. This classification, however, is as much due to the fact that while its banking system is *not small* (as in the Philippines which is also classified as "market-based"), Brazilian banks are relatively *inactive* in terms of new lending or refinancing (Demirguc-Kunt and Levine 2001,

[6] This table is based on Demirguc-Kunt and Levine (2001, 121).
[7] China does not appear in Levine's database, but is commonly considered a bank-based system.

108). China and India have huge banking systems with vast reservoirs of deposits and consistently high savings rates.[8] This begs the questions if, and how, these funds will shift from banks into securities.

This is precisely the institutional and policy challenge faced by the central elites of the developmental states in China and India during the 1990s and beyond. The graph in Figure 2-2 graphically crystallizes this challenge. It is a version of an overhead slide presented to leading members of the Chinese financial community at a Beijing symposium on China's capital markets in July of 2001. The symposium was sponsored by the once-powerful State Council Committee for Restructuring the Economic System (SCRES, known as the *Tigaiwei*) in collaboration with the top French investment-banking house BNP-Paribas. SCRES was a key agency in formulating and implementing the central state's governance of securities finance as early as 1989. The author of the presentation in which this slide appeared was Chen Xingdong, BNP Paribas' Chief Economist for China. Chen had formerly worked at SCRES in the agency's early years. His presentation, like that of many China-oriented investment bankers during the late 1990s, highlighted China's persistent robust economic growth, while minimizing the many structural problems in securities governance identified later in this thesis.[9]

[8] In the 1990s, Chinese saved over 40 percent of GDP yearly, Indians over 20 percent (Bank 2002a).
[9] During this period, other major investment banks such as Morgan Stanley and Goldman Sachs hired well-connected Chinese to guide their Mainland operations. Less than a year after this symposium, BNP Paribas became the first truly foreign investment bank to win a rare and much coveted license for operating a joint venture investment bank serving clients interested in foreign listings.

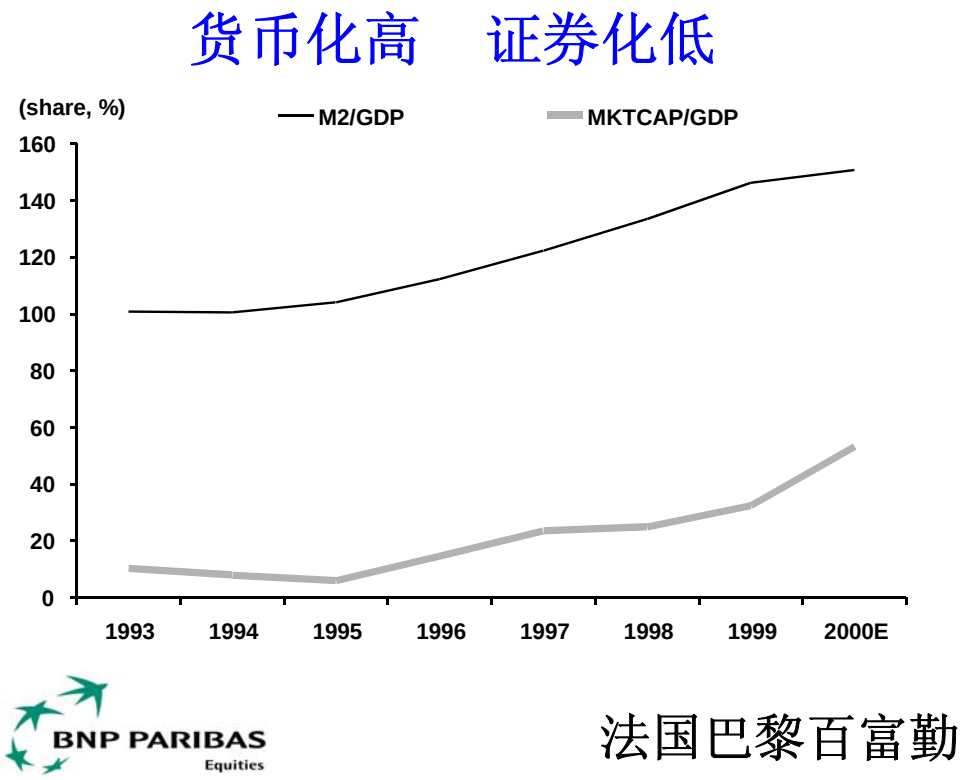

Figure 2-2:
Trading Places:
"Monetization" and "Securitization" in China's Developing and Transitional Economy
BNP Paribas, 2001

The slide depicts very succinctly the central question of securitization in China and India. In Mr. Chen's rather imprecise yet provocative investment banking lingo, the top line of the graph indicates "high monetization" (*huobihua gao*) measured as the ratio of money and "quasi-money" (made up largely of banking deposits, and known as M2)[10] to national output (GDP). The bottom line, "low securitization" (*zhenquanhua di*) displays the ratio of stock market capitalization to GDP (the same measure used in Figure 2-2 above). The point of this slide was to invoke the prospect of the structural shift in Chinese finance were the two lines to "trade places," with the M2/deposits funds that constitute the "high monetization" flowing into securities and shifting the "low securitization" line upward, eventually inverting the positions of the two lines.

The next slide in the presentation elaborated on this prospect, clarifying why the audience should be interested. The flow of Mr. Chen's presentation followed the not uncommon argument that, as financial systems develop, they will approach the Anglo-Saxon "market-based" model, and securitization will overtake monetization. A selection of the data from this second slide (plus Brazil, South Korea, and the Philippines) is shown in Figure 2-3.

[10] M2 is technically defined as money and quasi money comprising "the sum of currency outside banks, demand deposits other than those of the central government, and the time, savings, and foreign currency deposits of resident sectors other than the central government" (Bank 2002b).

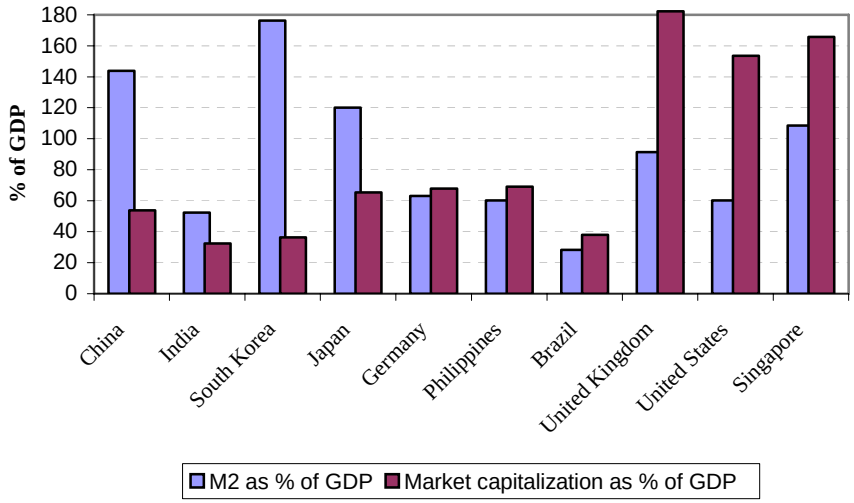

Figure 2-3:
Securitization Teleology?:
M2 to Market Capitalization for Selected Countries
Source: World Development Indicators (Bank 2002b)
German data are estimates from Yu (2001)

At the left of Figure 2-3, the late industrializing, directed-credit developmental states like China, India, Korea, and Japan all record "monetization" exceeding "securitization." At the right of the figure, highly developed and Anglo-Saxon cases like the U.K., U.S., and Singapore all demonstrate the reverse. The great attention now given to this potentially shifting locus of financial activity from banks to securities is not just a technical matter. There is also considerable money to be made in creating these new securities, bringing them to market, and managing them. The distance between the top and bottom lines of the graph in Figure 2-3 and the vision of their trading places in China, India, and elsewhere among "emerging markets" quickens the pulse of investment bankers and financial service providers. But it is also a political predicament for central-state-elites, since this shift represents a challenge to the matrix of financial resource distribution and the structures of power associated with the developmental state's directed credit system – that is, in short, coalition politics. Moreover, the shift also threatens to refashion the ways in which property rights claims over major industry are constituted and exercised.

II. The Economic, Social, and Political Dynamics of Securitization

It is hard to dispute economists' claim that, relatively speaking, modern electronic securities exchanges are perhaps reality's closest approximation of the "perfect market" envisioned in economic theory (Bernstein 1990).[11] Already, much

[11] This claim is based on the low transaction costs of trading securities and the uniformity of the units being traded (stocks or bonds). The exchange of financial assets like securities as digital information involves very little cost and friction as compared to the exchange of merchandise, labor, or services. The modern digital market for stocks is perhaps the closest approximation of the "perfect market" envisioned in economic theory (Fama 1991). The dominant theory in financial economics is the "efficient market hypothesis" (EMH). The EMH is applied to the market for securities and holds that because transaction costs are low, information is abundant, and competition vigorous, the prices of securities will tend toward their "true" fundamental value. While there are many trends in real securities finance that persistently violate the pristine theoretical expectations of the EMH, it is hard to dispute

research has focused on the importance of electronic technology in the growth of global finance, but little attention has been directed to the variable impact of electronic technologies on different finance sub-sectors, and the attendant *political consequences* of that variability.[12] Key to the politics of securitization is the technical fact that the digital revolution favors securities finance over bank-mediated loan finance (Mayer 2002).[13]

Digital technology lowers costs, facilitating payments and insuring banks' survival as financial service providers generally. However, it does little to change the process and cost structure of scale lending, which entails independent risk-evaluation and project monitoring by the lender. At the same time, it decreases the advantages previously enjoyed by those big banks that assembled the largest lending deals.[14] By contrast, for securitization, digital technology dramatically reduces the cost structure and process, making the issuance, trading, and settlement of securities significantly cheaper and faster than in the era of paper-based share and bond certificates. Banks

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economists' relative claim that much of the time, modern, digital securities markets are purer realms of market action than almost any other arena of exchange.

[12] Digital automation helps securities markets to further approach "perfection" in several ways. It reduces transaction costs, increases transparency, improves price information (making information availability more "symmetrical" among market participants), and homogenizes the interpretation of that information among participants. [I think I would combine this with the previous note so as to avoid too many footnotes in one paragraph]

[13] As the cost of information exchange declines and its speed increases, "insider" advantages of banking relationships are reduced. Similarly, as the cost of computation necessary to create and evaluate securities products such as stock indices and derivatives pricing declines, the utility of these instruments rises. The classic statement of this technological element in financial change is Richard O'Brien's 1992 monograph. "The communications revolution," he wrote, "alters the roles of different financial intermediaries by encouraging securitization…The grip that banks have over the credit assessment process has been reduced…In short, the new information technologies have reduced the barriers to entry into core areas of banking by improving the market's ability to process information and by cutting the costs of information processing" (O'Brien 1992, 13-14).

[14] There is the potential for technological determinism in this argument. At the level of transaction cost analysis, I am comfortable with such determinism when it is limited to comparisons between the costs and benefits of disintermediated securities finance and monitored bank-mediated lending (Allen and Gale 2001) But for a broader understanding of securitization, I think that economic and sociological factors must also be considered.

themselves therefore rely increasingly on securities and, indeed, the traditional process of loan syndication is steadily giving way to securitization.[15]

From a sociological perspective, the "marketness" of a transaction depends on the degree to which affective ties or authoritative relations play a part (Callon 1998). Comparing financial sectors, the trading of securities on an electronic exchange is fundamentally a more marketized process than is bank lending.[16] The existence of a liquid secondary market imposes a form of market discipline on the securities industry that does not exist for banking.[17] There is no secondary market for bank loans.[18] The secondary market in securities contrasts fundamentally with non-securitized credit lending due to the effects of potentially large numbers of participants and the presence of continuous, anonymous trading.

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[15] This trend has driven the erosion of the Glass-Stegall-like segmentation of finance in the Anglo-American context, pushing banks to maximize scale economies in the provision of financial services, even while fighting for access to a piece of the securitization action (Barth 2000).

In the PRC and India, automation of the securities industry has been implemented in a severely compressed time frame. In 1990, both countries were still conducting paper-based trades of share certificates and bonds, and neither of them had centralized depository, clearing, or settlement systems. The low transaction-cost effects of automation therefore only began to "bite" in the latter half of the 1990s. By contrast, these transaction-cost effects of automation were already apparent in the U.S. financial system in the late 1970s, provoking banking interests to urge the U.S. Federal Reserve to undertake the *de facto* dismantling of Glass-Stegall segmentation that began in the 1980s (Barth 2000).

[16] Even where banking services are highly competitive and interest rate regimes free, bank-based finance is still less marketized than securities finance, because it is less anonymous, less standard, and the potential for liquidity much lower. However, it is important not to overstate [is that what you meant?] that even highly securitized financial markets (such as those in the U.S.) are still embedded in domestic and international social relations, which significantly influence the functioning of securities finance. In this regard, the primary market for securities depends heavily on non-economic factors such as affective networks and reputation in much the same way as bank-mediated loans. A number of popular studies illustrate the dense "social" nature of securities finance in the U.S. (Burrough and Helyar 1990; Chernow 1990; Lewis 1990). The "society" of securities financiers was also of great interest to Max Weber (Roth 2000).

[17] Not all secondary markets are liquid, a significant assumption central to my argument, requiring a caveat. This is why the definition of securitization employed here stipulates "the potential for liquidity."

[18] In China and India, markets for securitized assets other than stocks and bonds, things such as mortgage loans were only beginning to grow after 2000. But in the U.S. and elsewhere, assets such as credit card debt and telephone receivables are packaged as "securities."

A. Securitization as Meta-Commodification

Thinking about the "market value" of a country's capital stock and economic factors is important to understanding the implications of securitization. A country's stock of businesses and other income-producing properties (known as "capital stock") has a market value, which is the price paid if the entire capital stock were sold. Moving from the macro-level of a country's organized business and governmental sectors to the micro-level of individual firms and governments, financial economist Edmunds explains how securities "valorize" (impart a market price to) capital stock or revenue streams:

> The value of a manufacturing company, an electric power plant, toll road (or any revenue stream such as government tax receipts) is the price it will bring in the financial market. Investors pay higher prices for ownership rights that have wide appeal to potential buyers. A productive enterprise's listing of shares on the national stock exchange makes the shares easy to buy and sell and establishes the company's value. The liquidity makes the shares acceptable to banks as collateral for loans. Listing the shares gives some protection against abuses, which raises the value of the shares (Edmunds 1996, 119).[19]

Securitization is thus a way of creating a market for capital stock and for firms' and governments' revenue streams.[20] Viewed from this perspective, securitization may be understood as an extension of the familiar process of commodification.

Commodities are "objects, persons, or elements of persons which are placed in a context in which they have exchange value and can be alienated. The alienation of a thing is its dissociation from producers, former users, or prior context" (Thomas 1991, 27-28). Commodification is the process whereby social relations, knowledge, and

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[19] Liquidity is defined in two related ways. First, it refers to the degree of ease with which an asset (such as a stock or bond) can be converted to cash. Second, in the more technical definition used among financial economists, liquidity refers to the ability to buy or sell an asset quickly *and in large volume* without significantly affecting that asset's price (Downes 1998, 329).

[20] Government bonds can be understood as claims on tax receipts and other government revenue, and corporate bonds are claims on firms' earnings.

productive capacity are reduced to an exchange relation.[21] But securitization is not just an incremental *difference of degree* in the process of commodification. Rather, because it moves beyond the alienation or disembedding of objects and persons, it represents a significant, punctuated *difference of kind* in the process of commodification.[22]

Marx, Weber, Simmel, Polanyi and others examined the social and political consequences of the commodification of a country's economic factors and capital stock – land, capital, and particularly labor. But from this perspective, securitization is not just commodification: It is *meta*-commodification.[23] It is the highest possible level of commodification: the apex stratum of markets. A highly securitized economy creates a market for a huge proportion of the country's capital stock, social relations, and revenue streams in the organized economy. As such, securitized finance potentially represents a qualitative variation in the organization of national and international capitalism.[24] Societies' most productive and value-enhancing forces, and their largest revenue streams, are "captured" in the claims represented by securities. When they are packaged in units like stocks and bonds – which are divisible, standardized, uniform, anonymous, and easily tradable – securities have commodified

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[21] The securitization of a country's capital stock, as described above, links securities finance with the origin of the commodification concept in modern political economy. Writing in 1867, Marx suggested that "the wealth of those societies in which the capitalist mode of production prevails, presents itself as 'an immense accumulation of commodities,' its unit being a single commodity. Our investigation must therefore begin with the analysis of a commodity" (Marx 1990 (1867), chapter 1).

[22] As discussed below, the continental *Regulation* school has for some time been grappling with the concept of "financialization," which is similarly defined as the increasing commodification of equity and debt claims as securities, but with the addition that financial services and transactions associated with these claims represent an ever larger share of economic activity (Boyer 2000).

[23] The word "meta" can be as provocative as a toreador's red cape. In this case I refer not to "post-modern" discursive approaches to commodification, but rather to the classical political economy approaches represented in the work of Marx, Weber, Simmel, Veblen and, most importantly, Polanyi. The word "meta" here carries its conventional connotations of "later," "more comprehensive," and "at a higher state of development" (Language 2000).

[24] Stock markets are celebrated as the core of modern capitalism precisely because 1) they commodify everything, and 2) they are, as discussed above, the closest approximation of a "perfect" market available in reality (see note 11).

everything from factor inputs such as land, labor, and capital, to technology, brand recognition, management skill, distribution systems, and (in the case of government bonds) the governments' main revenue streams including tax receipts.[25]

It is important to note that these commodification effects impose their logic in any liquid secondary market for securities.[26] However, a wholly electronic secondary market, such as the screen-based trading systems that became increasingly common around the world in the 1990s, magnified these consequences of meta-commodification and shifts in financial structure toward securitized finance. Once the instruments (bonds or stocks) are created in the less-commodified primary market, the prospect of price-setting on a highly commodified secondary market such as a stock exchange imposes a level of market discipline qualitatively distinct from that found even in "hard-budget" banking systems with significant degrees of "arm's length" relations among government, finance, and commerce.[27]

B. Debates Over Securitization

There is agreement that the securitization process has progressed the furthest in the Anglo-American economies, and that it is a trend elsewhere in both developed and developing countries. Advocates of securitization emphasize its wealth-generating effects and its alleged growth-enhancing properties. Critics emphasize its tendency to concentrate wealth, disrupt non-market forms of social organization, and corrode republican institutions.

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[25] The revolution in derivatives has created securities that in turn commodify other securities (see note 1).

[26] Phone-based and "open-outcry" order systems can be highly liquid. The former are common in many bond markets, and the latter was in use in 2003 at the New York Stock Exchange. The existence of highly liquid, non-electronic exchanges is an important point of rebuttal against the charge of "technological determinism" occasionally leveled at arguments about securitization.

[27] For a discussion of how "fear" of secondary market dynamics influences firms and their investment bankers, see Burrough and Helyar (1990) and Fligstein, (1990).

1) Securitization and Finance-led Growth

Debate over securitization is not entirely new. In the field of economics, a related debate was waged among development economists about the sources of growth: Was it production-led or finance-led? As far back as the 1960s, Joan Robinson staked out her position against John Hicks in her famous remark, "where enterprise leads, finance follows" (Robinson 1962, 80). In the 1970s, some economists argued that "financial repression" was slowing growth in developing countries (McKinnon 1973; Shaw 1973). In recent years, there has been increasing empirical and theoretical fortification of Hicks' view that finance is not just "a side show," and that financial development can contribute positively to economic growth. The relative contributions to growth of securities-based ("disintermediated") finance and bank-based ("intermediated") finance as part of financial development are as yet uncertain (Allen and Gale 2001). Moreover, when the *characteristics* of growth are considered – how evenly it is distributed, for example – the debate is still messy and bitter (Henwood 1998).

Turning specifically to securitization, then, those who see it as a positive development tend to focus on the economic issues of growth and wealth realization. Among the cheerleaders for securitization, financial economist John Edmunds is surely the head. In a 1996 article in the journal *Foreign Policy*, he argued that:

> Securitization…has become the most powerful engine of wealth creation in today's world economy. Financial securities have grown to the point that they are now worth more than a year's worldwide output of goods and services, and soon they will be worth more than two years' output. While politicians concentrate on trade balances and intellectual property rights, these financial instruments are the leading component of global wealth today as well as its fastest-growing generator. Overall, securitization is fundamentally altering the international economic system (Edmunds 1996, 118).

2) The Socio-Economic Dynamics of Securitization

In the debate over securitization, some analysts prefer the less precise, but broader term "financialization" instead of "securitization" because it facilitates the inclusion of the customary, status, and demographic implications of the growing use of securities. Max Weber was one of the first to write about the political sociology of finance in his study of the German stock exchange scandals of 1890s. Weber was interested in the social structure of brokers and exchange participants, the modalities of "self-regulation," and the connections between finance and the real economy (Roth 2000). Today, this concern over the socio-political causes and consequences of securitization has made some strange bedfellows.

The best example of this is agreement on the dangers of securitization (they call it "financialization") between two elder statesmen of the Anglo-American Left and Right, respectively – Ronald Dore and Kevin Philips.[28] Dore sees financialization as the characteristic feature of contemporary Anglo-American "stock market capitalism" and the intrusion of financialization into Japan and Germany as a threat to those countries' "welfare capitalism." For Dore, the British leftist, the key features of the financialized Anglo-Saxon model are: 1) economic action determined more by competition and less by regulatory and customary governance; 2) finance-led growth and the ascendance of financial over fixed assets; 3) the ascendance of "capital" income over "earned" income; 4) the increasing social importance of securities, typified by securities finance becoming a leisure activity and a fixation of retirement planning; and finally, 5) the growth of the financial services industry and its appeal to a society's top talent (Dore 2000, 6).

[28] Long before Phillips' (2002) *Wealth and Democracy*, John Kenneth Galbraith had weighed in on this issue in his famous attack on wealth concentration and finance capital in the U.S. in "The New Industrial State" (1967).

American conservative Kevin Philips concurs with Dore in identifying and lamenting most of these elements. For Philips, "financialization" involves "securitizing…income and debt streams, becoming electronically dependent, and exalting the stock exchanges." The key turning point for Phillips' view was in 1995, when mutual funds' assets under management surpassed the quantum of deposits in U.S. commercial banks for the first time. The consequences of this, Phillips argues, are "record wealth concentration, and rising inequality," as well as the corruption of republican institutions as financial power steers American democracy toward the gratification of private interest and away from the achievement of public purpose.[29]

The economists' focus on the growth consequences of securitization intersects with social scientists' interest in the political and sociological causes and consequences, when we consider the possibility that different financial structures may deliver different types of growth – for example, high but unequal, or low and even – and that there may therefore be a policy tradeoff, or regulatory necessity, to be contemplated by financial institution builders. Increasing securitization may contribute to overall growth (Demirguc-Kunt and Levine 2001). Increasing securitization and the growth it delivers may come at the cost of increasing inequality and wealth concentration.[30] This is a concern that even the most ardent securitization enthusiasts acknowledge (Edmunds 1996, 123).[31]

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[29] In an argument reminiscent of Gilpin (1981). and Kennedy (1987), Philips later argues that the corrosive impact of financialization has contributed to the downfall of other great powers in history, particularly Spain, Holland, and Britain.

[30] Henwood (1998) and Phillips (2002) both document how securitization is certainly correlated with and very likely causes increasing wealth concentration. Since 1976, when American securitization took off following the 1975 "May Day" and National Market System reforms in securities finance, U.S. wealth concentration has increased monotonically. The U.S. is now the most unequal of OECD countries when comparing the wealth of the top quintile against that of the bottom quintile.

[31] The wealth concentration potential of securitization is a problem confronting many countries, particularly Russia and the United States. Dealing with the concentration of financial power has been a concern of analysts ranging from Marx, to Hilferding (1981 (1910)), to Drucker (1976), and was

C. Firm- and Government-level Dynamics of Securitization

As discussed in previous sections, securitization commodifies a country's capital stock. This is a macro-sociological effect. However, that commodification process also has effects at the micro-sociological and micro-economic levels, within and among firms. Economic sociologists analyze these effects by examining how inter-firm relations (competition and coexistence) and authoritative structures (state-cultivated institutions such as property rights, corporate law, and anti-trust regulation) influence the norms governing corporate action (Mizruchi and Stearns 1994).[32] It is here that the economic and political sociology of finance intersect with corporate finance, corporate law, and state power in debates over corporate governance, principle-agent theory, and economic performance.[33] The fundamental issues in this debate pertain to information symmetries, the management of potentially conflicting interests (those of owners and managers – outsiders versus insiders – or shareholders and "stakeholders"), and the organization within and among the firms that constitute an economy's most productive assets.[34] Empirical areas where these issues are observable – such as enterprise finance, wealth capitalization (both of which matter to issuers of stock), shareholder rights, and industrial organization (which matter to investors in stock) – are presented in the analytic matrix introduced in chapter 3 and examined in detail in chapter 6.

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recently the subject of a popular book *The Ownership Solution* by corporate governance activist Jeff Gates (1998).

[32] Fligstein calls the dominant norm governing corporate action among large firms in a given national enterprise system the "conception of control." In Fligstein's formulation, the conception of control is a classic sociological "collective representation" operating in the heads of those who control firms (insiders and outsiders alike), and shaping how those firms compete and cooperate (Fligstein 1990).

[33] On corporate finance, see Stearns (1986). On corporate law, see Sciulli (1999). On state power, see Schmidt (2003) and Strange (1988). On debates over corporate governance, see Roe (2003) And for principle-agent theory, see Fama and Jensen (1983).

[34] The category "stakeholder" is most often defined to include employees, suppliers, and consumers, as well as shareholders.

Ownership and control of firms in good times is a matter of equity (stock) finance. Tradable loan obligations issued by firms and governments, and the consequences of firm (or government) insolvency are a matter of debt (bond) finance. Here, as in equity finance, the economic and political sociology of finance intersects with corporate finance, corporate law, and state power, but bond finance also involves government debt and the monetary system. The debates here are over enterprise finance, fiscal and monetary policy, and contract enforcement (bankruptcy).[35] The key issues in these debates pertain to firms' capital composition, the structure of federalism, and the institutions and culture of credit. Empirical areas where these issues are observable such as enterprise/public finance, monetary policy (which matter for bond issuers), and bankruptcy (which matter for bond investors) are introduced in chapter 3 and discussed further in the conclusion.

D. Society-level Dynamics of Securitization

These individual issues of enterprise/public finance, monetary policy, ownership, control, industrial organization, and creditor rights all aggregate, having effects at the macro-socio-economic level for innovation, growth, and social justice. Following Galbraith (1967) and Shonfield (1966) in considering such macro-effects, Robert Boyer and other analysts in the continental *Règulation* School of economic sociology have updated these earlier analyses of "Fordism," placing financialization at the heart of their comparative analyses of Anglo-American and German-Japanese

[35] The literature on bond finance is much less developed and more dispersed than that covering the economic and political sociology of equity finance. Recent work has been dominated by economists (Claessens, Klingebiel, and Schmukler 2003; De Broeck, Guillaume, and Stichele 1998; Herring and Chatusripitak 2000; Settlements 2002). This is an area wide open for new research in comparative economic and political sociology of finance.

models of capitalism in the twilight of the Keynesian Welfare State (KWS) (Boyer and Drache 1996).

Financialization, they believe, is an important factor in the transformation of the KWS, and they too believe it has been scanted in contemporary political economy research (Boyer 2000). Others, particularly David Harvey and Bob Jessop, have rightly focused on a crucial contradiction at the core of the financialization/securitization phenomenon: the mismatch between the respective temporal and spatial horizons of different types of capital ("financial" versus "productive"). Financial capital (and securities in particular) today inhabits a digital world in which time and space are severely "compressed," while "real" capital such as productive capacity or fixed property inhabit a material, human world in which project completion and return on investment take time, and in which physical location matters.[36] This mismatch is central to the increasingly common analyses of the ongoing displacement of the KWS and Fordist production regimes, as well as the equally popular speculation and lamentation about what will replace them in "post-Fordist" era (Jessop 2000).[37]

III. Finance, Power, and Lineages of the Developmental State

The broad securitization of the Chinese and Indian economies has experienced setbacks and course changes in its first two decades, and is likely to experience many more. But much has already occurred in a compressed time frame, suggesting that

[36] The contradiction is between "productive capital as abstract value in motion (notably in the form of realized profits available for reinvestment) and [productive capital] as a concrete stock of time- and place-specific assets in the course of being valorized" (Jessop 2000, 326).

[37] Harvey argues that this mismatch in the forms of capital, together with the "time-space compression" produced by high-speed digital, communications, and transportation technologies, is a structural shift in human history that began in approximately 1972 (Harvey 1990) Securitization – and particularly the meta-commodification aspect of securitization – is central to this shift.

international and comparative political economy theories of late development based on state-dominated, directed-credit regimes of financial governance merit some revision to account for the advent of securitization in these large and economically powerful countries, and in other DTEs.

My argument begins with the notion that finance differs from other economic sectors, or factors of production, in the degree to which its structure can act as a form of social control. States have a stake in the structures of finance because of the economic control associated with those structures, but also because of the political or social control they represent. John Zysman highlighted this element of social control when he argued that state involvement in finance facilitated industrial adjustment. Marx, with his emphasis on variable relations to the means of production; Gerschenkron, with his emphasis on ideology and organization; Woo-Cummings, with her emphasis on the brutality of rapid capital accumulation; and Winters and Frieden, with their emphases on the mobility of finance capital, all represent a rough intellectual lineage demonstrating the importance of this relationship between finance, state power, and social control.[38]

The politics of financial change are important because finance is both a source of power and means of exercising it. Along with monopolies on the use of force, and the right of taxation, the control of finance can be a crucial component of state power. A focus on official control of the finance system, writes Skocpol, provides "the best general insight into the direct and indirect leverage a state is likely to have for realizing any goal it may pursue" (Skocpol 1985). Financial structures are the pathways that connect the state to the forces of production and thrift in society, and have consequently received a fair share of the attention in analyses of the lineage of

[38] See, respectively, Marx (1990 (1867)), Gerschenkron (1962 (1951)), Woo (1991), Winters (1994), Frieden (1991).

the developmental state (Woo-Cumings 1999; Woo 1991). The financial sector is a strategic, Archimedean point from which to evaluate a country's political economy. By following financial flows in the "economy and in the institutions that structure that flow, we can learn a great deal about the uses to which society's resources are put, the people who make the allocative decisions, and the process through which control is obtained and exercised" (Zysman 1983, 7-8).

This concept links the current study to a tradition in political economy that views financial structures and the organization of finance capital as central to the exercise of power by state or private actors. Sixth-century French jurist Jean Bodin wrote that finance forms "the nerves of the state." Finance is also the means by which the state nourishes a country's "sinews of power" (Brewer 1989). Official control of finance is the defining characteristic of the developmental state (Gerschenkron 1962 (1951); Johnson 1982; Woo-Cumings 1999). Turning to private or societal actors, the potential mobility of certain forms of capital – such as convertible "hard" currencies and other easily fungible financial assets like securities – represent a form of "structural power" (Gill and Law 1989; Goodman and Pauly 1993; Winters 1994).

The developmental state as a form of political organization can be understood as part of a remarkably durable historical pattern that survived because it effectively served the imperatives of late industrialization. The developmental state has been defined in political, ideological, and institutional terms as a "state which can create and regulate the economic and political relationships that can support sustained industrialization," and which "takes the goals of long-term growth and structural change seriously, 'politically' manages the economy to ease conflicts inevitable during the process of change (but with a firm eye on the long-term goals), and engages in institutional adaptation and innovation to achieve those goals" (Chang 1999, 192). A dominant, centralized, "developmental" state was effective in promoting fast and

massive accumulation of capital for the purposes of rapid industrialization. It was thus an effective means of marshalling a society's resources in the international game of "catch up." At the heart of this pattern was finance.

The most commonly referenced explanation for the political economy of finance in late developers was first formulated by Gerschenkron (1962 (1951)). He argued that the timing of the push for industrial development would shape a particular pattern of state-structure and state-economy relations. Based on historical and comparative observation, Gerschenkron reckoned that the crucial problem facing late developers was the accumulation of capital. Historically, late-developing states dominated finance in an effort to accelerate industrialization through centralized capital accumulation and allocation. A fairly coherent theory has emerged from Gerschenkron's synthesis and historically grounded propositions.[39] Together, their arguments stipulate that the combination of backwardness and geography was a powerful motivation for political mobilization in the service of development. In his view of modern Eurasian history, the later the hour, and the further the eastward distance from the English channel, the greater would be the imperative for concentrated political power in the effort to overcome the challenges of backwardness. The catch-up game necessitated ever more centralized forms of control in order to accumulate capital and generate productive capacity in a compressed time frame. From such a perspective, it's hard *not* to see teleology in Soviet and other developmentalist "solutions" to the problem of backwardness – the political and economic systems of what Hungarian economist Janos Kornai calls "classical socialism" (Kornai 1992).

[39] These elements of Gerschenkron were foreshadowed by Hintze (1902 (1975)) and masterfully recapitulated by Gourevitch (1978).

Chapter 4 examines how this state domination served to prevent the commodification of capital, as control of societies' most productive assets was achieved often by direct state ownership, and almost always indirectly, as the allocation of finance came under the administrative discretion of the government. This took the finance of large enterprise out of the market. Such domination was achieved, according to Gerschenkron's thesis, by means of state-promoted ideological and organizational mobilization. Finance capital was governed at the discretion of the state, with financial resources being directed through government ministries or government-controlled institutions such as banks or bank-like long-term lending institutions.

Late-developing states in Gerschenkron, the "Developmental State" in its classic formulation by Johnson, and the effective executor of industrial adjustment in Zysman all relied on the "non-commodification" of finance. The state became the dominant financial accumulator and allocator, while it "repressed" finance (McKinnon 1973). Developmental states like India and China intervened in various degrees to administer product, labor, and land markets, but the ultimate source of economic control was finance. Economic control is an important, though by no means the only, means of social control. From this perspective, the *sine qua non* of the "developmental state" as a category in economic and political sociology is state control of financial allocation.

Such systems of financial governance were a means of pursuing development; a fundamental instrument of state power; a shaper of the relationship between state and economy; and an elemental expression of these states' social purpose.[40] *Mutatis*

[40] Michael Loriaux argues that the developmental state is not merely a means of achieving economic growth. The "developmental state" is also a "mythological" expression of national "moral ambition" in the pursuit of which he believes state-dominated regimes of financial governance play a central role (Loriaux 1999, 236-237).

mutandis, this created a general type of political economy variously referred to as *dirigisme* or "developmental states" in cases ranging from France and Japan to Argentina and Korea. At a first order of approximation, the standard model of directed-credit finance deployed by developmental states has been fairly consistent across time and space. This is elaborated in light of Kornai's model of socialist political economy in chapter 4. The model has been present in various types of economies, from fully socialist command economies such as the Soviet Union and China, through mixed, quasi-socialist economies such as India, to capitalist economies such as Japan and Korea (and to some extent Taiwan). Starting with France, Germany, and Russia in the 19th century, and continuing with the Newly Industrialized Countries after World War II, developmental states have used administered interest rates and credit-based systems of financial allocation, "directed" through centrally controlled banks and long-term lending organizations, for the purpose of promoting development through industrialization and general employment.[41] In the idiom of economic sociology, developmental states' directed-credit systems of financial allocation were hierarchical and heavily embedded in the social networks and purposes of these countries' development regimes (both political and economic). They were not market-based forms of allocation.

A significant but often neglected element of the developmental state pattern was that among most late-developing states (roughly from Bolshevik Russia onwards), developmentalism and intervention in the economy were the result, not of state strength, but rather of relative state *incapacity*. Most often, the planned economy was not a policy driven by the desire of strong states to intervene in their countries' economies, but rather a defensive reaction of relatively weak states lacking the capacity to create national markets. As one scholar of developmentalism explains,

[41] See Gerschenkron, (1962 (1951)), Haggard (1990), and Zysman (1983).

"direct state participation in the (economy)…serves as an administrative shortcut. At a purely administrative level, the involvement of the state as a producer, direct employer, and *lender* in countries lacking a regulatory infrastructure is simpler than, and thus preferable to, the much more elusive alternative of creating and regulating a market economy" (Chaudhry 1993, 252), italics added).

The success of the developmental state in the years immediately following World War II, in countries ranging from Russia and China to Korea and Japan, ingrained the institutions and ideologies of that system's financial script: directed credit. The recent difficulties faced by Japan and Korea, some of the earliest "late, late" developers in reforming this system testify to the "stickiness" of directed-credit political-economy arrangements. Whatever the current impasse, however, the early acts of the directed credit drama were heroic. Japan, Korea, India, Russia, and China were successful in the 1950s and 1960s in concentrating financial resources for the expansion of their heavy industrial base. This lineage was based empirically in the historical practice of state-controlled financial allocation through ministerial planning and directed-credit finance.

China and India are often cast as contrasting examples of the developmental state, China as a successful case and India as a failed one (Maswood 2002). Development should not be conflated with growth; in the period from 1950 to 1993, the PRC delivered steady growth at a rate higher than India, even while doing more to improve the basic welfare of its citizens (as measured by poverty, public health, and literacy) (Dreze and Sen 1995). If India's developmental state "failed" because of what political scientist Ronald Herring calls "embedded particularism," then we may perhaps say that China's succeeded because of its "autonomous universalism." Success or failure, financial control was the core of these states' structure. As Herring puts it, "India's failed developmental state slowed capital and restricted its

circuit…but the social purposes that legitimated this cost were largely unrealized."[42] In the argument that follows, I demonstrate that these differences – Indian failure and Chinese success – contributed to outcomes in the securitization component of economic and financial reform. The failure of India's developmental state contributed to its later success in changing *functionally* (not just formally) the structure of financial control and the transformation of state economic authority. The success of China's developmental state contributed to its later failure in changing *functionally* (though it did change formally) its structure of financial control and the reproduction of the old forms of state economic authority.

IV. Securitization in Developing and Transitional Economies

Until recently, economic development in DTEs and research on that subject tended to cleave to the "production-led" growth view of development, neglecting finance. Consequently, through the mid-1990s, the preponderance of IPE and CPE research on development and economic transition focused on labor, industry, and commodities. Such preoccupation was reasonable, given that in most developing economies, including the Newly Industrialized Countries (NICs) of East Asia, financial systems were relatively static and state-administered.

As Gerschenkron's thesis suggested, capital accumulation in DTEs, at least until the 1980s, was largely state-led (Haggard 1990). However, from the early 1980s, the fruits of rapid economic growth, in conjunction with a scarcity of investment options, produced high savings rates in many Asian countries, including India and China. For some years, this growing pool of savings capital was directed almost

[42] See, Herring (1999, 332). In the same article, Herring discusses the confusion surrounding development and growth.

exclusively through banks or state-run long-term lending institutions. Then, in the late 1980s, various developments led to the redirection of some of these funds into securities.

Furthermore, until the 1980s, external capital in the form of foreign bank loans, bilateral government-to-government loans, and loans from multilateral lenders were administered by central governments (Chaudhry 1993). In China and India, from the 1980s onward, direct foreign investment augmented these funds, but was also carefully regulated. Where the finance of DTEs was studied during this period, the focus was on debt, foreign direct investment (FDI), and the political determinants of *economic performance*. But in the mid- to late 1980s, these old patterns of state-administered directed-credit finance began to change and were modified in practice among many DTEs. In the early 1990s, some political economists began to address the strategic importance of finance in DTEs, and the implications for *state power* of changes in financial organization (Haggard and Lee 1993; Haggard and Maxfield 1996; Loriaux 1991; Maxfield 1990; Winters 1994; Winters 1996; Woo 1991).

In China and India, as in many other DTEs, securitization grew in the 1990s, driven by the global techno-market and sociological forces mentioned in the introduction to this thesis. Summarizing the role of technology and markets in the spread of securitization, one commentator observed that what gave securities finance "new momentum" in the 1990s "was its congeniality with other expansive forces: computer programming,[43] advanced mathematics [technology], global deregulation of capital movement, global trading, and a Noah's Ark of new speculative instruments [markets]" (Phillips 2002, 138, parenthetical remarks added).

[43] In the 1980s and 1990s, the financial sector bought 30 percent of the computers sold to U.S. businesses (Phillips 2002, 112).

A. DTEs, Global Forces, and a Changing World Economy

Innovations in technology have made securitization easier, cheaper, and more efficient, lowering transaction costs and time delays. First, communications technologies such as fiber-optic and wireless networks have facilitated the instantaneous transmission of large amounts of data, making securities transactions easier and providing more and quicker access to the information needed to evaluate them. Digital technologies have made the depository and trade settlement components of securities transactions cheaper and easier too. The "dematerialization" of stocks and bonds by secure digitally encrypted records has replaced bulky and easily manipulated paper certificates. These innovations make cross-border portfolio investments using multiple currencies easier and more reliable. Finally, ever faster and more capable computers make high volumes of transactions and ever more sophisticated securities investment analysis or strategies possible. These innovations have also favored securities finance over bank-based finance.[44] As a result of these technological changes, in the late 1980s and into the 1990s, merchandise trade and long-term fixed investment were vastly overshadowed by the volume and value of exchange and investment in financial assets, including securities (Kurtzman 1994; O'Brien 1992). This was a major change in the nature of the global economy.

In the 1960s and 1970s, world markets were expanding as cross border trade grew with developments in transport, shipping, communications, the post-War revival of Europe and Japan, and the rise of new traders in the developing world. In addition to this growth in cross border trade, the mobility of capital that began in the 1970s dramatically changed the nature of the world economy. This was spurred by the technological innovations discussed above and by policy changes in the U.S., first

[44] See note 13 above.

with the shift to a floating currency, and then with other financial deregulation policies in the 1970s (Sobel 1994). Growing trade, capital mobility, and the huge volumes of financial transactions that accompanied that capital mobility represented a fundamental change in the nature of the global economy in the 1980s, leading up to the eve of the securitization boom that shaped the world economy faced by China, India, and other DTEs during the 1990s.[45]

Capital flows to the developing world in the 1950s and 1960s were generally in the form of aid, multilateral bank loans, and some direct investment. In the 1970s, this composition of capital shifted to include a high ration of private lending from large banks in the developed countries. This was particularly true for capital flows to Latin America. In these years, there were still only "developing" economies, as the "transitional" economies now included in "developing and transitional" economies had yet to begin their formal "transition" phase. With the Latin American debt crisis in the 1980s, however, much of this private lending and other forms of capital were replaced by "equity" investment. The memory of the Latin debt crisis and the steadily falling interest rates of the late 1980s and early 1990s forced developed country capital to venture abroad in search of more ample returns. This inaugurated what economists Eichengreen and Fishlow call the "era of equity finance," in which a stream of capital flowed into what were now both developing *and* transitional economies (Eichengreen and Fishlow 1996). This flow of equity investment into DTEs was dependent largely

[45] Frieden and Rogowski's opportunity-cost syllogism summarizes best the market dynamics of spreading securitization in the 1990s. As their first premise, they argue that trade and payments are exact substitutes for finance capital, and that their argument holds equally for trade in goods or money. Second, they argue that openness and internationalization increase aggregate welfare through growth and efficiency. *Even in closed economies* (as most DTEs were and largely still are), they conclude, financial openness in the world economy at large imposes increasing incentives (in the form of opportunity costs) on domestic economic actors, including the state, to liberalize the securities finance (Frieden and Rogowski 1996). Gourevitch presents a more general articulation of what Charles Lindblom even earlier (1982) called the "market as prison" thesis of how market forces shape policy and institutions. He suggests that economic development in an international context "is like a market in that it rewards and punishes certain economic and institutional forms according to their utility in a process that is constantly changing" (Gourevitch 1986, 64).

on market variables such as liquidity and interest rates in the developed economies of the North (Maxfield 1998).

By the early 1990s, facilitated by the technological innovations discussed above, a U.S.-led securities investment *zeitgeist* seemed to infect much of the rest of the world. The decade-long American expansion, propelled by the boom in technology stocks, did much to spread the "equity cult."[46] This *zeitgeist* spurred a number of developments. First, inspired by the International Finance Corporation (IFC), foreign (mainly U.S., Japanese, and European) institutional players led an unprecedented increase in cross-border portfolio investment.[47] Second, beginning in the mid-1990s, firms in developing countries began raising money and listing on exchanges in the U.S. and Europe (Claessens, Klingebiel, and Schmukler 2002).

Another driver of securitization is the sociological process by which ideas, practices, and institutional forms diffuse across the increasingly dense connections among countries. This literature seeks to explain institutional isomorphism with reference either to the "world society" or to information about "best practices." Explaining the world society approach, John Meyer writes, "Many features of the contemporary nation-state derive from worldwide models constructed and propagated through global cultural and associational processes" (Meyer and al 1997, 144-145). These sociological processes may operate in "mimetic," "normative" or "coercive" dynamics, producing similarity – or "isomorphism" to use the sociologists' term of art – in practices, and organizational or institutional forms such as those associated with securities finance (DiMaggio and Powell 1991b, 67-74). This idiom of "isomorphism" is perhaps more appropriate in this argument, as its connotation emphasizes similarity

[46] Analyst Daniel Yergin summarized this saying, "this global equity culture is redefining capitalism and the New Economy in every corner of the planet," quoted in Weber (2000).
[47] "Portfolio investment" is investment in financial assets such as securities, and differs from direct investment in fixed assets known as "foreign direct investment (FDI)."

in form and shape, while the idiom of "convergence" emphasizes substantive similarity.

First, turning first to the mimetic dynamic, proximity to and interaction with other countries using securities finance in the 1980s and 1990s increased a state's likelihood of adopting securities finance, through a process of contagion in which the exchange of information and status-seeking play a role (Strang and Soule 1998; Weber and Davis 2000). The U.S. financial model, which stresses the role of competitive securities finance, became the basis for a pervasive global financial episteme in which the securities market "script" became a powerful and infectious norm.[48] The establishment of stock exchanges or even of Nasdaq-like "Second Boards" (stock exchanges dominated by innovation-driven "new economy" companies) in Europe, Japan, and Hong Kong, and the pressure on companies to offer employee stock options, served to spread the forms of American-style securities-based entrepreneurship.

Second, normative dynamics encouraging isomorphism are considered by international sociologists to be the most powerful. This seems to be true for securities finance in the last twenty years. Increasingly, the use of securities finance has become one such feature of a "contemporary nation state." Particularly since the collapse of the Soviet socialist systems, it is an expected attribute of "actorhood" in the modern society of states. Other such attributes include a centralized bureaucratic governance structure, a legal system, or a system for the expression of popular sovereignty. In the conceptual framework of sociological neo-institutionalism, these are "macrolevel abstractions" and quintessential "institutions": that is, they are "rationalized and impersonal prescriptions" that become "taken-for-granted *scripts*, rules, and

[48] For a discussion of how norms, international standards, and global best practices influence DTE equity markets, see Echeverri-Gent et al (2001) and Weber et al (2000).

classifications" (DiMaggio and Powell 1991a, 15 italics added; Meyer and Rowan 1991, 44).

Is having a stock exchange like having other attributes common among sovereign nation-states in the modern world – attributes such as a legal system, a centralized governance structure, or an air force? It is easy to imagine securities markets as comparable. What does it mean that China has a stock market? Functional conformity with the standards of the world polity does not necessitate uniformity in the *enactment* of those functions. For example, the enactment of the unit-attribute "legal system" can be achieved through a common law or civil law system, while enactment of the unit-attribute "system for the expression of popular sovereignty" may be enacted through parliamentary, presidential, or "vanguard party" systems. How can securities finance be enacted? This is one of the questions raised and answered in this thesis.

Third, coercive isomorphism can operate through the economic competitive dynamics mentioned above in the discussion of the market drivers for securitization. The norms and practices of any society reflect to some extent the ideas and interests of its most powerful members. U.S. policy, as broadcast in that country's foreign policy and by multilateral international organizations – such as the World Bank and the International Monetary Fund (IMF) – further amplified the securities finance message.[49] The World Bank's multilateral investment promotion arm, the International Finance Corporation (IFC), enthusiastically endorsed the idea of open equity markets as a developmental solution for "emerging markets." [50] Moreover, the

[49] See Biersteker (1995) and Wade (1998). U.S. securities market proselytizing was pursued through direct official avenues such as USAID's Financial Institutions Reform and Expansion (FIRE) program, as well as the aggressive lobbying of international financial service providers such as Morgan Stanley and Goldman Sachs.

[50] Attracting risk-averse portfolio investment to unknown and unappealing under-developed destinations presented a key problem. IFC public relations mavens did much to change the investment-chilling discourse with seminars, papers, and data transparency. Among their most brilliant coups was

U.S. government and the World Bank were offering free support for the evaluation of financial policy reform and the training of securities market regulators. The privatization or (as in China) corporatization of state-owned assets and the creation of new companies in the newly liberalized market spaces of DTEs led to the rapid growth of equity securities and the rising capitalization of stock markets. Similarly, the shift in public finance to the use of market borrowing in the form of bonds (issued with an increasing range of maturities) for both fiscal and monetary policy management was equally swift. Corporate and local government debt markets have been much slower to develop.

B. The Expression of Global Forces in DTE Securities Exchange

A crucial component in the securitization process is the securities exchange. The stock exchange, after all, is where securities are traded.[51] The stock exchange is one, but not the only, place to observe the causes and origins of securitization in the era of global finance. They are a good place to look for evidence of the techno-market and sociological drivers of securitization in DTEs. A number of indicators show how these techno-market and sociological drivers propelled securitization. In 1980, only 59 countries had stock exchanges. In the year 2000, more than 100 countries have them. More than 31 of those opened in the heyday of the equity cult (between 1990 and 1997). This was the same period in which China's exchanges were established in Shanghai and Shenzhen, and India's transformational National Stock Exchange

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the spin and promotion of the more enticing moniker "emerging markets" in place of the off-putting "under-developed" economies (Kristof and Sanger 1999; Weber and Davis 2000).

[51] While there is a long history of OTC trading, a necessary first step in the development of any sophisticated securities market is the centralization of trading on an exchange.

presented its upstart competitive challenge to the archaic Bombay stock exchange (Weber and Davis 2000).

In the techno-market realm between 1990 and 1996, China and India established fully electronic exchanges with digital “dematerialized” share trading, settlement, and depositories. Figure 2-4 indicates the degree to which these techno-market changes attracted global investors to the numerous new exchanges. Finally, market structure also became ever more similar, as transactions were increasingly conducted on simple price-time priority basis.

In this context, China and India undertook their financial reforms. Initial reforms in the 1980s began with restructuring firms and the growth of securities finance. In the late 1980s and into the 1990s, globalizing financial price signals and norms with the support of the powerful U.S.-led financial model and episteme provided compelling incentives to state actors in China to undertake further corporatization and securities market development.

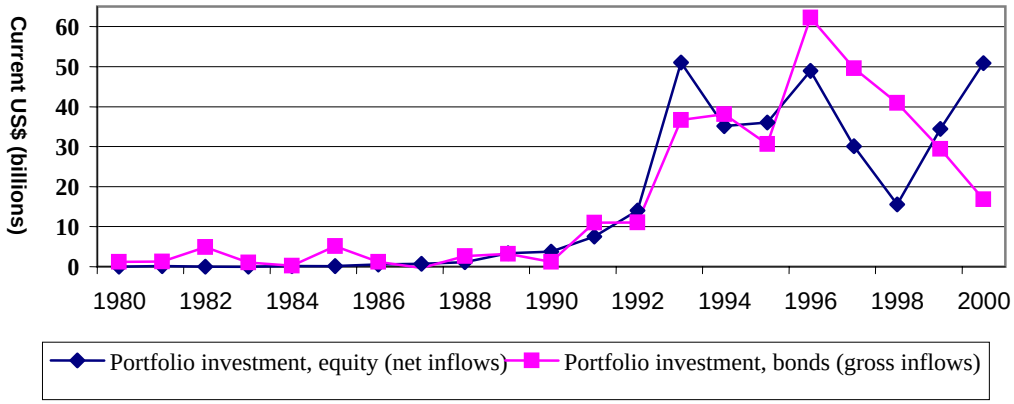

Figure 2-4:
Portfolio Inflows to Low and Lower Middle-Income Countries
World Bank, 2002

Techno-market-imposed isomorphism and sociologically-imposed isomorphism help explain why China and India began adopting securities finance. These complementary forces drove the adoption of the securitization script and help us understand where it came from and how it spread. They also tell us where the highly formulaic script outlining the set of practices and institutions that constitute securities finance – securitization – came from. These are often treated as alternative explanations for diffusion and adoption of various forms of financial action in an increasingly interdependent world. I see them not as exclusive explanations or processes, but as complementary ones. Nevertheless, they should not be confused with the various explanations for why India and China *differ* in their patterns of securities governance. They say very little about the ways in which these countries enacted that script, or about *why* countries enacted the script in particular ways. To understand this variation in Chinese and Indian responses to the common international script of securities finance, we must look elsewhere for explanations. That is the subject of chapter 3.

V. The "New Commanding Heights": The Politics of Securitized Finance in DTEs

Much has already been made of the power of finance, global and local, because of the ability of financial capital to move – from firm to firm within a political jurisdiction (domestically), or across firms *and* jurisdictions (internationally). This mobility confers "structural power" on financial capital, making its movement – or threat of movement – politically consequential. Securitization makes mobility easier across firms, sectors of the economy, jurisdictions, and even asset classes (substitution between bank deposits, bonds, or stock). This increases the potential relative power of

capital holders. The relative absence of the affective element and the ease of transactions enabled by securitization increase the potential for "mobility," or what financial economists call "liquidity." The market power of securitized finance derives ultimately from this mobility, and can have an independent effect on governance.

The potential political consequences of securitization unfold as a result of changes (or the threat of such changes) in the relative power of the controllers of capital. I call this the "politics of securitization," but it can also be thought of as the "politics of financial liquidity." In chapter three, I introduce a new way to analyze these politics using an asset-class/financial-position matrix. In the new commanding heights of securities finance, price signals from the secondary market in stocks and bonds come to be seen as a daily vote on the health of the economy and the quality of governance at the corporate and national levels. Furthermore, circulation of securities in the secondary market puts pressure on the specification of property rights. Corporate law, the market for companies or company control, the nature of ownership, and the credibility of contracts (in bankruptcy particularly) are tested by the exchange of securities. As these claims circulate, anyone can end up holding them when positive or negative events occur (such as adverse price changes, or a default/bankruptcy).

There is less affect in the realm of securities-based than in bank-based financial allocation, and therefore it is more difficult to impose political control. From a sociological perspective, the "marketness" of a transaction depends on the degree to which affective ties play a part. Standardized, anonymous, tradable claims on productive assets and revenue streams make it easy to "frame" the exchange of society's assets in discrete, fully marketized transactions.[52] The inherent "marketness" of securities-based finance relative to banking renders the hierarchical character of

[52] For a discussion of this sociological view of market exchange as "framing," see Callon (1998).

state intervention in securities-related transactions both more transparent and more difficult to achieve.

As discussed above, the secondary markets for securities are very good at such framing, because the items exchanged are so commodified. The zenith of this type of un-embedded, abstract transaction is the digital screen-based trading of stocks, and program trading in particular (in which computers buy or sell securities based on pre-programmed instructions regarding price and volume). Comparing financial sectors, the trading of securities on an electronic exchange is more marketized than bank lending, even in cases where interest rates are completely liberalized and banking services highly competitive (and India is still some way away from this).[53]

State control of institution-based lending is fairly straightforward. It requires administering interest rates, setting quotas for the destination of credit, planning and evaluating large credit projects, and controlling appointments. The secondary market in securities is fundamentally different, due to the effects of vast numbers of potential participants and the fact of continuous trading. There is a technological element to this. An electronic secondary market magnifies these two effects. The existence of a liquid secondary market imposes a form of market discipline on the securities industry that does not exist for banking. That is, once the instruments (bonds or stocks) are created, the prospect of price setting on the secondary market imposes a level of market discipline that does not exist in the banking industry.[54]

[53] Even where banking services are highly competitive and interest rate regimes free, bank-based finance is still less marketized than securities finance, because it is less anonymous, less standard, and the potential for liquidity much lower.

[54] In the primary market for securities, networks and reputation play a crucial role, both in terms of how the market is organized and in terms of individual motivation. In this regard, the primary market for securities depends on non-economic factors such as affective networks and reputation, in much the same way as markets for loans from credit institutions. See supra-notes 14-19.

A. The "Liquidity Spectrum": Securitization and Political Control

From this understanding of securitization, it is possible to design a scale representing various forms of financial allocation based on the potential for affective versus price-based relations, and their vulnerability to political intervention. I call this the "liquidity spectrum." The liquidity spectrum depicted in Figure 2-5 illustrates why central-state political control of finance is easier in directed-credit systems than in securitized finance. This is particularly true under conditions of directed credit finance, and at least potentially true in private bank-based systems.[55]

[55] Though the power of a Morgan or Rothschild vis-à-vis the state may be large because the huge concentration of financial power in few private hands presents a challenge to state control, it also means the state has fewer actors to deal with. When such actors begin to control not just bank funds, but also securities, the picture may change. This is what happened in the period of securities finance development in the U.S. prior to the 1933 Glass-Stegall Act. The era of "combinations" provoked in the state and society a concern that too much private power in the hands of financial actors who owned both banks and holders of large concentrations of securities (Chernow 1990). The dual control of banks and large concentrations of securities by German "universal" banks has (until recently) been made possible by the "corporatist" arrangement between government, business, and labor there (Schmidt 2003).

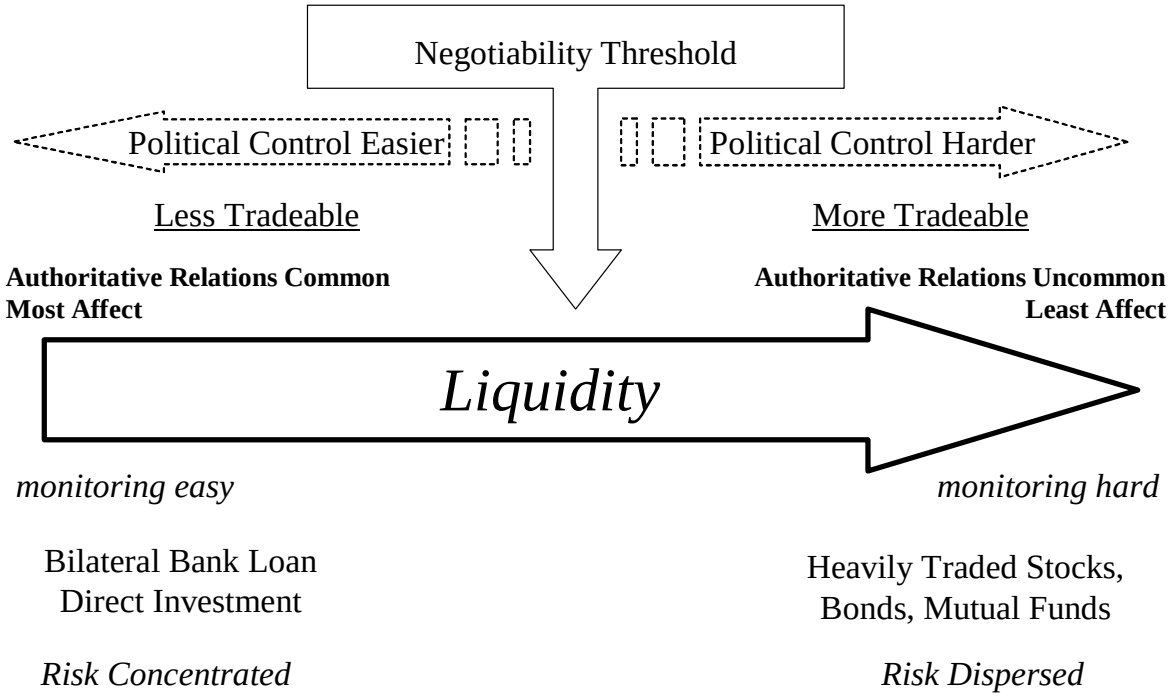

Figure 2-5:
Securitization and the Liquidity Spectrum:
Political Control and the Commodification of Finance

The liquidity spectrum draws on insights about capital mobility within and across borders, which scholars of IPE and CPE refined in the 1990s. Of particular importance are Jeffrey Frieden's concept of "asset specificity" and Jeffrey Winters' elaboration of the "structural power" of capital concept. The former is defined as "the degree to which the return on an asset depends on its use in a particular circumstance" (Frieden 1991, 20). Finance capital has low asset specificity. Land, labor, and fixed capital have high asset specificity. In critique of Frieden's model, Jeffrey Winters proposed an alternative (Winters 1994). Like me, Winters focused on state power over capital, but he operates with a paradigm of "control." He argued that state power over capital can best be understood by determining 1) its source; 2) the constraints that those supplying it can exercise (and their motives); 3) the intermediary channels through which it moves; and 4) policy makers' discretion over end use (Winters 1994). This paradigm of "control" is useful for understanding the financial dynamics of the planning state and directed credit system.

As the analysis and empirical circumstances move away from authoritative (developmental state) allocation and toward market allocation, however, this "control" model unravels in reverse order. The expansion of securities finance reduces policy makers' discretion over end use, intermediary channels proliferate (investment banks, brokerages, and mutual funds, for example), suppliers' (savers and investors) discretion widens, and (to the extent that there is external openness) sources proliferate. This suggests at least a *prima facie* case that the mechanisms of the developmental state would be increasingly blunted by the growth of securitization.[56]

[56] Note that this is conceptualized based on the potential for affect in the transaction. Securities transactions can also be affective, see note 16 above. For example, one category of Anglo-Saxon primary market practice reserves shares for "family and friends." The practice of employing a trusted stockbroker is an affective link to both the primary and secondary markets, and persists today despite the growth of Internet trading. It is common now to consider "insider trading" (an affective transaction) a violation of the principals of "fair" securities market practice, but this was not always and everywhere

It leads to the theoretical expectation that political intervention in securitized finance is more demanding in terms of state capacity than in bank-based finance – that is, the powerful "thumbs" of the developmental state financial structure, so useful when state authority in the economy was exercised in a *dirigiste* distributive intervention mode, may be less useful when the state needs nimble "fingers" to exercise economic authority in a procedural regulation mode.[57]

Securities finance is a challenge to the developmental state in a number of ways. At the front end, the enactment of securitization is very demanding in institutional, ideological, and political terms. At the back, once a significant portion of financial assets take the form of securities, governance is also very demanding. Securitization makes political control more difficult for two reasons. First, capital mobility and the disclosure imperative diminish the potential scope of discretionary intervention. Second, the public goods provided by securitization (increased efficiency and participation) bring with them the potential for significant public "bads" (volatility, herding, crises, fraud, and corruption).

Remembering, as mentioned earlier, that Chinese and Indian *dirigisme* was a consequence of weak state capacity and an inability to build national markets or regulate society-driven accumulation of capital (Chaudhry 1993; Shue 1980), we immediately see why securitization could be problematic for these states' development objectives. If the command economy was initially the result of state incapacity to manage political conflict, "regulate, define, and enforce property rights, dispense law, and (to) tax," and the ubiquitous *dirigisme* of the developmental state perpetuated this incapacity, the more severe demands of securities finance with its implications for

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the case. For example, see the discussion of how insider trading was justified practice in the U.K. for many years in (Laurence 2001).

[57] This insight is the foundation of John Zysman's argument that the political economy of "bank-based" financial systems facilitates the conduct of "industrial policy" by the state, while that of "market-based" systems (analogous to "securitized" systems) renders it more difficult (Zysman 1983).

coalition politics and property rights structures will be particularly challenging in the relatively low-capacity twilight of the developmental state.

Securitization presented a challenge to the institutional arrangements in the old directed-credit system of financial governance and its relationship to both the structure of distributional coalitions and the structure of property rights in each country. In both cases, however, the politics of coalitions and property rights varied by asset class (stocks versus bonds) and financial position (issuers versus investors). This is revealed and analyzed through the application of the asset-class/financial-positions matrix to equity (stock) assets in chapter 6, and briefly to debt (bond) assets in chapter 7, the conclusion.

VI. Conclusion

Financial economist and securitization cheerleader John Edmunds argued that for countries early in the development of securities finance, securitization "offers two clear alternatives: keep the country's financial system closed and grow slowly through production, or open the financial system and grow quickly by revaluing upward the market prices of income-producing properties" (Edmunds 1996, 133). For countries lacking large domestic markets and huge populations with available savings, Edmunds' claim may be right. China and India have not made been forced to make the choice as starkly as Edmunds argued. Rather, they have been able to choose both, relying on production-led growth and opened finance. On the latter, China has "hacked" the securities finance logic, while India has been forced to cleave more closely to it. Many states would wish to "have their securities finance cake and eat it too," but few have been in the same sort of advantageous external macroeconomic position that allowed China to do so. At the same time, many states in similarly

precarious macroeconomic positions have not been able to achieve what India has under those circumstances. To understand why, we must look at how these external macroeconomic conditions interact with domestic politics.

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Chapter Three

EXPLAINING SECURITIES GOVERNANCE IN DEVELOPING AND TRANSITIONAL ECONOMIES

Chapter 2 introduced the securities finance script. If the enactment of that script in the Indian and Chinese contexts had been direct and frictionless, these countries' securities governance regimes should have been the same, or at least convergent. Furthermore, this "marketization" of finance through securitization should have, according to conventional theories of globalization and market transition, led to a diminution of the state's role and its authority in finance. While there is some evidence of these trends, the more obvious outcomes suggest otherwise.

Until recently, much of the research on comparative and international political economy has treated institutional variation as an independent variable. Such analyses take the institutions of economic governance as given, seeking to explain outcomes such as growth, industrial adjustment, liberalization, debt management, or government business relations.[1] Some have criticized this approach for taking outcomes and reading back into history for their institutional "causes." Taking institutions as given ignores how they come to embody both the political incentives of countries' relationship to the world economy, and the domestic politics of interest aggregation or property rights.[2]

Taking DTEs' institutions and practices of financial governance as outcomes to be explained addresses what is considered by two eminent surveyors of the field to be one of the major unexplored areas of the comparative and international political

[1] Zysman linked financial structure to variation in the ability to adjust industrial policy (Zysman 1983), and Katzenstein used domestic political arrangements to explain policy responses to the oil crisis (Katzenstein 1985).

[2] "Using institutions as explanatory variables stalls the analysis precisely where it links up to the critical issue of how exogenous resources affect institution building itself" (Chaudhry 1997, 18).

economy of finance. Haggard and Lee lamented that studies have "not bothered to ask whether financial market policy was in fact a result of political pressures or whether it sprang from economic constraints or the projects of state officials." This failure to treat financial institutions as outcomes is responsible for a major blind spot in contemporary research on the political economy of finance: "The inability to account for variations across countries in terms of the *extent or nature* of government intervention in financial markets" (Haggard and Lee 1993, 8-9). Analyses emphasizing "extent" have crowded out those of "nature" in scholarly research.

The design of this study helps address these two problems directly. It explores the disjuncture between global script and local enactment in securities finance. In doing so, it offers an explanation for why different Chinese and Indian responses to the single common exogenous stimulus of securitization produced contrasting outcomes in their patterns of securities governance. The study also addresses the "*extent or nature* of government intervention" question – what economist Charles Lindblom called the problem of "strong thumbs" versus "nimble fingers." Why and how do developmental states shift from the distributive intervention mode (strong thumbs) of state economic authority to the procedural supervision mode (nimble fingers)? What role does securitization play in provoking this shift in the doctrine and practice of state authority in finance? To address this problem I present a Weberian ideal-type scheme – contrasting distributive intervention with procedural supervision – with which to analyze changing governance regimes in DTEs.

This chapter presents in detail the analytic framework used to deal with these questions in subsequent chapters. The next section introduces the concept of economic governance regimes, the dependent variable in this study. It also briefly lays out how I characterize the different governance regime outcomes in China and India. In the following section, I present the "dual imprint" two-level analysis in detail,

distinguishing between the structural incentives of these countries' external economic exposure, and the process of domestic political dynamics based on political coalitions and property rights structures. An innovative part of the dual imprint framework involves unpacking and deciphering these domestic political dynamics of securitization. Section four describes the analytic tool I use: the asset-class/financial-position matrix. Section five summarizes important existing explanations for variations in securities governance and the exercise of state economic authority. Finally, I close the chapter discussing issues of method and application.

I. Country Responses to Securitization

Policy and institutional patterns are constituted during the process of securities market building and the regulation that accompanies that process. One term for these policy patterns is *economic governance regimes* (EGRs). EGRs may be thought of as relatively stable patterns generated by the aggregation over time of discrete but complementary institutions and policy measures, often driven by a stable set of purposes and cohering into a trend. In countries with a tradition of state-led development, the purposes reflected in the governance regime will tend to be most significantly shaped by the state. The patterns we observe in these regime outcomes demonstrate a significant degree of routinization, and are often reproduced in new rounds of reform. In China between 1994 and 1997, a distinct pattern I call *discretionary involution* emerged from the welter of *ad hoc* stop-and-go measures of previous years. In India between 1993 and 1996, the emergence of a pattern of *constrained evolution* was discernable.

The categories on which I draw for defining the dependent variable in this study – the securities governance regime – come from the work of economic and

political sociologists investigating convergence and diversity in the institutional structure of advanced industrial political economies. They use an approach focused on regimes of governance within and across economic sectors.[3] This approach regards economic action as a special case of social action requiring coordination and governance by institutional arrangements. The actions and variables to be coordinated include prices, quality, sources of finance, standards and safety, information to consumers, labor recruitment, allocation, and compensation.

A regime governing the coordination of economic factors is defined as the totality of institutional arrangements – including rules and rule-making agents – that regulate production and transactions inside and across the boundaries of an economic system.[4] Until recently, this research has focused largely on collective bargaining, consumption norms, and the processes that generate economic governance regimes. The research in this thesis follows Boyer, Jessop, and others, who shift the study of EGRs from production to finance, reflecting an explicit cognizance of the securitization shift.[5] While Japan has been studied in this way, few, if any, researchers have applied this conceptual idiom to cases of Asian DTEs.

A. Governance Regimes

Economic and political sociologists use the concept of "economic governance regimes" when studying the ensemble of actors, institutions, and practices that "govern" a given sector or factor in the economy. This privileges the ensemble of formal political institutions, and of informal socio-economic institutions *themselves,* as

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[3] For the sectoral approach to "economic governance regimes," see Hollingsworth, Schmitter, and Streek , (1994). (Echeverri-Gent 1998) points out that the EGR concept is especially useful in studying Chinese and Indian reform "given the unevenness of reform across sectors."
[4] This is a revision of the definition in Hollingsworth et al, (1994, 5).
[5] See the special issue of the British journal *Economy and Society* (Society 2000) in which Boyer and others presented an initial foray into research on "financialization".

an outcome to be explained. Relying on this analytic tradition but simplifying it for application to the domain of securities finance in this analysis, I use the term "securities governance regime" (SGR) in referring to the actors, institutions, and practices involved in the *creation, circulation, and use of securities*.

The word "governance" often evokes the role of governments or states. It can also evoke two other mechanisms of governance commonly used in mainstream economics: markets and corporate hierarchies (firms). But the point of the economic governance regime concept as a research variable is precisely that it includes all three forms of governance – states, markets, and firms – while also recognizing a role in the coordination of economic action for the media, for less-official and less-corporate institutions such as associations, and even for informal institutions such as networks. This makes the "governance regime" concept useful as a dependent variable because it is precise yet sufficiently inclusive, even while it is an evocative and compelling referent (Gerring 2001). As such, a governance regime includes both state and civil society.[6] It also includes the market as the arena in which these two spheres and the actors that inhabit them operate and interact. Figure 3-1 is a graphic rendering of the governance regime concept.[7]

[6] I prefer to think of "civil society" in this context as the "civil economy." That said, I continue to use the more familiar term. For important caveats on the over-zealous application of the state-society distinction, and the analytic costs of doing so, see Mitchell (1991), and Kohli and Shue (1994).
[7] It is inspired by a similar rendering in Hollingsworth and Boyer (1997).

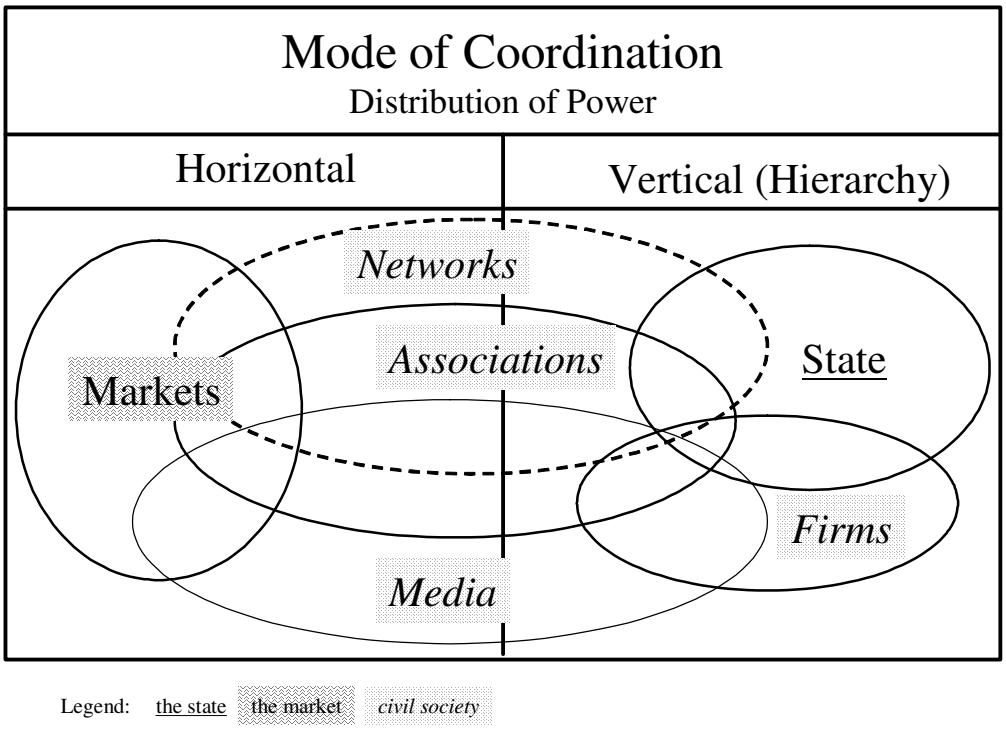

Figure 3-1:
Economic Governance Regimes

The dependent variable in this study – governance regime – is defined as the ensemble of institutional arrangements and practices involved in the creation, circulation, and use of securities. Those arrangements and practices have state and civil society elements, and they are enacted in the market. They include 1) structures of authority, 2) social linkages, and 3) arenas of exchange, which may be considered analogous to the common social science categories of state, market, and civil society.

Structures of authority include hierarchies like governments or firms. Governments are part of the state, while firms are part of civil society, except in the case of state-owned enterprises (SOEs). *Social linkages* include associations of interest and networks of affect. Corporate entities that formally represent businesses (the mutual fund industry, for instance) or consumer groups (like investor protection federations) are examples of *associations of interest*, and are most often part of civil society.[8] *Networks of affect*, the other form of social linkages, include identity-based connections like ethnic, linguistic, native place-based or professional background. These should also be thought of as part of civil society.[9]

Finally, *arenas of exchange* include markets and the media. Markets for goods, services, and production factors (labor, land, money) are neither state nor civil society. They are, among other things, arenas in which the state and civil society interact. The media is an element that previous research has tended to neglect, but is an essential component in the ensemble of governance regime components. Information and opinion are both oxygen and intoxicant for securities finance. The media is an

[8] This becomes a difficult category in the Chinese case, where such associations are colonized or co-opted by the state (Foster 2002).
[9] This is true, I think, even if such a network exists among members of "the state," such as factions within the Chinese Communist Party and state or among members of India's Administrative Service.

important arena of exchange for information, and is typically considered part of civil society.[10]

Structures of authority, associations of interest, networks of affect, and arenas of exchange each represent distinctive modes of governance. In the conception of Hollingsworth and his colleagues, such modes "are likely to be present to varying degrees in any given economy or economic sector. The object of comparative empirical research on institutional arrangements for coordinating economic activity is to determine the relative importance of various modes of governance in different contexts, to describe how they are articulated with one another, and to assess the extent and direction of change in regimes over time" (Hollingsworth, Schmitter, and Streeck 1994, 8).

The governance regime is thus a summary variable encompassing both institutional/policy outcomes *and* market outcomes.[11] This distinction is not always made sufficiently explicit, often leading to analytic confusion (Vogel 1996, 261).[12] Among the institutional outcomes there are often (but not always) formal and informal institutional elements. Institutional outcomes include market building measures, intramural coordination of securities activities, and extramural coordination with other financial and real economy sectors.[13] Market outcomes include, *inter alia*, the capitalization of stock and bond markets; the volume of trading; market liquidity; and the number of firms using the securities markets.

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[10] Anyone focusing on the governance of securities finance cannot afford to ignore the role of the media. When considering the China case, as with associations, so with the media. The colonization and control of the media can make its analytic disposition in the "civil society" sphere a delicate matter.
[11] For an explication of the "summary variable" as methodological device, see Easton (1953).
[12] This is discussed in the introduction with regard to the debate between international political economists Steven Vogel and Edward Laurence (chapter 1). I am grateful to John Echeverri-Gent for encouraging me to emphasize this distinction Echeverri-Gent (1998).
[13] Developments in commercial banking, insurance, and pension and social welfare systems are also important in determining the securities governance regime. There are interaction effects between the process of securitization and developments in these other areas.

Formal institutions can be official and unofficial. For example, ministries of finance and securities regulators or securities-related statutes and rule-making are some of the official and formal institutions of an SGR. This includes the methods and institutions for exercising state power with respect to financial allocation, such as official distributive intervention in or procedural supervision of securities finance practices. Examples of unofficial yet formal institutions include business and consumer associations. Informal institutions include ethnic, linguistic, native-place, and professional background networks.

But we shouldn't take the word of economic sociologists on the value of governance regimes as a category for social science research. As political scientists James Scott (1985) and John Gerring (2001) have pointed out, the best concepts are those that make sense, not just to academic audiences, but also to the actors whose worldview or behavior the concept purports to theorize. Arthur Levitt, onetime stock broker, erstwhile chief executive of the American Stock Exchange, and former chairman of the U.S. Securities and Exchange Commission, provides an example of how securities finance participants think implicitly in terms of a securities governance regime, even if they do not themselves use the term. In discussing the Enron collapse of 2001, Levitt explicitly enumerated the components of the U.S. securities governance regime (which, for better or worse, is a formal model that many of the Indian and Chinese official and unofficial informants confessed to using as a cue). In his inventory of those responsible for coordination, Levitt listed "the boards of directors, the accountants, the lawyers, the rating agencies, the Congress, the regulators." Furthermore, he emphasized the importance of their configuration in the governance regime ensemble to the healthy operation of securities finance. "In fairness," he remarked, "Enron wasn't the failing of any one entity" (Levitt 2002).

Looking to China and India, we find a similar cognizance of the relevant players and interactions in the field of securities governance. According to an experienced securities financier in Bombay, "regulation of securities in India should be, and sometimes is, a dialectic. We interact with SEBI (the state securities regulator), but they also rely on us. Not as much as I would like, mind you. My association (the association of Indian bond dealers) sometimes mediates between its members and SEBI, sometimes members go straight to SEBI." Finally, in a telling remark, the same securities financier explained that when securities market participants got wind of improper or risky behavior on the part of a "colleague" among the "Marwari brokers," someone "knowing his *chacha* or his boss will call, and it will be taken care of."[14]

Or take for example the remarks of Shi Meilun, Vice Chair of the Chinese Securities Regulatory Commission: "in a developed (securities) market," Shi explained, "the regulator worries about few things because self-discipline and market forces can solve problems. But ours is an emerging market and our listed companies and securities sector lack the concept of self-discipline as in a developed market" (Hu, Wei, and Niu 2002). Why China's securities governance remains so underdeveloped, twenty years after the first securities were issued in that country, perhaps also bears some consideration. Nevertheless, in both these cases we hear securities finance participants themselves voicing their awareness of the various components of the securities governance regime, and describing how those components articulate with

[14] The affinity this securities financier feels with this "colleague" is based on the fact they are both part of an ethnic network known as Marwaris. His offhanded reference to the offending brokers' *chacha* indicates the way ethnic and familial ties overlap. While *chacha* technically translates as "father's younger brother," this affectionate honorific is used to refer to close older males who one might deem as close as an uncle. This interviewee was the scion of a family involved in a range of securities services. The family businesses are medium sized in capitalization terms, but the scope is broad, encompassing stock broking, bond trading, securities underwriting, and financial information. The geographic scope of the family is also broad, with businesses in Bombay, New Delhi, and Calcutta. Author's interviews, Bombay, 2000, #58; and Bombay, 2001 #110.

one another in coordinating the creation, circulation and use of securities. Each component was identified: the state as represented by the regulator; markets as arenas of exchange and sources of competitive constraint; firms; associations; and (in the Indian case) networks.

B. Coding the Cases

In this study I trace the process of securitization in China and India, two countries whose systems of financial governance shared a common legacy of state-dominated, centrally-planned financial allocation through grants and directed credit. I find that different responses to the securitization process led to distinct patterns of securities governance in each case: *discretionary involution* in China, and *constrained evolution* in India. Chapter 4 describes the developments within the various components and their articulation with one another in the overall configuration of the Chinese and Indian governance regimes that constitute these patterns.

China's securities governance regime of discretionary involution was largely in place by 1996. Many comparative studies applaud Chinese policy makers' ability to incrementally reform the economy and their governance of it. Yet, evidence from securities market is a prominent exception to this trend of success. Securities markets appeared almost out of nowhere in 1981. Merely twenty years later, they constituted one of Asia's largest securities markets (though not as large as the Chinese authorities would like the world to believe), equipped with state-of-the-art technical elements.

In the early 1990s, the Chinese government launched ambitious plans to establish stock exchanges as part of their broader financial reforms. This held out some promise for a significant shift in the way the Chinese state interacted with the capital markets. Between 1981 and 2001, there was an enormous change in the formal structure of China's securities markets. But substantively, in terms of the functions

that financial economists typically attribute to securities markets,[15] there was much less than met the eye. Growth in the scale of Chinese securities finance was indeed remarkable, but the function of securities finance, its governance, and particularly the state's relationship to it has changed little since the establishment of the *involutionary* pattern in mid-decade.

More than ten years after its reform began, Chinese securities finance languishes. Volatile casino-like markets provide no credible savings/investment substitute to bank deposits, have little bearing on corporate finance, and contribute insignificantly to deepening the financial system. Moreover, having established a new market regulator ostensibly designed to conduct procedural supervision of securities finance and develop civil society supplements to state governance, policy makers persisted in using that regulator to conduct distributive intervention, cultivating or permitting only minimal development in unofficial and informal governance structures. Development of non-state elements of the governance regime – such as firms, associations, and networks – were stunted. To the extent that substantive change occurred, it happened before 1994. Between 1994 and 2002, there was little substantive or *intensive* development, but lots of formal mimesis, *extensive* growth, and segmentation. Changes of scale in the Chinese securities finance were impressive, changes in scope significantly less so.

India's constrained evolution securities governance regime was also largely in place by 1996. The development of modern securities markets in the U.S., from the Great Crash of 1929 to the implementation of the National Market System after the "May Day" reforms of 1975, took almost fifty years. By contrast, in formal terms, despite much turmoil in 1993 and 2001, Indian securities markets have taken less than

[15] These include the efficient allocation of finance, a market for companies, a market for corporate control, and (recently, some argue) a market for risk (Bernstein 1990).

ten years to evolve from a commercially irrelevant peripheral enclave, replacing a long-entrenched network of paper-based traders isolated in sleepy regional clubs, into a highly sophisticated, nation-wide, fully electronic market that "now approaches global standards." More importantly, however, in substantive terms, market scope and non-state elements of the Indian governance regime have flourished. This would be fast for any country. It is particularly surprising for India, a country not well known for either the vigor of its economic reforms or its love of financiers.

Involution occurs when "state organizations expand (into the economy) not through the increasingly efficient use of existing inputs (such as personnel and administrative apparatus) but through replication, extension, and elaboration of an inherited pattern of state-society (or state-economy) relations" (Duara 1988, 75-76).[16] Reproduction of old patterns or functions, as well as replications, are key characteristics of involution.[17]

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[16] Involution, particularly in the Chinese case at hand, is not unlike mercantilism as conceived by Polanyi. "That mercantilism," he wrote, "however emphatically it insisted on commercialization as a national policy, thought of markets in a way exactly contrary to market economy, is best shown by its vast extension of state intervention into industry (and, one might add finance). On this point, there was no difference between mercantilists, feudalists, crowned planners, and vested interests, centralizing bureaucrats and conservative particularists. They disagreed only on the method of regulation, not on the commercializing of labor and land (and one might add capital)." And in an elaboration of this characterization with prescient relevance to the Chinese case, Polanyi added, "The mercantilist was concerned with the development of the resources of the country, including full employment, through trade and commerce; the traditional organization of land and labor (and/or finance we might again add) he took for granted. He was in this respect as far removed from the modern concepts as he was in the realm of politics, where his belief in the absolute powers of an enlightened despot was tempered by no intimations of democracy" (1957, 74 parenthetical comments added). This macro-historical perspective reminds us that, though the term "involution" in contemporary social science is attributed to Geertz (1963), the lineage of the idea in general terms goes back through the work of Sinologist Karl Wittfogel's "oriental mode of production" (1957), to the works of Weber (1949) and thence back to Marx.

[17] Geertz's early formulation included both reproduction (of old patterns) and replication (and segmentation of units). Drawing on Duara, Burrowoy, and Stark (1996), I see replication as an equal constituent of the involution pattern, not its dominant characteristic. The fact that there is replication of past modes of organization (discretionary allocation of finance), and replication of forms (such as the multiple and segmented share types, and the market segmentation all discussed in chapter 6) to my mind adequately qualifies the Chinese behavior on the "replication" criterion.

Whereas the conventional wisdom is that China has in the last twenty years been steadily "liberalizing,"[18] evidence from some sectors such as finance or the petrochemical industry suggest there may be as much "flow" as there is "ebb" in the role and control of the state.[19] Political scientist Lu Xiaobo has also used the involution concept to elucidate the dynamics of Chinese Communist Party organization in the reform era (2000).

The involution pattern of China's governance regime for securities is not only consistent with the empirical cases just mentioned. The pattern also conforms to theoretical expectations derived from what economic anthropologist Hill Gates has called the "tributary mode of production" (TMP) in Chinese history. The tributary mode of production is defined as a political-economic system in which "a class of scholar officials…transferred surpluses from the various producer classes (peasants, petty capitalists, laborers) to themselves by means of direct extraction as tribute, taxes, *corvee*, hereditary labor duties, and the like." These political and institutional circumstances, which produce a bias for scale over scope (that is, for example, extensive versus intensive growth, characteristic of involution) are thus evident elsewhere in Chinese history. The "high-level equilibrium trap" that stagnated Chinese economic development into the early 20th century was described by economic historian Mark Elvin as "quantitative growth, qualitative standstill," and is yet another historical example of involution (Elvin 1973). The modern Chinese state, TMP analysts argue in the idiom of involution, has "reproduced" this centuries-old tributary system in the current transitional context, following a pattern in which it is often the

[18] "Liberalization" refers to the introduction of greater competition, easier market entry, and, typically, growth in the private sector.
[19] An important example is the takeover of "private" oil wells in Shaanxi province in early 2003 (Economist 2003). For detailed treatments of this elsewhere in finance, see Shih (2003) and Sehrt (1999). For a discussion of this dynamic in the petrochemical sector, see Lin (2002).

case that "cadres in state-run institutions subordinate the goal of efficient production to the goals of control, stability, and self-promotion" (Gates 1996, 7; Hertz 1998, 14).

The term "evolution" here designates the incremental development of a substantively new pattern of state-society (or state-economy) relations. Michael Burawoy explains that involution is an "economic regression that is not merely preparatory for a future resurgence but is chronic and persistent. Involution is the antithesis of evolution and…leads to systemic underdevelopment" (Burawoy 1994, 2-3). The question is what turns an involutionary, often predatory, pattern into one that can be durably developmental. These contrasting outcomes furnish an opportunity to identify and analyze the political factors that are most important in shaping financial governance responses to securitization. This, in turn, helps me address the central themes of this thesis: 1) The degrees of convergence and diversity in state responses to global market and social forces, and 2) The changes in the character of state-economy authority relations occasioned by the expansion of markets, and particularly markets for finance.

II. The Dual Imprint Explanation

The explanation that I offer involves a two-level analysis highlighting how both international and domestic phenomena leave their mark on governance regimes, accounting for differing patterns of securities governance in China and India. I call this, following Chaudhry (1997), a "dual imprint approach." Such an explanation requires an analytic framework that explicitly regards the *institutions* of economic governance as a dependent variable.[20]

Few authors, other than Chaudhry and researchers in the world-systems school, have specifically explored how countries' juncture with the world economy shaped, not policies, but the development of domestic institutions of governance, particularly economic governance.[21] Proposing a modification to the dominant techno-market approaches that posit a direct link between "exogenous easing" in the international economy and government policy, political scientists Geoffrey Garret and Peter Lange argued for the importance of domestic institutions as significant intervening variables in explaining policy outcomes (Garret and Lange 1996). Garret and Lange's institutional perspective is more sensitive to context, and they recognize that a country's particular position in the world economy may shape policy outcomes theory; but only when researchers take domestic institutions *themselves* as outcomes to be explained does the full relevance of the specific character of each country's

[20] For a working definition of institutions, I rely on sociologist Neil Fligstein's formulation, in which institutions are "rules and shared meanings (implying that people are aware of them or that they can be consciously known) that define social relationships, help define who occupies what position in those relationships, and guide interaction by giving actors' cognitive frames or sets of meanings to interpret the behavior of others. They are intersubjective (i.e. can be recognized by others), cognitive, (i.e. depend on actors' cognitive abilities), and to some degree, require self-reflection by actors. Institutions can, of course, effect the situations of actors with or without their consent or understanding" (Fligstein 2001). I agree with Paul Pierson that "policies" are "political institutions" (personal communication 03/12/2003).

[21] For discussions of this, see Chaudhry (1997 Chapter One), and Rand Smith (1993).

relationship with external economic forces become apparent. It is this foregrounding of institutions themselves which is emphasized in the dual imprint analytic used here.

To explain the institutions and practices of securities governance, I need to be able to trace the response of states like China and India to the stimulus of global techno-market and social forces favoring securitization, as mediated by the profile of their structural juncture with the world economy on the one hand, and by the influence of domestic political coalitions and property rights on the other. The explanation offered here satisfies these analytic requirements.[22] In the conceptual development of comparative and international political economy explanations of national variations in economic policy, Peter Gourevitch's "production profile" approach was one of the clearest early efforts to trace how international and domestic variables together shape consequential political outcomes.[23]

In a similar vein, political scientist Kiren Chaudhry's analysis of liberalizing late developers argued that these countries' institutions of economic governance "will carry the dual imprint of the international economic context in which reforms were undertaken and the confluence of domestic institutional and political factors that marked the initiation of liberalizing policies" (Chaudhry 1993, 248). The dual imprint explanation identifies the institutions of securities governance as a dependent variable. It accommodates analytically the empirical significance of both external exposure to the international economy, and the role of domestic forces. Finally, by focusing on the institutions of economic governance themselves, foregrounding institutional change,

[22] In her study of Saudi Arabia and Yemen during the 1970s and 1980s cycles of boom and bust in the oil industry, Chaudhry examined how the timing of "structural junctures" with the world economy, punctuated by changing oil prices, reconfigured the institutions of economic governance in her two cases (Chaudhry 1997; Vogel 1996).

[23] The production profile explanation concentrated on "the preferences of societal actors as shaped by the actors' situation in the international and domestic economy" (Gourevitch 1986, 55).

the dual imprint explanation also provides a conceptual platform for considering the character (not just the quantity) of state-economy relations.

At the international level, a dual imprint explanation of institutional change involves an analysis of "structural junctures" with the world economy. The character of the structural juncture will vary for each country, based on the general systemic conditions prevailing in the international economy at the time of juncture and the character or "profile" of each country's exposure to the world economy. Scholars of IPE and CPE have suggested a range of profile parameters with salience for political outcomes *within* countries, including, *inter alia,* the timing of industrialization, country size, location on the product cycle, or location in the global hierarchy of capitalist production. Other variables important to the profile could include countries' balances on their current and capital accounts, currency reserves, indebtedness, and the composition and control of capital flows.

This analysis focuses on elements of the external profile associated with a country's volume of foreign industrial investment and balance of payments position, including: 1) the size and reliability of FDI; 2) the size and stability of export earnings; and 3) the size and stability of foreign currency reserves. The central state in almost all developing countries acts as a gatekeeper between the world economy and society on the outside, and the domestic economy and society on the inside. The profile of a country's structural juncture with the world economy, therefore, presents a hugely important opportunity structure – both incentives and constraints – to which central states respond. Chapter 5 elaborates on the mechanics of this structure and traces the political implications as these economic variables influence strategies of policy making and institution building in securities finance.

At the domestic level, a dual imprint explanation of institutional change involves a political sociology of interest aggregation and coalition dynamics "that is

sensitive to historical context." This entails an explicit recognition of how institutions embody the accommodations struck between stratified and segmented group interests in both state and society, and particularly their role in the dynamics of the dominant political coalition (Chaudhry 1997, 17-19). The domestic side of the "imprint" also includes the prevailing structure of property rights.

Two imprints thus forge countries' securities governance regimes: one from above and outside, the other from below and inside. The first is the hammer of international forces, the second the anvil of domestic structures. Figure 3-2 is a stylized depiction of this dual imprint.

At the international level – one side of the dual imprint – the key variable is a country's profile of exposure to the international economy. That profile presents states and other actors with a powerful inventive structure. The securities finance preferences of central-state-elites were crucial in almost all DTEs' financial changes. Those of the center in cases of state-led reform such as China and India were no different. Consequently, these two countries' profiles of external exposure significantly molded the preferences of central-state-elites regarding securities finance.

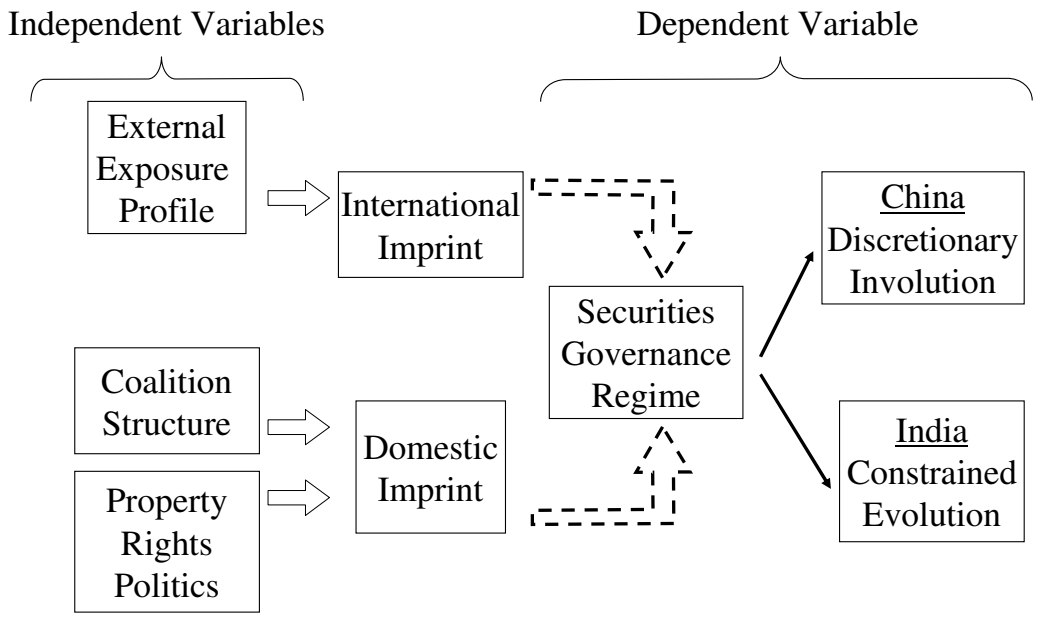

Figure 3-2:
Depicting the Dual Imprint

At the domestic level – the other side of the dual imprint – the key variables are the configuration of political coalitions and the structure of property rights. Accordingly, this analysis emphasizes how the domestic politics of securities finance are dominated by struggles within the dominant coalition over the property rights implications of securitization. The strategies pursued by central-state-elites to satisfy their preferences shaped the regimes that governed securities finance. These strategies were formulated by interaction with political coalition actors and with the domestic structure of property rights. This process is a fundamentally political one, because by revealing, specifying, and enabling the exchange of property rights, securitization at a minimum puts pressure on, and at maximum fundamentally challenges, the prevailing definitions of property rights in the organized economy, and the arrangements for the allocation of those rights. The politics of securitization are thus a struggle over the very definition of property rights, and over the allocation of access to those property rights embedded in securities. This struggle involves political contestation and institutional change. Its outcome is shaped by the configuration of each country's dominant political coalition, and by the inherited institutions that structure the property rights of the productive assets being securitized. Making sense of this domestic-level struggle is not easy; for the purpose of analyzing and explicating this struggle, I developed the asset-class/financial-position matrix described below.

China and India embarked on their respective experiments with economic reform and securitization at roughly the same time. Both countries were drawing on the same formulaic global securitization script. On the eve of the 1990s securitization thrust, China and India had comparable financial governance regimes, characterized by a legacy of state-dominate directed credit. Their respective structural junctures with the world economy began simultaneously in the 1980s and hit their stride, also at the

same time, in the 1990s. The timing of the common juncture is crucial. As Gerschenkron first emphasized, and Skocpol later elaborated, conditions prevailing in the international system at the "world time" moment of juncture will powerfully shape the development of domestic institutions. In the late 1980s and early 1990s, having relied on state-dominated directed-credit finance to achieve the stage of heavy industrialization, China and India peered out upon the world economy and wondered: What "different instrument" of finance for further industrialization would be "suitable to the new stage of backwardness"?[24] This was the moment in world time when securities finance was ascendant. Techno-market forces and sociological normative pressures among the community of states encouraged the adoption of securitization in financial practice. Consequently, the first component of the structural juncture – the prevailing conditions (favoring securitization) in the international economy at the time of juncture – is held constant for both country cases.

Whereas the world time of securitization was the same for both countries, the second structural juncture parameter – the profile of each country's exposure to the international economy – differs dramatically. The focus of process-tracing in this analysis, therefore, turns to the profile of each state's exposure to the international system, not to the conditions in the international system itself.[25] Each country's profile of external exposure was *imprinted* on the institutional response to securitization – the securities governance regime. Variation in external exposure profiles established differing political incentive structures for securities reform in the two countries.

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[24] This is a reference to the passage of Gerschenkron's "Economic Backwardness" paper in which he discusses the transformation of Russian financial governance after the "government had fulfilled the function of industrial banks" (1962 (1951), 22).

[25] This is a key deviation from "opportunity cost" explanations of the effects of internationalization on domestic politics (Frieden and Rogowski 1996).

Comparing the international side of the imprint, the benign profile of China's external exposure contrasted with India's precarious form.[26] In contrast with India, China possessed a stable, positive balance of payments position and abundant and persistent flows of FDI, producing very different political incentives. These incentives determined the preferences assigned to securities finance reform among those in government and business who were fashioning the institutions of securities governance in China and India. This explains why Indian policy makers and economic actors made a high priority of the securitization process – setting as their goal substantive changes in the institutions of securities-related financial governance – while Chinese policy makers and economic actors were casual about the pace of securitization. It also sheds light on their willingness to set predatory goals for the development of securities governance in the new securities sector. The political effect of the incentives generated by China's benign external profile was that the state and large business had a range of discretion in the process of securitization. In India, with its precarious external profile, the state and business felt constrained in the process of securitization. China *involuted* because it could. India *evolved* because it had to.

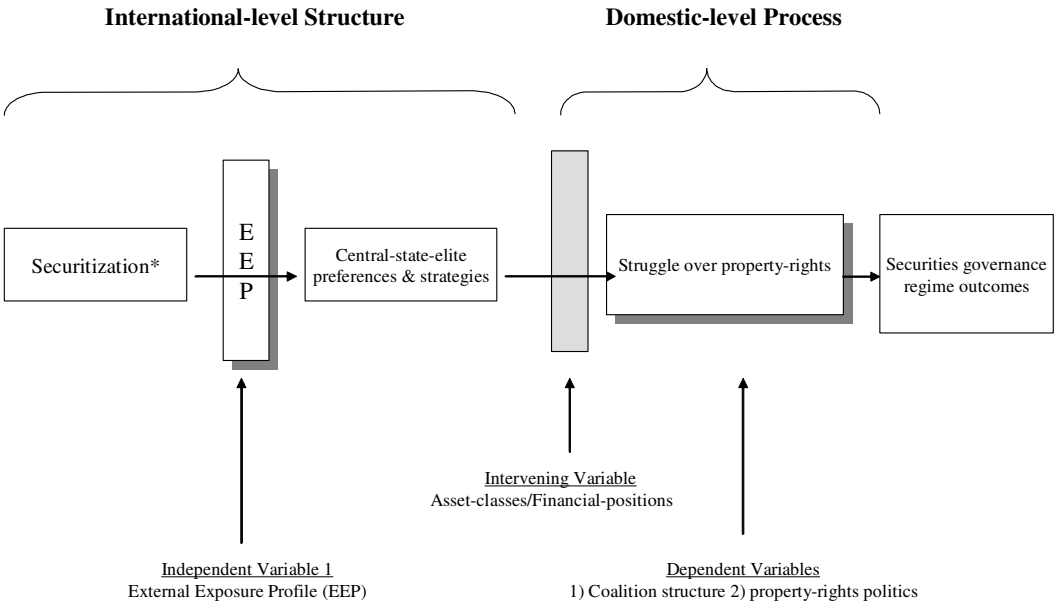
However, given the preferences for securitization imposed by these countries' respective profiles of external exposure, the particular process for enactment of the global securities script also bore the imprint of local domestic coalitions and property rights structures. Use of the term "enactment" might suggest that I consider the development of securities finance regimes in China and India to be just an "act"; not "real" economic reform. Such arguments are common with regard to China's securities markets, including the "Potemkin Village" charge cited earlier. Indeed, the realist tradition of domestic and international politics has always held that forms and

[26] In this instance, use of the word "benign" refers to the semantic range of its second definition in the American Heritage dictionary: "Tending to exert a beneficial influence; favorable" (Language 2000).

institutions are unimportant, and that strong actors will do as they wish. There is evidence for such a claim in the Chinese experience of securities markets. Yet, the state did not do just as it pleased, though the benign structure of its external exposure afforded a wider margin for manipulating the "script" than was available to countries such as India with less benign profiles of external exposure. Nevertheless, securities finance involves a set of social actors and social relations. It is thus a social construction, and as such, this Athena of securities finance does not spring forth fully formed from the head of some economic Zeus. It is enacted, and in both country cases, the actors, their identities, and the social relations among them reflect how coalition politics and property-rights structures interacted with the inherent logic of the securitization script. This is how distinct patterns of policy and institutions emerged to govern securities finance.

Figure 3-3 is a stylized depiction of how this dual imprint framework works in the explanation I offer here.[27] When viewed together with Table 3-1, it is easy to see how these pieces fit together.

[27] This is a version of Garrett and Lange's (1996) well known "Institutions and Political Change" model, modified for sectoral relevance in securities finance.



* Encouraged by global forces (social and techno-market).

Figure 3-3:
Structure and Process in the Explanation
International Junctures, Domestic Politics, and Securities Governance Regimes

Table 3-1: The Explanation

	China	India
International Juncture ***structure***	**Enabled** by *benign abundance* • benign balance of payments position • abundant capital • abundant foreign exchange	**Constrained** by *precarious scarcity* • precarious balance of payments position • scarce capital • scarce foreign exchange
Domestic Conditions ***process***	**Constrained** by • state dependence on *intramural* distributional coalition • rigid state-socialist property rights	**Enabled** by • state autonomy from *tripartite* distributional coalition • flexible mixed-economy property rights

In explaining the contrasting Chinese and Indian regimes of securities governance, I first turn to the profile of these countries' juncture with the world economy to identify central-state-elite preferences in both countries' undeniably state-led responses to securitization. Difference in these junctures, or *external exposure profiles* (EEPs), was a structural variable that provoked contrasting central-state-elite preferences in the two cases. These preferences established general trajectories for the local Chinese and Indian enactment of the global securitization script. From the structural EEP variable and the preferences it inspired, I then explain how the particular attributes of Indian and Chinese SGRs were forged through a domestic process in which these preferences were translated into specific strategies of securities script enactment. The dual imprint analytic thus showcases the linkages between structure and process in the development of a country's securities governance regime. At the international level, that country's juncture with the world economy – the EEP – is the relevant *structure* (see Figure 3-4, top row). At the domestic level, the struggle among coalition members over securities-related property rights is the crux of the political *process* (see Figure 3-4, bottom row).

A. Structure: External Exposure and State Preferences

Securitization is of such potential significance to both the real and financial sectors of the overall economy that its dynamics are perforce influenced by the profile of a country's juncture with the world economy. This is true even for countries like China and India that strictly control the flow of capital.[28] In the early 1990s, when securitization began in earnest, China and India were mirror images of one another.

[28] Both countries have maintained closed capital accounts (and their concomitant, non-convertible currencies).

China's stable, positive balance of payments position, robust exports, and abundant and persistent flows of FDI produced very different political incentives than did India's dubious balance of payments position, anemic exports, and scarce and erratic FDI flows.

Precariousness in the balance of payments plus scarcity in the flow of capital equaled jeopardy for the Indian state. The constraints of its *precarious scarcity* EEP therefore imposed on India's central policy makers a preference for a securities governance regime that would provide sufficient, stable foreign exchange, while contributing directly and indirectly to improving industrial finance. Foreign direct investment into China by overseas Chinese drove the export boom that fueled as much as a quarter of China's growth in the 1990s. The liberty conferred by China's *benign abundance* EEP provoked among Chinese central policy-makers a preference for manipulating securities institutions (because there was a margin to do so) to service its dominant coalition, providing life-support to the large state-owned enterprise (SOE) sector, interior provinces, and sunset sectors, and limiting disruption to those elements of the state-socialist property-rights regime that facilitated the exercise of CCP discretion. This structural, international-level dimension is summarized in the top row of Figure 3-4.

B. Process: State Strategies, Domestic Coalitions, and Property-Rights Struggles

Where did the specific attributes of India's constrained evolution and China's discretionary involution come from? How were their differing EEP-derived preferences transformed into the specific patterns that characterize their contrasting securities governance regimes? The next section of this chapter discusses this process-oriented, domestic-level part of the argument (depicted in the bottom row of Figure 3-

4). In each case, I trace how the preferences of the central state-state-elite interact with domestic coalitions and property-rights structures. This interaction translates those preferences into the strategies producing each particular SGR outcome. Untangling the politics of such a Byzantine and opaque process in any developing and transitional economy is tricky. Such untangling is the purpose of the asset-class/financial-position framework that I use to analyze the Chinese and Indian cases in subsequent chapters.

In characterizing these contrasting securities-related governance regimes, the coding of China's involution pattern as "discretionary" captures two related elements of the case. First, it indicates the latitude enjoyed by the Chinese state in institution building and policy making with respect to securitization, flowing from the country's benign profile of external exposure. Second, the term indicates the way governance structures and institutions were developed, to maximize state discretion in the management of securitization. In short, the government enjoyed a wide range of *discretion* in setting priorities and objectives in response to securitization because of the benign EEP profile. In pursuing those preferences, the strategy that developed in response to the constraining domestic structures of the "intramural" political coalition and the rigid state-socialist property rights led to an SGR in which the state institutionalized a wide range of discretion for itself in the emergent governance regime.

The opposite was true for India. The coding of India's evolution pattern as "constrained" captures two related elements of the case. First, it indicates the limitations confronting the Indian state in institution building and policy making with respect to securitization, flowing from the country's precarious profile of external exposure. Second, the term indicates the way governance structures and institutions were developed, to restrict state discretion in the management of securitization. In short, the Indian government suffered from a limited range of options in setting

priorities and objectives in response to securitization because of the precarious EEP profile. In pursuing those preferences, the strategy that developed in response to the enabling domestic structures of state autonomy vis-à-vis the dominant coalition; the flexible mixed-economy property rights led to an SGR in which the state institutionalized a constrained role for itself in the emergent governance regime.

III. Asset-Classes, Financial-Positions and the Political Analysis of Securitization

The politics behind the governance of securities-related finance is important, but poorly understood. For the governments involved, the shift of financial assets from directed-credit systems into securities has been a complex political challenge. For students of political economy in developing and transitional economies (DTEs), securities finance can seem a particularly opaque sphere in which the interests, incentives, and relevant actors are often unclear.

One objective of this thesis is to present a framework for clarifying this opacity, and to demonstrate the utility of that framework in analyzing the political responses to securitization. This new framework – the asset-class/financial-position matrix – relies on the distinction between asset-classes, and on the different financial positions of the issuers of securities and those who invest in them. The matrix reveals the politics of securitization in DTEs to be a struggle over the definition and allocation of property rights in this new and rapidly expanding domain of finance. Two variables – the role of the central state (its preferences and strategies), and the relationship between the dominant political coalition and the structure of property rights – influence this struggle, thus shaping the regime governing the creation, circulation, and use of securities.

A. The Asset-Class/Financial-Position Matrix

At the domestic level, specifying the actors, their properties, and the nature of the domestic environment relevant to the politics of securities finance is a significantly less tidy task than was sorting out the stark and easily measured parameters of the external exposure profile at the international level. However, the center-state-elite's preferences, derived from the EEP, are not sufficiently fine-grained to account for strategic interaction among a variety of domestic public and private actors in the securitization process. Analyzing this process at the domestic level thus requires creating a map of the factors influencing central states' strategies for achieving these preferences within the lineaments of the dominant coalition and its relationship to the institutions and ideologies of securities-related property rights. Unfortunately, pre-existing theories are not much help in providing such a map, which at least partially accounts for the dearth of contemporary research on the comparative political sociology of finance. The absence of such a map explains the difficulty previous studies have encountered in accounting for variations across countries regimes of financial governance.[29]

[29] There are few good concepts for analyzing the political sociology of "non-real" economic sectors such as finance. For real sectors, Shafer's synthesis is very useful (1994). For tertiary sectors like finance, the word of (Vogel 1996) and Laurence (Laurence 2001) is the state of the art in the comparative and international political economy literature, but of limited use in the context of closed capital-account DTE country cases.

	Issuers	Investors
Equity	**I** **Firms, Entrepreneurs** *"free" finance vs. dispersal of ownership & control* high market value, minimize loss of control/ownership, wealth capitalization	**II** **Financial Institutions, Individuals** *Ownership & limited liability vs. variable return* capital appreciation,* "voice," market for firms (or parts of firms), liquidity, investor protection
Debt	**III** **Firms, Governments**[@] *finance w/out loss of control vs. debtors exposure (bonding)* deficit finance, low i-rate, large long term project finance	**IV** **Financial Institutions, Individuals** *fixed return vs. default risk* Creditor-rights enforcement, liquidity

Bold = the actors
Italics = the attributes of the asset for actors in that financial position (typically a trade-off)
Underline = actors' interest with respect to that asset

* Some would argue that an "equity premium" is involved here.
[@] Central and sub-national governments (states/provinces/municipalities)

Figure 3-4:
Process-Tracing the Politics of Securitization
The Asset-Class/Financial-Position Matrix

The asset-class/financial-position matrix presented in Figure 3-4 offers such a map. It is a new approach specifically formulated to address this need for a framework with which to analyze the comparative political sociology of securities finance.[30] The matrix is derived from the highly formulaic scripted distinction in securities finance between equity and debt on the one hand (the rows of Figure 3-4), and the structural distinction between the issuers of securities and investors in securities on the other (the columns of Figure 3-4).

The differences between stocks and bonds in the types of claims they represent furnish the first dimension along which to analyze the politics of securitization and its

[30] Among those studying the political economy of finance, Chernow (1990) and Maxfield (1995; 1998) have had some success using analysis similar to, but less fully developed than, the asset-class/financial-position matrix presented here.

consequences for securities governance. This is the distinction between *asset classes*: debt versus equity. The two different locations in the creation and subsequent circulation of any given security, between the user of finance and its supplier, furnish the second dimension. This is the distinction between *financial positions*: issuer versus investor.[31] With the growth of securitized finance, issuer-investor relations increasingly affect capitalist outcomes because they involve the relative power of enterprise insiders and outsiders; determine the structures of enterprise ownership and control; influence the rules governing the merger and acquisition of enterprises; and finally, establish the balance between creditors and debtors. Together, these two distinctions – asset-classes and financial-positions – create a matrix that helps specify, across the cases, commensurable actors, interests, and relevant institutional outcomes within which public and private actors create, exchange, and use securities. The matrix, like any heuristic or ideal type, helps provoke analytic thinking about a complex and contingent reality; it does not purport to be a comprehensive rendering of that reality.

In Figure 3-4, these parameters are arrayed within the appropriate cells of the matrix, identifying relevant actors, attributes of the corresponding asset-class for these actors, and a deductive expectation of the actor's preferences regarding that asset-class based on the formulaic dynamics of the securitization script. From these expectations, it is possible to infer which empirically observable domains (institutional outcomes) might offer useful evidence with which to analyze the political struggle over securities-related property rights.[32] These domains are presented in a modified version of the AC/FP matrix depicted in Figure 3-5.

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[31] There are government and corporate entities whose need for finance leads them to create securities by issuing bonds or stocks. These are issuers. There are entities (public or private) and individuals who provide finance when they "buy" these securities. These are investors.

[32] Researchers conducting structured, focused case-comparisons are advised to identify observable implications that apply across (and hopefully beyond) the cases at hand (George and McKeown 1985).

	Issuers	Investors
Equity	**I** **Enterprise Finance** • *share issuance* **Wealth Capitalization** • *"founders rent"* • *equity leverage, equity currency"* **Privatization**	**II** **Shareholder Rights** • *transparency/disclosure/dividends, investor protection (information symmetry)* **Industrial Organization** • *Market for Companies, M&A, Corp. Governance, Market for voice/control*
Debt	**III** **Firms** • Enterprise Finance **Governments** • *Public Finance* • *Monetary Policy*	**IV** **Bankruptcy** **Returns** • *Corp./Govt. Yield Curve*

Public Finance = Fiscal policy, deficit spending, local developmentalism
Monetary Policy = Open-Market Operations, sterilization, and monetizing debt

Figure 3-5:
Using the AC/FP Matrix
Observable Domains of Securitization Politics

The alternative issuer-investor financial positions are analogous to the dichotomy familiar to many political economists from work on power distribution in the economic (or political) marketplace between producers (politicians and political parties) and consumers (voters).[33] Multiple dynamic equilibria between issuers and investors are possible across the domains identified in Figure 3-5. These outcomes are the result of political struggles over finance-related property rights. Their aggregate configuration shapes each country's SGR, and ultimately the type of capitalism it encourages. In chapter 6, evidence on stock exchange development demonstrates how the Chinese SGR has served to organize securities finance in that country into a

[33] In the 1960s and 1970s, the academic debate focused on the conditions favoring either producer or consumer sovereignty in different political economic systems (Downs 1965; Lindblom 1977; Wittman 1973).

system "of, by, and for" issuers. The Indian SGR has served to create a system increasingly characterized by dynamic contestation between issuers and investors.

IV. Securities Governance and the Politics of Securitization: The Intellectual Terrain

Though they both started the decade with similar developmental state-led directed credit systems of finance, by the end of the 1990s the Indian and Chinese cases display evidence of variation, both in their responses to the conformity-inducing power of global techno-market forces of securitization, and in their local enactment of the increasingly shared global script of securities finance. What might explain this variation?

Within the existing corpus of social science theory, the possible explanations for these different securities governance regime outcomes may be divided into two general groups: those that emphasize international factors, and those that emphasize domestic factors. On the international side, some of the arguments for how global forces shape domestic institutional development and policy change in DTEs (including economic governance regimes) emphasize the role of international markets, technological change, and an emergent world society, as I have already mentioned. Other international or systemic explanations for domestic governance structures emphasize the ideas or interests of powerful global actors such as transnational corporations and hegemonic states like the U.S. Among domestically focused explanations, arguments about the autonomy of the state relative to other actors or differences in regime type are most commonly invoked to explain variation in national policy institutions or economic governance structures.

A. International Explanations

Many scholars of IPE argue that globalization, acting through technological, market, and sociological processes, is leading to a convergence of cultures, economic practices, and regulatory structures. They point to the similarity of formal structures and practices (referred to by sociologists as institutional isomorphism) such as central banks, stock exchanges, regulatory practice, and economic openness. [34]

The first generation of "second image reversed" theories explored how broad global historical forces such as the timing of industrialization or the product cycle shaped domestic institutions. More recent innovations have tried to link globalization and domestic politics using variations on the techno-market-based opportunity-cost analysis popularized by political scientists Jeffrey Frieden and Ronald Rogowski (1996). According to these arguments, states are passive adjusters to global market forces, as increasingly free, open, and voluminous financial flows in the international system impose rising opportunity costs on differentially positioned domestic actors. Following the logic of a pluralist model of political change, these domestic actors influence government policy and institution building. This view was partially successful in analyzing the effects of internationalization in pluralist polities such as OECD member states, where the dynamic density of interactions in trade, ideas, and communications, along with the democratic process, make the translation of actors' changing policy preferences quicker and easier. The model suggests that this dynamic will be roughly the same for small open economies as it is for large relatively closed ones.[35] It is a "bottom-up" explanation that does not account very well for the state-

[34] The forces behind institutional isomorphism form the core empirical domain for the neo-institutionalist research agenda (DiMaggio and Powell 1991).

[35] They reason that *even in closed economies*, financial openness in the world economy at large imposes increasing incentives on domestic economic actors, including the state, to liberalize economic policy including the capital account. For a contrary view regarding the politics of closed economies, see Evangalista (1996).

led, top-down financial reforms undertaken by strong states with relatively closed financial systems (Echeverri-Gent 1999). States such as this, like China and India, can proceed with some independence as either domestic or transnational actors. But the international economy does not act equally on all states, and the profile of each state's exposure to international markets will shape the political incentives for domestic financial change. In this regard, China and India represent polar cases, with China enjoying a benign profile of external exposure and India suffering from a precarious one.

Finance is a medium through which the influence of markets, social norms, technologies, ideas, and the interests of powerful actors spread around the world. Few now dispute the claim that global finance is a significant cause of domestic change and convergent policy tendencies among nations. But there is no *prima facie* means of ascertaining whether there are multiple intermediate equilibria, or only one ultimate convergence point. The most common explanations of convergence and economic reform, focusing on markets, "mislead us by portraying markets as determinants of outcomes rather than as stimuli to which national governments respond in distinct ways" (Vogel 1996, 262).[36] In other words, there is good reason to believe that "the accommodation between liberalizing LDCs (Less Developed Countries) and the global economy will, no doubt, reflect the diversity of economic endowments in late, late developers" (Chaudhry 1993, 254). This suggests that investigations of specific countries, and specific sectors within those countries, will reveal important differences in the manner in which they respond to global forces. These two ideas provide the structure of the following investigation. Securitization is taken as a "stimulus" in the

[36] The market-based convergence model suggests that successes in Chinese and Indian financial reform "are the consequences of …institutions being allowed to converge with those of non-socialist market economies," and that these successes are diminished as a function their degree of divergence from such models (Woo 1999, 117).

global economy and international society that provokes policy responses from states. This addresses a prominent debate among scholars of IPE and CPE over the degree to which such policy responses will tend toward convergence or diversity in governance regimes.

Ideas are another important international variable often used to explain both convergence and diversity among national policy institutions (Darden 2000; Drezner 2001; Goldstein and Keohane 1993; Sikkink 1991; Yee 1996). Indeed, the "idea" of securities markets is crucial to the Indian and Chinese changes in financial governance. But the outcomes I observe in India and China testify to the limit of ideas as a convergent force. The nominal structure of securities markets designated by the script of securitization has become a taken-for-granted intersubjective social fact in both countries. Even the most aggressive critics among Indian nationalists and Chinese "leftists" accept the stock and bond markets (at least in their domestic mode). The securities exchange and the basic script of securitization have been de-linked from the competition of economic ideas. However, the *ideas* of neoliberal marketization find expression in the projects of coalition members and in property rights institutions. It is the ideas expressed in the interaction of interests, and legacy institutions *in response to securitization* that generate diversity in newly forming policy institutions, and the governance regimes of which they are a part. The outcome of these political interactions circumscribes the effect of ideas on the development of governance regimes, and determines the degree and vector of convergence.

It is not clear how an ideas-based argument could account for the variation in Chinese and Indian securities-related financial governance. The International Finance Corporation promoted the use of securities equally in both countries. The United States Agency for International Development provided assistance and training in securities market development to both countries. Moreover, China, the less eager

promoter of the "ideas" associated with securities markets, experienced a much higher volume of interaction with heavily securitized capitalism through its links with Hong Kong, Asia's most advanced and active securities market. India had no equivalent. Both countries had a volume of foreign-trained economists and financial experts who were carriers of these ideas circulating in policy and business arenas.[37]

Ideas-based explanations suffer from the difficulty of determining which ideas matter. One of the most consistent messages from numerous interviews in both China and India was the persistence of competing ideas about how to proceed with securitization. Policy makers in both countries reported to me that from the 1994 Mexican Peso crisis onward, there were active debates in both capitals about the merits of financial opening policies prescribed by neo-liberal economic ideas. The chairman of the Securities and Exchange Board of India (SEBI) explained how, in debate with Ministry of Finance officials, he invoked the success of Malaysian controls on Singaporean stock holders as validating the use of *ad hoc* measures in managing foreign portfolio investment.[38] Likewise, an opponent of China's push to establish a NASDAQ-like "second board"[39] argued that even before the March 2000 NASDAQ crash, Chinese policy makers were wary because the idea of second boards didn't seem to be doing so well in Japan and Hong Kong.[40] The flow of ideas about finance provides little insight into the difference between the two countries' securities-related financial governance regimes. However, the ideas behind the formulaic global securitization script are important as a stimulus to institutional response, in the same way as global markets and elements of global society.

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[37] Both countries suffered severe "brain drain" in the 1980s and 1990s, but there were also significant numbers of returnees, particularly in the 1990s (Desai, Kapur, and McHale 2001; Zweig, Chen, and Rosen 1995).
[38] Author's interview, Bombay, 2000, #49.
[39] The idea, which became popular after the 1999 establishment of Hong Kong's "Growth Enterprise Market" (GEM), was called the *chuanye ban* ("innovation board").
[40] Author's interview, Beijing, 2000, #17.

A final international explanation commonly deployed to explain national financial policies is the role and interests of powerful actors like transnational corporations (TNCs) or hegemonic powers such as the U.S. (Sobel 1994; Stopford and Strange 1991). On these accounts, a country with greater exposure to TNCs or U.S. power, or the U.S. financial episteme, would be more likely to undertake substantive reform (Wade 1998). This argument is best summarized by Andrew Sobel's use of the "inside-out" view of financial reform in the U.S., U.K., and Japan in the 1980s. He argues for the importance of exposure to American interests in trade and other international interactions. It is not, he contends, opportunity costs or attributes of the international system that cause financial policy change in the domestic policy institutions of countries, but interaction with U.S. ideas backed by U.S. power (Sobel 1994).

For the last two decades, China has run a large trade surplus with the U.S.; many U.S. companies involved themselves in that trade, mostly as investors in export-oriented joint ventures. This exposed China significantly to U.S. power and interests, while over the same period India's exposure in these areas was minimal. Furthermore, during the 1980s and 1990s, great numbers of Chinese students attended American universities and were exposed to the U.S. educational emphasis on neo-liberal ideas of financial reform. Based on this exposure, Sobel's model would lead us to expect that China, not India, should be the more aggressive adopter of U.S.-style financial institutions. Furthermore, when it had the chance, the U.S. did not push for securitization in India. The IMF, on whose board the U.S. enjoys a veto, *did not* include securities market reform in the conditionality requirements of its 1991 structural adjustment loan to India.

B. Domestic Explanations

The contrasting securities governance outcomes in China and India are not well explained by existing comparative political approaches to institutional change. Comparative politics scholars often argue that authoritarian regimes are better at pursuing economic reforms than are democracies.[41] Indeed, by the end of the 1990s, there was a general consensus that because of its one-party control, "by any account, China's economic reform has been far more successful than India's."[42] The arguments about state capacity or state autonomy and about regime-type often get tangled together. The deductive expectation of such arguments is that governments with an electoral base will be less autonomous and less capable than authoritarian ones.[43] China's single-party state is generally understood to have a large degree of autonomy in economic policy making and a relatively high capacity to implement those policies (McCormick and Unger 1996; Rowen 1998; Weiss 1994).[44] India is considered to be a state with constrained autonomy, and little capability to implement policy (Evans 1995; Herring 1999).[45] The common theoretical expectations for India predict a state captured by *status quo*-inclined interests, leading to particularistic biases favoring certain industries, sectors, or social groups. In China, the expectation is of the state as a relatively autonomous adjuster of policies, willing and able – because of its

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[41] While the evidence regarding regime type and the effectiveness of economic reform in industrial states and middle-income developers is mixed, there has been some agreement that in low-income developers, authoritarian systems may better facilitate economic reform (Chhibber and Eldersveld 1995; Geddes 1995).

[42] Such analyses often stress GDP growth and scant the substantive institutional and political elements of "reform." For example see, Studwell (1995).

[43] Such arguments emphasize politicians' preference for re-election, while discounting the possible effects of inspired leadership shaping public opinion and overcoming organized interests, or the benefits of legitimacy conferred by strong electoral victories. For a good discussion of this generally, see Haggard et al (1992). For India, see Jenkins (1995).

[44] For a dissenting view with specific reference to the late 1990s, see Pei (2002). For a review of the more nuanced understandings of subnational variation in state capacity within China, see Chung (2000), and for India, see Kohli (1987).

[45] For a view of the contradictory nature of Indian state capacity, see Jenkins (1999).

monopoly control over political power – to undertake change where necessary in the interests of long-term welfare.[46] The explanation commonly given for this difference is that authoritarian regimes can stifle and control the opposition of organized political interests. Thus, India's slow pace at reducing state intervention "is seen as a result of its democracy," while China's "spectacular success" is usually attributed "to the more authoritarian one party rule" (Chhibber and Eldersveld 1995, 74-75).

Theories of state autonomy and state capacity would lead us to expect that the current beneficiaries of the financial *status quo* will resist changes in the regime of financial governance associated with increasing securitization (Stallings 1992).[47] According to this line of reasoning, "weak" states like India would be unable to overcome such resistance. Any changes that did occur would reflect shifting interests among powerful *status quo*-disposed actors. By contrast, a "strong" and autonomous state such as China would exhibit the opposite dynamic.[48] The two cases confound such expectations.

We see almost exactly the opposite of these expected outcomes in the real development of securities finance in the two countries. 1990s securities reform was state-led and top-down in both countries.[49] The irony is that in India's multiparty pluralist political system, the state pushed ahead with neo-developmental securities

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[46] For India, see Harriss (1987), and Kohli (1990, Chapt. 11). For China, see McCormick et al (1996).

[47] Such expectations are based on the "Olsonian" logic of collective action, public choice theory, and the concepts of "neoclassical political economy" (Colander 1984). For an application of such arguments in various comparative cases, see Haggard et al (1992). One of the earliest expositions of the neoclassical political economy approach was in fact an empirical study of Indian economic policy (Krueger 1974).

[48] In a challenge to such arguments founded on Latin American and Eastern European case material, Hector Schamis has proposed that state autonomy explanations do not take the interests of the variety of economic actors seriously enough. He argues that beneficiaries of reform may be equally likely to prevail in promoting reform, based also on Olsonian logic, because "there are increasing opportunities for rent seeking during reform" – a possibility many scholars have ignored (Schamis 2002, 18).

[49] It is important to note, however, that the less spectacular but nevertheless significant securities reform of the 1980s in both countries included an important "bottom-up" dynamic. This was true for elements of corporatization in China. For discussions of this dynamic, see Zweig (1997), Ma (1999), and Yang (1998). It was also true for the early stages of the "equity cult" in India (McDonald 1998, especially Chapter 5).

reform in the face of societal opposition and in the absence of any existing societal constituency for reform. More ironically, in China's one-party monopoly-sovereignty political system, the state pursued involuted reform in order to manage distributional and coalitional politics, and because it needed to calibrate property rights and corporate control in the absence of the contractual and institutional prerequisites for increasingly securitized finance. Why did the superficially more autonomous and capable Chinese state fail to reform its institutions of securities governance, while the apparently less independent and less capable Indian state moved ahead with vigor and a large measure of success?

A corollary of domestic explanations based on regime type relates to the role of voters as potential investors, and the electoral politics of securitization. India has voters who are savers, and Indian voter-investors might be expected to use the electoral system to promote securities market reform. In China, where savers have no vote, one would expect them to have little voice in financial reform. To evaluate this subsidiary explanation, one would first want to explore potential collective action dynamics favoring the interests of incumbent concentrated financial interests over those of saver-voters. There were few such concentrated interests in India. However, there was an even less significant force of voter-investors, and where they existed they had been institutionally co-opted into the old regime of state-dominated directed-credit in a fashion similar to that of the large private businesses (Herring 1999). At the beginning of reform, the independent Indian investor base was small, but the "dependent" investor-voter base was relatively large, and it was co-opted into the old financial governance regime via a monopolistic state-owned mutual fund, the Unit Trust of India.[50] These investors had no incentive to reform the system because that

[50] UTI, a statutory creation of the Indian parliament in the early 1960s heyday of Nehruvian mixed-economy planning, is a government-run mutual fund that paid guaranteed returns on a portfolio that consisted largely of state-owned enterprise assets. It is the subject of extended analysis in Chapter Four.

would end the privileged position of UTI and threaten their guaranteed returns from that source.

If electoral politics were important to financial policy in India, we would expect to see parliamentary activism on the issue of governance in securities finance. In the early 1990s, there was an extensive investigation by a Joint Parliamentary Commission (JPC) into the famous "Scam" of 1992.[51] Yet, it was the executive branch of government (the "permanent government" of bureaucrats) in the office of the Ministry of Finance – not the parliament of elected politicians – that took the lead in fashioning an institutional response in the aftermath of the scam, much as it had been doing since it first established the embryonic securities market regulator (SEBI) in 1988.

Turning to China, to the extent that citizen-investors affected securities market policy, they did so by voting with their savings. Unable to invest abroad due to the PRC's strict capital controls, Chinese citizens kept their large savings[52] in bank deposits bearing negative real interest rates, investing only a small share of that pool in the securities market. This is because, with such a huge supply of individual savings chasing a limited supply of shares available to the public, valuations of Chinese shares in the late 1990s reached levels that were obviously inflated by any standard, and that were particularly unrealistic given the well known unprofitability of Chinese state-owned enterprises (SOEs).[53] To the extent that it considered citizens' interests, the

[51] This was the largest stock market fiasco in India history, and involved the illicit use of bank funds for speculation in the stock market, leading to volatile boom and bust. Not long after the JPC submitted its report, Indian Prime Minister Narasimha Rao resigned, partially due to the taint from allegations of his corrupt links to the powerful stock-broker Harshad Mehta, whose unethical and often illegal practices had been central to the progress of the scam. For detailed accounts of this event and its profound effect on subsequent Indian securities market development, see Basu et al (1993), and Barua et al (1993).
[52] China had an average savings rate of over 30% of GDP in the 1990s (Bank 2000).
[53] In the period since 1996, Chinese shares have traded at an average price-to-earnings ratio above 35/1. In 2002 they were at an unbelievable 57/1 (Commission 2001). As a matter of comparison, at the height of the 1990s boom, average Indian and American P/E ratios reached the range of 30-35/1. Eventually, wealthy Chinese savers got fed up with the Hobson's choice and began investing informally in illegal banks and illegal asset management schemes (Rudolph 2002; Tsai 2002).

PRC government therefore had to accommodate itself to the "votes" cast by individual savers. Furthermore, the major element of China's involuted securities policy was the development of an FGR designed specifically to channel stock market funds into the obsolescent SOEs. This capital market "subsidy" to the SOEs was part of the central government's top priority effort to avoid instability by making good on the "Socialist Social Contract," maintaining employment and the provision of social services linked to the SOE system. In other words, contrary to the expectation of policy autonomy for the authoritarian CCP state, the development of China's securities-related governance regime was vulnerable to "societal interests" despite the country's lack of formal democracy.

Finally, if variation in regime type – democracy versus authoritarianism – is to explain the differing PRC and Indian outcomes, it must also account for why India does well at securities finance reform but badly in other economic sectors, both relative to itself and relative to China.[54] After all, voters are also consumers of water, transportation, communications, education, technology goods, and clean air, sectors where India lags relative to finance and to the same sectors in China.

V. Selecting Cases, Applying Methods, Using Evidence

Much of the research on the governance of securities finance has been focused on OECD countries that are open to capital flows and are therefore "easy cases" for the argument that global forces cause convergence. If we don't see convergence in the OECD cases, that is, we aren't likely to see it anywhere. But two key studies of OECD states, by political scientists Steven Vogel and Edward Laurence (discussed in the

[54] For an excellent cross-sectoral analysis of regulation in India that discusses the success of financial regulation relative to other sectors, see Bhattacharya (2001).

introduction), were indeterminate on this question. In contrast to OECD countries, China and India severely restrict capital flows. Does this make them a "hard case" for convergence theory? At the same time, one conclusion drawn by this study is that, even if securities finance is seen as an "easy case" from the international perspective because of the size and scope of global securities finance, it should also be viewed as a "hard" case because of its crucial importance for the exercise of central state power. As discussed in chapter 2, securities finance in developing and transitional economies is an especially useful issue area in which to explore the transformation of state authority in the economy, because of the particular challenges it presents to the old developmental state mode of authority and the political arrangements that supported that mode of authority.

One uncommon element of this research project is the introduction of India as a case study in the comparative analysis of economic transitions. It may often be analytically useful to corral post-communist states together, distinguishing between research on "post-Communist" or "post-socialist" political economy – classified as "transitions" – and research on other "mixed" or heavily socialized economies where the political economy of change is referred to as "liberalization" or "reform." But such a distinction often elides some commonalities with other political economies, and may unnecessarily restrict the generalizability of research findings. This is the case with China and India in this issue area at least. Consequently, this research started by ignoring conventional professional divisions in comparative politics, attempting to develop a unified analysis of the politics of economic change in India and China. This should direct attention to the comparable elements of financial reform in the mixed economies of the two countries in 1990s.

India and China are different countries in terms of many social, economic, and political factors. Their political economies do not permit the tight "matching" of

variables necessary to conduct a “Millian” comparison. However, the timing of securitization within the international economic system is the same, beginning in the early 1990s in both countries. The official stated objectives of the central states were also equivalent. The two countries adopted many of the same forms and idioms in developing securities finance. And most importantly, my findings suggest that, given the character of state control through systems of directed-credit and industrial planning, China and India were commensurable political economies when we compare the form and function of financial allocation to the organized corporate sector on the eve of securitization in the early 1990s. This rough matching of the cases is elaborated in chapter 4.

Comparative research is conducted in a variety of ways. One typology of these methods conceives of comparative research as first considering a universe of relevant cases – the “sampling frame” – and then considering a specific number of cases to be studied in the actual analysis (the “units of analysis”). Table 3-2 is a graphic representation of this conception. The common debate in political science is between Cell I and Cell IV.

Table 3-2:
Varieties of Comparative Case Selection[55]

		Units of Analysis	
		Large N	Small N
Sampling Frame	Large N	I. Laitin/Fearon "Explaining Ethnic Cooperation"	II. Peter Katzenstein "Small States"
	Small N	III. Ashuthosh Varshney "Ethnic Conflict"	IV. Peter Hall "Governing the Economy"

Taking formerly directed-credit DTEs as an example, the researcher would have chosen a sampling frame that is abundant (there are many DTEs, making it a reasonably large-n sampling frame). The researcher could then choose to study only two specific cases of DTEs, such as China and India. This would put the researcher in cell II, with a (moderately) large-n sampling frame, but a small-n number of units to analyze. Such is the orientation of this study.

Using the dual imprint framework to understand the politics of securitization in specific empirical contexts involves a number of analytic choices. As Figure 3-3 illustrated, three independent variables (the EEP, coalition politics, and property rights structure) shape the securities governance regime outcomes. Intervening among these

[55] See Fearon (1996), Varshney (2002), Katzenstein (1985), Hall (1986).

are the preferences and strategies of the central-state-elite, and the configuration of financial actors (issuers/investors) with respect to different asset-classes (stocks/bonds). In weaving these together in a coherent analysis of securities governance regime outcomes, this argument relies on a combination of "rationalist" and "sociological" approaches. Without explicit analytic recognition of the preferences, strategies, and sequencing of them among central-state actors and other actors, it is difficult to make sense of the politics of securitization. The "process tracing" approach to case comparisons used here requires the investigator to examine closely the "decision process by which various initial conditions are translated into outcomes" (George and McKeown 1985, 35). This is not necessarily inconsistent with the sociological institutionalism that anchors the overall analytic framework of the thesis. As economic sociologist Neil Fligstein writes, "a sociological theory of action needs to take rational actor views seriously in the sense that actors do pursue interests and aggressively engage in strategic interaction. But it must 'sociologize' them by making actors collective, and motivate their actions by having them orient their strategic behavior to groups" (Fligstein 2001 p. 11).

Political Scientist Jeffrey Frieden has argued that it is helpful to start with a "theory of preferences" (Frieden 1999). He suggests that the analyst be explicit about how she arrives at the preferences she ascribes to key actors. I specify preferences both deductively and inductively. We already have existing theories of Chinese and Indian state preferences and political coalitions that point us in the right direction, and fieldwork results allows me to get hints of "private information" that facilitate refinement of these. Moreover, I can further supplement my specification of these preferences by matching and comparing my observations of contentious debate with private information hints, public documents, and expert "local knowledge."

In both "rounds" of my argument – the "structure of international exposure" round, and the "process of domestic politics" round – I use two of the techniques Frieden recommends for ascertaining actor preferences. I combine theoretically derived specifications of Chinese and Indian central elite preferences with inductively inspired inferences about preferences based on the research process discussed above. In round one – how each country's structure of external exposure interacts with fundamental central-state-elite preferences – I rely on previously existing theories in the China and India literature, supplementing them with some observations about preferences from my field research. In round two, the domestic central-state-elites devise policies and institution-building strategies based on preferences formed in the previous round. Those strategies must be devised in interaction with the dominant political coalition and the prevailing structure of property rights. To follow this process of strategic-interaction-based institution building, I use a synthesis of deductive and inductive techniques to specify the identities and interests of the relevant actors – that is, the asset-class/financial-position matrix. These intensive analytic demands are not surprising, given that round two is much more focused on process, and that this political action is occurring within the more "dynamically dense" context of domestic politics.[56]

The asset-class/financial-position matrix furnishes an important part of the "structure" for the "structured-focused" comparison of these two cases. In a structured-focused comparison, the researcher seeks some "congruence" among the cases in order to facilitate a careful tracing of the processes that lead to the particular outcomes in question. In multi-case, cross-country comparisons, the researcher must craft a compelling focus for the comparison. Methodologically, the matrix provides

[56] Ruggie defines dynamic density as "the quantity, velocity and diversity of transactions that go on within society" (Ruggie 1982).

this kind of common analytic framework for tracing the politics of securitization. It does not provide a theory of change in securities governance regimes, but it does facilitate the process-tracing analysis central to structured, focused comparison by providing some deductive guidance to be applied uniformly within and across cases. That guidance helps identify actors, specify their structural position, and infer their preferences. It also demonstrates that these basic elements of the political dynamics of securitization are comparable across cases, even if the socio-political context in which that process occurs is not perfectly commensurable.

Finally, George and McKeown advise researchers conducting "structured, focused, comparison" to proliferate observable implications that apply across the cases under examination (and hopefully beyond them as well) (George and McKeown 1985). So, while the number of institutional pieces comprising securities governance regimes (state, market, and civil society) and a number of intermediate outcomes they influence (the elements in Figure 3-5 such as enterprise/public finance, etc.) are analytically challenging, they also offer a useful opportunity to tease out more observable implications to be deployed in the analysis. To find evidence about these outcomes and the processes that produced them in the policy making and institution building process, I relied on macro-economic and financial data, official documents, biographies, newspapers, interviews, and also secondary sources such as more detailed studies of securities finance, coalition politics, and property rights in China and India.

This is neither a typical IPE monograph nor a typical CPE monograph. IPE studies are expected to "take sides," arguing that the outcome they are explaining is primarily determined by either domestic or international factors. Akin to much of the economic and political sociology work from which it draws, the framework I deploy in this study emphasizes, empirically and theoretically, the meso-level. First, it investigates a "local social order" – governance in a specific sector of the economy –

securities finance. Second, the framework locates the social construction of securities governance regimes at the mezzanine between the celebrity forces of globalization on the international floor above, and the rough and tumble of domestic coalitions and property rights on the domestic floor below. In the cases at hand, institutionalization of securities governance regimes in China and India entails precisely the process neo-institutionalists hope to understand: how powerful actors, ideas, and ambient structural forces interact with local social orders.

I devised the dual imprint framework because I judged it the best fit with the evidence collected in the field. Those materials, however, were not selected haphazardly. They were selected based on deductive inferences derived from theories of global convergence and state-economy relations during marketization. I use the dual imprint explanation to represent analytically my explicit empirical conclusion that variation in the Chinese and Indian securities governance regimes can't be satisfactorily accounted for by either domestic or international factors alone, or even that one of these can reasonably be considered more important than the other. The explanation is not, therefore, stark in its parsimony. But one of its conclusions, that China may be worse off and India better off than many think, is at least moderately counterintuitive, and I hope that the analysis will convince the reader that this particular combination of factors was the most reasonable trade-off between parsimony and explanatory scope in two distinctly non-trivial cases.

A. Final Thoughts on Method

The theoretical expectations of the techno-market approach would predict that the securitization changes of the early1990s globally and locally opened avenues for the operation of such political processes. The theory assumes that the opportunity

costs of a country's relative economic closure and divergent policy regime are steadily rising.

Even before considering the empirical record, this is a puzzling assumption. It often puts financial economists who agree with the argument and who therefore favor more aggressive financial liberalization in the awkward position of ignoring the fundamental principle of their own discipline: That returns are related to risks. The returns from openness should be no different, and rational domestic actors contemplating external or internal financial reform would calculate the risks as costs just as they calculate potential returns as benefits.

Considering the empirical record, the assumption of steadily rising opportunity costs is also puzzling; particularly from the perspective of the late 1990s.[57] For government and business in DTEs contemplating financial reform, the mid-1990s brought new information about how to calculate the opportunity costs of their financial governance regimes. As a series of spectacular international financial crises unfolded beginning mid-decade, vivid evidence crowding the news highlighted the real and potential costs of international and domestic financial opening. The parade of disasters that began in late 1994 with the Mexican Peso crisis, continued with the 1997 East Asian Crisis, spread with the 1998 Brazilian and Russian debt crises, and culminated ominously with major American banks' bailout of Long Term Capital Management (LTCM) at the very heart of the open international capital system. These events could reasonably be construed as evidence of significant potential costs to be weighed against the benefits of domestic and international financial openness, and by

[57] International economists began turning their attention to this problem in the mid-1990s. The conclusions for national economies were not unlike those for financial firms. That is, the development of prudential norms and mechanisms for risk management were essential to protect financial firms from devastating losses as they increased their exposure to international financial activity Rodrick 2001). Countries, the argument goes, like firms, must cultivate "software" such as appropriate institutions and practices as a basis for stable and equitable market development.

late 1997 many governments and businesses had begun to re-evaluate their rational expectations of the opportunity costs of relative closure. As a consequence, in the second half of the 1990s we did not witness a unidirectional bottom-up operation of the internationalization and convergence mechanisms predicted by opportunity cost theories. What happened?

It is true that there is some evidence supporting the unidirectional variant of the techno-market opportunity cost approach, particularly when one looks at leading Indian sectors such as software and services (both commercial and financial). Both of these sectors have been aggressive lobbiers favoring greater capital account flexibility, improved corporate governance, greater flexibility in industrial organization (M&A), and improved enforcement and disposition of financial claims (bankruptcy and creditor claims). For this reason there is no denying the existence of bottom-up political momentum in the convergence of financial governance structures. But, in China, for example, the growth of financial interests has not always led in directions that opportunity cost theories would predict. For example, in 2001 it was the domestic securities industry that scuttled the government's plan to sell down the state's large ownership of shares in SOEs.

However, the predicted changes that did occur were accompanied by many changes that contradict the expectations of liberalizing change. I have explained above how Chinese and Indian profiles of external exposure produced political incentives that shaped the policy trend in which securities-related financial governance proceeded during the crucial first half of the 1990s. But a remarkable feature of the Chinese and Indian patterns of securities governance identified here is their durability. Despite repeated indications that the discretionary involution equilibrium in China was about to be upset in favor of fundamental reforms in 1997, 1999 with a change in the procedure for listing companies, following and finally with the WTO signing in 2001,

and with the opening to institutional investors in 2002, the pattern still persists. In 2003 the U.S. and Chinese authorities clashed over the keystone of China's capital control policy, the Yuan peg to the American dollar. U.S. Treasury Secretary Snow and Commerce Secretary Evans both made forays to Beijing in the first of many skirmishes over policies related to Chinese central control of finance. The Chinese had hoped to head this problem off by making a seemingly significant concession by permitting foreign investors (read U.S. financial service providers) an opportunity to participate in the country's share markets through a specially mediated route known as the "Qualified Foreign Institutional Investor" program. In India faced a spectacular fiasco in 2001, and major embarrassments in the mutual fund industry in 1998 and 2001. Nationalist and quasi-socialist resistance to further privatization and modernization in the securities sector continues.[58] In spite of this resistence, the constrained evolution pattern with its state-led emphasis has also persisted.

In numerous interviews with Chinese and Indian financial policy makers, the most common justifications given for gradualist changes to their regimes of financial governance, particularly securities markets and capital controls were presented with reference to the East Asian Crisis and the LTCM bailout. One international economist who frequently advises the Chinese government said simply, "Even pre-Asian Financial Crisis, they were reluctant to allow foreign participation in equity markets and the Asian financial crisis only bolstered this view."[59] Several of my foreign-trained interlocutors also commented on the ill effects of the junk bond fueled savings

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[58] The left in India persists in criticizing the securities governance regime, often on reasonable concerns about volatility and inequality. However, not only does the Left fail to fails to propose useful substantive alternatives. They don't even bother to make *any* alternative proposals. See, Ghosh (Ghosh 2002b) and Chandrasekhar (2003). The nationalists, best represented by the vocal and well-organized *Swadeshi Jagran Manch* (SJM), has opposed the reliance on foreign portfolio investment and related measures at every step. The SJM, a small but influential member of the *pariwar* (family) of Hindu nationalist parties and groups, does not oppose marketization of securities finance, only internationalization. Author's interview, Chennai, 2000, #59.

[59] Author's confidential correspondence, 2002, #6182.

and loan crisis in the US as an example of overzealous domestic deregulation and excessive financial complexity.[60]

This misfit between theory and evidence does not fatally undermine the techno-market-based opportunity cost approach. Rather, they do not adequately consider the implications of their *own* assumptions. There is more then a hint of teleology in many applications of the approach. The argument presented here suggests an important revision based on the politics of institutional change in cases of state-led reform and severe turbulence in the international economy. As this discussion of Indian and Chinese external exposure profiles suggests, variation in countries' juncture with the world economy means domestic actors do not face a uniform set of incentives. Furthermore, conditions in the international economy do not present a uniform and unidirectional set of incentives over time. The benefits of international openness were calculated very differently before the 1994 Mexican Peso Crisis than they were after the 1997-1998 Asian and other crises. The opportunity costs of closure, and more importantly governments and businesses perceptions of them, do only go up. Opportunity costs and perceptions of them can fluctuate just as they do for any other costs, and risks. In particular, the variability in the "uncertain" risks (*a la* Knight) associated with the human element behind the global economy, were reckoned very highly as such by Chinese and Indian policy makers and business people in the late 1990s.

[60] Various interviews in China and India, author's notes 1999 to 2001.

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Chapter Four

FINANCE AND THE DEVELOPMENTAL STATE IN CHINA AND INDIA: COMPARISONS AND ANTECEDENTS

Chinese and Indian state responses to the global securitization boom in the early 1990s began at the same time. In this chapter, I argue that at the time of these responses, the two countries' financial systems were comparable. Both sheltered their capital-scarce economies from the downside of capricious effects and the upside benefits of global finance. Both Chinese and Indian policy makers have, over the last decade, applied themselves to the institutional development of the finance sector. In spite of these similar beginnings, a shared emphases on capital control, and a common goal of financial market evolution, there are significant differences in the outcomes we observe today in the governance of Chinese and Indian securities finance. This chapter addresses describes and explains the important points of comparison in the two cases in the period preceding the 1990s global securitization push.

The contrast between the two countries' patterns of securities governance discussed in the later chapters becomes clearer if we first consider: 1) the formulaic character of the securitization script; and 2) the similarity of Chinese and Indian financial governance regimes and their relationship to organized industry *in the period preceding reform*. The formulaic nature of the securitization script was outlined in chapter 2 and is elaborated throughout this thesis in discussions of the asset-class/financial-position matrix.[1] The purpose of this chapter is to provide an

[1] This "formula," elaborated in chapter 2, includes the main enactors of the script (issuers and investors), the main devices of the script and their attributes (stocks and bonds), and the main venue for the script (the securities exchange). The actual narrative or plot followed by the script – its enactment – however, is not predetermined. It is the result of the politics shaping the configuration of state, market, and civil society. That configuration yields a country's particular securities governance regime.

assessment of these countries' financial governance regimes prior to reform. This is a necessary point of comparison that advances the analysis in two ways. First, it helps to reveal more clearly the variation in post-reform governance regime outcomes that I seek to explain. Second, it helps identify possible historical and institutional reasons for that variation.

This chapter refers to the pre-securitization history of China and India to make several points that are important to the dissertation's subsequent analysis. First, since China and India had different polities – China authoritarian and closed, India democratic and open – one might think they had very different economies, and in particular that India had an open economy to match its open politics. One point of this chapter is to stress that on the eve of securitization in the 1980s, both countries had comparably controlled regimes of financial governance. Second, the most common reaction to a comparison of Chinese and India securities finance is reference to the long history of stock markets in India. It is true that the Bombay bourse, established in 1875, is Asia's stock exchange, but while that history may indeed be long, this chapter explains that it is not very significant, at least in the period from Independence until 1991. Securities finance in pre-reform India was co-opted to the directed-credit regime of India's developmental state. Stock markets were marginalized in an innocuous and largely irrelevant enclave. Third, past as prologue. In spite of similarities in the way both states controlled finance, the future differences in the development of securities governance were nevertheless foreshadowed by the basic principles of private property, and the ability of the state to act autonomously. These elements are identifiable in the antecedents discussed here.

I. Developmental States, State Capacity, and Financial Control

In countries such as China and India facing the problem of economic backwardness, control of finance was a pragmatic tool in the race to "catch up." This control of finance had political effects, shaping the state and its political relations with society and powerful actors economic actors. In this section I summarize briefly the ways in which the developmental aspect of these states relate to the analysis of securitization and financial reform. Why was the dominant form of the state in China and India so interventionist? Following the work of economic historian Alexander Gerschenkron (1962) and political scientist Kiren Chaudhry (1993) I argue that the severe *dirigiste* aspect of some developmental states is related to the issues of state capacity and the prerequisites for capitalist development. I take state socialism to be the most extreme form of the *dirigiste* developmental state.

Hungarian economist Janos Kornai has mapped the "classic" socialist economic and political system. In his model, which stylizes the facts of numerous socialist economies, the dominance of a single party and its associated ideology are the common wellspring of the socialist system – the ultimate cause of the socialist economic outcomes he identifies.[2] The other two structuring elements of the socialist political economy (property rights and bureaucratic coordination) emerge from this initial party-ideology component. In this model, the purpose of state-led socialist developmentalism was "forced growth."[3]

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[2] It is worth noting that in India a single party, the Congress Party, has ruled at the federal center for 45 of the years since Indian independence in 1947. Until 1991, this hegemonic perennial incumbent pursued a remarkably consistent economic policy, e.g. significant dedication to directed-credit finance and a large measure of socialist commitment.

[3] The notion of "forced growth" which Kornai seems to accept, necessarily implies the existence of an alternative, that of "natural growth." In what system does growth occur "naturally"? Kornai suggests an answer in his chapter on property. In the section "Capitalism, Socialism, and Property" he makes the extraordinary claim that "though the regulations of the state gives a greater boost to capitalist ownership in certain periods, one certainly could not say that the state had organized capitalism's development and

Kornai's model seems so elegant because all the elements of the system appear to flow logically from this conjuncture of ideology and single-party absolutism. This elegance may seduce the reader into accepting the inevitability of the system's evolution as he presents it. However, other scholars studying the specific paradigmatic cases from which Kornai derived his model have proposed alternative hypotheses to explain the growth of developmental state-socialist intervention.

Specifically, scholars looking at Lenin's New Economic Policy in the USSR (Nove 1982), the pre-collectivization period in China (Shue 1980), and the first three five-year plans in India (Chibber 2003) have argued that alternative, less comprehensively controlling versions of state socialism were tried and abandoned. They were discarded, however, not because the state preferred to exercise a preponderant role, but, on the contrary, because these states were administratively incapable of regulating mixed economies on near-continental scales. This is a very different motivation from that proposed by Kornai to explain the preponderant state role that coincided with socialist-inspired ideology and single-party dominance.[4] Moreover, this alternative account of *dirigiste* interventionism provides an equally sound explanation for why these states focused so much on the control of finance.

Chaudhry has made a compelling argument that the colonization of the economy by the plan was not inevitable in these cases. The plan in many developing countries, she suggests, was a policy driven, not by the desire of strong states to intervene in their countries' economies, but rather, in large measure as a defensive reaction of weak states lacking the capacity to create national markets. They were, in

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stabilization" (1992, 87). Such a statement requires a certain forgetfulness, both with regard to capitalist development in the early modern period (Polanyi 1957), and with regard to the stabilizing policies that followed the Great Depression and the growth of the Keynesian Welfare State in the second part of the 20th century (Ruggie 1982). States played an important role in dismantling the pre-capitalist institutions that obstructed the growth of competitive market forces. They continue to do so in fighting the monopolistic tendencies of large business.

[4] For an extended version of this argument, see Chaudhry (1993).

short, "strong weak states."[5] From an institutionalist, market-building-as-state-building perspective, the "political conquest" (Vogel 1969) of the economy in China after 1955 was not driven by state strength, but by state weakness. The "world time" of the post-World War Two decolonization and third-world self-reliance era encouraged China's early *dirigiste* autarky (Skocpol 1979). In India, the occupation of the economy's "commanding heights" by Nehru's Planning Commission, and the state-run heavy, urban industrialization had a similar dynamic. Writing about a group of countries that – like China and India – had heterogeneous pasts and even varietal differences under socialism, economic historian Ivan Berend explained that the Soviet model "rendered Europe east of the Elbe more homogenous than it had ever been before." Berend's ultimate conclusion was as true for China and India as it was for Hungary and Poland: "The role of the state in socialist transformation," he wrote, "became practically absolute" (1986, 168).

Thus, the reason for such extensive planning and the establishment of such hard-to-break institutional path-dependencies began with a lack of state capacity to establish unified national markets (Chaudhry 1993; Shue 1980; Solinger 1984). As Chaudhry explains, "direct state participation in the (economy)…serves as an administrative shortcut. At a purely administrative level, the involvement of the state as a producer, direct employer, and *lender* in countries lacking a regulatory infrastructure is simpler than, and thus preferable to, the much more elusive alternative of creating and regulating a market economy" (1993, 252 italics added). The interventionist episodes from 1955-1978 in China, and 1947-1984 in India, did not resolve this problem. They merely forestalled its resolution, and produced the

[5] This phrase is borrowed from Rudolph and Rudolph (1987), and I take it to be consistent with the argument of Shue (1980; 1988).

institutional legacy that constrains the options available to financial reformers in the current period.

In India, government occupation of the economy's "commanding heights" emphasized state administration and direction of finance. This reached its zenith with the bank nationalizations of 1969 and 1980. While preserving the principle of private property and private enterprise, a combination of institutions and practices produced, in India's *ancien regime* of financial governance, a situation functionally equivalent to that of the pragmatic socialist financial regime operating in China by the end of the 1980s.[6]

A. The Singular Logic of Financial Control across Developmental States

Both states considered finance to be a crucial sector, and as Gerschenkron (1962 (1951)) suggested in his "backwardness" thesis, Chinese and Indian state structures had been profoundly influenced – ideologically and organizationally – by the imperatives of capital accumulation.[7] This is consistent with the theory of pragmatic socialism first proposed by Hilferding in his *Finance Capital* (1981 (1910)) and later put into practice by Lenin in the *April Theses* (1975 (1917)). Both men argued that state domination of finance was the key to socialist planning, and that control of the rest of the capitalist enterprise system was less important. The justification for directed-credit exercised through state control of the banks, and the

[6] For an exposition of finance in "orthodox socialism," see Kornai (1992, especially Chapters Eight, Nine, and Twenty Three). For a summary of the formal and institutional changes that shifted Chinese financial allocation flows from ministries to banks during the 1980s, see Lardy (1998, Chapter Three).
[7] The Chinese Communist Party, for example, refers ominously to finance as the "life-blood" of the country (Johnson 1999). In the period from Indian Independence to the first stirring of economic reform in the mid-1980s, there was a secular trend of increasing state domination of finance (Dhar 2000; Patel 2002, Chapter 7; Sen and Vaidya 1997).

precursor to the monobank concept that eventually prevailed in China and the Soviet Union, found its most clear expression in these two formulations.

To argue that Kornai's model overshoots in its claims regarding the causal priority of party and ideological dominance is not to say that these don't matter. Indeed, Kornai's view that analysts must adopt a "system paradigm" in studying national political economies, either in their socialist or transitional forms, explicitly stresses that various parts of a system – material, social, and ideological – may vary in their relative importance over time. A system paradigm is an analytic framework that deals, "not just with individual details of the economy but with the system as a whole, and not just with the economy but with the political, ideological and social dimensions, paying special heed to the interactions between each sphere" (Kornai 2000). Kornai's analysis of the "socialist system" is an example of the system paradigm whose lineage includes the work of Marx, Polanyi, and Schumpeter, among others. Kornai has regarded the study of post-socialist transition to be the priority for inquiry among students of the system paradigm today. The research presented in this thesis is intended to help clarify the changing relationship between the state and finance in this context.

The model Kornai presented in *The Socialist System* is useful to this analysis in two ways. First, Kornai's model outlines the core elements of socialist systems. Almost all the challenges of market reform in post-socialist cases relate to the key elements Kornai identifies: state dominance, ownership/property rights, interventionism, plan bargaining (that is, vertical bargaining within the state), soft-budgets, and price-**in**sensitivity. The second way in which Kornai's model is useful is in assisting in the conduct of sociological and historical-institutional analysis, which

requires that we identify the elemental features of what came before. This is not controversial. However, the problem is identifying which antecedents are important.[8]

After the initial industrialization drive in late developers like China and India – in most cases this coincided with the first two five-year plans – socialist productivity (extensive not intensive) began to level off or slow significantly. Later, this moderate growth was insufficient to compensate for the absence of innovation and the other costs of autarky. The system began to collapse almost everywhere by the early 1980s. Why, then, do we care today about the structures of this old system? And how can Kornai's model help us distinguish and diagnose the patterns and pathologies of reform in political economies emerging from variations of the classical socialist system?

Had enough change occurred in the Chinese and Indian socialist systems in the period before the early 1990s securitization drive to relegate Kornai's model to the role of a quaint historical reminder? Or were there still historical-institutional antecedents persisting into the 1980s which rendered Kornai's model relevant for a binary comparison of the two country cases? This exercise suggests that, based largely on the singular logic of financial control across varieties of developmental states, as well as on the reliance on directed-credit systems of finance in marketizing socialism, the two cases are comparable. The similarity of these directed-credit systems highlights several points of comparison: the mode of government financial control in developmental states (i.e. directed-credit), as well as the *purpose* of such control. State intervention was a reasonable response to limited state capacity, and as Lenin and Hilferding pointed out, was a powerful tool of state intervention in the economy. The levers of finance are the best way to exercise control over economy and society.

[8] There is a danger of infinite regress. How far back is far enough?

Despite this similarity, there are also many important differences between China and India. While similarities in state financial control ground the comparison, variation in macroeconomic and institutional contexts (beyond finance) offer important potential explanations for differences in the governance regime outcomes of reform.

II. Comparing Financial Governance in India and China Prior to Securitization

Chinese and Indian finance were comparable on the eve of the securitization boom. This is a point of comparison between the two countries' systems of political economy that is not always well understood. In this section I explain the dimensions of state control of finance that make the two systems commensurable.

The comparability of Chinese and Indian financial governance circa 1990 depends on the recognition that finance was the least "mixed" sector of India's "mixed economy." The central state-socialist organization of Chinese finance was simple and easy to identify. But in India, the existence of private property and a thriving realm of small- and medium-scale free-market production and exchange might confuse the casual observer. Despite this zone of economic independence, in aggregate, India's mixed economy was, until 1991, subject to extensive planning and central administration, particularly in the "organized" sector.[9]

The consensus view of India's political economy prior to 1991 was summarized thus: the "private sector's decisions in all significant areas – investment, expansion, use of foreign exchange, and imports – are regulated by a system of licensing and controls that imposes social objectives and public priorities on the

[9] This is large-scale enterprise (employing at least 100 workers) that is subject to specific regulation.

calculations, decisions, and costs of private firms" (Rudolph and Rudolph 1987, 26). Making this Sino-Indian comparison more compelling is the fact that, in the late 1980s and early 1990s, a significant source of growth in the Chinese economy came from the informal sector, particularly if semi-private township and village enterprises are included in that category. As in the China of the 1980s and early 1990s, so too in India: labor and capital as organized interests were marginal forces in the political arena.

Describing the conditions prevailing in India in the 1980s, two experts painted a picture that could just as well have describe the role of the state in China's post-Mao reformist period during the same decade:

> Much of the organizational and representational "space" occupied by pluralist actors and processes in the Anglo-American world and by societal corporatism in Western Europe is occupied in India by state agencies. This is not surprising in a state that opted, in the industrial policy resolutions of 1948 and 1956, for a mixed economy in which the public sector would dominate the "commanding heights": that nationalized finance capitalism – banks and insurance – in the 1960s; and that had at its command a proliferating series of state long-term lending institutions. By occupying the commanding heights of industrial and finance capital, the state also came to occupy the commanding heights of the representational infrastructure. At the same time, the line between the public and private sectors has become increasingly obscure, as state-controlled lending institutions and equity holders – (such as state owned financial intermediaries like the Life Insurance Corporation of India or the government-run mutual fund, the Unit Trust of India) – have acquired sufficient equity in private-sector firms to give them, potentially, the power to control management (Rudolph and Rudolph 1987, 255).

To be sure, control of organized business was not exercised in the same way in both China and India, but the net effects of that control were very similar, and finance played a key role in both.

In both countries, the financial decisions of large enterprises were determined by the plan in two ways. On the supply side, allocation was determined by quintennial and annual allocations through ministries, state-run banks, and (in India) state-run development financial institutions (DFIs). At the first level, most fixed asset investment and infrastructure spending came from plan allocation of grants flowing through ministries and state corporations to state-owned enterprises and construction projects. At the second level, bank credit[10] to industrial corporations was controlled by "policy lending," government-administered interest rates, and targeted lending quotas. At the third level, government control of bank management meant that lending decisions were implicitly (or in China, explicitly) controlled by the state.

On the demand side, the state indirectly determined large firms' financial requirements by licensing procedures (in India) and production quotas (*in both countries*).[11] Writing in 1985, one close observer of the range of Indian organized industries concluded, "there are few, if any, purely private large-scale enterprises in India today." [12] Internationally, both countries were very strict in their control of capital flows, creating a situation in which foreign sources of finance in the form of FDI, credit, or grant aid were incorporated into the system of administered finance.[13] In sum, the plan, systems of directed credit, licensing and production quotas, and capital control in India circa 1988 all combined into a system that produced a regime of financial governance that was, in its impact, comparable to the "un-mixed," orthodox socialist regime of financial governance operating in China at that same time.

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[10] Bank "lending" in China only begins in recognizable forms in the 1980s (Bowles and White 1993).
[11] For China see Naughton (1996).
[12] Erdman quoted in Rudolph and Rudolph (1987, 31). Also, see Erdman (1989).
[13] See the summaries of capital control measures listed in Figures 4-1 (for China) and 4-5 (for India).

Both countries had securities markets before the 1990s. These are discussed at greater length below. China's pre-1990s securities finance developed willy-nilly, was poorly regulated, and had little influence on government or large-scale industry. In India, there was what I call a "securities finance enclave," tolerated and even cultivated by the Nehruvian developmental state as long as the enclave's denizens did not challenge their ghettoized status. I argue, therefore, that during the 1980s the role of securities in the financial governance of both countries was an uneven mix, characterized largely by severe repression in accordance with the singular logic of developmental state directed-credit regimes, yet unable or unwilling to completely squeeze out a small element of haphazard "marketness" and independent irregularity. Thus, while neither stocks nor bonds played a significant role in allocating financial resources or in shaping the real economy, they were tolerated. It is nevertheless very important to carefully map out and distinguish the ways in which pre-1990s financial structures (including incipient securities finance) interacted with political coalitions and with property rights structures.

During the 1990s, however, securitization proceeded in response to the global techno-market and social forces, further encouraged by both countries' broad projects of state-led financial reforms. There were dramatic formal changes in both countries' securities markets, accompanied by varying degrees of substantive change in the institutions of financial governance. Why was the transformation of China's product, transport, and communications sectors so aggressive – formally dramatic *and* substantively thorough – compared to the mere formalism of securities reform? Why was the transformation of India's securities sector so dramatic and thorough, while reform in other sectors persisted in what political scientist Atul Kohli likes to call its "middling" character? Why are there such different outcomes in the patterns of Chinese and Indian securities finance in the first decades of reform?

III. Chinese Securities Finance before the 1990s

In the autumn of 1987, the practice of financial capitalism in China experienced one of its most unrestrained moments since the pre-World War One Shanghai rubber boom (Thomas 2001). Less than a decade after reform began, bonds and stocks were traded willy-nilly among individuals and institutions around the country, using methods ranging from quasi-formal over-the-counter exchange to completely unregulated kerb trading. While China's formal securities markets today are vastly larger than they were in 1987, they are in many ways more constrained. In this section, I outline the characteristics of the early development of Chinese securities finance, before the 1990s global securitization push and the development of the discernable discretionary involution governance regime for securities finance in the mid-1990s. The period of approximately a decade from the issuance of the first bonds in 1981 and progressive liberalization, through the reaction of the late 1980s ending with the establishment of formal exchanges in 1990, lends itself to clear division into two phases. In what follows, I identify and assess some of the most important market characteristics and policy changes, highlighting en route the heterodox outcomes and uneven regulation of this period. This serves to accentuate the multiplicity of possible trajectories or futures that might have come from this early start. This historical *tour d'horizon* should serve as an important empirical base from which to gauge the institutional change that emerged during the 1990s, and to evaluate the policy choices that drove those changes.

A. "Wild West" Liberalization and Chinese Securities Finance: 1981-1987[14]

As Deng Xiaoping and his team of economic reformers set about refashioning China's economy in the post-Mao era, a range of changes took place. For the state itself, growing macroeconomic instability in the form of increased deficits and rising inflation focused attention on the issue of fiscal management, forcing leaders to consider alternative sources – domestic and foreign – of public finance.[15] Furthermore, the broad trajectory of reform policy that emerged from the 1979 Wuxi Conference, and particularly the emphasis on greater "enterprise autonomy," and more "local responsibility," opened up space for experimentation in firm structure and firm finance.[16] In this context, the government and firms in China turned to securities finance for the first time since the 1950s.[17] As with the many other domains of reform-oriented experimentation in these early years, innovation in equity finance began first in the countryside with small production units. State council blessing of such activity in a small-scale and rural milieu was politically less provocative it would have been in a large urban enterprise.

Governing Bond Finance. In the early years of Chinese bond finance, it was not difficult to distinguish the modes of state dominance. The state was everything, while markets and civil society were incipient at best. During the era of strict socialist control of the economy under Mao, China's financial system had been based on a so-

[14] In their book "Privatizing China" (2003, 28), Walter and Howie use the "Wild West" phrase to characterize Shenzhen stock trading, but in an interview in 2000, Fraser Howie first suggested to this author the appropriateness of this term for the whole pre-1988 experience in Chinese securities finance.
[15] Deficits stood at 17 and 12 billion Yuan in 1979 and 1980 respectively. The urban cost of living rose 5.5. percent year-on-year 1979-1980 (Fewsmith 1994. 87).
[16] A prominent promoter of these reforms was Zhao Ziyang, whose political power base in Sichuan made that province an important pioneer in some of the securities finance developments (Yang 1998).
[17] During the 1950s, two different types of central government bonds were issued (People's Victory Bonds and National Economic Construction Bonds) and enjoyed heavy demand. These were ended in 1958 (Ecklund 1966, 87-90).

called "monobank" regime, in which the financial system was coordinated by one enterprise that served as central bank, the main commercial bank, and financial supervisor.

In 1981, the Chinese government issued the first government bonds since the establishment of the People's Republic. These bonds were "sold" via mandatory allocations to state-owned enterprises (SOEs), individuals, and financial institutions. Officially, there was to be no trading or exchange of these bonds. However, as generalized commercial exchange flourished under the Deng-era reforms, bondholders facing immediate liquidity needs[18] began selling their bonds or using them in other ways. They were used to settle debts, and some shops even accepted them as payment.[19] A black market emerged in bond-based payment and in the inevitable "secondary" trading of bonds themselves. In July 1987, the central bank began official discounted bond transactions.[20] This only fueled the black market by providing further arbitrage opportunities using the official discount window (Li 2000, 93-95).

The State. During the early 1980s, the institutional structure of the state in finance changed in form. A range of new financial institutions, including state-development banks (often called "policy banks"), state-owned "commercial" banks (central and regional), and trust and investment companies (TICs, central and regional) were developed. The People's Bank of China (PBOC) continued to control the others on the instructions of central authorities, but it was granted some margin to focus more on its central banking role. In that role, it emphasized last-resort lending, regulation,

[18] That is, they had to make payment for something, and required some means like cash or a close substitute with which to make that payment.
[19] In return for present liquidity the initial bondholder accepted a loss on the face value, and an additional discount for the risk born by the seller of goods in this illegal transaction.
[20] This means the central bank was selling bonds below their face or "redemption" value.

and serving as banker for the government, including management of government bond debt for the Ministry of Finance and control of sub-national and corporate bond finance. Initially, starting in 1981, treasury bills (T-bills) and other government bonds were issued as part of new experiments with deficit spending and long-term debt-based projects or enterprise finance. This practice has grown ever since, subject to the "plan-rational" central decision making of key apex economic agencies like the Ministry of Finance and various incarnations of the State Development and Planning Commission.

These formal changes were accompanied by substantive change in the institutional locus of power. This was part of a decentralizing trend in governing economic development that characterized the 1980s, contributing to the country's robust economic growth during that decade (Oi 1999; Qian and Xu 1993). As a way of both managing and recapturing some of the resources lost to provinces and localities in the course of decentralization, the central state required banks, financial institutions, provinces, firms, and even individuals to buy and hold government bonds (T-bills and "special project" bonds). This created, in effect, an additional form of taxation (Gordon and Li 1999). Government set the interest rates on these bonds administratively. Moreover, when it wasn't convenient to pay off its bond debts, the state merely "rolled over" (extended) the payments or the whole bond issue itself.[21] At the same time, in selected cities during 1986, SOEs, trust and investment companies, and other financial institutions were permitted to issue bonds. Often these issues were sold to the firm's employees or to other state-owned firms. Approval from central or local PBOC authorities was always required, though not always obtained.

[21] In an interesting, albeit exceptional concession to the popular politics of finance, the central state, in one important instance in 1990, exercised this kind of arbitrary power, rolling over bonds held by SOEs even as it paid off the same bonds held by individuals (Bowles and White 1993, 136-137).

The Market. Markets for these debt securities were incipient at best. The vast majority of bonds were forced upon their owners at pre-set prices, and most could not be transferred, limiting the potential for trading and liquidity in any bond markets that might emerge. Nevertheless, "markets" for these debt securities did exist. As discussed above, state bonds were themselves sometimes used as a form of currency. There was a sizeable black market for government bonds, but prices in this market were 70 to 80 percent of face value, and occasionally as low as 50 percent (Yi 1994, 263). In 1986, formal secondary markets – approved "trading centers" – were authorized for operation in "experimental" selected cities.[22] "Inflation-proof" indexed T-bills were issued and highly coveted. Typically, in a capitalist economy with even moderate reliance on debt securities, the interbank market is an important venue for securities trading, as the circular flow of cash and bonds among banks and other major financial actors provides stability and flexibility in the financial system. Between 1983 and 1985 there was an informal interbank market operation in China, but it was not very large and developed mostly among branches within a single bank. Later, after the official 1986 establishment of secondary markets, there was formalization of these markets and more growth (Xu 1998, 94-96).

In the realm of corporate securities, with the rise among SOEs of the so-called *sanjiao zhai* ("triangular" interenterprise debt), enterprises that sold bonds (issuers) to other enterprises (investors) were sometimes known to service the interest payments on those bonds with in-kind payments (of cement or steel, for example) (Bowles and White 1993, 138). For some of these years, enterprise bonds were permitted to pay as much as 20 percent above interest rates prevailing on other financial assets, making them very attractive. Thus, as inflation grew in the vigorous, newly opened, pre-

[22] The term trading center (*jiaoyi zhongxin*) was preferred because it was more politically palatable than the explicitly capitalist term "securities exchange" (*zhengquan jiaoyisuo*).

Tiananmen economy, demand for enterprise bonds increased rapidly in the 1986-1988 period.

In their early analysis of the political economy of reform in Chinese finance, political economists Bowles and White enumerated the forces that they believe combined in shaping the market for bonds at this time. In ranked order (most to least significant), these were coercion (by the state), collusion (among specially entitled actors like SOEs), and choice (by actors selecting among alternatives). Offering a general summary of China's early experience with bond finance, Bowles and White aver that the effort led to "complex and often perverse results because of the activities of powerful agents in the economy, agents which had no binding mechanisms to solve distributional conflicts" (1993, 139). Recognition by the central-state-elite of these problems with bond finance have, I will argue later, led to an institutional bias favoring strict central domination and control of this asset class.

Governing Equity Finance. The early period of equity finance was in many ways wildest part of this "Wild West" era. Equity securities finance in contemporary China began with experimentation in shareholding companies and cooperatives in the early 1980s. In the two years after the PRC issued its first bonds, the first shares of stock were offered to the public by shareholder cooperatives (*gufen hezuo qiye*), and after, 1984, SOEs restructured as companies limited by shares (*gufen youxian gongsi*). Between 1979 and late 1984, many rural enterprises and a few urban firms issued shares of stock in a variety of ways. In late 1984 and early 1985, however, the Shanghai companies Feile Acoustics and Yanzhong Industrial (nominally a manufacturer of photocopiers) made the first formal, regularized equity issues by urban state owned enterprises. Feile's issue was placed privately with special large

investors. Yanzhong's was a truly "public" issue in which average individual Chinese could and did invest.

Before broad financial reforms were introduced in the early 1990s, the exchange and handling of equity securities in China was a mix of ad hoc controls and informal irregularity. Stock issuance grew in the 1980s as firms restructured themselves in various corporate forms. At the time, there were no formal securities exchanges, and the creation, exchange, and use of stocks was haphazard. Under a range of different understandings and agreements, firms initiated stockholding arrangements. The shares themselves were paper certificates. As discussed below, trading took place sometimes over-the-counter, sometimes in special trading centers, and very often spontaneously in informal kerb trades (Chen and Shi 2002; Chen 1996; Yang 1998).

Under the circumstances, one could hardly call the acquirers of stock during these years "investors." Most were employees of the firms that issued the stock. Often they were compelled to buy the stock, or faced the Hobson's choice of taking the shares in lieu of wages. Sometimes shares or vouchers representing some right to buy or bid for shares were freely distributed (Ma 1999). Individual and corporate outsiders also bought shares or acquired them in lieu of interenterprise debt or other institutional relationships. Most of these "investors" held their shares. These stocks were treated more as a fixed-income instrument like a bond or bank deposit (Walter and Howie 2003). Indeed, dividend payments were largely benchmarked to bank deposit rates, though there was no formal dividend system as understood in Anglo-Saxon equity finance. The claims represented in shares of stock were unclear, and varied across municipal and provincial jurisdictions. The irregularity of these shares, their issuance, and their trading was such that they served little financial or commercial purpose for the firms involved.

The State. In the early 1980s, firms were still tightly bound to, or embedded in, the state at various levels from central ministries down through other sub-national strata of government to the township and village level. Indeed, the latter were proliferating and developing rapidly in the early 1980s and would become the basis for the many local enterprises that came to be shareholder cooperatives. Various state directives incrementally provided space for equity finance experimentation, but all on a distinctly *ad hoc* basis. The most significant of these were the provisional measures issued by the Shanghai branch of the PBOC in mid-1984. The terse "eight articles" (*batiao*) of these regulations laid the groundwork for the Feile and Yanzhong issues and began the general use of shareholding by SOEs in the 1980s.[23]

Much of the liberalizing pressure came from the Shenzhen Special Economic Zone (SEZ), where the Communist Party's "zone of indifference" was most relaxed, and where market experimentation was often most daring. The existence of shares of stock or corporate bonds is premised on the existence of companies limited by shares. In 1986, the Shenzhen city government issued formal rules regarding the process of corporatization and the use of equity finance. The language invited firms from other localities to incorporate in Shenzhen using these rules, which were heavily inflected with English corporate practice reflecting the influence of the nearby British colony in Hong Kong (Walter and Howie 2001, 24-28). Building off the early 1983-1984 restructuring of enterprises large and small, a sharp expansion in the primary market – the supply of new shares – was sparked by the Shenzhen's 1986 provisions and the fillip they gave to corporatization around China. A year later, there were 6,000

[23] The *batiao* specified that collective enterprises could issue shares, what types of shares could be issued, how various different types of investors could be compensated with dividends, how share transfers should be executed, and that only actual, physical trading was permitted (delivery-versus-payment and not options or futures).

shareholding enterprises nationwide, and another 3,800 were added the next year (Li 1998, 55).

What was most remarkable about this period was the rather cavalier attitude of the central state to these developments in equity finance, and the haphazard quality of regulation. Regulatory authority over the issuance and trading of shares was unclear. Supervision of the issuance process was lax and was overwhelmed by volume. Local branches of the People's Bank of China (PBOC, the central bank) and municipal governments were ill prepared. There was confusion over jurisdictional competence. The PBOC and its local bureaus scrambled in a game of catch-up, as the rising tide of stock issues and a swell in trading volumes overwhelmed their limited understanding of the problem as well as their institutional resources (Chen 1996; Hertz 1998). Two experts described the situation thus:

> Almost as an afterthought, the People's Bank of China was given responsibility for securities in 1986 as part of more elaborate regulations governing the commercial banking sector. From that point on, until its displacement in 1992 by the China Securities Regulatory Commission (CSRC), the PBOC or, more properly, its local branches, played an active role in promoting developments (in securities finance), even to the extent of establishing its own brokerages (Walter and Howie 2003, 8).

It was not until the 13th Party Congress in 1987 that a clear official statement came from the central state. "The shareholding system form that has appeared during the reforms," declared the Congress, "including state majority ownership (*konggu*) with participation in shareholding by ministries and local enterprises as well as involvement by individuals, is one kind of organizational form of enterprise property and can be continued. The ownership (*chanquan*) of some small scale enterprises may

be transferred to collective bodies (*jiti*) or individuals."[24] The phrasing of this declaration is significant as an early and prominent official pronouncement in the public record pointing toward the chief elements and possible trajectory of the emerging political economy of securities finance in China before the 1990s securitization boom. The guiding and dominant role of the central-state is affirmed. The key players in the "intra-mural coalition" are identified and located in subordinate yet beneficial positions relative to the central state.[25] Finally, property rights relations are stipulated, with the state (and the *central* state is clearly implied in this case) maintaining majority control, while subsidiary rights are bestowed on the subordinate coalition members. No property rights (*chanquan*) are conferred to individuals, who may "enter" stocks (*rugu*) but do not enjoy the same right to "participate" (*jiancan*).

The Market. Due to China's isolation from the outside world during the Mao era, and the consequent absence of exposure to the technologies, markets, ideas, and practices of securities finance for over thirty years, most Chinese had little idea of what stocks and bonds were. Initially, few common Chinese, firm managers, or party members understood the purpose or value of the stocks and bonds they held. In this sense, the secondary market that did emerge in many parts of the country can indeed be fairly described as "spontaneous" (Yang 1998) (Ma 1999).

The available evidence regarding the nature of share issuance and secondary trading at the time is thin. Businesses wishing to restructure and issue shares were

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[24] This is translated from Section 4, Article 1, of Party Secretary Zhao Ziyang's address to the 13th Party Congress, which reads "*gaige zhong chuxian de gufenzhi xingshi, baokuo guojia konggu he bumen, diqu, qiye jiancan gu yiji geren ru gu, shi shehuizhuyi qiye caichan de yi zhong zuzhi fangshi, keyi jixu shixing. Yixie xiaoxing quanminsuoyouzhiqiye de chanquan, keyi you zhuanrang gei jiti he geren.*" Significantly, the word "investment" (*touzi*) appears nowhere in this statement regarding shares (Zhao 1987).

[25] "Ministries" here can be understood as representing the bureaucratic aspect of industrial ministries, but also the broader interests of the sectors in their jurisdiction. "Local enterprises" may be understood as a proxy reference to local governments, particularly provinces, but also to lower levels (though these tend not to be represented in national political coalition dynamics).

encouraged to use the 1986 Shenzhen provisions, but regional and local variation in corporatization persisted. In Shenzhen and Shanghai, a few formal OTC venues were open. The Shanghai branch of the People's Bank of China ran counters, as did the then-new trust and investment companies and some of the newly semi-independent commercial banks (Chen 1996; Yi 1994, 260-268). Some major provincial cities such as Tianjin, Shenyang, and Wuhan established "securities trading centers" where local company stocks were traded (along with some local company bonds).[26] Nevertheless, a lot of share trading occurred informally on kerb markets, not just in Shanghai and Shenzhen, but elsewhere around the country. Equity trading was heaviest in Shenzhen, reflecting its importance as the inspiration for much of the firm restructuring and stockholding movement. Conversely, reflecting the importance of Shanghai as the locus of the central state's interest in securities finance, such as it then was, debt trading was heaviest in Shanghai (Kumar et al 1997).

By 1986, a "secondary market" was certainly evident in which these shares were trading informally in various cities around the country (Yang 1998). By 1987, official trading was partially formalized as "over-the-counter" (OTC) transactions at seven points in Shanghai and elsewhere. These OTC trades were initially transacted at a price fixed by the state, and buyers and sellers had to find each other and appear together at the counter. Later, transactions could be anonymous, but were restricted to within an officially limited trading band. However, a vast sub-economy of "scalpers" (*huangniu*) operated outside trading centers, and informal deals were struck practically everywhere (Chen 1996). Again, as with bonds, a black market emerged in which

[26] These are the same trading centers mentioned in the previous section on bond finance.

prices were set by negotiation among parties prior to formal settlement at the official rate, or informal settlement outside of official channels (Yang 1998).[27]

The big change in stock trading came in 1989, when the Shenzhen Development Bank issued handsome dividends and offered a stock split. This made share acquisition obviously appealing, sparking an interest in the secondary market. Increased demand caused share prices to climb precipitously, further feeding interest in the secondary market. This was a dynamic familiar in other stock markets, but new to mainland China. Interest in the share market thus spread beyond the dividend chasers, arbitrageurs and liquidity seekers[28] of the mid-1980s to the wider public (Walter and Howie 2001, 29-31).

[27] This process was facilitated by the fact that physical share certificates were in use, and were transferable. Furthermore, there was sufficient leniency in the system for illegal transfers to be "laundered" (Chen 1996).

[28] As discussed above, early holders of securities were willing to use or sell them because they did not comprehend their value, or because they faced liquidity pressure.

Table 4-1
China Securities Governance before 1992

Period Policy Cycle Policy Tenor	State		Market	Civil Society	Asset Classes
	Institutions & Administrative Organization	Capital Controls (domestic and international)			
1981 – 1987 Open "Wild West"	Liberalization Bottom-Up Localism Central Discretion Limited People's Bank plays "catch up" and is a beneficiary participant	Financial repression w/ some interest-rate relaxation Some Forex sharing to firms FDI in Joint Ventures Dual-track currency (forex vouchers) Foreign commercial borrowing (loans) Sovereign debt (bonds) issued Loosening the Monobank "Commercial Banking" established	Experimental Heterodox OTC Black markets Spontaneous Informal/Kerb Bonds as informal currency and collateral (at a discount) Regional trading centers	Experimental Spontaneous Involvement Danwei-based networks Pamphleteering	**Bonds** Coercion, Collusion, & Choice Corporate bonds pay up to 20% above benchmark interest-rates **Equity** "Shenzhen Provisions" for corporatization
1988-1991 Close "Tiananmen"	Reaction Top-down Central fiat Central repression Central discretion ↑	Same as above	Increasingly Constrained Formalized on exchanges	Repressed	**Bonds** Corporate bonds pay up to 15% above benchmark interest-rates

In sum, during this "Wild West" period, securities finance was enacted mostly from the bottom up. It was spontaneous, experimental, local, and most importantly indeterminate in its future bearing. As one prominent Chinese financial economist explained:

> The emergence of new financial instruments and markets during the period was apparently not the outcome of an explicit government policy…there was no official blueprint…The spontaneous and rudimentary nature of financial market development was, at the time, typified by a general absence of any form of professional guidance from financial bodies to direct the issue of various kinds of securities…(and) by the fact that the government and financial authorities lacked clear policy orientation to guide the use of the new means of finance (Xu 1998, 95).

Under the heading "Wild West," Table 4-1 summarizes the state, market, and civil society characteristics of what served as a regime of securities governance during this period. The central state was conspicuous by its absence in the regulation of equity shares. The Shenzhen regulations on corporate restructuring were loose, and reflected nearby Hong Kong (and therefore Anglo-Saxon) practice. OTC trading, as always, was a relatively decentralized system of exchange, and the ubiquitous informal share trading was a grass-roots affair. Two veteran foreign observes of Chinese securities finance remarked that, had the Shenzhen experiment – with its intrepid corporate spirit and its vigorous trading atmosphere – not been interrupted by the events of 1989 and other related policy reactions discussed below, the continuation of the securitization script as it was being enacted through this early period would have taken China in a very different and (they believe) probably more productive direction (Walter and Howie 2001).

B. "Tiananmen" Repression and the Imposition of Central Control: 1988—1991

In 1988, a decade after China embarked on her major economic reforms, securities finance had touched many parts of the economy from small rural enterprises to large state owned steel companies. Individuals and companies were trading in the secondary market for bonds and stocks. Securities finance in China was vigorous and heterodox. The economy was growing rapidly – perhaps too rapidly. Macroeconomic conditions were again unstable. Debt and inflation were once more climbing precipitously. Policy makers at the center feared the economy was overheating. Financial factors were probably contributing to these problems, as local governments twisted the arms of local bank branch managers to lend funds even as local SOEs issued more corporate bonds (Shih 2003). Furthermore, compounding these economic stresses, the central political elite was in the midst of a conservative realignment following the ouster of party leader Hu Yaobang in 1987. When Hu died in April 1989, the mix of economic and political instability quickly escalated to a bloody climax in Tiananmen Square.

In the realm of securities finance, the initial thrust of the early 1980s corporatization and share issuance had carried the pendulum of economic change far in the direction of openness. However, in the post-1988 environment, political pressure had already begun to slow the pendulum's liberalizing progress. Yet, these pressures had largely taken the shape of *ad hoc* measures only. The ceiling limiting interest rates paid on corporate bonds was lowered. The company restructuring process was modified in a more constrained and uniform direction. OTC trading was regulated through measures such as price ceilings and more rigorous registration. But these measures were fragmented across jurisdictional levels and competencies, with municipal and central action incompletely coordinated (Chen 1996). The pell-mell

issuance and trading practices spreading around the country had not gone unnoticed, and in the grim post-Tiananmen atmosphere, the pendulum began its repressive return swing. The central state elite resolved to shift from the ad hoc approach to securities finance. In the period immediately preceding and succeeding the Tiananmen tragedy, Beijing moved across a broad front to centralize, rationalize, and control securities finance. Even as they did so, however, popular interest in using and trading securities was finally blossoming among localities, firms, and individuals.

This period can conveniently be characterized as the "Tiananmen" phase of securities finance development and, accordingly, it was distinctly "top-down" and repressive. In the bottom row of Table 4-1, bearing the period heading "Tiananmen," are summarized the state, market, and civil society characteristics of what served for a regime of securities governance. In contrast to the multiple city experimentation, the Shenzhen restructuring principles, and the OTC/informal markets for secondary trading of the Wild West days, this period ushered in two new high-tech centralized exchanges and preparation of the Standard Opinion for corporate equity finance, which was implemented shortly thereafter. This represented a diminution of heterodoxy and market-oriented pricing.

During this phase of repressive reaction in China's local enactment of the securities finance script, we begin to see some of the institutional elements that would later contribute to the discretionary involution governance regime, though this was then still a contingent future outcome. With respect to the primary market for stocks, this phase of enacting the securities finance script served to increase central government discretion in distribution and control of equity finance. Similarly, in the central government's first major secondary market initiatives (the establishment of the Shanghai and Shenzhen securities exchanges), the content of the global securitization script stipulated a bundle of technologies and trading practices – centralized electronic

securities trading on an exchange – that seemed benign or "power neutral." Yet, in hindsight, the consequence of enacting these parts of the script was actually reactionary, facilitating the exercise of state power and curtailing a more organic course of growth in securities finance. The irony is that, in many ways, the opening of the bourses and the formulation of a formal nationwide restructuring in the Standard Opinion policy for firms represented a step forward for central state control of securities finance.

IV. India's Securities Finance before the 1990s

From a sociological perspective, India's pre-reform, directed-credit system of finance, based on state-controlled banks and long-term lending institutions, was an "instituted economy." This system was itself part of a larger state-planned "mixed-economy" system. In this system, the embedded finance regime of directed credit was a suitable complement to the equally embedded prevailing production regime of licenses and quotas. The ideology and organization of this system, begun under India's first post-Independence Prime Minister Jawaharlal Nehru, was inspired in large measure by the tripartite anti-finance biases of anti-colonialism, upper caste Brahminism, and Fabian Socialism. The evolution of this mixed economy was part of Nehru's ambition to create what he famously called a "socialist pattern of society" that would complement his larger national vision of "secularism, socialism, and democracy" in India. These notions did for many years become the basis of an ideological consensus in the country, entering the lexicon of Indian political economy as the "Nehruvian" system.

Under this system, neither finance nor the production regime were "market-based." They were embedded in the socialist-developmental institutions and purposes

of the Nehruvian political economy, and administered hierarchically by state bureaucrats led by an elite corps of rigorously selected officials hailing from the prestigious Indian Administrative Service (Potter 1986). In post-Independence India, private property coexisted with state-ownership. While the enterprise controls of the so-called "license-permit-quota raj" are most often cited as the typical characteristic of India's planning state, this is only because the *dirigiste* control regime in production was solidified before similar controls were achieved in finance. Yet, eventually government power and discretion in the allocation of finance came to be just as significant as licenses and quotas in the state's ensemble of dirigiste tools.[29] Moreover, state-guided capital allocation complemented both the powerful anti-finance bias of the Nehruvian economic-planning ideology, and the omniscient aspirations of the powerful state planning bureaucracy. Addressing his apex planning body, the Development Council, in 1956, Nehru explained his vision:

> Forgetting the words public sector and private sector, the main thing is that power, economic power, should not be concentrated in private hands, that vested interests should not grow up in regard to any important matter, strategic matter, or socially important matter, that there should be a dispersal of economic power and, therefore, (there) should be avoidance of development of monopolies of any kind (Mehta 1965, 5).

Accordingly, licensing and permits were strictly allocated and enforced, and large scale investment was determined by the state, with planned allocation to the private sector constituting two thirds or more of the amount designated for the public sector in the first three plan periods (1951-1966) (Mehta 1965, 6-7).

[29] When the statesman C. Rajagopalachari coined the term "license-permit-quota raj" and broke with the Congress Party, signaling his rejection of what he believed was overzealous economic control, the edifice of state financial control was still a work in progress.

This regime of directed-credit finance was a remarkably stable system of capital accumulation and regulation. The regime was foreshadowed but not yet fixed in the years immediately following the presentation of the 1944 Bombay Plan.[30] The plan's authors argued, "practically every aspect of economic life will have to be rigorously controlled by the government"(Thakurdas, Tata, and Biòralåa 1944, 48). Although they were leading private industrialists, the supporters of the Bombay Plan seemed concerned with the perils of a free-market approach in India's late development and therefore explicitly sought to work in a partnership with the state.[31] Assaying the evolution of Nehruvian political economy twenty years after Indian independence, one-time private secretary to Nehru, former Planning Department Joint Secretary, and erstwhile central bank Governor H.V.R. Iengar explained that: "It is all there in the Bombay Plan — the concept of massive state intervention in the economy, of mixed private and public sector enterprise, the emphasis on heavy industry…and (the) need for deficit financing. Indeed, there seems little difference between the basic approach of the Bombay Plan and the approach of the Planning Commission of the Government of India and it would by no means be far-fetched to say that the Planning Commission actually got its inspiration from the Bombay Plan" (Iengar 1968).

[30] The Bombay Plan set the tone for post-Independence government-business relations in India. The plan, proposed by a group of influential Indian industrialists, offered suggestions for promoting Indian economic development after independence. It supported state action in planning equitable growth, protecting national industries against foreign competition, and developing heavy industries using state-ownership to concentrate capital.

[31] Mine is a charitable interpretation of these industrialists' concern. Some have argued otherwise, suggesting that Indian industrialists orchestrated the license-permit-quota raj of Nehruvian socialism to provide a comfortable, lucrative, and assured incumbency (Chatterjee 1997; Kochanek 1974). This has been the source of a long and bitter historiographic controversy over the degree to which Bombay Plan supporters "captured" the Indian state or were themselves "captured." This debate, and a new view that it was the state who was captured by India's large capitalist class in the 1950s and 1960s is presented in Chibber (2003).

A. The Political Conquest of Credit and Banking in India

In the post-Independence era, India did not go as far as China or the Soviet Union in crafting a full "monobank" structure. But by the early 1980s, it got fairly close. The Reserve Bank of India (RBI) was nationalized in 1948 with the central government reserving authority over appointments and direction. By the mid-1950s, the government[32] had secured (*de facto* but not *de jure*) the commitment of the bank to underwrite its deficit spending as and when it needed.[33] The nationalization and restructuring of the State Bank of India (SBI) and its subordinate link to the RBI in the late 1950s meant that the central bank was now a provider of funds to the government, a commercial banker, and a banking supervisor.[34] By the late 1960s, on the eve of the next bank nationalization step, the RBI was indirectly in control of well over a third of the nation's commercial bank deposits: not quite a full monobank system per se, but moving in that direction, a trajectory soon to be further enhanced by other significant measures.

Iengar's above-quoted observations were penned in 1968, on the eve of another institutional shift that definitively assured the Indian state's colonization of finance. The very next year, Prime Minister Indira Gandhi, Nehru's daughter,

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[32] In Indian politics, reference to "the government" involves an inescapable measure of semantic imprecision related to the objective and subjective uncertainties inherent in Indian political institutions. It can designate "the state" more generally, in the way Nettle famously theorized the concept. But, when juxtaposed with other parts of the state such as the central bank, the term should be understood as in the classic Westminster model, referring to the executive role of the Prime Minister and her/his appointed cabinet of ministers.

[33] This was the fateful development of the so-called "ad hoc Treasury Bill" issuance (Rangarajan 1998, 38-41).

[34] A 1955 act of parliament constituted the State Bank of India (formerly the venerable Imperial Bank of the colonial era), bringing more than a quarter of the resources of the Indian banking system under the direct control of the State. Later, the State Bank of India (Subsidiary Banks) Act was passed in 1959, enabling the State Bank of India to take over eight former State-associated banks as its subsidiaries (later named "Associates"). Even in the late 1990s, the Reserve Bank of Indian still held a 60 percent stake in the SBI (Balachandran 1998).

nationalized many of the country's remaining private commercial banks, further restraining any vestigial power of private financial interests (Dhar 2000). The rationale given in the enabling legislation – couched in characteristically developmentalist language – was the need for the Indian government to "control the heights of the economy and to meet progressively…the needs of development of the economy in conformity with national policy and objectives" (India 1969). This fixed ever more deeply and durably the power of the state in finance.

Moreover, as it became clear that bank nationalization had, as promised, facilitated the building of new distributions systems which were successfully delivering credit to previously under-served areas (rural areas and small scale industry), New Delhi's financial policies enjoyed growing popular legitimacy in the countryside (Singh 1998).[35] This further enhanced the state's dominion in finance (Patel 2002). In a sense, Indira's ability to act autonomously against the interests of the capitalist controllers of these banks in the bank nationalization was an important foreshadowing of the kind of state autonomy exhibited in the 1990s. In the 1990s a different government took similarly autonomous initiative operating in the opposite direction – toward greater marketization – when the center took the initiative against the stock broking community in favor of a new securities exchange in the course of building new institutions of securities finance institutions and expanding the scope of securitization.[36]

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[35] As with many policy initiatives, success did breed excess. As the potential political utility (as opposed to ideal-typical developmental utility) of such financial intervention measures became clear, more particularistic uses of finance were devised. The most egregious example of this was the use of loan "melas" (fairs) in the early 1980s to attract the support of young lower middle-class voters to the Congress Party.

[36] It is often argued that this nationalization had as much to do with Prime Minister Gandhi's immediate struggle with politically powerful capitalists as it did with any ideological or developmental objectives. For this reason, her behavior in this matter, as in other populist measures such as inter alia her anti-poverty *garibi hatao* ("halt poverty") campaign and her effort to deprive formerly sovereign Indian Princes of their "privy-purses" of Indian Princes, have been drolly characterized as "slightly left of self-interest."

Between 1951 and 1969, the number of banks in India fell from 566 to only 85 (Sen and Vaidya 1997, 13). In 1980, still more banks were nationalized, bringing the public sector banks share of total domestic deposits to a hegemonic 92 percent (Sen and Vaidya 1997, 14). While bank nationalization did not put more banks directly under immediate RBI control, as would have occurred in an orthodox socialist monobank format, indirect state control of both the central bank and these commercial banks brought the Indian banking arrangement close to that model.

The stability of this state-dominated, directed-credit financial governance regime is evident in the long-term expansion of state power in finance from the 1950s through the 1970s, the durability of its structure, and its ability to resist – like Dr. Frankenstein's monster – challenges from one of its own creators. These challenges came during the early-80s reform flirtation of Indira Gandhi, and later from the comet-like mid-1980s reform foray of her son, Rajiv Gandhi.[37] So, by 1980, the Indian state had achieved a remarkable political conquest of banking finance, putting it in charge of the rapidly increasing savings deposits of the country's numerous citizens. This, in turn, meant that the state controlled the funds with which "its" commercial banks furnished the short-term and working capital loans needed by businesses. More importantly, however, long-term finance capital was also controlled through what Indians call "Development Financial Institutions" (DFIs).

These DFIs include three different kinds of financial actors, all of which are large and national in their scope of operations. Most important and well known were the long-term lending institutions. The first of these, the Industrial Finance Corporation of India (IFCI) – formed in 1948 and wholly state-owned – was the prototype for its several siblings. Later variations on this model, like the Industrial

[37] For arguments about these reforms, and their often unheralded positive effects on industrial productivity, see Ahluwalia (1991), Rosen (1992) and Jenkins (1999).

Credit and Investment Corporation (ICICI) established in 1955, and the Industrial Development Bank of India (IDBI) set up in 1964 under the Reserve Bank of India, extended the reach of India's developmental state into industrial finance.[38] These DFIs provided medium- and long-term capital to industry for capital improvement and project finance.

The state's stable of DFIs also eventually came to include providers of other financial services. The nationalization and concentration of the insurance industry magnified the centralized dynamics of Indian finance, as these insurers were a major investor in, and manager of, financial assets. In 1955, life insurance was nationalized, and in 1973 general insurance also came under state control, making the Life Insurance Corporation of India (LIC), and the General Insurance Corporation of India (GIC) powerful levers of state-directed finance. This put the government in the position of owning and running financial intermediaries that, as fiduciaries, managed stocks and bonds on behalf of many Indians. Finally, this ensemble of DFIs eventually also came to include a mutual fund-like organization. The Unit Trust of India (UTI) set up in 1963 was a government owned and operated mutual fund-like asset management "trust." It is of such significance to both pre- and post-reform securities finance that it is discussed in detail in the next section. UTI was the DFI most actively involved in securities finance under the Nehruvian system. At the periphery of that system, corporate securities such as stocks and bonds circulated through the stock exchanges and through UTI. The actual role of securities in several

[38] Its partisans regularly hasten to stress that ICICI was a collaborative enterprise promoted by the World Bank and some domestic financial institutions with what one official called the "government's blessing." Author's interview, New Delhi, 2000, #14.

One wonders if these partisans did protest too much? Until the early 1990s, its status was never entirely clear. The government's role in its operations and appointment structure were always politely obscure. The distinction between it and the other DFIs was further obscured by the fact that it enjoyed many of the same rights as the other DFIs and by the way in which its personnel organization largely mirrored that of the other DFIs.

of the areas identified by the AC/FP matrix (enterprise finance, wealth creation, and industrial organization) was minor. They were, however, as discussed below in the case of government bonds, important to public finance and monetary policy. Finally, shareholder rights were largely irrelevant in the enclave system of stock finance.

In this sense, the DFIs were a direct substitute for the sources of large, long-term project funds that equity (stock) and debt (bond) finance typically provided to firms (commercial or financial) by securities finance.[39] As in the political control of commercial banking, credit allocation through the DFIs was politicized by the appointment procedures and by the political-bureaucratic subservience of the DFIs to the central-state-elite. However, additional government control over firms receiving credit was exercised by DFI membership on corporate boards, and in some by equity control gained through debt-for-equity swaps.[40] Control of such a wide scope of financial action through these DFIs meant that the state held a plurality of equity capital in most of India's largest firms, putting it in a position of significant potential influence over management and personnel decisions.[41]

As a consequence of the industrial regulations and financial organization discussed above, neither industrial capital nor finance capital were commodified under the Nehruvian system. Large-scale production belonged either to the state, or to India's large family-run conglomerates, both of which were tightly hemmed in by the licensing and quota systems, by an assortment of strict regulations on other fronts such

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[39] One study of the use of securities finance by Indian firms concluded that during the 1970s in particular, reliance on securities as a source of external funds was "minimal…(since) most private firms relied on the cheap credit provided by the government through commercial banks and DFIs like IDBI, IFCI, etc., and used less of stock market sources of finance like debenture and equity" (Murali 2000, 12).

[40] Some of these debt-for-equity swaps occurred when firms were in distress. However, options to exercise debt-for-equity swaps were often written into loan agreements from DFIs. Even if the options were not exercised, however, their mere existence was a significant form of securities-based coercive financial power enjoyed by the state (Kochanek 1974, 84-85 and 251-253).

[41] Customary practice and even statutory language discouraged the exercise of such power, but given the regulation of industrial capital and the control of financial flows discussed above, such crude measures were rarely necessary.

as protections and subsidies for "small scale industry," and by the direct political control of ministries overseeing large portions of the formal economy in state-owned enterprises at the central and state levels.[42]

Finance capital was thus intricately enmeshed in the state, limiting its commodification and creating tight government-business ties through state-run banking and DFI financial relationships. In this governance regime, finance was controlled and allocated in a hierarchical fashion by government-directed financial institutions and the central administration of interest rates. The directed-credit system orchestrated through this network of DFIs and state-owned banks thus allowed the Indian state to enjoy the *dirigiste* benefits of a non-commodified, embedded form of lending-institution-based finance. While it may have had some early benefits, particularly in the provision of credit at the local level in rural areas, the directed credit system also had negative consequences for banking and aggregate industrial performance in the long run.[43]

B. The Unit Trust of India: The Developmental State's Two Faces

Political Scientist Chalmers Johnson notably argued that the essence of the developmental state was the "plan rational" exercise of state discretion in the conduct of industrial policy and economic development (Johnson 1982). Michael Loriaux

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[42] Capacity and prices were controlled under the Industrial Development Regulation Act (1951). The Industrial Policy Resolution (1956) ensured the reservation of some sectors of the economy for state-owned enterprises. Regulation of the transfer and control of firms was achieved through the Monopolies and Restrictive Trade Practices Act (1969).

[43] In 1991, the Ministry of Finance admitted that the old system had "led to a decline in the productivity, efficiency, and profitability of the banking sector" quoted in Sen (1997, 42). Summarizing a number of empirical studies on various determinants (including investment and finance) of Indian industrial performance, economist K.L Krishna concludes that despite some improvement during the 1980s, "in terms of growth, the progress of industrialization in India has been far below expectations and targets" (2000, 499).

demurred, arguing rather that the developmental state was defined by the expression of "moral ambition" (Loriaux 1999). Both elements – the commanding vanguard expression of state guidance and the intrepid spirit of moral purpose – were behind the 1963 establishment of the Unit Trust of India (UTI).[44] UTI stands out as an unusual institution even amid the Noah's ark of Indian government agencies. It demonstrates how the politics of the developmental state can create strange bedfellows. UTI is a blend of quintessentially capitalist elements with *dirigiste* Nehruvian socialism. The details behind UTI's peculiarity merit some attention, because they are responsible in large measure for the important and controversial role this institution played, both in the securities finance enclave of the old Nehruvian financial governance regime, and in shaping the new evolutionary pattern of securities governance that emerged during the 1990s. Of particular interest are the subtle ways – formal and symbolic – in which control and responsibility were framed in the legal, institutional, and informal elements of UTI's development.

The idea of establishing these mutual fund-like investment unit trusts had been circulating in India's elite policy-making circles since the mid-1950s, but at that time key planners were too preoccupied with other initiatives in the flurry surrounding the reparation and implementation of the much-fêted Second Five Year Plan (1956-1961).[45] Then came war.

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[44] The term "unit trust" comes from the British financial lexicon of collective asset management. Shifts in the idiom of financial services and asset management are a subtle indicator of the changes in Indian financial doctrine and practice from the British colonial legacy to the American-inflected global securitization script of the 1990s. A "unit trust" is similar to an American mutual fund. Shares are called "units." A trust corresponds to what in the U.S. would be referred to as a "family" of funds. In India, individual funds under the trust are called "schemes." In the 1990s, the common parlance of Indian asset management mostly shifted to the Americanized "mutual fund" terminology, but the above terms remain.

[45] Under the direction of A.D. Shroff, influential industrialist and executive of the august Tata & Sons company, a 1954 blue ribbon panel made some recommendation about improving industrial finance. The committee reasoned that "such institutions (unit trusts) seem to be particularly suitable to India, where in order to increase capital available to industries, small savings have to drawn into the investment market," and that, "unit trusts can be operated with advantage to the investors as well as to

Following what many Indians considered a humiliating defeat in the 1962 war with China, there was a distinct national sentiment that new, ambitious steps must be taken to reinvigorate the development and industrialization drive. That war had adversely affected the economy and created a perception that the policies of the 1950s had fallen short, provoking in many Indians – elite and popular – a sense that they must redouble their efforts (Singh 1990). In economic policy-making circles, agreement emerged that the nation was in need of more aggressive mobilization of national savings, as well as more energetic and creative efforts to direct those funds.

In this atmosphere, all that was needed to launch the unit trust idea was a capable promoter, and it found one in the person of longtime Congressman T.T. Krishnamachari (known as "TTK"). TTK, a close Nehru friend and political supporter, was a uniquely motivated champion of the UTI cause.[46] In announcing the UTI plan to Parliament in 1963, TTK – recently appointed Finance Minister – explained that "the basic idea of the proposal is to afford the common man a means to acquire a share in the widening prosperity based on industrial growth of the country which combines the advantages of maximum security and reasonable return."[47] UTI was to achieve this goal by "encouraging savings and investment and participation in the income, profits and gains accruing to the corporation from the acquisition, holding, management and disposal of securities" (India 1989 (1963)). Thus was born the Unit Trust of India, an apex national securities finance institution that would deeply influence the tenor of Indian organized industry for the next forty years through both

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the industries, and that steps should be taken by both the public and private sectors to encourage (their) formation" (Pendharkar 2003, 3-4).

[46] In the success of UTI, TTK glimpsed the potential for his own political redemption from the embarrassing finance-related Mundhra scandal that had less than a decade earlier sidelined him within the Congress Party elite (Balachandran 1998).

[47] Quoted in Pendharkar (2003, 5).

dimensions of developmentalism: Johnson's "plan rational," and Loriaux's "national purpose" vision.

UTI was modeled on British investment trusts, institutions that collected savings from many individuals and managed the investment of these funds in securities and other financial assets. The "trust" structure, dating back to the 1880s in England, was both a legal and organizational innovation in financial engineering that was the precursor to American mutual fund. During the "Go-Go" years of the 1960s, trusts in the U.K. and mutual funds in the U.S. were gaining popularity, promising "to make the 'people's' capitalism' a reality and not just a catch phrase."[48] The staid English trust structure committed such institutions to a fiduciary responsibility over the assets they controlled on behalf of investors. The trust structure was simultaneously an organizational solution that permitted the spreading of risk among multiple participants and across a variety of assets (investments). It also enabled the pooling of smaller sums from many individuals, facilitating investment in what might otherwise have been prohibitively large or costly asset purchases.

UTI was established in 1963 by a special independent act of the Indian parliament. This was an unusually public procedure and one that conferred an aura of sovereign grandeur and state commitment on the institution. The creation of UTI in this way blended the practices of conservative British finance capital with the institutional structure of Nehruvian socialism. In the event, the details of UTI's genesis located it in the bureaucratic firmament of other statutorily empowered apex financial institutions such as the Reserve Bank of India, the State Bank of India (SBI), and Life Insurance Corporation (LIC) of India. In the ranking of the official agencies,

[48] John Brooks of the New Yorker and author of the famous history of the Go-Go years, quoted in Nocera (1994, 46).

this situated UTI in a status position subordinate to the RBI and on a par with that of SBI and LIC.

As stipulated in the UTI Act, the primary contributors of capital to this latest addition to India's growing stable of development financial institutions were the RBI (50 percent), SBI and LIC (15 percent each), with the balance (20 percent) provided by other financial institutions and commercial banks yet to be nationalized. These contributing institutions appointed some board members, the RBI appointing most of the others (a plurality). The RBI also appointed the executive officer. The government itself selected one board member.[49] Appointment of the UTI chairman was reserved for the "central government in consultation with the Reserve Bank."[50] The Act further authorized UTI to borrow money and issue bonds (guaranteed by the government). It was also tax exempt. All these elements together helped cultivate UTI's broad public service image.

The Act's stipulations regarding the appointment of UTI's top two officials have been the subject of much subsequent historical debate and policy analysis. The word "consultation," wrote one former official in his analysis of UTI politics, "does not imply approval." Thus, explained this official, V.G. Pendharkar, a man with top-level experience at both UTI and the RBI, "the government could appoint a person of its choice even if the (Reserve) Bank did not approve him." Furthermore, since "it is an established convention (in Indian administration) that the appointing authority is also the disciplinary authority…the government could remove the chairman if he did not fall in line with its wishes, which in practice meant the wishes of the Finance Minister. This meant that although the government did not have the power to give

[49] Typically, a joint secretary or higher-ranked official at the finance ministry has represented the Government of India on UTI's board of trustees (Thakurta 2002).
[50] Section 10 [a] (India 1989 (1963)). In 1975, this clause and those discussed later in this section were amended when the Reserve Bank devolved its UTI-related authorities to the Industrial Development Bank of India (IDBI), an institution created by, and beholden to, the RBI.

orders directly *it could covertly influence the Trust through this relationship to invest in particular securities*" (Pendharkar 2003, 61, italics added). This allocation of appointment authority to the government was a change from the penultimate draft of the Act, which had granted appointment authority to the RBI.[51] Some argue that this change was fateful both in symbolic and practical terms, as it bound UTI that much more closely to the sovereign authority of the state. The revised draft rendered the chairman directly beholden – symbolically and administratively – to the apex political authority rather than to a professional agency.

As a centralized national institution for investment in securities under government control, UTI would furnish yet another lever of state power over the economy and large industry. This was obvious to the industrial interests, who initially opposed the UTI proposals. They feared the new powers this would give the government, but they also lamented the prohibition on private sector participation in the investment trust business.[52] The predominant apex business association, the Federation of Indian Chambers of Commerce and Industry (FICCI), offered an alternative proposal that would develop both public and private sector investment

[51] In earlier drafts of the Act, appointment authority had been vested with the RBI. The last draft mysteriously divided the UTI control mechanisms in a legislative twist that deviated from standard Indian practice of agency control mechanisms in such enabling legislation, subsequent articles the Act specified that, while the government had appointment authority, the Reserve Bank would have the authority to demand information from UTI. Most importantly, the RBI was also entitled to issue "written directions" to the UTI board. The right to issue written directions – a notorious Sword of Damocles in the Indian bureaucratic hierarchy – is a power rarely exercised explicitly because its mere existence compels subordinates to cooperate (India 1989 (1963), Sections 29 and 30). The result put the UTI chairman in an "anomalous" position. On the one hand, the RBI could give him direct orders. On the other hand, he was under the direct disciplinary control of the government. If the two "did not agree on a matter of public interest the chairman would be faced with a dilemma" (Pendharkar 2003, 63).

[52] It was only after some years of operation that private Indian corporations learned that they could use UTI to their own benefit. Firms realized that when they had idle cash on hand, having not yet decided how to invest that money for the long term, just like individual investors, they could avail themselves of the ease, liquidity, security, and reasonable returns offered by UTI. This short term "parking" of corporate cash balances led to high volatility in the Trust (Mujumdar 2002).

trusts.[53] This plan was rejected by the government, and during debate, advocates of the bill in Parliament were careful to build a case against private involvement.[54]

"Flagship": US-64 and the political conquest of Indian equity finance. UTI's first "unit scheme" or fund was made available to the public in 1964. This open-ended[55] scheme was given the rather dull moniker "Unit Scheme-64," or "US-64" for short. In the Indian press and financial vernacular, US-64 is referred to as UTI's "flagship" scheme. The flagship metaphor – evoking the image of US-64 cleaving the wide seas of the Indian economy with all the other UTI schemes steaming along behind in its benign wake – aptly captured both the commanding spirit and the vanguard expression elements of state developmentalism that UTI embodied. There was for many years a familiar, yet reverent tone in the way Indians referred to US-64, which carried over to UTI as an institution more generally. As discussed later, this all began to fall apart in 1998; but in the meantime US-64 attracted over 20 million investors and defined many average Indians' relationship with government and industry as their periodic dividends arrived on handsomely embossed UTI vouchers.

US-64 quickly became extremely popular. Its profound impact was based largely on the reliability and seemingly persistent returns it paid to its investors. In its first year, US-64 set a fixed rate of return at 6.1 percent. Thereafter, the scheme periodically stated the dividend it would pay out to unit holders. This number

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[53] See Kochanek (1974, particularly chapter 6).

[54] Opponents of private involvement in the trust industry based their case on three main arguments drawn from the mainstream of then-prevalent Nehruvian mixed-economy doctrine: 1) an "infant industries" argument for a state-led single entity in the context of India's primitive financial services sector; 2) the dangers of too much competition; and 3) the potential for industrial interests gaining financial power. See the parliamentary debate collected in Pendharkar (2003). In the end the disagreement was resolved when private firms were at least permitted to use UTI (as discussed in note 52 above).

[55] An open-ended fund continually creates new shares of itself on demand. Typically the shares of the fund are sold at a "net asset value" (NAV) and can be redeemed for cash later at a NAV that may be above or below the price at which they were acquired. Net asset value is the value of all the assets in the fund divided by the number of outstanding shares.

fluctuated from as low as 6.1 when the scheme opened, to as high as 26 in the early 1990s. Even more unusual was the commitment US-64 undertook to "redeem" units at a premium to their face value of ten rupees. These premiums for repurchase and sale were also periodically announced. At an early date in the history of UTI, the Governor of the Reserve Bank made an unusual commitment to the investment scheme, stating that "any loss in repurchase of units (if their value fell below face value) would be borne by the RBI."[56] The first chairman of UTI, R.S. Bhatt, later wrote, in a disarmingly uncritical assessment, that this measure "went a long way to sustain the confidence of the unit holders in the formative period" (Bhatt 1996, 20). Here again were two dimensions of UTI practice that were unusual and potentially troublesome, though they were clearly favorable, at least in the near term, for savers who invested in UTI.

Thus, on the one hand, the formal structure of UTI largely mimicked that of a professional British trust, with clear fiduciary responsibilities. On the other hand, the state charter, combined with the original state-owned or state-related sources of capital, the embedded control mechanisms of appointment, discipline, and direct written instructions, and the symbolic sovereign commitment these represented, demonstrate what an odd beast was UTI. These odd conditions do lend credence to the argument that UTI was a joint expression of the plan rational and moral ambition dimensions of the Indian developmental state. This, at least, is how one might present the charitable account of UTI's purposes and functions. It was certainly designed to serve broad public service goals, and in large measure delivered on this promise. As indicated in the statements of UTI's political promoters documented above, the central state recognized that special inducements and guarantees were needed to encourage individuals to invest in government and corporate securities. And UTI did undertake

[56] Quoted in Bhatt {, 1996 #7587, 20}.

to organize the management and concentration of the formidable transaction costs and risks of dealing with India's slow, costly, and corrupt stock markets. This provided convenient transactions and reliable returns to poor and middle class individual investors, as well as to opportunistic corporate clients.

Yet, a complete account of the UTI project must also emphasize the *dirigiste* aspects of the UTI project. UTI could influence firms, securities markets, and the overall economy in a variety of ways. Until 1988, UTI was the monopoly mutual fund provider in India, and it continued to dominate into the post-1991 reform period. Its decisions in securities finance were therefore the most important and could move the market. Through its operations, UTI became the manager of large blocks of corporate shares, either purchased for its own portfolios in the market or acquired as part of debt-for-equity swaps from its debtors (firms).[57] As a large shareholder, UTI was often represented by directors on company boards. Convention dictated that government representatives on boards not exercise their voting rights in crucial matters (strategic decisions or mergers and acquisitions), but UTI did influence outcomes – particularly preservation of the Nehruvian *status quo* – through moral suasion, agenda setting, and occasionally even through outright voting.[58]

While UTI was encouraging the "direct" flow of funds from savers to borrowers such as government and business (avoiding the "intermediation" of banks), the state did not wish to encourage an overly familiar relationship between investors and firms lest its own dominion over the "commanding heights" be eroded. Use of a

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[57] As mentioned above, UTI was empowered to extend term loans and as such was also a source of loan credit for large projects in the same way as other long-term lenders among the development financial institutions (DFIs). See supra note 40.

[58] This system favored the status quo of dependent capitalism under the Nehruvian financial governance regime, because, as to two experts on Indian finance explain, UTI "coordinated" the exercise of its voting rights with other DFIs. These two financial economists point out that, "this enabled many managements to retain control of companies without needing to own a significant share of the paid up capital (the firm's total shares of equity)." This limited the threat of takeovers because any bid would require UTI acquiescence (in coordination with other DFIs), and UTI largely favored incumbent management (Sen and Vaidya 1997, 86).

state-managed mutual fund was one way to "mediate" this relationship. UTI played a *primus inter parus* coordinating role in managing the voting rights associated with the share holding of government-run financial institutions. Of the thirty stocks that comprised India's benchmark Sensex share index on the Bombay Stock Exchange, these institutions had share-holding ranging from 13 and 50 percent.[59] Through UTI, the government was thus "capable of indirectly influencing the market and has done so on occasions of a major downswing by asking financial institutions to prop up the market by increasing their buying activity" (Sen and Vaidya 1997, 86).

A parliamentary statute was used to deploy elements of Anglo-Saxon financial practice and fiduciary law pursuing the customary goals of late developmentalism: capital accumulation and administrative financial allocation. The British investment trust model was embedded in a powerful central bureaucratic structure, subject to the politically potent organization of India's civil service with its rigid personnel management system (including the patronage elements of promotion and the ossifying effects of numerous hard-to-fire employees). UTI hence fittingly embodied the overlapping principles and practices of developmental Nehruvian mixed-economy socialism in India. Here was an institution comprised of capitalists elements – an investment trust focused on stocks and bonds – yet capitalized from funds provided by the state, directed by public officials, and using price signals (the dividend yield and redemption price) administered at government discretion not set by the market.

Adding to the many demand-side constraints on Indian industrial finance discussed earlier in this chapter, UTI led the state's colonization of the supply side of Indian securities finance under the Nehruvian regime of economic governance. In this sense, UTI reproduced the role of banks as a risk bearing, mediating institution,

[59] The Bombay Stock Exchange's SENSEX is India's equivalent of the Dow Jones Industrial Average. The Sensex debuted in 1979. When the National Stock Exchange eclipsed the BSE in the 1990s, the NSE's NIFTY index of fifty industrials came to compete for the claim to benchmark status.

though it did not do so explicitly. This point is the main target for UTI critics. The latent conflict between the strict fiduciary objectives (serving investor interests) and the broader public purpose (as defined by the state) was evident even in the early parliamentary debate, when a prominent MP explicitly elided the distinction between them, saying the Trust would be managed "on business principles" which she claimed "would not be different from the larger public interest."[60]

It was this conflation of the government-defined public interest with investor interest, argue critics of UTI, that undermined the positive elements of the legal and organizational structure of the investment trust model. The institutional ensemble that constituted UTI was a Faustian bargain of sorts, inasmuch as the sovereign aura that attracted investors and gave UTI its various powers also provided the devices of discretionary action that facilitated the state's dirigiste capabilities. This vagueness and latent conflict introduced the potential for what economists call "moral hazard."[61] In this implicit deal, the state assured reasonable earnings and reliability in return for the ability to use UTI, as necessary, to achieve government goals that were not immediately coterminous with the formal fiduciary responsibilities and narrow financial objectives of the trust.[62]

The appeal of this arrangement was crafted using the symbolic sovereignty of the parliamentary act, in combination with the bureaucratic symbolism of the binding mechanisms of original state funding and the details of the appointment procedures, to

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[60] These somewhat insouciant remarks of Congress Party member Tarakeshwari Sinha in the Rajya Sabha (upper house of parliament) are quoted in Pendharkar (2003, 72).

[61] The strict definition of moral hazard derived from the economics of the insurance industry has more generally been applied (and more loosely interpreted) to include circumstances like the case of UTI in which the presence of implicit incentives or guarantees may lead to the socializing of private costs in the event of complications in a financial relationship.

[62] UTI failure could lead to the socializing of costs in a state bailout using taxpayer funds. This could happen in two ways. First, poor portfolio management, politically expedient investing, or adverse market conditions could cause the Trust to fail to achieve returns sufficient to pay the publicly promised rate of return. Second, the corpus of the trust as measured by NAV (see supra note 55) could fall so low in actual assets that there were not enough funds to redeem all outstanding "units" at the guaranteed repurchase value. Both of these things happened in 1998 and 2001.

come to a tacit social (but not legal) contract. Thus, UTI was given a special status that hindered the process of moving to a market-based system of securities finance involving procedural supervision and, in particular, complicated the regulatory treatment of UTI investment schemes for many years to come. Elevating UTI to this special status also produced uncertainty regarding the competency of other government agencies, such as the Securities and Exchange Board of India, to regulate any part of the UTI.[63]

C. Indian Bond Finance in the Era of Dependent Capitalism

As the Indian central state came to dominate the financial system through the 1950s and 1960s and reached its zenith in the early 1980s, a distinct set of institutions was produced which shaped each area of bond finance identified in the asset-class/financial-positions matrix: public finance, monetary policy, federalism and local development, creditor/debtor relations, and the interest rate structure. As development economists McKinnon and Shaw had expected, financial repression in India created a heavy issuer-bias. As the dominant issuer of bonds, the central state was keen to cultivate and preserve this systemic bias in the era before global securitization (McKinnon; Shaw).

The State. Government-issued, "paper"-like bonds or treasury bills dominated the realm of debt securities such as it was under the old regime. This use of government securities was largely an accounting shell game, moving funds around among state-owned banks, the central bank, and of course, the mint. Banks, insurance

[63] This became a matter of some contention during the development of India's constrained evolution securities governance regime in the 1990s.

companies, and pension plans (which were government run) were obliged to hold government bonds at specified levels, creating captive markets for government paper.[64] These bonds had a limited range of maturities, which made sense since they were very rarely traded, generally being held to maturity as part of the coerced system of government debt management. Markets for corporate bonds were relatively small and saw very light trading volumes.

Continual increases in deficit spending over time created a constant demand on government for more credit (see Table 4-2). This produced a cascade of additional financial control measures. First, it meant a corresponding supply of government bonds was needed to provide the state with the funds it needed to make up the deficits. Relations with the central bank and control of the financial system permitted the government to force banks to hold these bonds. This was achieved by way of an official regulation called the "Statutory Liquidity Requirement" (SLR). The SLR obliged banks to hold a specified ration of their reserve assets in the form of government bonds and DFI-issued securities. Designed initially as a monetary policy measure, over time the SLR became a fiscal tool, providing an ever expanding "captive market for government securities," and hence "served as a means of allocating a larger share of banks' resources to government" (India 1985, 254).[65] Between 1964 and 1991, the SLR rose steadily from 25 percent to 38.5 percent.

[64] For India, see Sen and Vaidya's excellent and concise summary (1997).
[65] This constant flow of state debt necessitated a growth in the money supply to pay for the government bonds, leading to what macroeconomists call the "monetizing" of the deficit. To offset the effects of this surge in the money supply, the government required banks to hold ever higher reserves of cash through (yet another) administrative requirement known as the cash reserve ratio (CRR).

Table 4-2:

Trends in Fiscal and Budget Deficits, 1971-1991 (as a percentage of GDP)				
	1971-1975	1976-1980	1981-1986	1987-1991
Fiscal Deficit	3.56	5.07	6.84	8.29
Budget Deficit	0.96	1.34	1.33	2.09

Source: Reserve Bank of India. 2002. Handbook of Statistics on the Indian Economy

Through constitutional authority and customary practice, the central state, over the years, came to be responsible for managing states' access to debt, and was thus in charge of their use of bond finance.[66] Thus, in sub-national finance, the ability of India's many states to issue bonds and undertake borrowing independently of the central government was limited. Even this limited ability was very rarely exercised by the states. Instead, they relied mostly on the center for direct grants and revenue dispersal through the national plan.

The Market. This dominant role of the state could not but affect the market for bonds. In the parlance of official Indian documents, government bonds are referred to as "market borrowings." This is particularly confusing since, before the 1990s, there wasn't much of a "market" into which these bonds were issued (known as a "primary market"). The SLR system meant that the price, the interest rate (known as the "coupon rate"), and therefore the yield on government bonds were not subject to market forces of supply and demand.[67] Nor was there much of a secondary market into which they could later be sold. Trading in government securities was very thin. It was conducted largely by phone or in person, and required a complicated procedure of registering trades and transfers in the Reserve Bank's oddly-named Subsidiary General Ledger.

[66] Article 293 of the Indian constitution limits state borrowing internationally and gives the center power over any state that is in debt to the Union (central) government.
[67] The yield on a bond is the (coupon) rate of interest, divided by the market price (not the face value) of the bond. This is why bond yields go up when the price of bonds goes down.

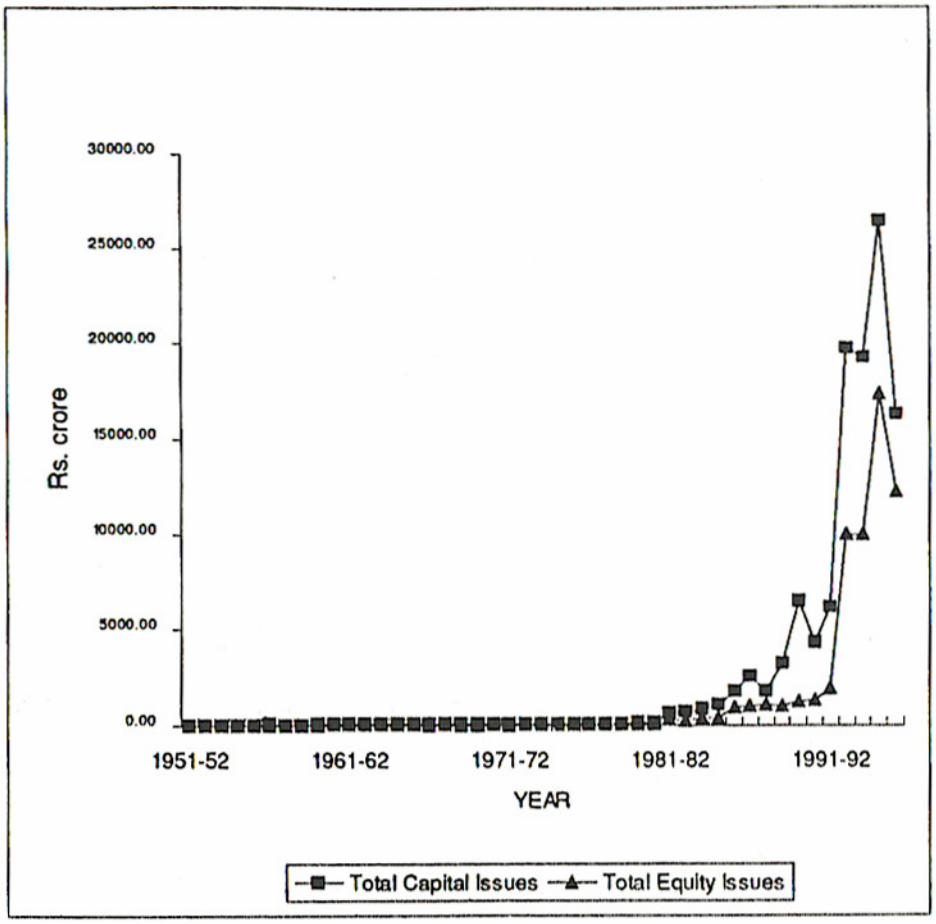
Corporate bonds, too, were a part of the Nehruvian finance regime, and they also were subject to strict regulation. Corporate bonds were of two types, private and public. The bonds of state owned enterprises (SOEs), also known as "public sector undertakings" (PSUs), enjoyed a *de facto* sovereign guarantee and were therefore considered low risk (but paid lower interest rates to investors). Private firms had to pay higher rates on their bonds. The major investors in these instruments, again, were the DFIs and state-owned banks, but firms also held one another's bonds. Corporate bonds were a distinct but not major source of outside finance for firms, sometimes exceeding 15 percent of total funding sources in the 1980s.[68] However, the use of bond finance was strictly constrained. There were rules governing firms' permissible levels of debt-equity ratios. Foreigners were prohibited from investing in corporate bonds. Finally, even the purposes for issuing such bonds were limited to long-term working capital needs (Ghosh 1991).

Summarizing the situation in Indian bond finance, a former Reserve Bank governor concluded that the "effects of financial repression policies quite clearly had a negative effect on the financial sector: markets were heavily segmented and underdeveloped secondary markets inhibited the competitive pricing of assets" (Rangarajan 1994). Other experts rounded out these conclusions, adding that "the presence of non-price allocation mechanisms led to an inefficient use of credit" (Sen and Vaidya 1997, 17).

[68] This estimate is based on an ICICI portfolio sample of 417 public listed companies referenced in Ghosh (1991).

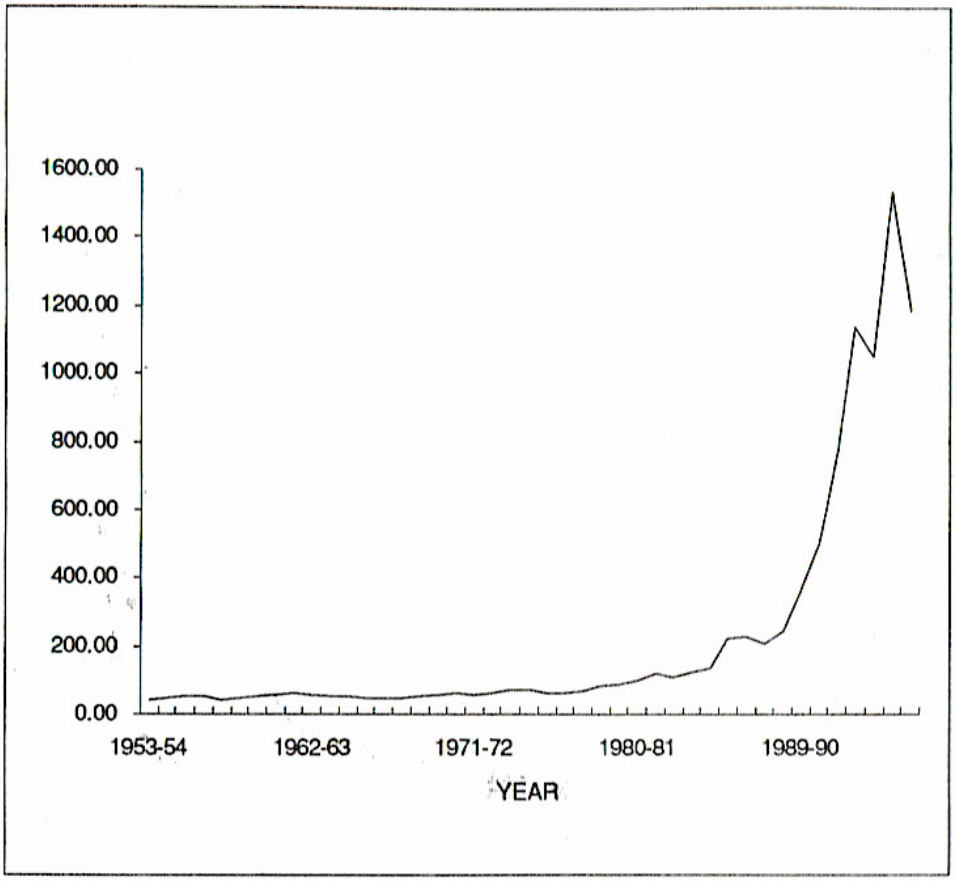
D. Indian Equity Finance in the Era of Dependent Capitalism

Before activity began to pick up on India's stock exchanges in the mid-1980s, few Indians outside of Calcutta and South Bombay paid much attention to the stock market index. Indeed, there was little point in doing so, since before 1984 it hardly moved at all, and up until 1990 was quite sluggish. Figure 4-1 – "Trends in New Indian Capital Issuance" – displays the degree to which non-government Indian corporations used securities to raise capital between 1951-1992. The monotonously low and flat curve of the trend line between 1951 and 1985 makes clear that such corporations only began using securities in a meaningful way in the mid-1980s, and only began raising significant sums through securities issuance late in the 1980s. Examining equities specifically, Figure 4-2 confirms the remarkable inactivity of India's stock markets in the heyday of the Nehruvian planning state. It shows that the value of Indian stocks only began to pick up with the stirrings of reform under Prime Minister Rajiv Gandhi in the mid-1980s.



Source: Misra (1997).

Figure 4-1:
Trends in New Indian Securities Issuance 1951-1994



Base 1980-1981 = 100. Source: Misra (1997)

Figure 4-2:
Movement of the Reserve Bank of India's
Ordinary Share Price Index 1951-1994

While the majority of finance capital in the form of short and long-term loans or grants flowed through the directed-credit circuits of the planning state and its post-Independence state-business arrangements, some finance capital was embedded elsewhere. The circuits of equity finance of India's shareholding system were by the mid-1960s rooted in two interconnected sets of institutions – one being the UTI and its DFI associates discussed earlier, and the other being the South Bombay and Calcutta communities dominated by ethnic Gujurati and Marwari stock brokers. Stock issuance and trading was conducted through these two distinct institutional cultures of securities finance civil servants and brokers, one official and bureaucratic, the other closely-knit, localized, and tightly networked through social, linguistic, family, and native-place ties. [69]

The State. The most significant role of the state in equity finance was played by the Development Finance Institutions such as the Unit Trust of India and the Life Insurance Corporation of India. But the state also had other instruments of direct involvement, particularly in the issuance of equity – the primary market for shares. The primary market was government controlled and little used by firms. Stock issuance was severely limited by the Controller of Capital Issues (CCI), who determined the volume and price of share issuance. The authorization to raise funds was at the discretion of the CCI, an agency with a small bureaucracy subordinate to the Ministry of Finance. The price of primary issues was set by the CCI, which consistently underpriced these issues of stock, favoring investors over firms (Shah 1995).

[69] For the classic discussion of these two communities roles in Indian business, see Kochanek (1974).

The Market. For most of the post-Independence period, securities played only a small role in industrial organization or in the financing of firms. Industrial organization issues were discussed above in connection with the production regime of the license *raj,* and the corporate governance subset of those issues was dealt with in connections with the DFI's default bias toward incumbent management.

With regard to enterprise finance and the primary market for securities, companies relied very little on securities finance as an source of external funds (see Figure 4-3).[70] Firm finance in general relied on internal sources for a plurality of funds. Nevertheless, as a proportion of the funds enterprises did bother to raise using securities, stocks played the dominant role in the period from the 1960s to the early 1980s.[71] In the 1980s the balance shifted in favor of bonds, even as firms' overall use of securities finance grew 23-fold. Whereas in earlier decades stocks represented 75 to 80 percent of securities finance for non-government public limited companies, that number fell to below 50 percent in the 1980s as bond finance gained in relative importance (Murali 2000, 13). Even if shares of stock did not play a significant role in enterprise finance or industrial organization during the Nehruvian era, they still were traded and circulated in the securities finance enclave.

The secondary market for shares was segmented and isolated. Regulated by the government's Controller of Capital Issues and operated by the Bombay- and Calcutta-based community of brokers, the secondary market further reinforced the marginalization of the securities finance enclave.[72]

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[70] Securities were a small source of firms' funds generally (external or internal). The DFIs and banks dominated external funding sources. Together securities finance from stocks and bonds made only a small contribution to gross fixed capital formation in the country in the 1957-1980 period, rarely exceeding 2 percent of Gross Fixed Capital Formation, and hovering around 1 percent for much of the 1960s and 1970s. See supra note 68.

[71] Equity finance as a percentage of firms' total sources of funds ranged from 2 to above just above 8 percent. See supra note 68.

[72] These are discussed at greater length in Chapter 6. The following paragraphs draw heavily on Holdsworth (2001), Government of India (1985), and Echeverri-Gent (1999).

In the mid-1980s, a special committee chaired by former UTI chief G.S. Patel was empanelled by the Indian government to examine the workings of the stock exchanges. The committee argued that amid the "diversity of organizational structures" prevailing in the country's securities markets, the mobilization of finance for "national development" had suffered. In a scathing attack on the Bombay and Calcutta broker community, the report asserted that "the securities business in the country has tended to be in the hands of a few families of stockbrokers whose actions are primarily governed by the need to protect their own interests and bereft (sic) of the interests of the investing public" (Government of India 1985, 10-11). The report criticized the brokers for a host of improprieties ranging from intentional delays (redounding to their benefit), insider trading, and price manipulation (Government of India 1985, chapter 2 passim). Political scientist John Echeverri-Gent's detailed study of the Indian stock trading community concluded that these brokers formed an "exclusive club" often subdivided into "cartels" which exploited the Indian stock exchanges (Echeverri-Gent 2001). Echeverri-Gent colorfully describes the brokers' pre-1990s behavior thus:

> …(T)heir ethic was similar to that depicted in Max Weber's concept of 'ancient capitalism.' Rather than increasing their profits by maximizing the volume of transactions that they conducted, the traders attempted to maximize their returns on individual transactions even if it meant manipulating institutions to the disadvantage of their transaction partners…As a group, the brokers brazenly manipulated the investments of the public to enhance their private wealth, and they resisted modernizing the archaic technology because they feared that changes would transform their traditional business practices and curtail their opportunities to exploit the system (Echeverri-Gent 1999, 211).

While Echeverri-Gent is certainly right that these circumstances "epitomized a classic rent seeking equilibrium," it is important to recognize that the marginalization and economic insignificance of the securities finance enclave limited the actual power

of the brokers (Echeverri-Gent 1999, 212). While their ethnic ties and special knowledge facilitated their concentration and organization as a collective actor, their ability to exploit diffuse public interests was limited by the enclave treatment of securities finance. Until the 1990s, the challenge presented by the Indian stockbrokers was trivial because securities finance was merely a ghetto. And it was a ghetto not because of the brokers' behavior, but because the state had designed and implemented a governance regime that successfully constrained securities finance.

A unique feature of pre-reform Indian stock markets was the form of trade settlement, or more accurately, the avoidance of trade settlement.[73] Typically, stocks are traded in a "spot" (or cash) market where each exchange transaction is deemed immediate or nearly immediate. This is distinct from a futures or options market where the delivery of shares or money is agreed upon for a later date. But for over a hundred years in India, the system known as *badla* allowed traders to defer "spot" settlement.

In Hindi, *badla* literally means "substitution," but as a trading practice it is typically translated as "carry-over" or "carry-forward" – as in "carry-forward my long position in Tata Steel Company into the next settlement cycle." The *badla* system dates back to the days when the settlement of stock trades took place on a fortnightly basis.[74] *Badla* permitted traders to defer settlement of their trades and to carry their "open" positions (orders to buy or sell) into the next period. This would be done with the assistance of a broker or a *badliwala*, who would of course charge for this service. The charge was akin to "interest" that the trader paid to keep open his position and

[73] The settlement of securities trades is the exchange of securities for payment.
[74] In the U.S. "day traders" buy and sell stocks all day "on margin," meaning that in the course of the day they do not actually pay for or take possession of stocks in every trade they make. Only at the end of the day do they "square-off" the many buy and sell orders they placed, calculating the net of sales and purchases and then paying out money or delivering stocks as necessary. In this way they trade many more shares they must actually "settle" for with funds or shares. In the badla system, the "day" was a fortnight (fourteen days) in length (Mulji 2000).

avoid having to produce either all the shares or all the money to complete a trade. The rate of this "interest" – published in newspapers and posted in brokers' offices – depended on the demand for the particular stock involved in the deferred trade (not the market value of the stock). Stocks in high demand attracted a higher *badla* rate. Often, settlements were repeatedly delayed in this fashion, and the volume of outstanding positions of unsettled trades carried forward under various forms of this system rose and fell significantly over the years. *Badla* was thus a *de facto* blend of elements of futures and margin trading in a nominally spot market.

Describing the system, a veteran foreign investor and long-time observer of *badla* explained:

> For more than a 100 years the badla system has provided 'risk capital,' in a flexible manner, to fund speculative positions taken by investors in the Indian equity market. Badla, and its derivatives, have allowed speculative positions to be built up and maintained with relatively little capital, and without the need for physical delivery. However, monies obtained through the badla system came to be used by brokers to fund their own operations and proprietary speculation within the market. Badla thus introduced systemic risks into the market through margining, and gearing up, of not only speculative positions but also brokerage operations themselves. In addition, the system provided the potential for the managements, and promoters, of companies to work in conjunction with select 'operators' or brokers to manipulate share prices. The diverse routing and locations of credit capital within the system have raised significant challenges to the regulator in monitoring the overall structure (Holdsworth 2001, 3).

Badla was very popular and created a distinct corps of vested interests for three reasons. First, and most important for those who were supporters of the system, by generating high trading volume *badla* provided greater liquidity to the market. Second, the earnings from providing badla services –lending either shares or money – were a major source of profits for many brokers and upper middle class participants in

the badla market in Bombay, Calcutta, and Ahmedabad.[75] Third, *badla* allows traders to speculate on stock price movements with very little original capital of their own.[76]

Badla created a broad domain of the trading system in which patronage networks guided by large lead brokers with access to sizeable *badla* financing acted as patrons to poorly capitalized smaller brokers, who in return helped the large brokers by providing a loyal trading network. Using the leverage provided by netting within the settlement cycle and badla finance, these "cartels" were able to manipulate prices by elevating trading volumes and ramping (for the bulls), or patience and shorting (by the bears).[77] Regardless of how one rates the ultimate worth of the *badla* system, argues Echevveri-Gent, any reform effort had to recognize the matrix of interests created by the existing badla-shaped structure of the market (2001). Those interests, relying on their incumbency in the Bombay financial community, the strength of the pro-badla arguments, and the fear of lost liquidity became a significant challenge to the reform of securities finance in the reform period. *Badla* and UTI were two major obstacles that the constrained evolution regime of securities finance governance in the 1990s had to overcome.

To summarize, then, Table 4-3 is a resume of Indian securities finance before the 1990s. The figure shows how the governance of securities operated during the majority of the post-Independence period. It suggests that there were some marginal

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[75] The size of the badla market in its various incarnations was not well documented, nor was the market well regulated. It was, in a sense, a very large informal system of "banking" for the share trading business. The "interest" rates were often well above rates prevailing on bank deposits or rates other financial assets (often in the 14 to 22 percent range on an annualized basis, occasionally even higher). Some brokers reported that their business earnings on actual brokerage advising and trade transaction was a "sideshow" compared to their badla business. Author's interviews, India, New Delhi and Bombay, 2000-2001; #58, #78, #85, #110.

[76] While the value of financial speculation in macroeconomic and social welfare terms is controversial – having both positive efficiency enhancing potential and negative volatility and risk producing potential – those who do speculate are naturally strong supporters of a system such as badla that facilitates the practice.

[77] "Ramping" involves running up the price of a stock artificially and then selling before letting it fall.

changes during the false dawn of the still-born reform efforts launched and abandoned by Indira and Rajiv Gandhi during the first two thirds of the 1980s.

India's long history of stock exchanges and shareholding companies had been effectively sidelined in the "securities finance enclave," with sleepy clubs of brokers operating listlessly at the fringe of a directed-credit finance system dominated by development finance institutions (DFIs); while a large state-run mutual fund-like institution, the Unit Trust of India, managed most of the country's listed shares (though these shares were seldom actually traded). In the idiom of development finance expert Edward Shaw, India's pre-1990s securities finance, though well established, was "shallow," and contributed only marginally to organized commercial industry. The trading of Indian shares was dominated by the two exchanges in Bombay and Calcutta, which were run as clubs. The trading practices at these exchanges insured extremely low trading volume and high rents for an exclusive exchange membership composed largely of two tightly networked ethnic groups whose corruption and incompetence further marginalized equity finance. Nevertheless, like China, the issuance of shares did grow in the 1980s, and then took off in the 1990s with the global securitization boom.

Table 4-3:
Indian Securities Governance before 1992

Period Policy Cycle Policy Tenor	State		Market	Civil Society	Asset Classes
	Institutions & Administrative Organization	Capital Controls (domestic and international)			
1956 – 1981 Closed "Nehruvian Securities Enclave"	Top-down Central fiat CCI UTI Central discretion complete	Financial repression Administered interest rates Foreign equity ownership capped at 40% ("FERA companies") Fixed-inconvertible currency/FERA Foreign commercial borrowing low Multilateral loans and aid hi Central hegemony over federal finance	Regulated by CCI Dominated by BSE brokers Badla Poor delivery Low volume Corrupt/fraud-ridden trades	Ghettoized Bombay-Calcutta Gujarati-Marwari nexus Bureaucratic & UTI/DFI-dominated organized finance	**Bonds** SLR and "captive" bond market **Equity** UTI-CCI-Broker created "enclave"
1982-1991 Semi-Closed "False Dawn"	Same as above Cement industry deregulation Central discretion slightly challenged (Escorts, Reliance Inc.)	Same as above Foreign commercial borrowing increase sharply	Primary market moderate growth Some secondary market growth	News coverage of finance ↑ Reliance-Ambani-inspired equity cult	**Bonds** Deficit growth & spending fuels sharp growth government bonds **Equity** Cement deregulation sparks expectation of some M&A fueling interest in construction stocks

V. Conclusion

Because this is part political sociology, part historical institutionalism, it is critical to assess the institutional system prior to reform in order to understand the dynamics of that reform. For China and India, financial governance regimes in the era of explicit directed credit – that is, the1950s into the 1980s – were remarkably similar. By the 1980s, China's state socialist system and India's dependent capitalism system shared a common reliance central political domination of finance for the organized sectors of the economy. This resemblance changed in the 1990s, as financial governance in the two countries diverged. The rest of this thesis explores what happened to Chinese and Indian financial governance in the 1990s era of increasingly globalized and securitized finance. The state in contemporary China and India responded to economic backwardness in similar ways in the era before global securitization.

Establishing the parameters of this comparability helps to reveal those elements that best explain differing patterns of securities governance that emerged during the intensive expansion of securitization in the 1990s. Demonstrating that the prior regimes of financial governance were similarly dominated by directed-credit systems is not to say that China and India were identical. These systems of directed credit were located in very different social, political, institutional, and macroeconomic contexts. We can divide these into two broad categories: the international, externally oriented context, and the domestic, internal context. It is within these two domains that I find the variables that significantly influence the development of Chinese and Indian securities governance regimes. In chapters 5 and 6 I examine these external

and internal factors that shaped Chinese and Indian responses to the securitization in the 1990s.

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Chapter Five

STRUCTURAL JUNCTURES AND POLITICAL INCENTIVES

Low-income countries, similarly large and similarly populous, predominantly rural and agricultural, China and India have periodically been the subjects of international and comparative political analysis. Yet, in the recent structure of their external macroeconomic profiles, they could not be more different. In those areas of what Indian officials call the "external sector" that matter most, foreign direct investment (FDI), exports, and foreign exchange (forex) reserves, the two countries were, by the early 1990s, already clear polar opposites. These three areas are critical dimensions of a country's external exposure profile (EEP). This profile plays a crucial role in shaping the nature of a country's structural juncture with the world economy.

Chapter 2 explained how global techno-market and transnational social forces encouraged the spread of securitization to developing countries in the 1990s, making securitization a prominent condition of the world economy at that time. Global technologies, markets, and transnational society may account for why states take at least some nominal interest in the process of securitization, setting up stock exchanges, restructuring and listing companies, and generally "following the script." Yet, chapter 2 also explained how securitization poses a challenge to directed-credit financial governance regimes, developmental states' most fundamental institutions of *dirigisme:* Institutions that contain or limit powerful independent financial actors, and that preserve states' discretionary control over the flow of funds to enterprise or public finance.

So why would developmental states seriously undertake to promote new systems of securities finance at all? Why, for example, do some states, such as India,

respond with fundamental change, while others, like China, merely go through the motions of reform even as they reproduce old directed-credit patterns of financial governance? One part of the answer, it seems, is that India changed because it had to, while China didn't change, because it didn't have to. The motivations for change, as I argue in this chapter, were produced in large measure by the political incentives that flowed from these countries' varying profiles of external economic exposure.

I argue that varying responses to securitization in China and India were the result of different political strategies formulated by central-state-elites in interaction with the dominant political coalition and the prevailing structure of property rights. These political strategies were driven by a collection of priorities and objectives that establish a policy trajectory pursued by policy-making members of the central-state-elite. These priorities and objectives constitute what political scientists call preferences. But, those preferences did not by themselves provide the *sufficient* conditions for determining the different patterns of securities governance in the two cases. Few specific institutional elements of the eventual securities governance regime can be derived from the analysis presented in this chapter. The contrasting junctures with the international economy – framed by each country's EEP – provide a *structure* of incentives directing the policy trajectory of central-state-elites. For a more thorough explanation of how those institutions developed within the ambit of the policy trajectory, we must look to the domestic political *process* in which the central-state-elite fashioned specific strategies for achieving those preferences in strategic interaction with coalition participants and property rights structures. This is the subject of chapter 6. Nevertheless, these preferences – shaped by the EEP-imposed incentive structure – did supply an important *necessary* condition – the policy trajectory – for securities governance regime formation. The political strategies that

shaped securities governance thus begin with these preferences. Where do they come from?

The last chapter began exploring the international side of the dual imprint. It followed the "second image reversed" tradition of exploring how variables that pervade the international system such as the intersubjective norms of the global society or spread of markets and technologies can influence institutional outcomes. This chapter now follows later innovations in second image research by focusing on the specific character of each country's links with the outside world – the profile of external exposure.

Relying on macroeconomic data, interviews with officials and businesspeople, government documents, and secondary analysis from experts, this chapter presents evidence that these countries' EEPs played a crucial role in framing the incentive structure within which important preferences were formed and political decisions made. The policy trend that led to China's discretionary involution pattern of financial governance was thus shaped by that country's *benign abundance* profile of external exposure.[1] India's pattern of constrained evolution was shaped by a very different profile of external exposure, one of *precarious scarcity*.

I. The External Exposure Profile

The external exposure profile variable used here is inspired by Political Scientist Peter Gourevitch's "production profile" concept.[2] My reformulation of the that concept is based on inductively-inspired modifications to that concept drawn from

[1] In this instance, "benign" is used as it is defined in the American Heritage dictionary: "Tending to exert a beneficial influence; favorable: a policy with benign consequences for the economy" (2000).
[2] This concept which helps explain the link between politics and policy outcomes was discussed in chapter 3 with regard to the "dual imprint".

my research. The EEP focuses on how a country's situation in the international economy shapes important political actors' preferences. As I sought to uncover what was driving the institutional changes behind differing Chinese and Indian patterns of securities governance, interview results, government documents, media coverage, and popular debates (both elite and vernacular) all pointed in one direction. It became clear that the key actor in both countries' state-led financial reforms was the central-state-elite. It also became clear that the pervasive influence, both explicit and implicit, of the external profile strongly shaped the structural conditions and decision-making context in which financial governance institutions were developing. As such, the EEP is not a deductive analytic tool derived from international macroeconomic theory.[3] Rather, the EEP is an heuristic intended to capture the way important elements of a developing and transitional economy's (DTE) interaction with the outside world impinges on domestic political decisions and ultimately the institutional structures of governance by shaping the preferences of the central-state-elite.

A. Defining the Profile

Components of the external profile do correspond to several of the major variables that determine the balance of payments position, which could serve as a convenient proxy for what I am calling the EEP. But, what experts call the "accounting balance of payments" is a statistical ledger and does not fully capture the

[3] EEPs may be practically related to international macroeconomic theory to the extent that bureaucrats, official decision makers, and policy analysts internalize the ideas, idiom, and practices (such as procedures for calculating national accounts) of modern trade theory through exposure to the dominant nodes of the prevailing international financial episteme, including foreign universities, the mainstream Anglo-Saxon economic business press [and translations of it in Chinese neibu (internal Party circulation) publications, and open-source "digests" such as the *Cankao Xiaoxi*], learned journals, and international institutions such as the IMF, the World Bank, international financial service providers, and the US Treasury Department.

practical, psychological, financial, and ultimately the political implications of the EEP, such as the significance of FDI inflows for industrial finance, or the fear of a "balance of payments crisis" when there is no foreign exchange left to pay for critical imports such as oil-related products.[4] Furthermore, the "market balance of payments" (the actual *flow* of payments in and out of the country) is *only observable in its effects*. The story of how one of these effects – a country's stock of forex reserves – has become politically salient in semi-open DTEs like China and India is central to my argument, and is therefore of great importance to the external profile concept.[5]

Over the course of two years exploring this problem in China and India, talking to experts and policy makers, and looking at the record of the crucial 1992-1995 period in both countries, it became clear that two variables in the accounting balance of payments itself were most salient to these countries' external profiles – exports and FDI. Also salient was one *result* of the B-of-P *flow*, the forex reserves. The case material below presents evidence supporting this claim, but the stylized facts that can be induced from them suggest that the politically important parts of the external exposure profile include:

> *Exports:* Exports as a component in the EEP are important in shaping political incentives for domestic financial reform for three reasons. First, high and growing exports typically contribute to GDP growth, which has salutary consequences for political stability and government legitimacy

[4] In the first heading of a typical developing country's balance of payments ledger, the "current account" is computed as the net export (or import) of goods and services for a given unit of time. In the second heading the capital account is computed from the sum of various capital flows including gross foreign investment (direct and portfolio), external assistance (net of grants and concessional loans), foreign commercial borrowings (net), debt service, inward remittances of forex, and a residual capital category. An overall surplus on the balance of payments will yield a reserve of forex. The treatment of precious metals in this accounting can vary and can influence the accounting of the total reserve stock.

[5] Another effect of the balance of payments in a fully open economy can be observed in "market determined" exchange rate movements. However, since China and India maintain non-convertible "managed" exchange rates [China with a de facto "peg" to the dollar, and India with a (aggressively) "managed float"], this effect is less relevant. Measuring the costs of adjustment under such managed floats is tricky. For a discussion of China, see Lin (2002). For a discussion of India, see Krueger (2001).

based on the effects of increasing employment and income. Second, where export production is efficient relative to the cost of imported inputs, the sale of merchandise or "invisibles" (such as services and software) to foreigners can contribute to the accumulation of hard currency reserves. In developing countries, export strength begets a virtuous circle of industrial finance as further investment is drawn into the export sector from home and abroad. Finally, the growth and earnings discussed above (in theory) link up with improvements in human capital and technology causing "development."

Foreign Direct Investment: FDI as a component in the profile of external exposure is important in shaping political incentives for domestic financial reform in two different ways. First, FDI enters the country as forex and as such has the potential to contribute to the foreign exchange reserve. Second, FDI furnishes funds for fixed capital investment in organized industry, providing an important supplement to, or compensation for, insufficient or inefficient domestic industrial investment. There are, of course, the other alleged benefits of FDI, such as the transfer of technology and managerial skills that can contribute to industrial productivity.

Foreign Exchange Reserves: As discussed already, in a semi-open economy with a fixed exchange rate (the result of a capital control regime of the kind used by China and India), forex becomes crucial in managing the exchange rate, and covering the cost of imports and debt-service. Forex reserves also come to have powerful symbolic value in a neo-mercantilist ethos that is now increasingly common among DTEs.

Not all of the components of the balance of payments are relevant to the profile of external exposure. Emphasizing FDI, exports, and forex in the EEP, I have neglected other components of the "capital account" that may contribute to industrial investment or forex reserves. Some of these components, remittances in particular, are hard for receiving national governments to influence in any meaningful way. Others, like external commercial borrowings (ECBs) are not necessarily appealing sources of *forex* or investment funds.[6] Thus, for countries like India that cannot rely (as China

[6] The volume of inward remittances by locals living abroad (or by members of a Diaspora) is largely beyond the control of national governments, depending largely on the real interest rate differentials. Chaudhry's (1997) study of Yemen discussed the institutional consequences of an EEP in which remittances play a large role. In the 1980s and 1990s grant aid and concessional loans to the developing world were declining (Chaudhry 1993). External commercial borrowing is not appealing to semi-open DTEs because of the pressure it can put on both exchange rate management and the supervision of domestic financial intermediaries. These were among the lessons of the Latin American debt crisis of the 1980s and the Thai and Korean crises of 1997 (Eichengreen and Fishlow 1996).

can) on FDI flows for industrial investment and forex, or on exports as a growth catalyst and forex source, foreign *portfolio* investment (FPI) becomes an important option in addressing an external profile characterized, as India's is, by precarious scarcity.

As DTEs shift to semi-open external sectors with open trading accounts even while they maintain capital controls, the stock of forex reserves has become an important shield against the vicissitudes of an international economy in which rich country interest rates, the whim of fund managers, and commodity price volatility (particularly oil) can capriciously destabilize a country's living standard and growth prospects practically overnight. Among DTE financial officials who frequent private meetings at the Asian Development Bank in Manila, the idiom in which currency reserves are referred to as "war chests" suggests the prevailing outlook on this matter (Lahiri 2002 p. 2). This attitude toward forex reserves has several sources. There is a Veblen-like "conspicuous consumption" element. To be counted as such, forex reserves must mostly be held in highly liquid forms like cash, precious metals, or as highly liquid securities (such as US Treasury Bills). This means they are financially inert, gaining little or no interest. The size of a country's foreign currency reserve has thus come to represent, among other things, a mark of prestige among DTEs.[7]

Another reason forex reserves have become so important among DTEs is the importance placed on such reserves by international credit-rating agencies (CRAs) and the growing reliance on those ratings by international financial service providers.[8] With the growth in the cross-border exchange of financial assets in the last twenty

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[7] In his 1995 address to his alma matter, Cornell University, Taiwanese President Lee Denghui addressed an audience gathered largely to celebrate Taiwan's achievements as a development success story and de facto independence. The climax of President's Lee's speech was his declaration that Taiwan was the holder of the developing world's largest reserve of forex (author's notes, June 9, 1995).
[8] There is a stunning scarcity of IPE research on the role of CRAs from a truly political perspective (Sinclair 2003).

years, and particularly the growth of investment in "emerging markets" by bank and non-bank financial actors, the services of CRAs have become indispensable in evaluating investment risk. Technically, the scores that credit-rating agencies assign to countries and companies are measures of credit risk. But overworked fund managers and portfolio investors who control the majority of foreign securities investment in DTEs frequently resort to credit ratings as a convenient short hand indicator of the investment quality of securities from a given country or firm-sector.[9] While the printed methodology provided to the public by CRAs professes commitment to a broad range of qualitative and quantitative measures, fairly weighted, the agencies do not make public their actual country-wise computations, only the results, and there is good reason to believe that ratings committees strongly emphasize forex reserves.[10]

Finally, probably because of the increasing power of the CRAs, governments do not make the task of estimating forex reserve positions easy. In discussing the issue of optimal forex reserve management, former Chief Economic Advisor to the Indian Prime Minister, Dr. Shankar Acharya explained, "if you want to carry out a study to find out the optimum amount of forex reserves that should be held by the government, you cannot do so. No government, apart from the US, gives out the composition of the forex reserves" (Acharya 2002 p. 5).

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[9] Fund managers in Mumbai and Hong Kong both said they used CRA ratings as "cover" when challenged on investment decisions by their superiors. Author's interviews, Bombay, 2000, #115; 1999, #31.

[10] The sovereign ratings methodology prospectus of CRA Standard and Poor's, describes the importance of currency reserves thus: "Central bank reserves are another external indicator, one whose importance varies across the ratings spectrum. Reserves usually act as a financial buffer for the government during periods of balance of payments stress. They include foreign currency and gold holdings, with the latter valued at market prices. Reserve adequacy is measured in relation to imports, and to projected current account deficits and total debt service. Whether a given level of reserves is adequate or not is judged in relation to the government's financial and exchange rate policies and, consequently, their vulnerability to changes in trade and capital flows" (ChinaOnline 2001).

a. External Exposure Profiles and Potential Endogeneity

None of these three components of the EEP are entirely "exogenous." That is, they are not independent of any country's general economic policy regime. They are certainly not impervious to concerted national policy adjustment or even accidental developments, as in the fortuitous and unplanned emergence of India's services and software export sectors in the mid-1990s. For example, China's high levels of inward FDI during the 1990s were certainly in large measure an outcome that was amenable in the medium term to the agency of political authorities including specific political measures designed to encourage FDI (Huang 2002).

However, these high FDI inflows were also the consequence of durable structural conditions such as the attractiveness of China's educated low-wage workforce, and the size, wealth, and affective ties of the Chinese diaspora who invested so much in the Mainland. The diaspora factor is an extremely significant contributor to the benign nature of the international economy that China faces (Thakurta 2002). These structural variables are, quite "sticky," and do not respond immediately to policy calibration or structural adjustment, and policy makers are aware of this stickiness. For example, in the India case, policy makers knew it would be some time before they could count on any substantial changes in FDI inflow,[11] or before the forex costs of import intensity in a new, expanded export base could be redressed by forex accruals earned from that export base. Chinese policy makers similarly understood that in the absence of further Tiananmen-like episodes, they could count on continuing FDI from the overseas Chinese community and continuing export competitiveness from the nexus of that FDI and their abundant labor.[12] For

[11] A key player in the formulation of the policy at the time told me "we thought in terms of a matter of several years." Author's interview, New Delhi, 2001, #104.
[12] Author's interview, Beijing, 1999, #35.

this reason it makes sense to treat *as exogenous in the short and medium term;* exports and FDI, as well as the degree to which both contribute (or do not contribute) to industrial finance, GDP growth, and the stock of forex. Understood in this way, these elements of the EEP form the salient lineaments of the political incentive structure during the crucial period (1992-1995) in which China and India were responding to rapid securitization, and in which the regimes of securities governance were established.

The endogeneity problem is particularly important when considering the possibility that the profile of external exposure (treated here as an independent variable) can be, and often is, influenced by the dependent variable – the regime of securities governance. It was Indian's policy makers' fervent hope that they could modify their EEP, or at least diminish its precariousness by changing the institutions of financial governance in ways that would invite foreign *portfolio* investment to cover their forex needs, and to mobilize finance in new ways so as to alleviate the short and medium term scarcity of FDI. By contrast, it has been the Chinese hope that their EEP will persist in its imperviousness to the patterns of domestic financial governance, allowing them to continue the flow of funds (what some call "life support") to the SOE sector out of domestic savings, while new industrial growth and forex needs are covered out of the FDI–export nexus.

II. <u>A Study in Contrasts: Chinese and Indian External Exposure Profiles</u>

The big China story of the 1990s, indeed the big Asia story of the 1990s, was the vast quantity of FDI that flowed into the Middle Kingdom. In spite of the reputation its authoritarian one party regime earned after the 1989 Tiananmen incident, the famous inscrutability of its business practices, and its well known reputation for corruption, China became the second most popular destination for direct

investment in the world during the millennium's last decade. Economic analyst Joe Studwell, dean of a growing club of China pessimists, and a veteran chronicler of what he calls "The China Dream," colorfully summed up the 1990s China bonanza in explaining what happened after Deng Xiaoping's famous 1992 "Southern Tour." That tour of the prosperous coastal region – reminiscent of similar dynastic imperial tours hundreds of year earlier – broke the post-Tiananmen frost: "When Deng offered up the China Dream," Studwell noted, "not only the mainland Chinese, but the whole world, arose in frenzy" (2002 p. 64).

Table 5-1:
Foreign Direct Investment into China and India

	Net Inflows Current U.S. $ (Billions)		Net Inflows as Percent of GDP	
	China	India	China	India
1985	1.7	0.1	0.54	0.05
1986	1.9	0.1	0.63	0.05
1987	2.3	0.2	0.86	0.08
1988	3.2	0.9	1.04	0.03
1989	3.4	0.2	0.99	0.09
1990	3.5	0.1	0.98	0.05
1991	4.4	0.7	1.16	0.03
1992	11.2	0.2	2.67	0.11
1993	27.5	0.5	6.37	0.20
1994	33.8	0.9	6.23	0.30
1995	35.8	2.1	5.12	0.61
1996	40.2	2.4	4.92	0.63
1997	44.2	3.6	4.92	0.87
1998	43.8	2.6	4.62	0.64
1999	38.8	2.2	3.91	0.49
2000	38.4	2.3	3.56	0.51

Source: World Bank, 2002

Export performance, the other key factor in the two countries' external sector, presents another diametric contrast. As the rest of East Asia climbed the product cycle or lost wage competitiveness, the coastal regions of Mainland China rapidly became the new-low cost workshop of the world. China jumped on the "export-led growth" bandwagon wringing as much as twenty-five percent of growth in gross domestic product out of its export sector. India might also have been exploiting its comparable low-wage, high-skill advantage to grab some of this market. But, it failed to do so; in spite of both the theoretical benefits of its fundamental low-wage comparative advantage, and the special policy measures it had taken to promote exports and depreciate the Indian rupee.

In the Chinese case, these two key parts of the external sector – FDI and exports – became increasingly intertwined with one another, and together helped contribute to the country's brisk growth rate, with foreign invested enterprises contributing as much as 47% of China's total exports and 37% of industrial output. Over the 1990s, coastal China became increasingly popular as the preferred location for the manufacture of low cost exports to the world, and late in the decade even began a run at the upper end white goods market. The story behind China's impressive export performance includes targeted tax incentives, "Special Economic Zones" (SEZs), the possible role of poor labor standards (including even coerced labor), and the special role of overseas Chinese investment.[13] Figure 5-1 summarizes the Sino-Indian comparative trends, highlighting the role of exports in growth and hard currency augmentation.

[13] Puzzling to some has been the persistence of the China's export competitiveness after 1995, when the Chinese currency was increasingly recognized as overvalued. For a discussion of this problem, see Song (2001).

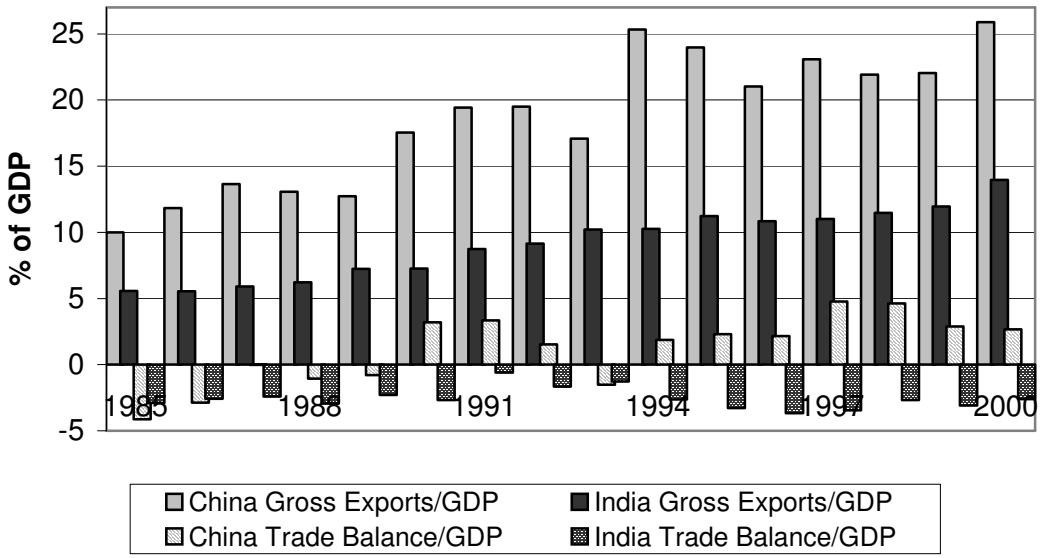

Figure 5-1
Export Contribution to Growth and Foreign Currency Reserves
Source: World Bank, 2002

In China the FDI-export nexus contributed remarkably to growth and to the accrual of foreign currency. At the dawn of the decade China's balance of trade shifted into positive territory and for the rest of the decade it exported more then it imported. While Indian exports grew moderately during the 1980s and 1990s, imports grew also. The inability of India in the near term to generate value or productivity dividends on the export side sufficient to offset this persistent import intensity was a key problem that Indian officals recognized, forthrightly admitting that it shaping their grand strategy for economic policy making.

It is worth noting that these contrasting country outcomes may themselves be related to one another. The empirical research is indeterminate on the degree to which global FDI is fixed. Indeterminate also is research on the degree to which the allocation of FDI into developing countries is a zero-sum game.[14] However, as two of Asia's largest economies, China and India are likely to be viewed by potential direct investors as competing destinations, with the two countries being targeted both as promising final markets and as attractive export platforms. It is therefore reasonable to infer that there is at least some element of a strategic interaction dynamic between them with regard to the external profile outcomes discussed above. There is evidence suggesting this to be the case. For example, executives of large multinational direct investors such as General Electric (Standard 2002) and Motorola (Srinivasan 2000 p. 669) are on record as claiming they consider the two countries as competing hosts for their production facilities. Over the last decade India has been on the losing end of these considerations.

Moreover, the role of the business and financial press in this strategic interaction, while hard to measure, is not insignificant. The media relish a face-off

[14] For a discussion of this, see Sader (1992).

between the heavyweight "Asian Giants," and with good reason. The India-China comparison has all the glamour of exotic, ancient civilizations that are easily portrayed by endearing and evocative mascots – the "elephant" and the "dragon" (Studwell and Sekhar 1995). Both business writers and academics enjoy the trope of a race, and this one has most often been framed in Aesopian terms, with India cast as the tortoise and China as the hare (Gilley 2002). Lastly, there is direct evidence that in the second half of the decade the two governments themselves were engaged in precisely this kind of strategic interaction. India's Ministry of Commerce has specifically sought to copy the Chinese FDI-export-led-growth model.[15] While discussions with officials and experts suggest this rivalry exists,[16] I do not consider it a driving cause, but rather an influential background condition.

Finally, FDI and export-led growth in combination with the broad macro-structure of the two economies produced a circumstance in which the levels of hard currency reserves that were accruing in each country were also in diametric contrast. Countries' foreign exchange reserves are typically measured in terms of "months of imports covered" by the current stock of hard currency holdings. This figure must be evaluated along with the balance of payments. As discussed below, the importance of this joint evaluation forms the base from which credit rating agencies evaluate country risk. Figure 5-2 displays this combination for the Chinese and Indian cases.

[15] According to a 1999 Ministry of Commerce report, "foreign direct investment has a direct coordination with an exponential increase in exports from China," and that "India should emulate China by opening free trade zones to attract more foreign investment and ensure higher economic growth" (Press 1999).

[16] Author's interviews with investing executives, (Hong Kong, 1999, #28), and with the central officials who deal with them in India (New Delhi, 2000, #14), and in China (Beijing, 2000 #35). A major difference between process of FDI investing in China and India, aside from the greater volume of red-tape in India, is that the center plays a smaller role in Chinese FDI interactions (Thakurta 2002).

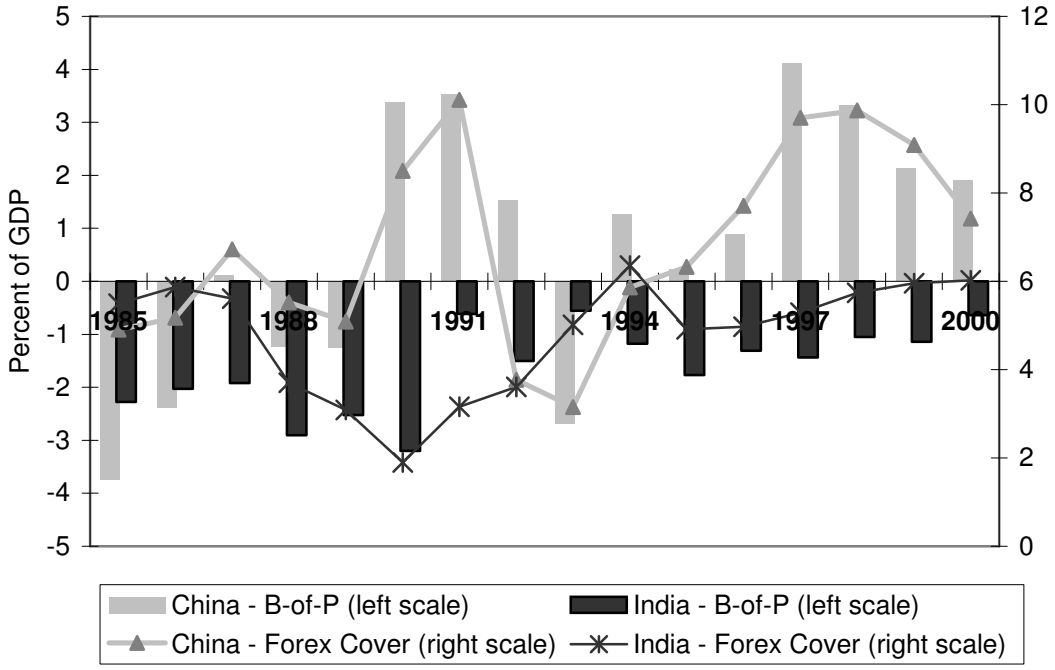

Figure 5-2:
Balance of Payments (B-of-P) and Forex Reserves for China and India
Source: World Bank, 2002

The stickiness of the trends in FDI and export-led growth, and the fixity of institutional and productive structure in the economy meant that this hard currency accrual trend was something the Chinese central-state-elites could reasonably expect to persist in the near future, and probably in the medium term as well, while the Indian state was forced to fight tenaciously for the hard currency needed to cover every month's worth of imports.

Table 5-2 summarizes the contrasting profiles of Chinese and Indian external exposure. It makes clear that China's benign profile meant that the country enjoyed an abundance of investment capital (from FDI) for industrial growth, a reliable trade surplus, and a consequently dependable inflow of foreign currency. Together these assured China of a stable balance of payments and imposed no urgent need for alternative sources of investment funds and foreign currency. Table 5-2 also shows how India's precarious profile meant that the country suffered from a scarcity of investment capital (from FDI) for industrial growth, a chronic tendency to trade deficits, and an accordingly insecure inflow of foreign currency. Together these undermined India's balance of payments and imposed an imperative for alternative sources of investment funds and foreign currency.

Table 5-2
Structure: External Exposure Profiles

Profile Component	China Benign Abundance	India Precarious Scarcity
Foreign Direct Investment (FDI)	High	Low
Export -led Growth	High	Low
Foreign Currency Reserves (Forex)	High	Low
Securities Governance Trend		
China - *Discretionary* • Growth from FDI • Balance of Payments Stable/+ • Investment funds/Forex suffice	India - *Constrained* • Capital mobilization needed • Bbalance of Payments Insecure/ - • Investment funds/Forex needed	

For those who cared, this contrasting symmetry of extreme conditions in the two country cases was rather remarkable. Polar cases like these should spark the analytic interest of social scientists. Such "naturally occurring" polar cases offer rare methodological opportunities for small-n historical-institutional researchers to isolate the effects of similar processes – such as responses to securitization – using the extreme contrast of polar cases to frame a process-tracing analysis. The international political economy (IPE) and comparative political economy (CPE) literature on the stark contrast in Chinese and Indian FDI has focused almost exclusively on explaining why overseas Chinese (OCs) invest in China more then non-resident Indians (NRIs) invest in India.[17] Few scholars have explored the contrasting records of export performance. Fewer still have bothered to inquire after the political consequences of these extreme conditions. Perhaps with good reason, since when dealing with the structure of FDI and the determinants of export performance, analyses quickly lead to technicalities in the balance of payments such as exchange rates, and the composition of, and relationship between, eye-glazing matters such as capital and current account

[17] For a review of the literature and the final word on this topic, see Guha (2002).

transactions.[18] The two countries' contrasting profiles of external exposure in the late 1980s and early 1990s did indeed produce very different balance of payments positions. This raises the question whether the political implications of these balance of payments positions might influence the development of domestic financial institutions.

The secondary literature was largely silent on this question, so I began by asking Chinese and Indian policy makers and financiers themselves. Precisely because of the sensitive politics associated with these different profiles of exposure it was not always easy to trace the process that links external exposure profiles with the institutions of securities governance. As discussed below, Indians consider their external exposure profile (EEP) an awkward topic, provoking nationalistic pride and even anti-Western indignation. Chinese are reluctant to consider their profile a possible source of financial pathologies. Nevertheless, there is good reason to believe that there existed some relationship between profiles of external exposure and the choices of central-state-elites with regard to securities finance. The rest of this chapter traces that relationship and presents evidence of its political nature.

III. <u>From Profiles to Politics</u>

How does each country's profile of external exposure make its mark on the international side of the institution forging "dual imprint"?[19] The material conditions created by a particular external profile, institution builders' perceptions of those

[18] The "current account" refers to the net of trade (imports minus exports) in goods and services. The "capital account" (which is strictly controlled in China and India) refers to the net of flows (purchases by locals minus purchases by foreigners) in financial assets such as securities and currency.
[19] For a discussion of the "dual imprint," see chapter three.

conditions, and their reactions based on those perceptions, must all translate somehow into the political process of actual institution building. How does this happen?

For a country that strictly controls financial flows, operating a closed or semi-open capital account, and sustaining the keystone policy of such a fundamental external sector regime, a fixed exchange rate, one of the most important macroeconomic priorities is maintaining a positive balance of payments position. Thus a top government objective must be to secure an ample stock of forex.

Both China and India have maintained capital controls that are comparatively strict for semi-open trading states. This is consistent with the "approved" reform sequence for DTEs. This is the sequence that multilateral lenders such as the World Bank and International Monetary fund advise. It was and continues to be (as of this writing) the sequence endorsed by mainstream international economists.[20] In this sequence the first step (following macroeconomic stabilization) is to open the "current account" and allow settlement of payments for the trade of goods and services in foreign currencies directly between transacting parties (firms).[21] Once this step is complete, countries are advised, with an important caveat, to proceed to the next step in the sequence, "capital account" reform, in which the exchange of financial assets directly between the transacting parties is permitted. The caveat is that this second step should only be undertaken when strong financial institutions are in place.

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[20] For a summary of the approved sequence, see Edwards (1992). For a summary of its application in general and in some Latin American cases, see Schamis (1999). The debate on this issue in Anglo-Saxon academia since the Asian Financial crisis has been increasingly lively, see, Bhagwati (1998), Edwards (2000), and Rodrik (1997). For explorations of the real-world politics of the issue, see Wade (1998) and Winters, (Winters). For the debate on this in India see Ghosh (2000) for the view from the old left, and from the more mainstream Indian view see, Raje (2000). For the debate in China, see Chiu (2002), and Chen (2001).

[21] For this to happen under a capital control regime, the access to foreign currency by local firms becomes the node of state control, and the deposits of those firms and their subsidiaries in foreign banks the node of non-compliance. For a review of how this sequencing has worked in India, see Ahluwalia (2002), and in China, see Lardy (1998). For a review of how China and India conducted trade prior to opening the current accounts see respectively, Lardy (1992), and Desai (1994).

However, the ultimate goal of full capital account convertibility was not always the mainstream view, and its merits continue to be a matter of debate politically, empirically, and theoretically, both within the wider international financial episteme, and locally within China, India, and other DTEs.[22]

Financial crises around the world in the latter half of the 1990s underscored what was at stake in "getting the sequencing right." Currency and financial crises from Thailand, and Korea, to Russia and Brazil made clear that optimal sequencing indeed had consequences beyond the seminar room, and that the task of "developing strong financial institutions" – the caveat that had been uttered almost as an aside in the early 1990s – was much easier said then done. India, it seems, has been making clear progress in following the prescribed sequence, while in China progress has been less clear.[23]

China and India took the first step in this sequence during the early 1990s and completed their current account reforms by 1996. Under the semi-open conditions of current account openness with capital account closure, trade flows and payments on merchandise and services were freed, but financial flows and payments for financial assets were not, and the balance of payments position could still be significantly influenced by ongoing government manipulation of components of the balance of payments. This magnified potential political contestation surrounding the balance of payments position and its consequences in a number of ways. Most importantly,

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[22] I return to this issue at the end of this chapter in discussing the role of the various 1990s financial crises in reinforcing the political incentives linking Chinese and Indian EEPs with the persistence of their differing patterns of financial governance through the late 1990s and early years of the new millennium.

[23] For three years India has been expanding the range of the band within which the "managed float" of the Indian Rupee trades. The quality of India's commercial banking sectors has steadily improved over the last five years. And, the maturity range of government securities and the mechanisms for their use in fiscal and monetary matters are increasingly transparent and sophisticated. On currency control, China shows no sign of movement. Despite heroic-seeming efforts, commercial banking may be worse today than it was three years ago. Only in central banking have measures to improve fiscal and monetary calibration have the Chinese shown much progress in the last three years.

persistent imbalance risks a payments crisis. Second, there is political contestation over the structure of authoritative allocation of benefits generated by semi-closure, which accrue differentially among importers, exporters, producers, and consumers.[24] And third, the contestation just mentioned must be refracted through the symbolic politics of external sector policies within a given national political culture and what citizens and policy makers consider appropriate ways of relating with foreign business and the world economy. The dynamics of the balance of payments under a strict capital control regime therefore require active and vigilant attention to both the technical and symbolic ramifications of every change. This line of reasoning would thus suggest the following general propositions:

Among developing and transitional economies with formerly directed-credit financial systems, a country's profile of external exposure will shape the political incentives for securities finance reform. In particular:

- The more benign a country's profile of external exposure *at the time of securitization*, the less will be the political incentives to alter the old principles and practices – the institutions – of securities governance.

And, conversely:

- The more precarious a country's profile of external exposure *at the time of securitization*, the greater will be the political incentives to alter the principles and practices – the institutions – of securities governance.

[24] This is standard Hecksher-Ohlin open market distributive politics. For the classic explication of this in the IPE literature, see Rogowski (1989).

The rest of this chapter will examine this proposition based on evidence from the Chinese and Indian cases. It should be obvious that the proposition is informed by the striking contrast between China's and India's junctures with international economy in the last two decades discussed at the opening of this chapter: China's favorable (benign) position in the international economy and India's unfavorable (precarious) position. In highlighting the external profile *at the time of domestic financial institution building* the proposition also seeks to capture world historical and world socio-economic "temporality" of the Chaudhry-inspired "structural junctures" approach so central to the dual imprint conceptual framework introduced in chapter 3.

If the proposition is valid, we should see evidence that the contrasting conditions in the two countries' external macro-economic positions – their profiles of external exposure – created compelling incentive structures and resource flows that influenced central-state-elite preferences and later significantly shaped the institutional development of securities governance during the 1990s. This chapter outlines the first step in this process: The step in which the incentive structure of each country's EEP moulds central-state-elite preferences.

To put this in a broader comparative context, Table 5-3 arrays the China and India cases along with some other developing and transitional economies within a two-by-two property space representing the intersection of ideal-typical exposure profiles (benign versus precarious) and ideal-typical securities finance reform trajectories (discretionary versus constrained).

Table 5 - 3:
External Exposure Profiles and Political Incentives

External Exposure Profile		Securities Governance Trend: Discretionary	Securities Governance Trend: Constrained
	Benign	**China** Hungary	
	Precarious		**India** Poland Brazil

Like China, Hungary enjoyed a flood of foreign direct investment, and did quite well as an exporter at various points along the product cycle (Bartlett 1997). Explaining why the Budapest stock exchange only "plays a bit part" in the Hungarian financial system, one analyst emphasized the point that "Hungary has relied more on FDI than any other Central European country" (Porter 2002, 5). Indeed, during the 1990s Hungarian net inflows of FDI as a percent of GDP were neck to neck with those of China (averaging well over 4 percent). Both Hungarian export receipts and foreign currency reserves were also quite high.[25] This structural fact, combined with the small total pool of firms and funds (savings) within the country, has lead to a range of problems for the Budapest exchange (including off-exchange trading of firms, fraud, and poor official support) even though it had a state-of-the-art trading infrastructure and the availability of good quality companies for listing. As a result,

[25] High export receipts and high forex reserves were offset however by the extreme import intensity of Hungary's aggressive post-socialist reconstruction.

like China, Hungary ended up with a formally impressive securities finance infrastructure that was hollow. Hungary did not involute as China had because its domestic politics were different, but its securities governance regime was discretionary in ways that much resembled China's securities governance regime.

For example, Hungarian securities attracted few issuers or investors (foreign or domestic), producing low trading volume, and its securities finance was of little significance to the Hungarian economic system (Review 1999). Investors, domestic and foreign, preferred direct equity involvement over portfolio investment in Hungarian stocks. High export earnings produced stable balance-of-payments and forex conditions. The Hungarians built a securities exchange with great potential, but no one came. The benign profile of Hungary's external exposure meant the country could ignore the relative insignificance of its stock market – that is, like the Chinese they both enjoyed discretion with regard to securities finance, and they pursued a discretionary policy trajectory in the governance of securities. With relatively abundant flows of FDI and reliably strong foreign exchange receipts from exports, the Hungarian central-state-elite had little incentive to fix the securities finance situation either for domestic users or to attract foreign portfolio investors. They just didn't care. This incentive structure created a preference for what we might call *discretionary neglect* in the Hungarian securities governance regime (as compared to China's discretionary involution).

Poland and Brazil present India-like contrasts to Hungary and China, and illustrate the political incentives of precariousness and scarcity in a country's external exposure. In the early 1990s both countries attracted meager FDI.[26] Their trade balances were highly volatile which meant they could not rely on export receipts.

[26] This did change for both countries, and by the end of the 1990s they were doing better at attracting FDI.

Poland began its post-socialist development with very scant forex reserves. Brazil seemed to have an ample amount, but the *Real* crisis of 1999 showed that in fact they needed more (Rajan 2002). In both cases, at the dawn of the securitization drive in the early 1990s, central-state-elites faced severe pressures to deal with the precariousness of the external macro-economic circumstances precisely at times that were sensitive for the domestic political position of new governments. Elite policy makers preferred to improve domestic capital mobilization and attract foreign portfolio investment as ways of addressing these problems.

IV. Indian Exposure: The Imperatives of Adversity

How is it that the Indian governance regime for securities evolved so quickly and involved such a remarkable transformation in the structure of hierarchies (in state-economy relations and within and among firms), markets, networks, and associations? This change is remarkable both in contrast to Chinese securities-related financial governance, the alleged "superior reformer," and in contrast to other sectors and factors of the Indian economy, such as power, telecommunications, or labor. Second, it is a remarkable achievement given the obstacles overcome in the course of this change, not only in confronting organized interests, but also in confronting deeply seated ideological beliefs and the institutions of economic governance associated with them. The former included the state-owned banks and their employees, and the old Bombay and Calcutta financial communities of stockbrokers, their exchanges, and their comfortable cartel. The latter included the ideological aversion to finance capital inspired by the Nehruvian- Gandhian principles of political economy and national development that pervaded the government, the elite, and large parts of small-scale industry. These profound changes were launched during the months and years

following the dramatic events of India's 1991 elections and balance of payments crisis.

A. Antecedents[27]

The politically salient antecedents of the 1991 crisis include the forty-year post-Independence development of India's institutions of economic governance and the ideology associated with them. These institutions included; central planning, export pessimism, a "modernization-oriented" heavy industrialization drive based on import substitution (ISI), combined (contradictorily) with institutions designed to promote small scale industry (in a nod to Gandhian values) (Herring 1999). When married to the prevailing ideology, a blend of self-sufficiency and Fabian Socialism inflected with the ideas of Gandhi and Nehru, this produced what came to be called India's "Nehruvian mixed-economy."

Blending the ideology of self-sufficiency with the institutions of export pessimism (and ISI) produced the specific circumstances of India's external sector in the forty years preceding the 1991 crisis, including the historical features most important to an understanding of India's external exposure profile (EEP). Students of India's modern development are fond of lamenting that, "India's share of world trade declined steadily from 2 percent in the 1950s to 0.05 percent in 1990" (Srinivasan 2000 p.698). As with other autarkic developers, including many countries in Latin America, the import intensity of India's export pessimism, and the related policy of

[27] By 2002, India may have won in the battle of foreign currency reserves, but has yet to win the war of the balance of payments precariousness. In July the Confederation of Indian Industries convened a conference in which there was some serious consideration that the growing forex reserves could actually become a problem (forcing appreciation of the rupee). This is because ten years after reform India still is not exporting enough or producing enough capital intensive goods at home to either produce large export earnings and create demand for dollars by importers in a healthy symbiosis of importing inputs for domestic and export-oriented production.

import-substitution industrialization produced persistent pressure on India's balance of payments.[28]

Deputy Governor of the Reserve Bank of India, and former Ministry of Finance official, Y.V. Reddy is a man whose career has placed him on every possible side of India's B-of-P problem. Reflecting on the historical context of the unusual position in which India found itself in 2002, holding approximately 66 billion US dollars in forex, a sum sufficient to cover over twelve months of imports (Figure 5.X: India's Forex Position 1950-2002), Reddy remarked:

> This position needs to be contrasted with the 1980s, when external debt, especially short-term debt, mounted while the forex reserves got depleted. In fact, it is often held that, between 1956 and 1992, India faced balance of payments constraints in all but six years (Reddy 2002).

In 1981, following the second world oil shock, India's B-of-P situation became so critical the government was forced to draw on its line of credit at the International Monetary Fund. The psychological and nationalistic sentiment associated with this episode, and its place in the public narrative of India's recent economic history is captured by an eminent Indian economist in his bitter quip that during the 1981 B-of-P crisis, "we had to go to Washington, DC with a begging bowl": A vivid metaphor in the Indian context (Acharya 2002 p, 2).

These comments underscore how, in India, the link between the balance of payments and the political incentives for financial reform emerge from the conflicted nexus of nationalist ideology and technical macro-economic necessity. We know this particular nexus was powerful because, as we shall see, it overcame another deep-

[28] For a discussion of this in comparative perspective, see Schamis (1999). For a classic treatment of the "import intensity of ISI," see Diaz-Alejandro (1965).

seated element of nationalist economic ideology – fear of, and principled resistance to, foreign financial interests, particularly foreign portfolio investment.

B. The 1991 Crisis

During the 1980s the Indian state ran out of money. A military build-up had been costly, and government revenues were slipping. Large deficits developed, national debt increased, and the government was no longer able to support investment as it had in the past (Rudolph 1989). Combined with poor export performance, and little FDI, these conditions conspired with the First Gulf War spike in oil prices to bring the Indian state to the verge of bankruptcy in 1991, when India went to the IMF for an emergency stabilization loan, and a new government embarked on a range of economic reforms.

Watching the shipment of forty-six tons of gold from Bombay to London might provoke in the casual observer a range of reflections on matters such as imperial expropriation and the power of money, particularly if the year is *1991* and not 1891. In mid-July of 1991 when that transfer of gold took place, there were, however, no such casual observers because, for security reasons, the transfer was kept secret until the new Indian Finance Minister announced the completion of the transaction on the floor of the Indian parliament. That Finance Minister, Dr. Manmohan Singh, had held his portfolio for less then a month, having been sworn in as part of the new cabinet of recently elected rookie Prime Minister P.V. Narasimha Rao. Rao was at the helm of a minority government, his Congress Party having failed to muster an absolute majority in the previous month's election. He was being asked to fill some large shoes, for the country had just begun mourning the assassination, during the recent election campaign, of the scion of the country's leading political family, Rajiv Gandhi, former

leader of Rao's Congress Party.[29] As if this were not enough trouble for the new administration, Finance Minister Singh explained in his Parliamentary floor speech on July 18, that drastic measures like the gold transfer (provided as loan collateral to the Bank of England) were necessary because India was facing its worst ever balance of payments crisis.

The 1991 crisis sparked a round of economic reforms across a broad front, marking a watershed in modern Indian history.[30] The rupee was devalued, tariff barrier reductions begun, and the industrial "license-permit-quota Raj (rule)" largely dismantled over the next two fiscal years.[31] Changing the related system of directed-credit that, together with the industrial licensing system, characterized the old pattern of financial governance in India was more difficult due to the scope of the state-owned banking system, the power of the unions who staffed it, and the political equilibrium associated with the provision of credit to "priority sectors." The 1991 reforms changed the face of the Indian economy, ushering in a period of sustained strong growth between 1993-1999 (see, Table 5-4).[32] However, no area of reform achieved such fundamental change as the restructuring of the governance regime in the securities sector.

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[29] At the time Rao, a kindly old Congress Party stalwart, was seen as an innocuous caretaker figure, who would occupy the premiership until a, more aggressive "real" leader could be selected. He upset these expectations, lasting in that position for six years based on a mix of success on the part of his economic team combined with the very innocuousness that had led observers initially to dismiss him.
[30] Previous efforts at reform in 1984 under Prime Minister Rajiv Gandhi had been largely still born, but had begun the incipient growth of securitization, particularly in the liberalization of the construction materials sector,especially cement where production quotas and M&A controls were loosened. Author's interview, Bombay, 2000, # 113.
[31] See the budget speeches of Finance Minister, Manmohan Singh for 1992 and 1993.
[32] For evaluations of the reform period, see Joshi and Little (1996), and Ahluwalia (2002).

Table 5-4:
India's GDP Growth in Percent

Year	Percent Growth
1991	0.4
1992	5.4
1993	4.9
1994	7.5
1995	7.6
1996	7.2
1997	4.4
1998	5.9
1999	7.0
2000	3.9

C. The Politics of Precarious Scarcity

In his assessment of the reform period, a former top official in the Ministry of Finance and the prestigious Planning Commission, summed it up thus, "No other regulator has achieved as much as SEBI (Securities Exchange Board of India) and no other SROs (self-regulating organizations) as those in the stock markets."[33]

The newly appointed Finance Minister Manmohan Singh was a technocrat with experience in all of India's top economic posts and a neo-Keynsian pedigree.[34] Singh embodied the nexus of old and new, the domestic traditions and institutions, as well as the cosmopolitan perspective and the exasperation with India's precarious external profile. With the Prime Minister's support, Singh collected around him what John Waterbury calls a "change team" composed largely of foreign trained technocrats

[33] Author's interview, New Delhi, 2001, #104.
[34] Singh was trained as an economist at Cambridge with Joan Robinson and Nicholas Kaldor.

who also were seasoned veterans of the New Delhi policy arena, and all like-minded in their desire to transform the ideas and institutions of India's economy.[35]

The ideological side of the EEP-politics nexus operated at two levels, the public, vernacular, intersubjective level of India's post-Independence political culture, and the elite, *entre- nous*, level of the policy-making elite's persistent psychological discomfort with India's precarious profile of exposure and mediocre macroeconomic performance.[36] At the first level, where political culture shapes economic institutions indirectly through ideological legitimation, and directly through the media and through the electoral and parliamentary processes, India's post-Colonial discourse of self-sufficiency and antipathy toward finance capital was embodied in the culturally and politically pervasive principles of *swadeshi* and Nehruvian-socialism.[37] As discussed in chapter 4, this discourse had shaped India's economic institutions over the course of forty years, with profound implications for the *ancien regime* of financial governance.

At the elite level, the genuine discomfort that these proud bureaucrats and politicians shared was another major factor linking the profile of external exposure to the political incentives for change in the institutions of financial governance. Like the political culture of *swadeshi* and Nehruvian socialism, this "sentiment" also took on an intersubjective, constitutive aspect based on many of these men's (they were all men) shared experiences. They shared the common bond of having endured long years of

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[35] Waterbury defines the "change team" as the "brain trust of the political leadership," requiring "the visible and consistent support of the head of state" (Waterbury 1992 p. 191). This discussion is drawn from Vanita Shastri's excellent and meticulously documented analysis of the Indian change team and the general reform process it spawned (Shastri 1996).

[36] I am here speaking of the "collective representation" of Durkheim (1895 (1964)). For a study demonstrating the intersubjective basis of political culture, see Mitchell (1988). Katzenstein (1996), and Wendt (1999 especially pp. 157-165) discusses the use of intersubjective knowledge as an independent variable in explaining foreign policy and IR outcomes. For a discussion of common knowledge in the "epistemic community" among technical experts such as macroeconomic policy makers, see (Haas 1992). For a discussion of the particular case of India, see Chatterjee (1993).

[37] Swadeshi, meaning literally "of our country" is the popular self-reliant expression of economic nationalism in India. As a political project it draws legitimacy from Mohandas Gandhi's framing of the anti-Colonial movement. The anti-finance bias was discussed in chapter 4.

arduous research and interagency policy strife in skirmishes along India's precarious B-of-P frontier. They also shared similar levels of exposure to Anglo-American macroeconomic theory. Finally, the cosmopolitan perspectives they had gained studying or working abroad, produced a general feeling of wounded national pride provoked by the "penury" of the precarious external profile.[38] For example, memories of the 1981 B-of-P crisis were vivid in the minds of change team members, among whom numbered several professional economists who had cut their open-economy research teeth on case studies of that episode among others.

It is hard to overestimate the impact of the cosmopolitan perspective, and how it affected the framing of the reform debate. Finance Minister Manmohan Singh was fond of pointing out in public fora the provocative fact that in 1960 India and South Korea had similar levels of per capital income and GDP, and that less then forty years later, "Korea has become a member of the OECD, and we (India) are where we are," with a annual per capital income of US$ 450 compared to South Korea's US$ 11,000.[39]

The 1991 crisis set the stage for an odd confrontation between the technical problems of FDI, foreign trade, industrial finance, and forex management associated with the external profile on the one hand, and the vernacular ideology of swadeshi and the institutions of Nehruvian-socialism on the other hand. Even the near apocalyptic urgency of the 1991 crisis was insufficient to propel the "feasible set" of policy making completely out of the orbit of India's finance-phobic post-Colonial discourse of Nehruvian self-sufficiency. The crisis was sufficient, however, to create political

[38] The rhetoric of the B-of-P precariousness constantly invokes this sense of shame using words such as "penury." See, Damodaran (2002).
[39] Singh has made this comparison in many interviews and speeches. For a convenient reference, see (Singh 2001).

space for significant innovation and change.[40] Yet, that change was constrained in turn by the mechanics of India's external profile. These ideological and psychological factors interacted with India's EEP and the new mechanics of the semi-open external sector management in interesting and politically complicated ways.

V. Chinese Exposure: The Liberties of Abundance

For the last twenty years one of the most striking features of China's political economy has been the huge inflow of foreign investment.[41] Already in 1993, FDI equaled 20% of fixed investment and accounted for more than 10% of industrial production (Naughton 1996, 303). Also, despite the size of its domestic market, China followed its neighbors Japan, Korea, and Taiwan in an export-led growth pattern. In 1998, two decades after initiating basic economic reforms, as much as 25% of China's GDP growth came from exports.

As discussed above in Section II, this "China Dream" was a factor largely beyond the near-term control of the state during the establishment of China's new pattern of securities-related financial governance in the 1992-1995 period. Nevertheless, it had profound consequences for many economic, political, and social elements of the transition process. Most significant, were the effects on growth, the fate of medium and some large sized organized industry, and exports. The "China Dream" and the benign structure of external exposure that the abundant inflow of FDI represented also influenced the development of the securities market.

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[40] For a discussion of how economic crises facilitate institutional change, see Nelson (1990) and Haggard and Maxfield (1996).

[41] Even if we significantly discount the official FDI statistics for "roundtrip investment" recycled through Hong Kong, and for sloppy or propagandistic Chinese accounting, the volumes are still world beating (Chandra 1999).

The initial corporate restructuring phase of China's enactment of the securities market script may have had cosmopolitan inspiration from Hong Kong, but the actual investment capital in the securities markets before 1994 was largely domestic. Then, as now, FDI was the major source of foreign funds. The central state carefully supervised the flow of FDI,[42] and through 1994 enforced a severe and wide range of controls on capital both domestically and internationally. Multiple administered exchange rates were in effect at an appreciated-level. Currency was controlled by a dual-track system in which local currency and "foreign exchange certificates" circulated simultaneously. Foreign exchange retention by provinces, municipalities, and state agencies, was based on centrally administered formulae. It was not until 1994 that foreign capital played any significant direct role in the securities markets through the growth of foreign listings and portfolio investment in B shares [Figure 5.X: The Composition of China's Share Market]. However, starting in the 1980s, and booming in the 1990s, foreign capital indirectly was playing a large role in securities market development as the process of corporatization expanded and FDI flooded in from the level of Township and Village Enterprises up to major Joint Ventures (JVs) in such areas as automobile manufacturing.

A. The Politics of Benign Abundance

Abundant flows of foreign direct investment in China, and the abundant foreign exchange cover derived from FDI and FDI-driven exports shaped securities market policy in the 1990s. FDI continued to pour into China, and foreign exchange reserves rose throughout the decade. Indeed, Chinese policy-makers were surprised

[42] For a discussion of Chinese control of FDI, and the "miniaturization" of FDI to avoid those controls, see Fu Jun (2000).

that these flows kept coming, and increasing.[43] The foreign invested sector was soon taken for granted as an important driver of economic growth. Paid-in capital from FDI, and the contributions of foreign invested enterprises (FIEs) to the trade surplus, together accrued large amounts of forex cover. Later, overseas listings by Chinese companies added to the security that China's formidable hard currency reserves offered against balance of payments risk.[44] Remembering, as discussed in section two above, the high esteem accorded the evaluations of credit rating agencies (CRAs) by central-state-elites, and the reverence with which the CRAs treat the components of the external exposure profile, the statement reproduced below from Moody's Investors' Service (the "gold standard" of CRAs) regarding several of China's sovereign ratings aptly captures how all good things went together in China's profile of benign abundance. Each of the elements discussed above are represented.

Moody's said it took the ratings action because of the "exceptional strengthening" of China's external-payments position. "Several significant factors – China's dynamic export performance, its ability to attract substantial amounts of foreign direct investment, its relatively modest level of external debt, and the very large buildup in official foreign-exchange reserves – make it likely that the nation will continue to reduce its vulnerability to external shocks," it said (Hong 2003).

So that the booming growth in foreign trade might be more smoothly administered, currency convertibility was introduced on the "trade account" in 1996.[45] Two years earlier, in a masterful implementation of reform sequencing, the currency had been unified (discarding the system of foreign currency certificates for foreigners)

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[43] The OECD calculated that China was the number two worldwide recipient of FDI in the twenty years between 1979 and 1999. The US was number one (ChinaOnline 2000). In the mid-1990s the foreign invested sector accounted for almost 75% of export growth. Export growth in turn accounted for anywhere from 18% to 27% of China's GDP growth (Chandra 1999).

[44] Given Chinese state preferences for stability and strength, BoP security is crucial.

[45] This meant locals and foreigners could exchange hard currency for the otherwise inconvertible Chinese Renminbi, but only for the purposes of settling contracts on the trade of goods and services.

and devalued. The feudalistic foreign currency retention regime was replaced by a system of foreign currency trading centers servicing the trade-related exchange needs of businesses.

Growth, together with B-of-P security from ample foreign exchange, provided the government with a wide margin to maneuver in directing access to financial assets in general, and to securitized equity and debt assets in particular. With continuous inward flows of investment and steady GDP growth,[46] the government could safely maintain a strict set of capital controls. This limited outward foreign investment by locals, maintaining a captive pool of savings for investment in stocks and government paper. The government then further "encouraged" the flow of these savings into the securities it had made available by imposing low interest rates (often negative in real terms). Faced with such a Hobson's choice, locals invested despite the poor quality of the firms and the poor quality of the claims embodied in their equity shares (due to the segmentation of property rights).

The boon of persistent foreign investment in China thus allowed the government to assimilate the securities market into the financial governance regime as; 1) a life-support system for the SOEs,[47] servicing the "socialist social contract" while providing a system of side-payments into the regional and sectoral coalition network, and 2) a means of managing an ambiguous state-dominated property rights regime.

[46] The degree to which there was growth after 1997 is now in doubt.
[47] This was done in conjunction with a system of transfer payments disguised as commercial bank loans (Lardy 1992).

VI. The Crux of the Matter: The Political and Economic Consequences of FDI

After more than a decade of what many experts consider Indian "underperformance" in attracting Foreign Direct Investment (FDI), the last two years witnessed distinct increases in direct investment from abroad.[48] This recent dramatic change raises the important question; what role did FDI policy play (and not play) in the development of Chinese and Indian securities finance institutions? The core analytical claims of this thesis and the strongest evidence supporting those claims are most succinctly revealed in the analysis presented through this thesis of the contrasting role FDI played in the recent development of Chinese and Indian financial governance.

FDI was a key element in the Chinese profile of external macroeconomic exposure discussed in this chapter. Its absence (particularly in the period preceding 1995) in the Indian case was symptomatic external closure; the export pessimism and the precarious scarcity that so distinctly characterized India's profile of external exposure. The evidentiary base at the level of structural incentives, elite ideas and purposes, and their consequences for the domestic politics of institution building in the domain of securities finance, is clearest and most compelling when the analytic lens is focused most intensively on FDI dynamics in the two countries.

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[48] The empirics of FDI flows are themselves painfully fraught. Indian data (for FY 2000 and forward) have now been aligned with those of most other major countries. Nevertheless, since Chinese (and increasingly Indian) FDI flows disguise a lot of "roundtrip" money clear apples-to-apples comparisons are tricky. ("Roundtripping" is when funds that originate in China or India sneak out and come back in disguised as "foreign" investment). Some have argued that when updated Indian data are compared with appropriate estimates of Chinese FDI (i.e. aggressively discounted for roundtripping) the differential between the two countries' FDI/GDP ratios would be much narrower.

These accounting disputes aside, few would argue that a country with India's economic potential and relative capital scarcity could not have "done better" at attracting FDI. FDI is one area where absolute numbers matter for two reasons. First, there is evidence that the global stock of potential FDI is limited, and therefore its distribution among countries tends toward a zero-sum dynamic. Second, FDI is prospective, and the amount of FDI relative to the current size of economy is not the best of indicators. See, Sader (1992), Pfeffermann, (2002), Eichengreen and Tong, (2005), Chantasasawat (2005).

To begin with, one must take explicit cognizance of the fact that these are still very different political systems.[49] A few apparently benign clauses in China's 1982 constitution do not make a secure business environment. Multi-party democracy, for example, has been part of numerous Chinese constitutions. It has never become reality.

Each political system has its costs and benefits. There are developmental advantages to China's blend of single-party authoritarian politics and state-socialist economics. Chief among these advantages are its long-term institutional consistency and its efficacy in policy implementation. But, there are costs too, and these are visible, for example, in the institutional structure and economic consequences of China's FDI experience. Similarly, there are developmental costs to India's blend of democratic federal politics and mixed economics. Costly populism, phobia of exposure to the world economy, and poor policy implementation are at the top of most experts' list of such costs. But the core economic problem in China also has a political source: The CCP's fear of an independent entrepreneurial class that might challenge the regime has produced perverse institutional contrivances to limit or co-opt that class. The Indian state and its agents do not fear an independent entrepreneurial class. While the Indian state has generally been apathetic, and occasionally even hostile to private business, there has always been political and economic space for an entrepreneurial class. Specific implications of this general conclusion become apparent from the way China has developed its FDI policy.

First, consider the politics and perverse outcomes of Chinese FDI policy, generally characterized as a positive feature of Chinese economic institutions. Looking at its downside, Chinese FDI policy can be seen as nationalist and unfriendly to

[49] A question slighted by Indian economist D.N. Ghosh and Chinese political scientist Yasheng Huang. See, Ghosh (2005), and Huang (2003).

private domestic entrepreneurs. Excessive Chinese dependence on FDI also does grave harm to the enterprise and finance systems. On the up side, China's external macroeconomic strength has given it an advantage in negotiating FDI. Also, the expatriate investment has had very positive consequences for small or medium sized industry.

A. Chinese FDI: Too Much of Good Thing?

In *Selling China* Huang concluded that FDI was "overabundant" in China.[50] He takes as given, a discriminatory politically-sanctioned hierarchy among Chinese domestic enterprises. According to Huang, ill-advised institutional design and misguided incentives resulted in economic and policy "imperfections" creating a "political pecking order" of firms.[51] State-owned enterprises (SOEs) and foreign invested enterprises (FIEs) enjoyed favorable political attention at the expense of private local firms without foreign investment. This institutional design, and the special incentives that accompanied it, favored FIEs through advantageous tax treatment, convenience in licensing, retained earnings dispensations, and export assistance. From this Huang concluded that China's "large absorption of FDI is a sign of some substantial weaknesses in the Chinese economy".[52]

Huang's central thesis holds: that China's FDI policy over the last quarter century *retarded and perverted the development of dynamic private enterprise in China*. In a 2003 article in the journal *Foreign Policy,* Huang and co-author Tarun

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[50] For example, many Chinese SOEs and regions really have no use for or did not deserve the FDI flows they received. In spite of this, government incentives directed investment to those firms, regions, and sectors. For Huang, "high" FDI is indicated by the ratio of FDI to domestic investment (DI) or the ratio of FDI to contractual arrangements.
[51] Huang takes these policies as given. He does not adequately consider the possibility that the "imperfect" economic institutions might have been designed "more perfectly" to serve political ends.
[52] Huang (2003xv) p. xv.

Khanna extended the *Selling China* thesis to a direct China-India comparison. They suggested that the reason why Indian firms are today on the whole performing better than their counterparts behind the Great Wall` is that the institutions of China's FDI-centered growth strategy discouraged merit–observing *domestic* investment in potentially dynamic private Chinese firms.[53] This is not a model for India.

B. Political Expediency First: Contriving Growth Without Private Capitalism

FDI was a "preferred instrument of change" for Chinese policy makers. What were the political advantages that rendered the institutional structure of FDI-intensive development preferable? That this institutional ensemble was politically useful to the Chinese Communist Party (CCP) is attested to by the durability of that institutional structure over the last quarter century.

China's FDI policy was not just an enlightened 'plan-rational' means of optimizing economic growth.[54] Chinese officials were concerned about foreign infringement of sovereignty and nationalist purpose. Political considerations, therefore, drove the fashioning of Beijing's FDI policy. Descriptions that feature the policy's "adaptive efficiency" scant both the domestic political priorities of the CCP and its government, and the many clever but economically counter-productive means with which Chinese FDI policy hemmed-in foreign investors.

Government relations with "business interests" in China are, along with religion and the management of laid-off or retired workers, at the top of the sensitive-issues list for Beijing's rulers.[55] FDI policy was not used to "revive…a dormant

[53] Huang and Khanna (2003) Pp. 75-83.
[54] Ghosh's account is reminiscent of the politically neutral ideal-type "developmental state" derived from Chalmers Johnson's study of Japan's Ministry of International Trade and Investment (MITI). See, Johnson (1982).
[55] One might now add disgruntled farmers who are losing their land to that list.

indigenous entrepreneurial class."[56] Huang makes clear in his book that FDI policy and the "political pecking order of firms" which it produced served powerfully to retard the development of domestic private industry. Indeed this was the favorable political outcome the CCP intended to achieve via what was a successful economic development policy in the short-term. The Chinese elite was deeply concerned to prevent the growth of an independent, business oriented domestic entrepreneurial class.

Independent business interests might contest the elite's power to calibrate the country's prevailing state-socialist structure of property rights and, ultimately, rival the party elite's control of the economy. It was the "corporatism" and commercialization of local state institutions – not an "entrepreneurial class" – that caused foreign-invested business to flourish among the townships and village enterprises and that were crucial to China's recent industrial-commercial growth.[57]

Let us turn now to the claim, often made by admirers of China's development policy, that China's stance on FDI reflects a clear-eyed non-nationalist acceptance of foreign investors. Is it true that the fashioning of China's FDI policy was, and continues to be, "pursued without any obsessive hangover (sic) about foreign domination or a nagging fear that their country's national interest or sovereignty is being compromised?"[58] Is it true that, "(t)hroughout the 1980s, continuing till the middle of the 1990s, foreign investors were freely allowed to play the role of venture capitalists in a big way" (Ghosh 2005). Nothing could be further from the truth.

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[56] See, Ghosh (2005).
[57] See Oi, (1999).
[58] Presumably, Ghosh here means to write the colloquial term "hang-up" which is defined in the Concise Oxford English Dictionary as, "an emotional problem or inhibition". The argument I present here with respect to FDI is that, because the Chinese are likely to suffer a painful FDI-induced "hangover", the Indians may be justified in their FDI-related "hang-up". See, http://www.askoxford.com.

It is rare for Chinese bureaucrats or politicians to use openly nationalist rhetoric in documents or public explanations related to economic policy.[59] Nevertheless, in trade, investment and foreign economic policy, nationalism is pervasive.[60] Ideologically China's economic nationalism is more akin to the mercantilist nationalism of America's Alexander Hamilton, Germany's Friedrich List, or India's Rajagopalachari than it is to the contemporary Indian economic nationalism of Sitaram Yechury [Communist Party of India (Marxist)] from the Left, or S. Gurumurthy (Swadeshi Jagran Manch) from the Right. Epic battles within China's elite over FDI policy in the early reform period produced "modern treaty ports" – the Special Economic Zones (SEZs) – along China's coast where "polluting" and "decadent" foreign trade activities were quarantined. Later a subtle and complex array of mechanisms was established to restrain the Gulliver of foreign investment as it stalked into the Middle Kingdom.

It is easy to misunderstand the clever and seemingly-contradictory Chinese FDI policy. Yes, FIEs were offered special treatment as inducements. In particular joint ventures (JVs) were encouraged with tax and other dispensations. Before Thomas Friedman coined the term, "golden straight jacket," the Chinese were enticing foreigners with incentive-laden access to their market while shrewdly keeping them constrained.[61] Yes, FIEs were favored over domestic private enterprise. But, this does not mean they were free. Nor does it mean they faced no competition. State-owned domestic enterprise, particularly at the local and regional levels, was often aggressive.

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[59] The exception is if the policy involves the Japanese, in which case a good dose of nationalist venom is generally de rigeur.
[60] See, Crane (1999) Pp. 215–32. Gries, (2004), and Zhao (2004).
[61] Friedman's "golden straightjacket" refers to the alleged economic benefits countries would enjoy if they adopted a range of constraining globally- and market-oriented policies Friedman (2000). In the Chinese FDI "golden straightjacket", FIEs enjoyed access to a low-wage high-quality infrastructure export platform if they complied with a range of constraining limitations on their business decisions.

The "golden straightjacket" contradiction is central to understanding the Chinese FDI experience. One can start by looking at the numerous fetters the Chinese used to restrain the foreign investment Gulliver.[62] The JV model adopted in China made it easy to control FDI. It ensured that JV enterprise ownership was fragmented (sometimes even adversarial) in ways that politically weakened both foreign and domestic partners.

The freedoms foreign investors enjoyed in China were curtailed by a range of measures: The 1980s Special Economic Zones literally fenced-in the physical and financial components of FDI. Foreign-invested enterprises (FIEs) were eventually allowed to move inland from their coastal quarantine. However, high up-front, non-interest-bearing equity deposits and a host of regulations at the national, regional and enterprise levels replaced the earlier geographic restraints. Added to the mix was an abundance of informal protections for wholly-domestic Chinese competitors to FIEs. Some of these were so brazen they might make even the drafters of India's *Press Note 18* blush.[63] Then there was the most important nationalist safeguard of them all: The product of all FDI investment was for export only.

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[62] Pearson (1999).

[63] Press Note 18 (1998) issued by the Ministry of Industry and the Foreign Investment Promotion Board seems to have worked well in giving Indian JV partners some protection from coercive or predatory foreign partners. The (2005) Press Note 1 was a shift in emphasis favouring contractual solutions to "conflicts of interest" among JV partners. See, Express (2005).

Those who claim that China never took action akin to India's 1998 Press Note 18 ignore the many informal "dirty-tricks" in the Chinese playbook. A good example is the "dual facility" common gambit in which a local JV partner allows the foreign collaborator to build, manage and link a new facility to the global supply chain. Then the local partner duplicates the facility as a non-JV, often in the same neighbourhood. Soon the first facility seems to be doing poorly and the new "duplicate" is vibrant. Though Chinese FDI policy is today much more liberal than in the early days of the SEZs, rules still strictly regulate equity size, geographic location and (as in India) investments in auto, retail, telecommunication services, and other sensitive industries are restricted. Discretionary approval for large-scale investment (over 30 million dollars) persists. Discretionary control of size lead to the "miniaturization" of FDI in China, yet another salutary outcome for the CCP which prefers that large-scale industry is state owned. See, Fu (2000).

FDI procedures in which foreign partners mange to devise some advantage over their local partners are quickly revised. This happened in the case of *zhong-zhong-wai* (Chinese-Chinese-foreign) partnerships in the telecommunications sector in the late 1990s. See, Folta (2005).

What was the broad political-economy context of this now-controversial Chinese FDI regime? For over two decades the Chinese government has taken advantage of its citizens' world-topping savings rates to operate its banking system as a supplement to both its fiscal and welfare/social-security systems. This produced an overhang of bad loans so large that by most accounting standards much of the Chinese banking system was (and may still be) technically insolvent. This institutional *leger de main* has cleverly disguised what would otherwise have been much higher government deficits. While the banking system was busy servicing this "socialist social contract" and helping keep large SOEs alive, FDI became the centerpiece of a new institutional ensemble that supported the industrial-commercial sector during the first two decades of China's post-Mao economic readjustment.

One of the most important parts of the Chinese FDI story and one that clearly distinguishes it from India has to do with the role of small- and medium-sized enterprises. The flourishing of small industry in rural China's "Township and Village Enterprises" (TVEs) was one undeniably positive consequence of China's FDI policy. The TVE boom provided employment and spread the benefits of industrial growth beyond core urban areas. Economist Pranab Bardhan has often noted – with pointed (if tacit) comparison to Indian Small-Scale Industry policy – that the key to the success of China's TVE experience was a hard budget constraint. China's TVEs were often allowed to fail.[64]

Where did much of the TVE investment come from? We must consider the role of overseas ethnic Chinese in China's FDI miracle. When wage costs for labor-intensive manufacturing around the Pacific Rim rose in the 1970s and 1980s, entrepreneurs of the ethnic Chinese diaspora relocated to mainland China. The Chinese government, particularly at the local level, welcomed expatriate investment.

[64] See Bardhan (2004).

True, there was no explicit ethnic nationalist policy here, but there was a powerful informal bias based on Chinese heritage, native-place and dialect affinities. On the other hand, the Indian government has, until very recently, failed to draw on the entrepreneurial skill and capital of its expatriate and ethnic diaspora.[65]

The FDI-intensive finance of China's export-led strategy was successful at doing two things: Attracting or earning foreign exchange (thus avoiding India's bane – a precarious balance of payments position) and providing an alternative (non-state, yet also tame) source of finance for new firms. It did so without overly empowering or emboldening either the domestic or foreign partners in those firms. *En route* the policy created employment opportunities (particularly at the township- and village-levels), and generated growth (much of China's recent growth was investment-driven, not productivity-driven).

The so-called "reform and openness" (*gaige kaifang)* of the FDI policy has, according to University of Michigan political scientist Mary Gallagher, "resulted in a strengthened Chinese state, a weakened civil society (especially labor), and a delay in political liberalization."[66] China's FDI institutions achieved a marriage of long-term political expediency with medium-term growth that helps to explain China's favorable external macroeconomic position. The consequence, however, (like China's banking policy) may be economically harmful in the long run.

C. FDI, Corporate Finance and the Broader Business Climate

China finance guru and economist Nicholas Lardy, along with Huang and most other experts agree that today China has a tremendously vulnerable Achilles heel: its

[65] See Guha and Ray (2000).
[66] Gallagher (2002). Pp. 338-372.

rickety and still highly-politicized finance system.[67] In conjunction with a state-socialist property rights regime, this system has stifled dynamism among the country's firms. Remember, according to Huang, the discriminatory "political pecking order" among firm types is the result of political favoritism.

To understand the full consequences of China's FDI regime we should follow Gallagher's lead and extend further the political logic behind it. Doing so reveals the system of Leninist capitalism that emerged in China at the end of the 1990s. Such an exercise also helps us understand how the politics of Indian financial reform, while tortuous, have yielded a more flexible and fertile environment for firms. Where Huang is satisfied with identifying perverse effects of the nexus between FDI and the "political pecking order" of firms, I argue that we must look beyond microeconomics and consider the consequences of the "success" of the Chinese FDI regime. A good place to look for such consequences is the realm of securities finance (the allocation of corporate or public funding through stocks and bonds). It is in this subfield of political economy that we see most starkly the contrasting effects of China's "successful" reliance on FDI and the alleged failure of India's neglect of FDI.

D. China: The Affliction of Abundance

For elite officials in the Communist Party and its government in Beijing, China's success in attracting FDI was part of a package in which "all good things went together". As mentioned above, FDI itself attracted foreign exchange and funded new industrial-commercial enterprise. However, exports from foreign-invested firms brought in the bulk of foreign exchange, producing a favorable balance of payments. These inflows produced a growing stockpile of hard currency reserves, which

[67] Goldstein and Lardy (2004).

authorities used to protect a low exchange rate based on pegging the Chinese Yuan to the US dollar. (The low exchange rate amplified the export advantage of China's already-cheap goods). At the margin, FIEs promoted growth and employment, particularly in rural and peri-uban areas. China's FDI-centered matrix of institutions based on political financing decisions produced abundant finance, trade and currency flows.

These flows did a lot of good for China's rulers and for the economy. They secured the external macroeconomic position of the country. They satisfied the finance-needs of a favored foreign-invested industrial-commercial sector. They produced economic growth to meet the rising material expectations of citizens. And they helped to legitimize the regime. Above all, these flows were organized (the FIE "golden straight-jacket") to minimize any challenge (foreign or domestic) to the political control of the single party state. This left the Chinese political elite at liberty to manipulate other parts of its financial system, particularly securities finance.

The system of securities finance made it possible for elite officials to allocate access to capital markets in a politically instrumental fashion. Initially, in the early 1990s, this took the form of political favors and competitive rivalries between the Shanghai and Shenzhen municipalities where most securities were listed, traded and regulated. These favors and rivalries disrupted the central elite's management of the economy and threatened its authority to define property rights (financial securities embody rights, after all). In response to such disruptive consequences, the center relieved the "troublemaking" municipalities of their securities-related authority, shifting control to agencies directly under the state council.

In the mid-1990s, a new system coalesced. This happened as a result of Premier Zhu Rongji doing two things: He asserted central control over securities and banking finance and he restructured the government into a more lean and responsive

instrument of Leninist *dirigism*. With all securities-related authority centralized and all innovative spirit squeezed out of the system, securities finance became a primary tool for discretionary allocation of access to funds. Premier Zhu used securities finance to pursue two primary objectives; restructuring state-owned enterprise (SOE), and managing the dominant political coalition in the polity. Zhu used access to securities finance to reward or punish the powerful ministries, sectors and provinces who are the "partners" in China's "intramural coalition".[68] The wily Premier also manipulated securities finance to provide life support to ailing SOEs, thereby helping the banking system to service (and delay the demise of) the "socialist social contract".

The result? A new system. Leninist capitalism. The nature of a country's securities finance regime says a lot about the variety of capitalism prevailing there. The Chinese Communist Party had successfully "hacked" the core institution of capitalism – securities finance – bending it to their political will. China's quarter century of reforms produced what economist and China-expert Barry Naughton has called "Potemkin stock markets".[69] Impressive façade of change, dysfunctional interior of atavistic *dirigism*. The securities finance regime in China today is merely the old wine of developmental-state directed-finance grandly presented in the new bottles of terminal-based nation-wide share trading.[70] In 2004 Chinese securities finance was where Indian securities finance was in 1964 when the state-promoted Unit Trust of India US-64 was established.

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[68] In the Chinese context of a state-socialist single party polity, that coalition is an "intramural coalition" within the Chinese state itself.
[69] See Naughton (1998).
[70] Carefully calibrated semi-repression of the financial system makes the whole thing possible. Low (sometimes negative) real interest rates on bank deposits, a tightly limited supply of equity shares, state support for the financial services industry, and central bank use of repurchase markets (along with massive sterilization routines) are the only reasons there is any value or trading volume at all in China's securities markets. Of course, there are also various controls on capital account convertibility.

Securities finance in China does not provide a market for companies or a market for corporate control. The nominally high market capitalization of China's two exchanges is inflated by two thirds, since only one third of the shares actually "float" or trade freely. The difficulty of accessing the market for initial offerings in China today is perhaps even worse than the challenges faced by Indian firms in the pre-reform days of the dreaded Controller of Capital Issues. Much of this is a political consequence of the "success" of China's FDI-intensive model: It provided the macroeconomic strength and institutional structure upon which the Party elite's recentralizing and manipulation of the financial sector was built.

E. India: The Advantage of Adversity

In 1991, as precious gold bullion was shipped from Bombay docks to deal with the reform-provoking balance-of-payments crisis, India was a reverse-image of China. Its profile of exposure to the international economy, its export capacity, and (as Ghosh rightly points out) its trade and investment philosophy all were the opposite of China's. Just as many "good things went together" in the macroeconomic and institutional matrix surrounding China's FDI policy, many "bad things went together" in an Indian macroeconomic and institutional matrix that lacked FDI. This created a powerful set of incentives for India's economic policy "change team" assembled in 1991 by the ruling Congress Party.[71] The mandarins (forgive the turn of phrase) in North Block explained to politicians that it would take too long to resolve India's chronically precarious balance of payments through a China-style FDI-intensive, export-led program.

[71] See Shastri (2001) pp. 241-263.

Analyses of Indian economic reform tend to focus on the "momentary" or transient aspect of the reform initiatives undertaken during and immediately after the crisis of 1991.[72] Indeed, looking at the reform period in general from the perspective of the late 1990s, some World Bank officials often quipped about the "Hindu rate of reform" (playing on economist Raj Krishna's adage about India's "Hindu rate of growth"). A central plank in the argument I present here is that the lack of FDI, and the associated Indian profile of macroeconomic exposure, produced an incentive structure that lasted beyond the crisis, and that created an enduring momentum favoring the transformative set of institutions that made Indian securities finance governance uniquely dramatic when compared to other Indian sectors or when compared to other developing and transitional economies (and particularly China, which is typically seen as a more successful reformer than India).

Instead of FDI, India would use FPI (foreign portfolio investment) to attract much-needed foreign exchange. Improvement in securities finance would have politically and economically useful second-order consequences. Firms would have a greater range of options for corporate finance. Securities finance would provide a useful temporary way to sidestep the obstreperous trade unions and hidebound managements of the country's then-lumbering banks. It would also put pressure on those banks to reform.

Many problems still plague India's regime of securities finance. But even the harshest critics of India's reform process concede that 1990s securities finance, driven in large measure by competition between the National Stock Exchange and Bombay Stock Exchange, was one of the most remarkable change stories of the decade. Today, Indian firms and their shares of stock are some of the most competitive and attractive in the developing world and beyond. Why? One important reason is that Indian

[72] See, also Mohan and Herring (2001).

businesses and regulators have operated for more than a decade with a securities finance system that (for all its failings) has steadily approached global best practices and, in the case of the takeover code, perhaps even set them itself.

How do we know India's regime of securities finance is so good? Discount the recent long bull-run. It may be rigged, and US interest rates have been low anyway. Ignore most of the Foreign Institutional Investors' (FII) money. Much of it is Indian (on a roundtrip ticket) or expatriate Indian investment.

Consider instead the behavior one of the largest, most risk-averse, socially progressive, and conscientious investors in the world today: The California Public Employees Retirement Scheme (CalPERS). This is not the "hot money" that gets India's Left policy intellectuals and politicians like Gurudas Dasgupta (CPI) so exercised. Not all foreign institutional investors are alike. CalPERS invests for a minimum of three years and normal investment durations are roughly a decade. For years now India has ranked high on CalPERS index of equities finance regulation among developing and transitional countries.[73] Two years ago the massive pension fund moved to invest 100 million US$ in Indian firms through Indian stock exchanges. Notably, CalPERS board withheld approval for such investments in China because,

[73] The securities governance regime indicator includes variables such as: 1) Market Liquidity and Volatility, 2) Market Regulation/ Legal System/ Investor Protection, 3) Settlement Proficiency, 4) Transaction Costs, and 5) Capital Market Openness. Every year the CalPERS board reviews the parameters of an investment index that includes a wide range of political, social, and economic factors. A private consultant, Wilshire Associates, then compiles the index. The board also sets thresholds for countries' overall scores on the index and on each of contributing sub-variables. Countries that exceed these thresholds are deemed "permissible," and the board can then vote to invest there (occasionally disregarding Wilshire recommendations and voting for even tighter standards). CalPERS approval is a widely-used benchmark for "responsible investing" among those in the institutional investment community worldwide who look for investment cues that combine social and political considerations with those of financial risk. For years India's securities and corporate "scores" were well above the threshold, but its labor standards were not. In 2004 India finally "scored" favorably on labor standards and the pension fund sank 100 million dollars into Indian equities. China is still verboten on various indicators including governance of securities finance. See, for example, Wilshire Associates (2003). Also see, Reuters (2003). And see, Business Line (2004).

among other things, that country's regime of governance for securities finance ranks too low on many measures of corporate and trading standards.

In summary, it is important to recognize that there are developmental costs that offset the benefits of China's non-democratic politics. Similarly, there are developmental benefits that offset the costs of an Indian democracy at once feisty and staid.

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Chapter Six

TAKING STOCK: THE POLITICS OF EQUITY SECURITIES

The late 1980s and early 1990s were a period of juncture between the "world time" global rise of securities finance, and the "domestic time" policy and business initiatives in China and India to begin securitizing in earnest. At this time, the arena in which securities circulated – the stock exchange – became an important focus of attention. I use the term "stock exchange," because that is largely what they were. Though some of the exchanges discussed in this chapter did support bond trading (or at least recorded such trades even if they were not actually executed on the exchange), the circulation of bonds happened largely off the exchange.

This chapter focuses on equity assets, drawing on case material that links the interests of issuers and investors to the politics of stock exchange development. It demonstrates the role of stock exchange development in the emergence of China's involuted securities governance regime – a regime heavily biased in favor of issuers. In the Indian case, the evidence illustrates how stock exchange development played a role in forging a regime that was dynamically balanced between issuers and investors. Using the asset-class/financial-position (AC/FP) matrix as a guide, I try to trace the process that causes the different outcomes in each country. I deploy the matrix to demonstrate how elements of it can be used to explain the politics behind the distinct securities governance regime outcomes in China and India, focusing particularly on the market outcomes and governance structures of their respective stock exchanges. The stock exchange outcomes are consistent with outcomes I find in other areas like mutual fund development, privatization, and mergers and acquisitions.

This chapter explores the politics of equity assets. It elaborates in detail the roles of enterprise finance and wealth capitalization in the calculations of various actors, including the central state and members of the dominant coalitions in India and China. However, this analysis also brings in the issue of shareholder rights. The discussion is organized as follows. In the next section, I first explain the importance of stock exchange governance and structure of exchange. Together, these two factors can tell us much about the role of states and markets in a governance regime. Exploring the politics of equity finance by way of stock exchange development requires that we consider how governance and market structure on an exchange affect particular domains of equity-asset politics of differently positioned financial actors, such as issuers and investors (and in the Indian case, intermediaries such as brokers too). Section three employs these insights in a case study of India's stock exchange development in the 1990s, with particular attention to the breakthrough of the new National Stock Exchange (NSE). Section four undertakes a similarly oriented case study focusing on the takeover of the stock exchanges by the central government during the mid-1990s.

I. The Politics of Equity Finance in Stock Exchange Development

An important part of how securities governance regimes developed in China and India is the place where securities are traded: stock exchanges. Changes in where and how securities circulate – such as the operation of securities exchanges – are crucial to understanding outcomes in several of the components that constitute the securities governance regime. The stock exchange is a market arena rich in linkages to other key components of the securities governance regime (SGR), the firms that list, agencies of the state responsible for securities regulation, business and consumer (in

this case investor) associations, providers of financial information in the media, and of course various affective networks among those who use or operate the exchange.

Most significant for India's SGR was the outbreak of vigorous competition between securities exchanges in the mid-1990s. In the Chinese case, the biggest story was the takeover of the exchanges by the central government in the period 1995-1997. In the analysis that follows, I trace how structurally-inspired central-state-elite state preferences were translated into regime-shaping strategies in the course of stock exchange development in China and India.

Ignoring the debt asset class of the asset-class/financial-position matrix, I will let the elements of Table 6-1 guide the analysis, focusing on how the connection between actors' (issuers or investors) relative coalition power and their interests with respect to equity property-rights institutions influenced the development of stock exchanges in several components of the securities governance regime – particularly the state, the market, and associations – and looking for evidence related to *enterprise finance*, *wealth capitalization*, and some parts of *shareholder rights*.[1]

[1] Stock exchanges themselves have little to do with the industrial organization outcomes mentioned in the full version of the AC/FP matrix introduced in Chapter 3.

Table 6-1:
Isolating Equity Politics: Breaking Down the Domains of Action

	Issuers	Investors
Equity	**Enterprise Finance** • *share issuance* **Wealth Capitalization** • *"founders rent"* • *"equity leverage, equity currency"*	**Shareholder Rights** • *exit-entry*

A. Governance and the Design of "Market Structure" on the Exchange

There are two key issues in the operation or development of a securities exchange: governance and design. "Governance" in reference to exchanges overlaps with way the word is used elsewhere in this analysis with regard to "governance regimes." The scope of the term here refers just to the exchange, and involves the structure of management and ownership as well as the conduct of supervision or regulation. Supervision and regulation in this instance refers to "self regulation."[2] Take, for example, two American examples, the NASDAQ and the New York Stock Exchange (NYSE). The NASDAQ exchange is a wholly owned subsidiary of the National Association of Securities Dealers. In principle, it is operated and managed by a professional team of managers who are not themselves participants in the exchange.[3]

[2] For the most part, the vocabulary used in India reflects the common English heritage of the two countries' legal and financial vocabulary. In China, exchange (*jiaoyisuo*) governance is referred to with using the word *guanli*, the same the all-purpose term for control/regulation/management. Supervision (*jiandu*) is added to *guanli* in the compound *jiandu guanli* used to translate the English word "regulation." Yet, in China's 1999 Securities Law, the only "self-regulating" organization *(ziluxing zuzhi)* mentioned is the Securities Association of China (Artlice 162). Stock exchanges are tasked (Article 110) with "supervising" *jiandu*-listed company disclosures mandated by securities law (not by their own rules) (Changwu Weiyuanhui 1998) This task is a common part of the self-regulating function of American and Indian exchanges, based on disclosure guidelines set by the exchanges themselves.
[3] In practice, this became truer after the 2000 "demutualization" of NASDAQ and its transformation into a publicly-traded for-profit firm, but it is not likely to be entirely true until the firm lists on an

The NASDAQ regulator, NASDAQ Regulation, Inc., is a separate subsidiary of the NASD, "responsible for regulating both issuer and trading activity on NASDAQ." The NASD is a "self-regulatory organization" (SRO) with legally mandated enforcement responsibilities. The SEC must approve any rule changes that affect trading or listing qualifications. The NYSE is a non-profit mutual organization owned and operated by its owner-members.[4] It too is an SRO under the rubric of the 1934 Securities and Exchange Act.

"Design" refers to the actual details of the way the market works – that is, the precise mechanisms and rules that determine how securities are traded on the exchange. Market structure, or "market microstructure" as financial economists call it, includes the practices and procedures by which prices are revealed and trades executed.[5] Taking the same two American examples introduced above, the NASDAQ is a centralized electronic limit order microstructure design in which securities trades are transacted by electronically matching "ask" (sellers) and "bid" (buyers) orders based on "price-time priority."[6] More than 500,000 terminal outlets around the world display NASDAQ trading and offer trading access.[7] By contrast, at the NYSE, the

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exchange and makes its management systems transparent and compliant based on listed company criteria. This listing has been delayed now several times (Barnard 2002).

[4] The term "mutual" refers to the way the NYSE, like the Bombay Stock Exchange, is owned and run by members who pay for their "seat" on the exchange, becoming member-owners. "Demutualization" of stock exchanges has been a major global trend since the zenith of the "equity cult" in the late 1990s. Demutualization of a stock exchange is "the entire process by which a non-profit member-owned mutual organization is transformed into a for-profit shareholder corporation." According to a recent report from the Asian Development Bank, "exchanges around the world have been demutualizing because of international competition and technological challenges to traditional modes of trading securities. The change of a stock exchange from a member-owned organization to a for-profit shareholder corporation triggers a number of questions about regulatory oversight. When a demutualized exchange is listed on its own board, some regulatory oversight needs to be transferred to a government regulator. In many countries, demutualization of the major national stock exchange has been accompanied by general securities regulatory reform" (Akhtar 2002, xiii).

[5] For a general discussion of this, see O'Hara (1995), and for a exploration of the Indian case, see in India, see Echeverri-Gent (2001).

[6] The computer looks at who placed an order at a given price first. That order automatically gets filled.

[7] With the advent of on-line trading and electronic communication networks (ECNs) in the late 1990s, the number of access points to NASDAQ trading has expanded even further.

market is organized as an "open-outcry" auction. This auction design is further "enhanced" by the presence of highly capitalized brokers known as "specialists" who "make the market" for specific stocks listed on the NYSE.

Market design does not, however, end with an agreed price between seller and buyer. Assuring the completion of the trade, including the exchange of funds and securities, and the guarantee to either party if one side fails to deliver, are part of the processes financial economists call settlement and "novation." These include such things as depositories for the securities (now typically stored digitally), and the legal and financial mechanisms necessary to guarantee all trades. Both the governance and the design of securities exchanges have implications for the issues of enterprise finance, wealth capitalization, and shareholder exit (the ability of shareholders to "liquidate" their securities by selling them for cash).

B. Using the Matrix: Enterprise Finance, Wealth Capitalization, Shareholder Exit

In one version of the matrix it is possible to populate the cells with familiar actors, attributes of each asset-class for each given financial-position, and to infer *a priori* interests for those actors in any given intersection of an asset-class and financial-position. This version of the matrix allows us to think about specific domains of economic action related to securities finance at each position in the matrix. Table 6-1 is a version of the AC/FP matrix modified to show only the issue areas of equity finance politics for which stock exchange development has relevance.

Looking first at the enterprise finance domain for issuers of equity assets: Unlike debt finance, where interest payments are required, enterprise finance gained through the issuance of equity has practically no pecuniary cost to the firm and its

founders.[8] In return for this low cost of finance, insiders must suffer the dilution of ownership control. This is the cost-benefit logic of equity finance for enterprises.[9] But equity finance for enterprises is not only a matter of efficient and diverse forms of capital allocation.

Another observable domain of equity finance for issuers is "wealth capitalization."[10] This is of particular importance in DTEs, where many of the productive assets in the organized economy were previously state owned or privately held. Stock markets make it possible for shares of corporatized enterprises (that is, firms limited by shares) to have a notional value based on the market price of publicly listed and traded shares of the same company, facilitating the price discovery and price realization that are both important parts of the wealth capitalization domain of equity assets for issuers.[11] As financial economist John Edmunds explains:

> Securitized assets are worth more than the "lumpy" assets that collateralize them, partly because they are more liquid. Shares trade daily and are easy to buy and sell. Buildings, factories, and farms (and the people who work in them) are harder to sell, so buyers take that into account by paying less for them. Securities trade at a higher multiple of cash flow (known as the "price/earnings ratio") than unsecuritized businesses (Edmunds 1996, 126).

From a political perspective, wealth capitalization may be more important than enterprise finance for issuers of equity assets. Founder's rent – the first component of

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[8] There are fees paid to merchant banks and the transaction costs involved with issuance, exchange listing, and regulatory compliance. None of these are significant for any individual firm paying them, though they aggregate across many firms to make such fees a major source of revenue for merchant banks and stock exchanges.

[9] Public exposure and brand recognition are additional benefits.

[10] For improvement of the discussion in this chapter, and the conceptual elaboration of the "issuers" column in the asset-class/financial-position matrix, I am grateful to political scientist Herman Schwartz for his suggestions and commentary (1989, especially Chapter Two); and (2002)

[11] Without a price set by secondary trading on an exchange, the value of insider shares (held by private or public actors) is difficult and costly to ascertain. This is one part – the "valorization" function – of share trading. Stock exchanges help facilitate this process. Without the exchange, it is also difficult and costly to realize (turn to cash) the wealth reflected in that price. Exchanges make it easy to "cash out" of the shares. This is the price realization function of an exchange.

this wealth capitalization attribute – is the potential capital gain insiders may reap when shares are listed and a price is set for those shares on an exchange.[12] "Equity leverage" – the second component of wealth capitalization – is the utility of those now-valorized shares that constitute a collateral against which they can borrow in order to buy other companies, or build new ones. Without the liquidity furnished by the market for equity securities on an exchange, insiders can't easily use current assets or the value of those assets' future income streams to either: A) actualize wealth today, or B) support new investments or the acquisition of existing productive assets.[13]

Finally, the design of market structure on an exchange matters for any shareholder because certain market designs can enhance liquidity and settlement security, thereby safeguarding shareholders' ultimate protection, the ability to sell shares quickly and reliably at the best price.

II. <u>The Politics of Stock Exchange Development in India's SGR</u>

The preferences of India's policy-making elite and the strategies those preferences inspired were imposed by, and were likely (but not predetermined) responses to India's *precarious scarcity* profile of external exposure. After all, many

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[12] Founder's rent is the gains that a firm's promoters may collect upon public issuance of shares either through an IPO, or later if they sell their original shares on the secondary market. This is one important element of the "wealth capitalization" domain identified in Figure 6-1 of the asset-class/financial position matrix.

[13] Edmunds offers the following useful example:

> A business that would bring $10 million in a private sale could bring as much as $20 million if sold via the stock market. The owner can sometimes sell half the shares on the stock exchange for $10 million and still keep control. If the company prospers, or if the stock market goes up, the half that still belongs to the original owner could be worth even $15 billion. After the shares are listed, they become excellent collateral for loans, allowing the original owner to borrow perhaps $7 million against the half he still owns, *while* retaining control of the business (Edmunds 1996, 126 italics added).

countries (such as those in Africa) have EEPs of similar precarious scarcity, and yet they do not adopt similarly effective strategies. Why was Indian securities-related development and re-regulation so speedy and wide ranging? Compared to the reform of other economic sectors, securities reform has been swift and thorough in "India's Ten Year Miracle" (see Table 6-2). I argue that the decisive factors in overcoming the obstacles to change were the compelling preferences of the state in conjunction with its relative autonomy in imposing those preferences, and the flexibility of Indian property-rights structures to accommodate change during the struggle among coalition actors over the fashioning of securities-related property-rights institutions. The Bombay Stock Exchange (BSE) was one such obstacle[14]: one of the most dramatic episodes in the struggle was the breaking of the BSE's monopolistic hold on securities trading by the upstart National Stock Exchange (NSE), the consequent establishment of competition among Indian stock exchanges, and the effects of that competition on the quality and governance of securities circulation and use. The success of the National Stock Exchange fundamentally changed the configuration of the previous Nehruvian directed-credit financial system, and was a decisive event in shaping the trajectory of India's constrained evolution SGR.

[14] The other two were the unusual settlement systems known as *Badla* (Rudolph 2001) and the colossal state-managed mutual fund, the Unit Trust of India (Pendharkar 2003)

Table 6-2:
A Decade of Change in the Indian Equities Markets

Competition	1993-1995	The NSE (the "sarkari" exchange") comes on-line, quickly becoming India's most liquid exchange, and succeeds in pressuring the BSE to change.
Electronic trading	1994	All exchanges in India switched from floor trading to anonymous electronic trading
Risk containment at the clearing corporation (novation)	1996	The largest exchange, the NSE, adopted risk management through "novation" at the clearing corporation. Other exchanges also substantially improved their risk containment mechanisms.
Dematerialization	1996	Begun in 1996, today almost all equity settlement occurs electronically at a depository.
Derivatives trading	2000-2001	Equity derivatives trading commenced, with index derivatives and derivatives on some individual stocks.

Adapted from Shah and Thomas (2001)

Placing the importance of the NSE breakthrough for financial change in the context of economic reform more broadly, Sucheta Dalal, the doyenne of Indian financial journalists, and a commentator not easily moved to applaud the success of those reforms, remarked in 1999 that:

> Capital market reforms in India have far outstripped the process of liberalization in every other sector of the economy. In fact….the Indian securities trading infrastructure compares with the best in the world – and in some respects is even better…The National Stock Exchange (NSE), a market intermediary, through example, demonstration and sheer success forced a swift and relentless pace of change in the markets.

Dalal, who has followed events closely since her 1992 (Basu and Dalal 1993) scoop of the big "Scam" that upset Indian financial markets and provoked the broad

reformist momentum that central-state-elites leveraged to launch their transformation of securities governance, was herself surprised at the rate and scope of change:

> The pace of reforms has been so dramatic that it is difficult to recall that less than five years ago the picture of stock trading in India was one of sweaty, raucous jobbers jostling to conduct trades in the crowded trading ring of India's oldest stock exchange (Dalal 1999).

Finally, summarizing the importance of the NSE breakthrough in a speech at the NSE itself in 2002, Indian Finance Minister Yashwant Sinha explained:

> In all, we had new institutions - electronic trading, novation at the clearing corporation, dematerialised settlement - which converted the possibility of economic freedom into a reality. The equity market is the one area in finance where the greatest changes have come about (Sinha 2002).

The story of the Indian stock exchanges involves each element of the governance regime ensemble summarized in this chapter's introduction, and in the formation of that regime the political and social responses to securitization in India depended on pre-existing institutional and ideological paths. The role of the state in the formation of that governance regime was decisive. The state, which was so important in the pre-reform political arena, persisted in its "central mediating role" as both promoter and pilot of change.[15] Yet, the state was also increasingly constrained in historically unprecedented ways. The economy's precarious scarcity profile of external exposure imposed a specific trajectory that prioritized *evolution*, *constraining* the Indian state to set market scope and progressive development as the objectives for securities-related governance. The origins and political significance of the preferences

[15] This finding is consistent with the view that the Indian state can at times act autonomously, imposing its preferences over those of organized corporate interests (industrial or rural), and those of the electorate. For the typical formulation of this view, see Rudolph and Rudolph (1987, especially Chapter One). For an update of this view in the era of reform, and an explanation of how the state promotes and pilots change via "stealth," see Jenkins (1999, especially Chapter Six).

this profile produced in the political elite were summarized in the previous section. They included two key policy elite preferences with respect to securities governance:

- Provision of sufficient, stable foreign exchange, and stabilization of the balance of payments.
- Improving industrial finance.

On the eve of general reform in India, the majority of finance capital was embedded in the state-dominated directed-credit system. However, a small enclave of equity finance activity existed in South Bombay, with outposts in Calcutta and Ahmedabad. Stock issuance and trading were conducted through closely-knit, geographically concentrated networks of securities brokers. At the periphery of the directed-credit system, corporate and government securities circulated through the stock exchanges run by these brokers, and through the state-run monopolistic mutual fund manager, the Unit Trust of India.

Though well established, this enclave of equity securities activity was shallow and commercially unimportant. It consisted of a primary market for equity that was government controlled and little used by corporations. Stock issuance was severely limited by the Controller of Capital Issues (CCI), who determined the volume and price of share issuance; the end of this system in 1992 portended a new world of rivalry and openness in the sourcing of enterprise finance.

In the secondary market where shares were ostensibly traded, the Bombay Stock Exchange (BSE) and its regional satellites were dominant. They were broker-owned and managed, and were run opaquely as clubs largely for the benefit of an exclusive exchange membership dominated by two tightly networked cultural-linguistic groups.[16] The "murky" trading practices of these exchanges involved entry barriers, poor transparency, geographic concentration of trading, unorthodox

[16] Gujuratis and Marwaris have dominated securities trading in India for the past century.

settlement procedures, and volatile fluctuations in leverage. Together, these practices produced limited trading volume, high brokerage fees, high transaction costs, settlement-related "payments crises," conflicts of interest (often favoring intermediaries or issuers over investors), and a variety of insider hijinks such as cheating and market manipulation. These practices also insured that the system of equity trading would help perpetuate the directed-credit system's sleepy but profitable (for the BSE brokers) marginalization of the securities market enclave (Echeverri-Gent 1999). The paper-based share certificates and their exchange through "open-outcry" floor trading operated in very limited hours were the foundations of the BSE "rent" maximizing system, and the Bombay, Calcutta, and Ahmedabad brokers would fight desperately to preserve those foundations. Outsiders came to view the BSE and securities trading as a market "of BSE members, by BSE members, for BSE members" (Shah and Thomas 2001, 10, 18). Nevertheless, as in China during that period, the issuance and trading of shares did grow as the corporatization of private and state-owned firms proceeded apace.

Promoting the new National Stock Exchange were the development financial institutions (DFIs), the vast bureaucracies of the former directed-credit system that were powerful members of the "permanent state" component of India's dominant coalition.[17] The state-directed DFIs played an unusual role in the Indian economy representing a wide range of financial activity including long-term development

[17] The dominant coalition in India under the Nehruvian political economy was composed of the state as a mediating actor, the "dependent capitalists," and rich farmers. The corporate actors referred to as "the state" can be disaggregated at a first order into professionals in the public sector, and the central elite located in the Prime Minister's cabinet and the related central ministries. These actors, despite their many conflicting interests, were common beneficiaries under the narrow finance and autarkic orientation of the directed-credit system (Bardhan 1998; Herring 1999; Rudolph and Rudolph 1987). With the decline of the Congress Party and the rising power of sub-national states and regional political parties, this coalition is now being transformed.

The power and role of the DFIs is distinct from that of the "central-state-elite" discussed here. They are subject to the orders of the Ministry of Finance, but have a margin to maneuver and a power base in their hard-to-fire, well trained, highly networked, broadly dispersed personnel. Thus they are often collectively considered an important coalition actor.

finance,[18] insurance and pension management,[19] and mutual fund management.[20] During the1980s, the brief and stillborn spurt of reform under Rajiv Gandhi provoked an increasing awareness among the DFIs of the costly and frustrating consequences of the securities market "enclave" that the directed-credit financial governance regime[21] had created. This increasing awareness had already caused enough concern among the DFIs to inspire their earlier ill-fated effort to launch a stock exchange to compete with the BSE. In the 1980s they failed in their effort to promote a new exchange – The Over the Counter Exchange of India (OTCEI) – for small, entrepreneurial companies modeled on the American NASDAQ.

The Bombay exchange and its regional allies were an important collective actor in the securities enclave of the Nehruvian financial system, but compared to the development financial institutions, they did not play a significant role in Indian coalition politics; not, that is, until the beginning of securities related reforms in the mid- to late 1980s and early 1990s. Under the directed-credit financial system, the property-rights claims embedded in securities were restricted to the point of effectively nullifying issuer and investor interests, while both enhancing the market power of intermediaries such as the BSE brokers and honing their interest in the enclave status quo.[22] Concentrated in South Bombay, and acting in alliance with their subservient satellites in Calcutta and Ahmedabad, they controlled the vast majority of

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[18] Most prominent among these are the Industrial Development Bank of Indian (IDBI), Industrial Finance Corporation of India (IFCI), and the World Bank-promoted Industrial Credit and Investment Corporation of India (ICICI).

[19] Most important among these are the mammoth Life Insurance Corporation of India (LIC), and the General Insurance Corporation of India (GIC).

[20] The Unit Trust of India is a statutory agency of the Indian government, established in 1964 to manage mutual funds.

[21] Another important factor was the 1985 publication of the *Report of the High Powered Committee on Stock Exchange Reforms* (known as the "Patel Report") – a comprehensive evaluation of Indian securities markets – that was an eye opener for the DFIs into action (Government of India 1985) Author's interview with former IDBI officials, Bombay, 2000, #117.

[22] Before the major securitization push, there were occasional efforts by issuers or investors to buck the enclave system. Celebrated cases include the "Mudhra Scandal" of 1957, the 1984 "Escorts Affair," and the grass-roots "equity cult" campaign of Dirubhai Ambani in the 1980s (McDonald 1998).

trading in Indian shares.[23] Thus, despite their relative lack of political power, the growing use of equity securities from the mid-1980s onward conferred upon the BSE the market power of a "natural monopoly."[24]

Establishment of the National Stock Exchange represented a potential challenge to the Bombay Stock Exchange and provoked a struggle over the control of securities-related property rights that ultimately pitted the DFIs against the Bombay brokers and their regional allies. Had it not been for an unusual alignment of actors and purposes, the aggressive implementation of the new National Stock Exchange project might have languished indefinitely as a rump electronic venue for the *ex post* reporting of bond trades, and nothing more. After all, judging from the DFIs' previous ill-fated foray with the OTCEI exchange, their prospects were not bright.

In the event, one important collective actor by the dominant political coalition – the "dependent capitalists" (large family conglomerates and the so-called FERA companies[25] that had been co-opted and constrained in the "license permit quota *raj*") – stood aside, neither promoting nor undermining the National Stock Exchange project.[26] Property-rights claims embedded in stocks not only facilitate efficient capital allocation through equity-based enterprise finance, they also help issuers of securities

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[23] In 1994, the Bombay Stock Exchange itself controlled 75% of national trading volume (Shah and Thomas 2001, 9).

[24] This was due to what financial economists call the "network externality character of stock market liquidity." For users, the appeal of a market depends on the number of other users. Trading flow is attracted to the most liquid market, and this in turn insures the liquidity appeal of that market. As financial economists Shah and Thomas explain with regard to the international empirical experience of such natural securities trading monopolies, "when a second market tries to compete with the first market, it is difficult to attract away the trading flow" (Shah and Thomas 2001, 5).

[25] The Foreign Exchange Regulation Act (FERA) of 1973 was an effort to control the flow of foreign exchange and limit a perceived threat of capital flight. It also limited the level of foreign direct investment of multinationals in their local subsidiaries. Multinationals like the Anglo-Dutch conglomerate Unilever were obliged to reduce their stake to comply with FERA, but continued to manage some of the most dynamic firms in India.

[26] The term "Dependent Capitalists" characterized the status of private capital as a "second actor" in India's pre-1991 dominant political coalition. "Private capitalism in India is dependent capitalism. It relies on the patronage and protection of the third actor, the state, for its profits and security" (Rudolph and Rudolph 1987, 25, and 25-35 passim).

capitalize their wealth. The potential improvements of the National Stock Exchange promised increased margins of wealth capitalization *and* control, because a more liquid, investor-friendly exchange would squeeze out as much benefit to issuers as possible from a "thin float."[27] Not coincidentally, the government, who owned many listed firms and wished to make money from further "privatizing" more of their holdings, shared a similar interest in maximizing wealth from thin floats, while minimizing the loss of control. Under these conditions, the dominant apex business association at the time took no stand on the issue of establishing the new National Stock Exchange, and the "dependent capitalists" as a collective actor in India's dominant coalition were indeterminate on the stock exchange issue, further opening space for the central state to exercise its preferences in the matter.[28]

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[27] A "thin float" is the issuance of a small quantum (relative to insiders) of publicly traded listed shares, and therefore a small dilution of promoters/insiders' ownership. Good liquidity on a "thin float" would benefit issuers' wealth capitalization interest by maximizing their potential to realize founder's rent and equity leverage, while minimizing their loss of ownership control.

The "thin-ness" of these floats and the tendency of more professionalized (read, not family-run) companies such as the FERA firms to use them has recently received further corroboration by the trend of such firms to "buy back" their listed shares.

[28] There had always been divisions among the "dependent capitalists." During the heyday of the Nehruvian system of financial governance, these divisions had been expressed in the rivalry among India's apex business associations, between the Federation of Indian Chambers of Commerce and Industry (FICCI – associated with India's large family-run business conglomerates) and the Associated Chambers of Commerce and Industry of India (Assocham – associated with firms such as the FERA companies and the Tata conglomerate) that presented a professionalized and cosmopolitan public image (Kochanek 1986). The failed round of Rajiv Gandhi reforms in the mid-1980s, followed by the post-1991 paradigm shift, had upset the status quo within and between these associational groups, as some saw advantages to be gained from the end of the license *raj* while others feared it. This was reflected in the decline of the two old associations and the rise of a new (formerly engineering-focused) association that was generally supportive of the post-1991 reforms – the Confederation of Indian Industries (CII). But by 1994 the issue of foreign investment – direct and indirect ("portfolio investment" in securities) – was provoking a division in the membership of this new leading business association (Bhattacharya 2000)

Former partisans of the FICCI apex business group (mostly status-quo-oriented family-run businesses) were largely satisfied with the coziness of the BSE-dominated securities enclave, and perhaps did not comprehend the threats and opportunities from reform. Former ASSOCHAM partisans, and the more dynamic family-conglomerates who had defected to the CII, were not necessarily converts to neoclassical economic theory and efficient market gospel of Anglo-Saxon financial economics, but they saw wealth capitalization benefits from the NSE breakthrough. These businesses wished to valorize their future income streams *while* maintaining the ability to control both their enterprises *and* the future structure of Indian industrial organization (shaped by the rules and practices governing mergers and acquisitions).

The Development Financial Institutions presented a unified and persistent front favoring the NSE, based on their overwhelming interests as both issuers of securities and investors in securities. This unified resolution, combined with the clear preferences and strategies of the central-state-elite, were decisive in resolving this struggle in favor of the NSE.

On the one hand, DFIs were issuers of securities and therefore particularly interested in realizing founder's rent.[29] In terms of the asset-class/financial-position matrix the DFI's were, in this role, located in the financial position of securities issuer and thus suffered from the structure of the Bombay Stock Exchange, both because it was difficult to participate directly in the exchange on its own behalf (entry barriers), and because of the illiquid, costly, and volatile nature of trading produced by the BSE's practices. Furthermore, the DFIs held shares in firms its loans had nurtured, until those firms went for an initial public offering (IPO). After the IPO took place, the DFIs faced severe constraints on trading in large transaction sizes[30] and were confronted with the general risk of severe illiquidity in the secondary market. There was also the problem that individual companies' share capitalization was probably constrained by the limited overall market capitalization[31] that resulted from poor volumes and investor wariness. These issues affected the DFIs' wealth capitalization interest as equity issuers by limiting potential both for collecting founder's rent and for equity leverage.

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[29] On founders rent, see note 12. The DFIs became co-promoters of the firms and long-term projects they funded, including private, public, and joint public-private ventures. As participants in such ventures, they had an interest in outcomes at all three domains identified in the first cell of Figure 6-1; enterprise finance, wealth capitalization, and the privatization of state owned enterprises.

[30] This was due to paper-based trading and other practices that served to increase BSE brokerage fees (good for the BSE), but increased impact cost, or obstructed large volume trading altogether (bad for DFIs).

[31] The overall market capitalization is the combined market value of all listed-company shares.

On the other hand, Development Financial Institutions were also investors in securities, thus suffering double jeopardy at the hands of the Bombay exchange. As investors and managers of major securities portfolios in fiduciary capacity and on their own account, BSE practices were costly and frustrating for the DFIs.[32] Moreover, there were "serious conflicts of interest" built into the BSE's "mutualized" governance structures.[33] In the "of, by, and for the BSE" world of Indian stock trading, poor self-regulation and worse enforcement often led to settlement errors and other problems. If an investor had a complaint against a BSE member, other BSE members adjudicated the dispute, with "few complaints resolved in favor of investors" (Shah and Thomas 2001, 14). Finally, the illiquidity of the BSE increased the risk, and diminished the appeal, of securities for investors. Following the paradigm shift in overall Indian economic policy, these problems faced by the DFIs, both as an issuer and as an investor, were magnified.

This compelling interest of the Development Financial Institutions as both issuer *and* investor provided a powerful sense of purpose in an important collective coalition actor with financial expertise. This meant that there was now some serious political gravity from both the issuer and investor financial positions with respect to the issues of market design and governance on the stock exchange. The market design and governance structure the DFI proposed were also compelling. The National Stock Exchange promised to replace the open-outcry, geographically concentrated paper-based trading system controlled by the BSE with a new market structure based on a nationally accessible, electronic, screen-displayed limit-order book, along with a shift to "dematerialized" (digital, not paper) shares. These changes would eliminate the

[32] An investor who sold shares on the BSE might get his or her money, but often with huge delays. When dividends or stock splits were due, brokers might delay share transfer to reap these benefits before executing the trade.
[33] Similar conflicts persist on other famous broker-run exchanges such as the New York Stock Exchange (NYSE). See Levitt (2001), and Ip (2003).

majority of the problems the DFIs faced as issuers and investors when dealing with the BSE. If the NSE succeeded in attracting liquidity, this new state-of-the-art trading platform would lower impact and other transaction costs. [34] It would also diminish risk, and improve the wealth capitalization potential of issuers' securities.[35] The NSE would also avoid the Bombay Stock Exchange's problems of conflicted governance.[36] It would be set up as a limited liability company, owned by public sector financial institutions – the large DFIs – and led by the largest long-term lending institutions (IDBI), but run by an independent professional management team, not by brokers. NSE brokerages would merely be franchisees of the exchange.[37]

Following the 1991 reforms, the Ministry of Finance (MOF), under the guidance of Manmohan Singh, was given a wide margin to pursue economic reforms by Prime Minister Rao. The debates and decisions of the economic policy elite were focused in the MOF's "Department of Economic Affairs" (DEA). The DEA was responsible for most of the dismantling of the old Nehruvian system, and it was there that the preferences imposed by India's external exposure profile, discussed earlier, coalesced.[38] In the absence of significant FDI and trade receipts, the Indian central-state-elite, whose most focused and powerful representative at the time was the DEA,

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[34] Impact cost is the "additional" expense of immediate trade execution, and is a measure of the price-per-share consequences of liquidity on an exchange. Highly liquid exchanges reduce impact costs (Bangia et al. 1998). Selling large positions (blocks) of shares tends to incur higher impact costs.

[35] A robust secondary market would also create a structural incentive on the investor side that could also improve the potential for equity-based enterprise finance.

[36] Another issue the DFIs faced under the old BSE-dominated securities enclave system was the corrupt and costly links between the BSE and DFI employees. The new NSE governance structure promised to alleviate this problem through surveillance and segmentation of exchanges operations, achieved through a variety of technological and organizational measures. (Author's interviews, Bombay, 2000, #16; Bombay, 2000, #17).

[37] The primary promoters and owners of the NSE were IDBI, UTI, LIC, and ICICI, with additional participation from other DFIs. The board of directors was composed of both DFI representatives and private sector directors. For background on these entities, see chapter 4.

[38] Bhattacharya (1999) and Jenkins (1999) discuss this. In the course of my research, this view was confirmed in interviews of three of the key DEA officials involved, and a variety of officials from other agencies (such as the central bank and securities regulator) who advised the DEA on securities related matters at the time. (Author's interviews, New Delhi, 2000, #14; confidential correspondence, 2000, #3).

recognized that foreign portfolio investment (FPI) could be a useful and quick solution to the balance-of-payments instability and foreign exchange needs associated with the precarious scarcity of India's external exposure. Improvements on a variety of securities-related governance issues that would attract FPI could be achieved more quickly than a turn-around in the FDI and export-led growth parameters. The strategy that emerged – the aggressive, pro-competitive stance, encouraging state-of-the art trading and settlement, and the sanctioning of professional exchange management and governance – was by no means a certain outcome from the *ex ante* perspective of anyone familiar with the politics of Indian economic reform. The broad effects of the NSE breakthrough were also facilitated by another dimension of the strategy that later emerged: simultaneously pressuring the banking system and working around it in the provision of enterprise finance.

In early 1993, the NSE was poised to go on-line with its "wholesale debt segment," a reporting venue for trades in corporate and government bonds that was to be a precursor to full-fledged, countrywide, screen-based bond trading, a market which was then still phone-dominated and concentrated in Bombay. While there was at the time no explicit plan to trade stocks on the NSE system, its infrastructure was extremely powerful and technically capable of immediately furnishing a trading platform for the trading of all Indian stocks.

The Ministry of Finance's Department of Economic Affairs had for some time been leaning on the BSE to upgrade its trading systems, begin the dematerialization of stocks, and initiate the development of "novation" systems of depositories, settlement, and trade guarantees. Ministry of Finance officials and other observers reported both contemporaneously and in retrospect that a common pattern was emerging in which the BSE seemed to respond positively on request to deal with the market design and exchange governance issues, starting task forces and study committees but doing

nothing.[39] It became increasingly clear to the government that the BSE was not acting in good faith. The DEA official in charge explained that the MOF was losing patience with the BSE. He reported that at a meeting in 1993, the DEA was ready to give the BSE a last chance to propose changes. But, he said, the BSE "just did not take the issues (improvements in market structure and exchange governance) seriously." Furthermore, according to former DEA officials, the BSE also underestimated the potential threat of the NSE – a claim that was famously and amusingly borne out.[40]

The Bombay Stock Exchange's splendid isolation in the Nehruvian securities enclave had facilitated their passive enrichment. It had also meant that they were not conversant with, or connected to, the wider world of Indian coalition politics. Consequently, at this critical juncture they were internally inflexible regarding organizational change, lacking the skill and clout to influence policy. Ministry officials realized that the Bombay Stock Exchange underestimated the DEA's resolve and the top-level support it enjoyed (meaning Finance Minister Singh and Prime Minister Rao). In the end, the central-state-elite, represented by the Department of Economic Affairs, tipped the balance in favor of the NSE. It authorized the Securities and Exchange Board of India (SEBI) to enable the National Stock Exchange to undertake equity trading.[41] The central-state-elite was forced to pursue their preferences through a strategy that was, in the Indian context, unusually aggressive and pro-competitive. However, the Ministry's *carte blanche* was no certain guarantee

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[39] In the 1980s, for example, a forward-looking leadership at the BSE (under the leadership of executive director M.R. Mayya and president Mahendra Kampani) had begun the process of automation, proceeding as far as selecting hardware systems. "But," writes Dalal, "the broker coterie simply forced it to drop the move, fearing that automation and transparency would end their dominance. This process was revived only after the NSE's turnover crossed that of the BSE, and continued to rise relentlessly" (1999)

[40] Author's interviews, confidential location, 2000, #118.

[41] In principle, SEBI is an autonomous regulatory agency. In practice this is only half true, because the complicated customary practice in which central ministries may issue "written requests" to statutory bodies such as SEBI is a Sword of Damocles over the heads of these agencies' chairmen.

of success for the NSE. The BSE still held the trump card of its natural monopoly position as the dominant locus of liquidity.

The BSE brokers were sanguine. There was knee-slapping mirth and ribald jokes made about the NSE. It was, after all, the brainchild of government-run financial institutions. The South Bombay community referred to it derisively (if not entirely accurately) as the "*sarkari share bazaar"* (government stock exchange). Smugly believing the government too incompetent in matters of securities finance, and probably misunderstanding the superiority of the market design and the degree to which the governance structure was civilian, the BSE fatefully dismissed the NSE out of hand.[42] NSE stock trading was made available nationwide through its state-of-the-art satellite connections and widespread network of trading terminals. The NSE business structure permitted small and regionally dispersed actors to become involved, attracting participants – firm listings, brokers, and investors – to the NSE in the face of the BSE's entrenched natural monopoly on liquidity. The laughing stopped at the BSE on South Bombay's Dalal Street when, in November 1995, within a year of opening, the upstart National Stock Exchange beat out the 120-year-old Bombay Stock Exchange as the highest volume exchange in India (see Figure 6-1).[43]

[42] The recent (1993) failure of a previous effort by the DFIs to establish a competing exchange (the Over the Counter Exchange of India), based on the then-popular American NASDAQ model, served to further confirm BSE partisans in this belief that the NSE was a dead letter. Author's confidential correspondence, 2001, #100.

[43] By 1999, the NSE was one of the world's four most active exchanges as measured by trades per day (Shah and Thomas 2001, 15).

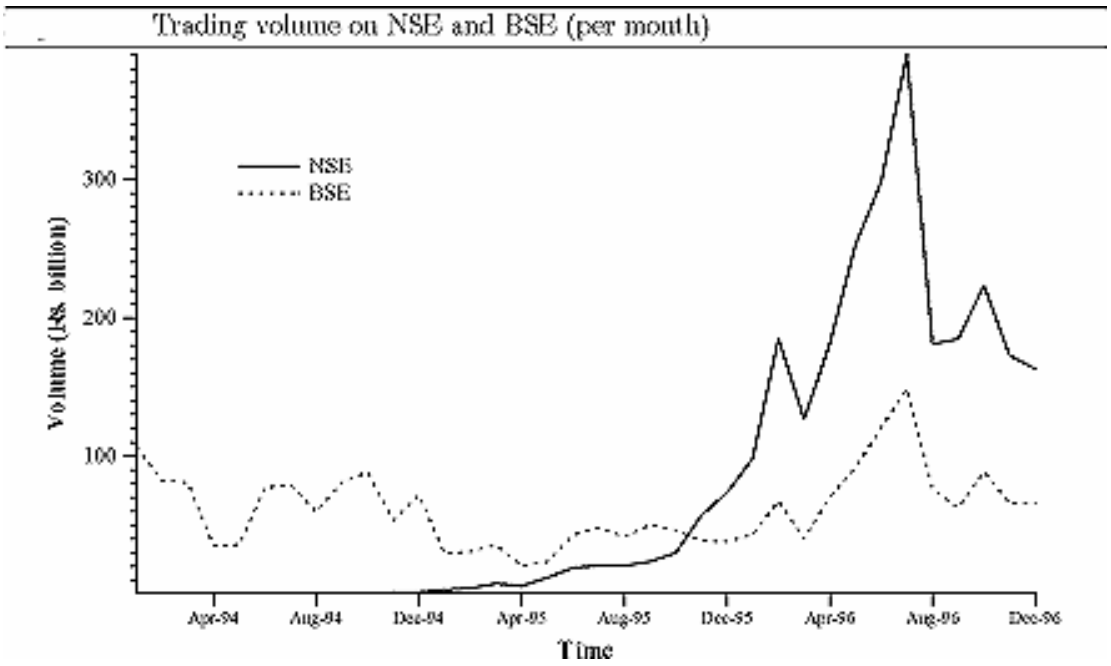

Figure 6-1
The Origins of Competition Among Indian Stock Exchanges[44]

Competition bred improvements that were a hallmark of the "scope" outcome in the market component of India's constrained evolution securities governance regime. The National Stock Exchange competed directly with the Bombay Stock Exchange and with other regional exchanges. This competition eventually provoked improved market structure on all Indian exchanges, improving price discovery, narrowing bid-ask spreads for equity securities, and provoking other dramatic improvements in trading practices, risk management, efficiency, and eventually settlement countrywide.[45] Most of the immediate effects of these changes on the observable outcomes identified in the asset-class/financial-position framework were

[44] Shah, Ajay, and Susan Thomas. "The Evolution of the Securities Markets in India in the 1990s." Bombay: Indira Gandhi Institute for Development Research, 2001.
[45] The original NSE plan envisioned the establishment of links to a related depository and related clearing agency. These came online in 1996.

achieved through market structure improvements, and their consequences for cost, trading execution (diminished transaction time and increased reliability), and liquidity. Such changes benefit issuers and investors of all asset classes alike. Take liquidity for example: By providing swift low transaction-cost equity sales, liquidity at once improves issuers' ability to capitalize their wealth, even as it is the first line of defense in investor protection from fraud or manipulation. Liquidity is also the most powerful means by which shareholders can exercise their "voice" vis-à-vis bad companies. Novation in a market structure eliminates settlement risk, further benefiting investors.

The stock exchange reforms explained in this section were provoked by a state-elite strategy that evolved in interaction with political coalition members' changing power and interests with respect to securities-related property rights. I started this section by reiterating the securities-related preferences of India's central-state-elite. I then mapped the institutional context, and the other actors and their interests with regard to stock market structure and exchange governance in pre-reform India. By demonstrating that the DFIs' interests and actions were influenced by their dual role as both security issuers and investors, I was able to show how, in the contest between the DFIs and the BSE, the autonomous, facilitative, "mediating role" of the central-state-elite in pursuing the specified preferences were translated into a political strategy. I demonstrated the impact of that strategy on the development of the stock exchange institutions, and the consequences of those institutional changes for observable elements in a securities governance regime primarily issuer interests like enterprise finance and wealth capitalization, but also some areas of interest to investors such as shareholder rights.[46]

[46] In regard to founder's rent and wealth capitalization, it may be argued that things went too far in the Indian markets during the period 1994-1996, provoking what came to be known disarmingly as the problem of "disappearing companies." In that period, a number of companies were established and made it to the IPO phase, whereupon the promoters disappeared with the IPO proceeds, leaving nothing behind.

Transformation in the area of securities trading, provoked by market structure improvements and exchange governance reform, are only part, albeit an important part, of outcomes in the market component of India's SGR. In combination with other changes (not discussed here) in securities-related markets, in the organization and orientation of the state with respect to securities, in the associational sphere, and in the role of the media and social networks, this stock exchange transformation was important in determining the configuration of those components in the overall pattern of the Indian SGR.[47] Whereas the development of the institutional framework for stock exchange in India showed how autonomous state action, and flexibility in the relationship between the dominant coalition and the structures of property-rights, contributed significantly to shaping the constrained evolution securities governance regime in that country, the development of the institutional framework for stock exchanges in China went in almost exactly the opposite direction, diminishing competition and enhancing state discretion.

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[47] What were some of the effects of the overall pattern of India's SGR? The central elite's strategy worked. By the end of the decade, the constrained evolution SGR helped achieve the state's preferences. In the decade of the 1990s, 52% of India's foreign exchange (forex) came from foreign portfolio investment (Damodaran 2002). In 2002, India's forex reserves of US $66 billion were sufficient to cover thirteen months of imports, well over the Asia average (ex-Japan, Hong Kong, and Taiwan) of seven months. Finally, regarding industrial finance, as the SGR developed, it enabled the central elite to achieve its goals of improving industrial finance by working around the state-owned banks and encouraging firms' use of securities markets. Indian firms' use of non-bank capital markets went up in the 1990s as compared to the 1980s by between 30% and 40%, and their use of funds from intermediaries (banks) went down by about 5%.

The effectiveness of India's SGR in attracting FDI has its dark side. Central policy makers now constantly worry that Foreign Institutional Investors (FIIs) will take their hard currency home at the first sign of falling share prices. They consider the consequent forex outflows a threatening symbolic challenge to the prestige of Indian markets. They are also wary of the impact on hard currency reserves. However, during the severe turbulence of the spring 2001 market scandal and crash, FIIs maintained their interest in Indian shares, remaining net buyers throughout. In its weekly newsletter, Morgan Stanley assured institutional investors that "such crises are usually short-lived and the market is likely to be back on its feet reflecting fundamentals," adding that "the upside is in the pipeline and that it makes sense to buy into the current weakness" (Rudolph 2001).

III. The Politics of Stock Exchange Development in China's SGR

Why have China's securities-related development and regulation focused so much on segmentation, quarantine, and increasing government centralization? This is particularly puzzling at a time when the government is retreating from product markets, and much commercial decision-making and economic power is being devolved away from the center. In the 1990s, Chinese securities finance seemed to be a greenfield prospect. There were few entrenched interests to obstruct the "optimal" design of securities institutions and governance. Yet, what emerged by the end of 1997 were the "Zhu Regime" and the discretionary involution pattern of securities governance (see Table 6-3).[48] One important piece of this pattern was China's stock exchange institutions. As in the Indian case, the role of exchanges as a market arena with dense linkages to the various components of the SGR (states, firms, associations, and networks) meant that the trading practices and organization of these institutions contributed to and reflected the country's overall SGR trajectory.

Carl Walter, the most seasoned foreign investment banker working in China, suggested that the establishment of China's bourses, and the policy regime of which they were a part, represented a successful strategy to "ring fence" China's Wild West securities market of the late 1980s.[49] Commenting on the cosmetic conformity of the exchanges to the social norms and technological standards of the global securities script, Fraser Howie[50] favors a Chinese metaphor that captures the contradiction of the exchanges' formal grandeur and substantive shallowness – the crux of the financial governance pattern identified in the following case study. In the days of confrontation

[48] For an introduction to the "Zhu Regime," mapping the factional configuration of elite politics and its consequences for macro- and micro-economic policy institutions (monetary, labor, and corporate), see respectively Shih (2003), Hurst (2002), and Lin (2003)
[49] The "ring fence" metaphor was Walter's. Author's interview, Beijing, 2000 #71.
[50] Howie is Walter's co-author and former colleague at China's first international joint-venture investment bank, China International Investment Company.

with Central Asian invaders, defenders of the Han heartland built forts along the frontier. The forts were quickly built, lightly garrisoned, festooned with banners, and bristling with shiny weapons. This was called the "empty fort" tactic of achieving border security on the cheap.[51] Finally, in describing the internal function of the stock exchanges, one of China's most well-regarded professional economists had this to say: "China's stock markets resemble a casino, only less standardized."[52]

The Chinese state operated under the severe uncertainty caused by economic backwardness and rapid, widespread social-economic transformation. It was also constrained by its distributional coalitions and state-socialist property rights. Under these conditions, the Chinese state preferred to avoid the *substantive* effects of the securitization that had begun during the liberalizing 1980s and continued through the establishment of the formal securities exchanges in 1990. These preferences and the strategies they inspired were facilitated by, and indeed were rational responses to, China's benign abundance profile of external exposure. The preferences of China's central-state-elite, as identified earlier, were:

[51] Author's interview, 2000, #72. This is a well-worn historical analogy in the China field, used in a variety of issue areas (Nathan and Ross 1997).
[52] *Zhongguo de gushi henxiang yi ge duchang, erqie hen bu guifan* (Wu 2002).

Table 6-3
China's Short March to Involution
Stock Exchange Institutions and Governance and the Emergence of Discretionary Involution in Securities Finance

Cycle ***Fang-Shou***	**Policy Trend & Central Discretion**	**Institutional Design**	
		Administrative Organization	Stock Trading Design & Governance
"Wild West" **OPEN 1981-1989**	LIBERALIZATION LOCALISM CENTRAL DISCRETION LIMITED	BOTTOM-UP REGIONAL-LOCAL	OTC HETERODOX EXPERIMENTAL INFORMAL
Tiananmen **CLOSE 1989-1991**	REACTION CENTRAL REPRESSION CENTRAL DISCRETION COMPLETE	TOP-DOWN CENTRAL FIAT	LIMITED TRANSITIONAL
Deng Tours South **OPEN 1992-94**	REFORM DECENTRALIZATION CENTRAL DISCRETION CONTESTED	COMPETITION: LOCAL CENTRAL & BUREAUCRATIC	EXCHANGE BASED ISSSUER-BIAS LOCAL RIVALRY LOCAL GOVERNANCE
The Zhu Regime **CLOSE 1995-2003**	RE-REGULATION CENTRALIZATION CENTRAL DISCRETION INSTITUTIONALIZED	*CHUIZHI GUANLI* VERTICAL INTEGRATION	EXCHANGE BASED ISSSUER-BIAS LOCAL SPECIALIZATION CENTRAL GOVERNANCE

- Servicing the distributional coalition and providing life support to the large SOE-sector, interior provinces, and sunset sectors.
- Limiting the disruption to those elements of the state-socialist property-rights regime that facilitate the exercise of CCP discretion.

A. Repression and Reform: Establishing Stock Exchanges, Expanding Securitization

Like many ground-up initiatives that grew out of the vibrancy of China's post-Mao civil economy and society during the 1980s, the heterogeneity and experimentation of securities finance were abruptly and dramatically halted with the Tiananmen event of 1989. In early 1990, a powerful agency of the State Council (the locus of China's central-state-elite) finally weighed in on securities policy. Its most concrete institutional change had to do with stock exchanges. First, the State Council Committee for Reform of the Economic System (SCRES, known as the *Tigaiwei)* issued rules limiting the spread of shares by restricting their flow to employees, directing newly issued share flow only to other SOEs. SCRES also limited the spread of OTC trading outside of Shenzhen and Shanghai.[53] At the end of the year, two new exchanges opened in Shanghai and Shenzhen.

All at once, China jumped from having no formal exchange trading system, to the world frontier. True to Gerschenkon's "imperative of economic backwardness," the Chinese bourses, *ex nihilo,* and at great expense, leapfrogged to state-of-the-art,

[53] Informal *zhengquan jiaoyizhongxin* ("securities trading centers") in a number of China's larger commercial cities and provincial capitals such as Chongqing and Shenyang persisted for several years, vainly lobbying the center to establish their own exchanges (Xiehui 1993). But as the nationwide network of satellite and fixed connections to the main boards in Shanghai and Shenzhen proliferated and local governance problems associated with *jiaoyizhongxin* became apparent, prospects for these regional centers withered.

centralized "dematerialized" trading and settlement systems.[54] This would appear to have been a major reform. It was well timed. The early hour of this measure – only a decade into the economic reforms and well before any significant or durable institutions of securities finance had emerged from the civil economy or civil society – meant that the Chinese state faced none of the political economy problems that confronted India in the initial establishment of exchanges. It avoided resistance or positive input to changes in market design that would have been the likely consequence if those civil economy and civil society elements of securities governance had been given space and time to grow and develop a collective consciousness.[55]

During his now storied *"nanxun"* ("Southern Tour") of February 1992, Deng Xiaoping sought to awaken China's economic reform movement from its post-Tiananmen torpor. Toward that end, he specifically used the symbolic gravity of the securities markets to amplify his message. In doing so, he succeeded in rallying the state propaganda apparatus and crucial party leaders in support of securities market development. "We must seize this opportunity," he declared. Silencing his more cautious, market-phobic, "hard-line" opponents, Deng instilled a sense of urgency in the reform agenda, arguing that a crucial, fleeting window of opportunity must be exploited. The focal points of his artfully staged foray were the new securities exchanges in Shenzhen and Shanghai. "As for securities and the stock market," queried Deng publicly in Shenzhen, "are they finally good or bad, are they dangerous, are they things only capitalism has, or can socialism also make use of them?"

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[54] The market microstructure of trading was an "order-driven" system based on "price-time priority" connected directly to the securities depository and the designated bank (ICBC), and linked over time to an increasingly large national network (Kumar et al 1997). The market microstructure of the primary market changed and proliferated frequently in this period as the government adjusted the corporatization policy and the associated primary market for those companies' new securities.

[55] This is, as the previous case demonstrated, in stark contrast to the Indian case where the NSE breakthrough involved a struggle to impose a "world standard" settlement and microstructure design.

Fatefully, he opined, “we are allowed to try and see…” [quoted in (Hertz 1998 90-93)]. This launched the expansion of Chinese securities finance in the digital era. The number of listed firms exploded, growing at more than 200% from that year to the next (see Figure 6-2).

The new exchanges where all these firms were listing – centralized platforms capable of nationwide linkages for electronic trading and settlement using a screen-based limit-order book – were the best way then known to enhance liquidity and supply fair, low risk securities trading. By itself, the 1990 Shanghai and Shenzhen exchange infrastructure did not foreshadow the discretionary involution pattern of securities governance in China. Nevertheless, at the same time, the centralization of trading and the dematerialization of shares made control and surveillance of securities finance much cheaper and easier. They provided a necessary, though not a sufficient condition for the convenient exercise of central-state-elite authority over securities finance that was crucial to the later emergence of the discretionary involution pattern. What gave the establishment of these exchanges their potential to be the regulatory equivalents of tanks rumbling into the central squares of Chinese financial would be their governance structures.

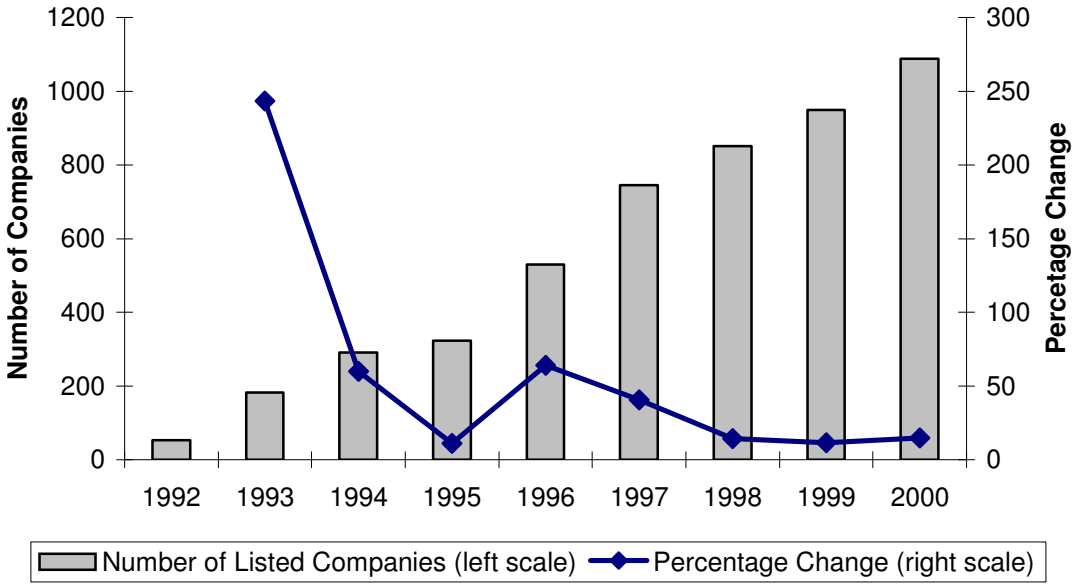

Figure 6-2:
Number and Percentage Change of Chinese Companies Listed Per Annum: 1992-2000

In the protean context of Chinese securities finance in the early 1990s, it is difficult to discern actual or even potential winners and losers. Guidance from the asset-class/financial-position matrix suggests we consider the consequences of various policies and institutions for differently situated financial actors. At the time, treatment of equity, including the shares available on primary equity markets,[56] and of government bonds, seemed to favor issuers of securities.[57] There were also, even then,

[56] Between 1989 and 1992, the development and implementation of the "Standard Opinion" (*guifan yijian)* was a major cause of this change. This bit of legislation, drafted by the then-powerful SCRES, was a crucial first step in directing the process of securitization to serve the needs of the state as an issuer of equity securities. It stripped away the regional and ownership-type heterodoxy of the 1980s, focused exclusively on the state sector, granted approval authority for corporate restructuring to specific government authorities, and most importantly developed the tripartite share categories that are the bedrock of state-domination of equity-related property-rights in China (Rudolph 2002; Walter and Howie 2001, chapter 2). The 1994 Company Law further enhanced the center's ability to exercise its discretion by further formalizing the share categories first detailed in the Standard Opinion.
[57] This growth and euphoria was not limited to the equity trading on the exchanges. Issuance and trading volumes in government-issued bonds were growing rapidly as the central government acquired an increasing taste for fiscal deficits.

early signs that the initial institutional design and governance structures of the exchanges were also likely to favor issuers of securities over investors in securities.

First, the structure of the relationship between the Shanghai and Shenzhen exchanges was set by central fiat. Companies were forced to list on one exchange or the other. Thus, the primary parameter of competition between the exchanges was for the listing of firms. The only variable of choice for investors, therefore, was the "merit" of the listed firms, not the quality of an exchange's listing requirements or the quality and price of trading and settlement. Second, the governance structure of the exchanges was state dominated. At first, local governments represented by the Shanghai and Shenzhen municipalities regulated their own local exchanges. This structure did encourage some competition between the two cities to promote their respective exchanges. The incentives of this institutional design strongly encouraged these municipal governments to promote local business.[58] Pressure was put on local bankers and businesspeople to lend and invest funds in the market, and local firms were dragooned into restructuring and later listing bids.[59] Enticing firms from elsewhere in the country remained a secondary concern to the local governments and their agents in the stock exchange management.

Within these new confines, securities governance in the 1992-1995 period was nevertheless one of experimentation, growth in scale, learning, and increasing international exposure. Then came the "Zhu Regime" and a full shift to the discretionary involution pattern.

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[58] Fore example, Shanghai ICBC branch president, Shen Roulei.
[59] Author's interviews with Shanghai Stock Exchange staff, Shanghai, 2001, #70.

B. Reaction: The "Political Conquest" of the Exchanges

The liveliness of the previous period came to an abrupt halt in the summer of 1995. In the spring of that year, a scandal erupted around the trading of government bond futures (Yatsko 2001; Zhongxin 2001). This event set in motion a series of policy measures over the next two years that completed the extension of Beijing's control over the exchanges. This process had begun with the state-centric bias in the specification of equity-related property-rights and the tying, at the time of its creation in 1992, of the new securities regulator – the China Securities Regulatory Commission (CSRC) – to the apron-strings of the State Council.[60] Between 1995 and 1997, the CSRC took over direct regulatory and operating control of the exchanges, completely sidelining the Shanghai and Shenzhen municipalities, and the earlier exchange management.

Significant personnel changes at the CSRC initiated a severely conservative shift in the wake of the 1995 bond futures scandal. These changes had implications for stock exchange governance. Liu Hongru, the cosmopolitan and dynamic first chairman of the commission, was removed in favor of Zhou Daojiong, a nominee whose twin qualifications for the job seemed to be his reputation as a "yes-man" for the State Council, and his well-known ignorance of securities finance (Nan 2001).[61] Customary practice is an important part of elite politics in China (Nathan and Tsai 1995; Tsou 1995). This first succession at the CSRC involved the performance of an important customary element in the state domain of securities governance: the signaling of

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[60] On equity-related property rights and share segmentation, see note 56, above. On the institutional history of the CSRC, see (Rudolph 2002).

[61] Expressing the prevailing gloom of the time, one former CSRC official commented, "The central authorities don't want experimentation, they don't want new products, they only want stability and that's what they'll get from Mr. Zhou, who prides himself on knowing little about the industry. Hopefully they will not choke the market to death" (Nickerson 1995). This quote is particularly credible and damning because there is good reason to believe that the former official quoted here was Gao Xiqing, *de facto* leader of the CSRCs *haiguipai* (the "sea-turtle faction" of foreign trained experts recruited by Liu Hongru), and the mainland's most respected securities finance expert.

control structures in informal politics or factions. During this succession, the extension of factional elite politics into the state domain of securities governance served to begin the process of inscribing the hierarchical relationship between the CSRC and the local stock exchanges.[62] The hierarchy was reinforced when this pattern of factional control and political allegiance moved both down to the local level and up into the apex stratum of the State Council during the next CSRC succession.[63]

The 1995 government bond futures scandal forced then-Vice-Premier Zhu, fresh from his triumphant taming of a severe inflationary episode, to direct his attention to securities finance. This was crucial to the consolidation of what until then had been only incipient elements in a contingent tangle of policy and institutional initiatives. Out of this tangle, Zhu would sort out and reinforce those elements that could be usefully woven into the pattern of discretionary involution.[64]

Zhu's attention to securities finance was a tipping point in the discretionary involution direction for several reasons. First, Zhu embodied the center's preferences, as described above. Second, his eventual post as Premier put him in an official position to profoundly influence securities governance. His heroic inflation-fighting reputation as a master of macroeconomic policy, and his demonstrated "managerial" approach, protected him from criticism.[65] Third, his attitude toward securities finance predisposed him toward the type of manipulation permitted by China's benign

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[62] Outgoing CSRC Chairman Liu's protégé at the Shenzhen exchange was replaced by a protégé of the incoming Chairman Zhou. Zhuang Xinyin – a man whose appointment puzzled all observers until it was discovered that he had close links to incoming CSRC chairman Zhou Daojiong – took over the important post of General Manager at the Shenzhen exchange (Ibison 1995).

[63] During the formation of his new regime as Premier, Zhu Rongji replaced Zhou Daojiong as CSRC Chairman with his own handpicked finance maven Zhou Zhengqing.

[64] Walter and Howie do a very good job in their book of drawing out the many contradictory trends and potential alternatives that "might have been" in the development of China's SGR (2001).

[65] For a discussion of the fundamentally "political" nature of Zhu's seemingly technocratic policies, see (Shih 2002)

abundance profile of external exposure.[66] Fourth, he had a motive to exploit securities finance. Upon becoming Premier in 1998,[67] Zhu made the resolution of the State Owned Enterprise "problem" his number one priority. Finally, there was the global economic zeitgeist of 1997/1998. The East Asian crisis was unfolding, and Zhu knew he was being scrutinized at home and abroad for how he would guard against its contagion. At the same time, the poor reputation of securities finance in the privatization of other former socialist economies spotlighted (in the domestic gallery) China's capacity to manage the privatization process.[68] Chinese banks were already facing serious problems, and SOEs were in desperate need of life-support from alternative funding sources. Seeing an opportunity and a resource in securities finance, Zhu proceeded to bend the Shanghai and Shenzhen exchanges to his will.

While Zhu was making choices, he was not making them under conditions of his own choosing. As premier, he was also coalition manager-in-chief. What locked in the central discretion of the discretionary involution pattern of securities governance during 1996/1997 was Zhu's strategy for managing the struggles within the dominant political coalition over securities-related property rights.[69] It is important to remember

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[66] As one China stock market expert aptly remarked, "for all his credentials as a radical reformer, Zhu was extremely suspicious of the stock market. He felt it was too speculative and of little economic use" (Green 2003, 21)

[67] For the argument made here regarding the development of the "Zhu regime," it is important to note that Zhu's post-inflation-episode reputation from mid-1995 on empowered him greatly. More important, however, was the general expectation from mid-1996 onward that he would be the next Premier.

[68] The following remark accurately reflected the consensus view in the Chinese leadership at the time:

> If China re-distributes its assets like in the former Soviet Union and the East European countries, the productive force in the country will be severely destroyed. Violent social chaos will be inevitable, and the economic reform will suffer a standstill or even retrogression quoted in (Gu and Art 1996).

While the validity of the assumptions underlying this assertion may be questionable, my interviews corroborate that this was indeed a common belief among Chinese policy makers at the time. Author's interview, Beijing, 2000, #19.

[69] That coalition is composed of those who were the winners before reform, and who, as potential losers in reform, continue to obstruct it unless they are accommodated. The coalition includes heavy industry, inland provinces, the military, and central agencies (Shirk 1993; Shirk 1996)

that the dynamics of China's dominant coalition involve the central state balancing and controlling the power and interests of other parts of the state. It is an intramural coalition. Zhu therefore cultivated an SGR that ensured that the spoils of securities finance could be distributed at the discretion of the State Council, acting through its agent, the CSRC. This distribution was managed to maximize the benefits of patronage regionally, while at the same time minimizing sectoral instability.[70] The management solution to this struggle biased the governance of securities in favor of issuers, distributing access to securities-related property-rights – in this case access to equity finance – in ways that would maintain support within the intramural coalition. This bias was achieved through a range of policies and institutional calibrations, including changes to the way the stock exchanges were governed. With low and often negative real interest rates, a closed capital account prohibiting overseas investing, and few alternative investment options for a 40 percent domestic savings rate, individual Chinese had little to lose by taking a punt in the market, however rigged. This provided a minimal reservoir of retail investment, and when trading volumes flagged and markets turned down, the state "encouraged" investment in the markets with a mix of propaganda, innuendo, tax incentives, and loans to securities companies.[71]

Recall that during the reformist period following the establishment of the stock exchanges and before the 1995 bond futures scandal, the Shanghai and Shenzhen municipal governments were in charge of the exchanges. The municipalities nominated the exchanges' top management, but nominees required State Council approval.[72] There had long been rivalry between the CSRC at the center and the local

[70] Regional patronage is an important source of stability and state strength (Shirk 1993). Sectoral stability – that is, the managed, slow-motion restructuring and winnowing of the socialist legacy of heavy industrial urban-bias, was crucial to coalition management and broader social stability.
[71] For discussion of the central-state's use of propaganda and "stamp-tax" incentives, see (Rudolph 2002)
[72] After the founding of the CSRC in 1992, approval authority shifted to that body.

governments running those exchanges. The 1995 bond futures scandal triggered realignment in the locus of regulatory authority and state discretion (Foo 1995a). That scandal undermined the credibility of the Shanghai authorities as a regulator, but the realignment that followed addressed some deeper structural problems as well.

The two cities were vibrant points of economic growth in China, but they had gotten greedy. Rivalry between the two municipalities was provoking volatility and risky practice in securities finance, threatening the stability of the dominant coalition. The cities' fierce competition for company listings and increased trading volume encouraged lax regulation and shameless local promotion through a range of enticements offered to listing candidates and securities traders, including tax incentives and preferential bank loans (to companies or to securities firms). Other regions of the country, and some sectors not well represented in the *Jiangnan* and Pearl River Delta regions adjacent to Shanghai and Shenzhen, felt neglected despite some central efforts to distribute listing access. The cities' flagrant instrumental exploitation of the exchanges looked risky and began to disrupt the coalition balance. More importantly, though, it also demonstrated to Zhu the potential for instrumental exploitation of securities finance.[73] Under the "Zhu Regime," that potential would be harnessed to the center's political agenda with according side-payments to the internal coalition.

All this was probably enough by itself to justify a more muscular central role in exchange governance, but in August of 1995 the Shanghai exchange openly clashed with the center over a matter that directly involved the property-rights status of equity securities, and the center's definition of those rights.[74] The CSRC disagreed with the

[73] Author's interview, Beijing, 2001, #43.

[74] The dispute developed over an arcane and seemingly minor matter of "bonus shares." These bonus shares had been issued to holders of the "Legal Person" category of non-tradable stock held only by state-owned enterprises (SOEs). Individuals were not permitted to own "Legal Person" (LP) shares, and their SOE owners could only exchange such shares with special permission from the Ministry of

Shanghai exchange over the exchange's ruling on the status of some bonus shares issued by a firm in Sichuan. The commission removed the exhange's Managing Director, and suspended trading of the company's stock. In the two years that followed – from August 1995 to August 1997 – the center aggressively intervened in stock exchange governance and made institutional changes that increasingly expanded State Council discretion. These changes began shortly after the bonus-shares fight, with a reversal in the procedures for appointing apex management at the exchanges. As discussed earlier, in the past, exchange leadership was nominated by the Shanghai and Shenzhen municipal governments and confirmed by the CSRC. Thenceforth, however, the process was to be reversed. Whereas municipal government and the exchange had previously ruled on the issuance of shares and supervised member brokerages, the final say now shifted to the commission. By August 1997, local governance of the exchanges had become a mere formality when the State Council officially instructed the CSRC take over direct administration of the exchanges in order to foster "legal, supervised, self-disciplined and regulated" markets.[75]

By the end of 1998, the "Zhu Regime" was in place. In 1998, the CSRC was elevated to a ministry-level rank nominally on a par with powerful agencies such as the central bank, the Ministry of Finance, and the State Planning Commission (SPC). This appeared to be a relative gain for the CSRC. Its power and jurisdictional competence relative to localities and other bureaucratic players such as the central bank were elevated and expanded. But this change also made the CSRC a more

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Finance. This prohibition was part of a system of share "segmentation" that ensured state domination of the property-rights embedded in equity securities. The Shanghai exchange (and therefore its patron the Shanghai municipal government) had ruled that some bonus shares that had been awarded on the non-listed "Legal Person" stock of a Sichuan-based company and later transferred to individuals *could* be listed and traded on the exchange (Foo 1995b) and author's interview, Shanghai, 2001, #70.

[75] It explained that "the rapid expansion and scale of development force the need to strengthen unified central control." To reinforce the point, high-ranking CSRC officials, veterans in securities finance, were dispatched to take charge of the Shanghai and Shenzhen exchanges (Standard 2000)

effective tool in implementing a governance regime of discretionary involution. At the same time that the CSRC was elevated, Zhu placed his loyal protégé Zhou Zhengqing at the commission's helm. Most important, circling its wagons around the finance sector, the central-state-elite established the powerful and secretive Central Financial Works Committee (CFWC), a body of carefully picked CCP members tasked with assuring party control in all financial departments.[76]

Since 1993, provincial governments had formally participated in the political competition (mostly, as we have seen, competing with Shanghai and Shenzhen) over securities markets, regulating local securities companies, and nominating candidates to fill the regional and sectoral quotas for new stock market listings (Cooper 2002). This changed during the 1997 and 1999 period, as the CSRC dominated these functions and established a network of regional branch offices modeled on the "U.S. Federal Reserve"– which had also inspired the system then being implemented by the Chinese central bank for its branch banks. These measures were consistent with the larger administrative thrust of Premier Zhu's 1997 plan to restructure the government, streamlining it and implementing a more vertical form of administration (*chuizhi guanli*) (Yang 2001. 8). In both cases the objective was the same: reducing local influence and preserving central discretion.[77]

The first potential threads of China's discretionary involution SGR emerged in the post-Tiananmen, reactionary phase of the enactment of the securities finance script. This phase served to increase central government discretion in the composition and control of equity finance in the categorization of shares, through rules on

[76] Author's interviews, Beijing, 2000, #20. At the time of its establishment, CFWC secretary Wen Jiabao declared its purpose to be assuring that "that the party's line, principles and policies as well as relevant instructions and decisions of the party Central Committee and State Council are implemented in financial departments" (Gilley and Murphy 2001).
[77] Material in this paragraph has been culled from (Zhongxin 2001), (Li 1998), and (Walter and Howie 2001)

corporatization such as the Standard Opinion and later the Company Law. Similarly, in the central government's first major secondary market initiative – establishing the stock exchanges – the content of the global securities script stipulated a bundle of technologies and trading practices that seemed benign or "power neutral." But the consequence of their enactment facilitated the exercise of state power. In contrast to the "Wild West" days of the multiple and heterodox principles for corporate restructuring,[78] and the OTC and informal markets for secondary trading of shares around the country, the advent of the Standard Opinion and electronic centralized trading on exchanges together represented a diminution of competition. They too represented a diminution of ground-up innovation in securities governance and market-oriented pricing. The irony is that, in many ways, the technological "advance" and "modernization" heralded at the opening of the world-class Shanghai and Shenzhen bourses, and the formulation of a standardized nationwide restructuring policy for firms, together facilitated the preservation rather than the diminution of that state discretion in securities governance. This result belies the common belief that "more market means less state."

In the 1980s, the issuance of stocks and bonds was a liberalizing salvo. In the 1990s, the march to domination by China's central regulatory authorities was a response to the political consequences of securitization provoked by the earlier corporatization heterodoxy and trading experimentation. Table 6-2 is a stylized depiction of the cycles[79] of openness and closure that afforded central authorities various opportunities to manipulate the securities finance script as it was enacted in

[78] The Shenzhen corporatization principles were discussed in Chapter 4.
[79] Analysts of Chinese political economy use the terms *zouzou-tingting* ("stop-and-go"), or *fang-shou* ("letting go/clenching"), in referring to this prevailing pattern in which punctuated change occurs in an oscillating cycle of reform and retrenchment (Baum 1994; Tsang 1995). *Zouzou-tingting* suggests a progressive, evolutionary trajectory, while the *fang-shou* metaphor connotes no teleology. This was a common talking point among a number of the financial experts I interviewed.

China. Stock exchange design and governance enhanced the bias in favor of equity issuers. The political purpose of this issuer-bias is revealed in how it contributed to enterprise finance. It contributed moderately in the crude sense of providing cash for SOE life-support, but not in terms of allocative efficiency and the provision of alternatives for firms' capital composition choices.[80]

Moreover, wealth capitalization in the form of founder's rent or equity leverage was subordinated to the exigencies of coalition management and property rights constraints of the Chinese political economy. Never mind that the "float" of tradable shares was less than a third of all ownership, and that investors got nothing for their investment other than occasional capital gains. This is why investment banker Carl Walter refers to Chinese stocks as "equity-like" securities: They confer no *de facto* ownership rights and few other shareholders rights. The segmentation of China's share structure ensures that investors access no rights that would allow them to shape industrial organization in the economy, and through the 1990s even the likelihood of receiving a dividend became remote (Xu and Renhao 2001).[81]

Tight control of the wealth capitalization dynamic reinforced the involutionary logic of Chinese securities governance. As discussed in chapter 4, the state, and state insiders, held shares that were not tradable on an exchange. Firms that listed did get "free money," in the sense that control of the firm changed in no appreciable way following the notional dilution of the state's ownership in the initial public offering (IPO) or in later additional ("seasoned" or "secondary") offerings of stock. The government entity that was responsible for the firm before the IPO, continued in that role after the IPO. The quota system of approval for candidate firms wishing to list

[80] At best, this cash was used as "working capital" (read: life support for failing SOEs) and immediate consumption by the firms. At worst, it was squandered on speculation in securities and real estate, or for personal enrichment (Wang, Xu, and Zhu 2001)

[81] For an argument about recent developments in private securities litigation that could portend some change in this, see (Hutchens forthcoming).

shares put the IPO-derived "founder's rent" at the discretion of the central state (as discussed in chapter 4). The "equity leverage" component of wealth capitalization was tricky, because shares pledged against loans had only their market value and no *de facto* ownership rights. Moreover, throughout the decade, the state regularly changed the policies regarding the use of shares as collateral.

However, a significant consequence of the discretionary involution pattern was a sort of "wealth capitalization" in two different senses for the central-state-elite. First, securitization through listings on the Chinese stock exchange (or by listings abroad) can have a "wealth capitalization" effect for the national economy as a whole. This macro effect occurs as securitization gathers momentum when more firms list on the exchange and there is increasing trading and valuation of those firms. This in turn increases the market value of the country's income-producing assets, including, as Edmunds points out, "those that have not yet been securitized."[82] Second, the "symbolic" founders' rent realized by valorizing China's capital stock was useful to the central-state-elite in establishing its credentials as effective economic reformers and pragmatic managers of "market socialist" development in China. To the extent that these pecuniary and symbolic macro-level wealth capitalization effects were achieved, the mercantilist purposes of the involution pattern were served by skillful central-state colonization of the stock exchanges.

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[82] Edmunds offers the following hypothetical scenario to illustrate how this might work. Securitization generates equally dramatic profits at the national level. The macro fact is to increase the market value of income-producing assets in the country, including those that have not yet been securitized. Companies that have already listed their shares on the stock exchange could buy the assets that are not securitized. A company with earnings of $5 million per year and a price/earnings ratio of 15 would have common stock worth $75 million on the stock exchange. That company could buy a closely held business (not listed and having a small number of owners) that earns $1 million per year and pay $9 million for it – a price/earnings ratio of only 9, due to illiquidity. The newly purchased business, if consolidated with the existing business, creates a company earning $6 million per year with common stock worth $90 million, or 15 times earnings. The company would have added $15 million to the value of its stock with the $9 million purchase (the assumption that the old P/E ratio of 15 will persist for the post-acquisition enlarged firm is debatable, but the general principles expressed in this stylized account are still valid) (Edmunds 1996, 125-126).

The ensemble of institutions that enabled the central-state-elite's "political conquest" of the stock exchanges was complete by the end of 1997. Almost every policy measure involved in building the institutions of that ensemble was enabled by the center's large margin for maneuver, by virtue of the country's external exposure profile. The benign abundance of that profile permitted the exploitation of securities-related finance. It did not, however, foreordain that outcome. Given such a structurally imposed disposition, the center's strategy, and the resulting SGR pattern, were sculpted by the exigencies of a relatively constrained central state managing its intramural coalition in the context of China's rigid state-socialist property-rights system. Changes in the design and governance of China's stock exchanges were one area where evidence on the development of this strategy could be found and traced with guidance from the asset-class/financial-position matrix.

IV. Conclusion

The politics of stock exchange development is important, because the governance of the exchange and the design of its market structure determine the quality of the market for securities, who controls that market, and toward what ends. Relying on guidance from the asset-class/financial-position matrix, the case studies in this chapter analyzed the politics of securitization in the domain of equity finance, drawing on evidence from stock exchange development in China and India. Market structure on an exchange is an important part of the market component of any securities governance regime. So too is the nature of exchange governance, which involves associations, and networks as well as firm and state participation in shaping the market arena of the exchange. Both market design and exchange governance matter for equity issuers in terms of enterprise finance, but particularly in terms of

wealth capitalization. They also matter for investors in terms of shareholder protection.

The National Stock Exchange breakthrough was crucial to the development trajectory of India's constrained evolution SGR pattern. The National Stock Exchange opened in 1994. A year later, it was the largest stock exchange in India, as measured by trading volume. It established a competitive position against a powerful entrenched incumbent. The contribution of the NSE breakthrough to the overall nature of securities governance in India is hard to underestimate. It introduced competition, improved self-regulation, and a host of other changes to the conduct of securities finance in India. The politics of the breakthrough, and particularly the role of the central state and its interaction with various actors in the dominant coalition, form the basis of the case material. The analysis highlights the autonomy of the central state, and the relationship of coalition actors such as the Financial Institutions and India's "dependent capitalists" to the property-rights claims that could be made over equity securities in India.

Beijing's conquest of the stock exchanges was crucial to the development trajectory of China's discretionary involution SGR pattern. The Shanghai and Shenzhen exchanges were established in 1990. Governance of these exchanges was initially in the hands of the municipalities. But the exigencies of China's intramural coalition and the rigidity of state-socialist property rights made such an arrangement politically unsustainable. In the end, the establishment of state-of-the art exchanges with impeccable market structure design and technical infrastructure became part of an exercise in building an ever better casino in which "the house always wins."

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CHAPTER SEVEN

EXTENDING CONCEPTS AND ARGUMENTS: THE POLITICS OF BOND FINANCE

The analysis in Chapter Six solved the chief problem plaguing the study of securities finance in developing and transitional economies (DTEs): How do we untangle and map the identities and interests of actors involved in the development of securities finance? What and where are the political forces shaping the governance of securities finance in DTEs?[1]

The framework supporting that analysis, developed throughout this thesis, was used to show why and how very different regimes of governance for securities finance developed in China and India.[2] Chapter Six focused on the politics that shaped the governance regime for the equity asset-class – that is, shares of stock. However, the debt asset-class (bonds) is just as crucial to understanding the changing structure and balance of financial power as securitization spreads internationally and within DTEs.[3]

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[1] Chapter Five explained how varying profiles of external economic exposure (China, benign abundance. India, precarious scarcity) produced different interests and goals of central policy-making elites in China and India. Chapter six moved from effects of that international structure to the domestic political process by which central state elites in China and India pursued those goals in the development of regimes governing equities finance. That chapter offered some answers to these questions in the domain of equity (stock) assets using a matrix that distinguishes asset-classes (equity/stocks versus debt/bonds) and financial positions (issuers versus investors) to guide conceptually the "process–tracing" of political interactions in the 1990s stock-exchange-related changes that produced Indian "evolution" and Chinese "involution".

[2] This is an asset-class/financial-position matrix (AC/FP) that helps identify actors and interests in the often-opaque realm of securities finance. That framework is a new and unique contribution to the international and comparative political economy of finance.

[3] The global "equity cult" of the 1990s, the "Las Vegas and Macau" appeal of bright lights and brokerage trading rooms, and the glamour of "owning" companies have focused attention on stock markets. This is as true among academic researchers as it is among the global public and global business research industry. Even among academic political economists (who should know better), the equity-asset class has attracted the lion's share of attention in the study of securities finance in DTEs.

Who gets bond finance? And, under what conditions? Firms can use bonds. So too can governments.[4] The regime governing bond finance, therefore, shapes the fate both of firms at the enterprise-level and of subnational governments at the polity-level. Businesses, provinces, central state elites and the coalitions with which they deal are very concerned, therefore, with the character of the bond-finance governance regime.[5]

In this chapter I examine how the same variables and analytic framework used in earlier chapters can be extended to other domains.[6] In particular, with the global and domestic pressures described in Chapter Two driving growth and change in Chinese and Indian securitization, what shaped the regimes governing bond finance? How is political authority exercised in the governance of bond finance? And, toward what ends? Economic development? Political interest? Analyzing the politics of bond finance in China and India during the "securitization decade" of the 1990s can reveal much about these two countries' different trajectories of capitalist development.

Further study of this issue would be driven by a simple question. What freedom do businesses and provincial governments have to access bond finance?[7] To

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[4] Municipalities too are in many countries users of bond finance. In China and India some municipalities are practically on a par with the state- and province-level stratum of government. "Direct-supervision cities" (*zhixiashi*) in China include Beijing, Shanghai, Tianjin and Chongqing. In India "Union Terrirories" like Chandigarh and Delhi have a similar role. Municipalities in the states and provinces of India and China do access bond finance, but they do not enjoy similar constitutional or statutory taxation, revenue, and lending (using bonds or banks) that state or provinces do. This was changed somewhat by the 1992 74th Amendment to the Indian Constitution.

[5] As a reminder, I first explained how each country's profile of external macroeconomic exposure created a structural incentive of central state elites in the two countries. The domestic politics of securities finance unfold as those elites pursue policies and build institutions in accordance (as much as possible) with those incentives. I thus identify the process of the domestic politics securities finance as the struggle over access to securities finance and the property-rights implications of increasing reliance on securities finance (securitization). Increasing securitization through greater use of bonds by firms or governments intensifies the struggle over access to bond-based securities finance with the rival actors focused on these property-rights implications and the potential distributive consequences.

[6] The framework is the asset-class/financial-position matrix. The variables are: a) the country's profile of external economic exposure, b) state autonomy vis-à-vis the dominant coalition and c) the structure of property rights.

[7] Henceforth, the reader should take the word "province" as referring to state- and province-level, "subnational" units in both China and India. This sidesteps the awkward formulation "state and

the extent that this freedom is restricted, what are the reasons? Is it a particular ideology and orientation to economic development? Elite desire to control the organized economy? Or, is it political partisanship used to manage implicit coalitions or formal party coalitions?

Making general comparisons of bond finance governance is tricky because, as mentioned above, the secondary literature is thin.[8] Data is of poor quality and poorly organized.[9] But some empirics (quantitative and qualitative) are clear.

First, the quantitative empirics. Data on bonds in DTEs other than government treasury bills are notoriously fickle and unreliable. Nevertheless, the snapshot of bond finance in China and India presented below tells most of the story. Figure 7-1 illustrates that India has many more pieces of the bond finance "pie" (7 to China's 4). This means more options as well as more detailed and transparent accounting. The range of corporate bond issues in India is more diverse. China's bond market, like its equity market, is larger than India's measured in dollar terms. But there are fewer bond instruments, and those that are available are almost all state-sanctioned, controlled and guaranteed.[10] The figures and their implications demonstrate the market patterns of *scope* in India and *scale* in China. These patterns are the same as those presented in earlier chapters' discussion of equity finance.

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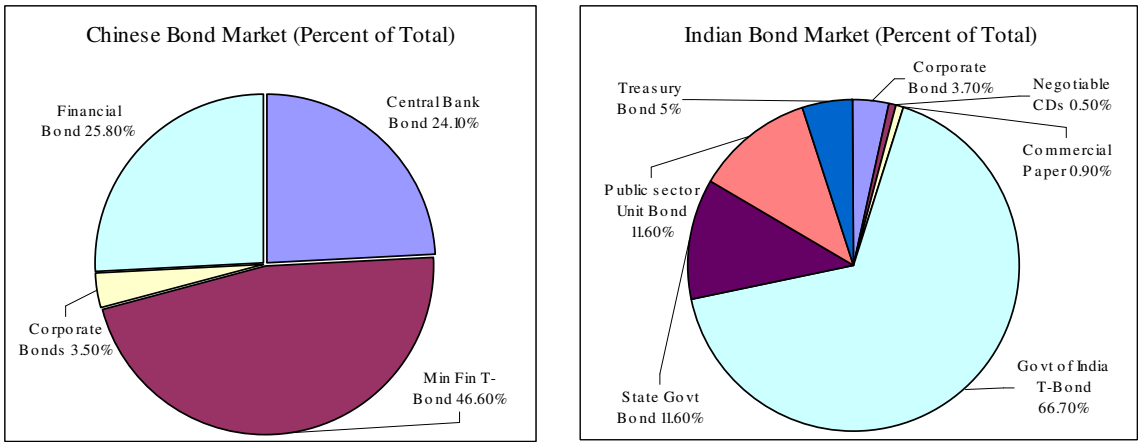
province" every time I refer to these subnational units. This will also prevent confusion between "The State" (meaning the central state in China, India and any other federal polity) and subnational "states" like California or Rajasthan in the US and India.

[8] It is dominated by papers from multilateral lending institutions like the World Bank and Asian Development Bank, or by investment professionals. They are speaking to one another and not a wider audience. Their assumptions and categories, particularly political ones, therefore go unexamined.

[9] No two sources I used for this research agreed even on the two most basic data points: 1) the size of corporate bonds relative to GDP, or 2) the size of state/provincial bonds to GDP.

[10] China's "Financial bonds" shown in Figure 7-1 are bonds issued by state-owned financial institutions such as the development lenders like its Export-Import Bank and China Development Bank, or by the four state-owned commercial banks. Corporate Bonds (*qiye zhaiquan* or "enterprise bonds") in China include the "transmuted bonds" that constitute Chinese provinces' indirect access to bond finance. Chinese Ministry of Finance Bonds are central bonds. Approximately half of the funds raised by these bonds (recently) has been handed over to provinces. "Public Sector Unit Bonds" are the bonds of central-government and state-government owned enterprises or "undertakings".



World Bank, 2004.

Figure 7-1:
The Structure of Chinese and Indian Bond Markets

These quantitative measures of market scope or scale tell us about the objective conditions of the market outcomes within the two countries. They don't tell us much about the quality of state regulation of these markets. What, for example, do outside experts have to say? How did they think and talk about Chinese and Indian bond finance? These are subjective opinions based on experience and the attention-focusing imperative of investing large sums of money in these markets. In Chapter Three I explained how the president for Asian operations of a top-three global investment bank himself used the business historian Alfred Chandler's idiom of scale and scope to contrast Chinese and Indian securities market outcomes. The clarity of the pie charts' presentation of objective conditions in Chinese and Indian bond finance is matched by the opinions of informed outsiders.

"Within the Asian region, India's bond market is clearly one of the strongest in terms of institutional infrastructure," explained the head of credit research for Asia at

another giant global investment bank. He singled out the country's broad investor base of local commercial banks, insurance companies, bond funds and mutual funds. "It's liquid, it's traded, and we ourselves trade this market." India's bond finance is not compared to China, where foreign investors were not even allowed in until very recently. It is more often compared favorably to much more developed countries known specifically as financial centers. "Many analysts agree", a 2000 report claimed, that "India's rupee bond market has more to offer foreign investors than some of its more-sophisticated Asian counterparts, including Hong Kong and Singapore" (Richardson 2000).

I. Bonds and Business: The Politics of Corporate Debt Securities

By constraining or encouraging firms' range of financing options, the structure of bond finance in a given country's securities governance regime helps determine firms' prospects of survival, expansion, adjustment or transformation. As with bonds in public finance, the regime governing bonds in corporate finance often serves a number purposes, including political interest of powerful political actors, elite control of the organized economy, economic development and financial stability, or the control of risk.

The comparison of Chinese and Indian corporate bond governance regimes is straightforward. Looking at the two fields of the governance regime discussed in Chapter Six – state and market – the same patterns outlined for equity asset (stocks) governance in the two countries are also evident in their patterns of corporate bond finance governance.[11] Consider first the role of the state and state regulation.

[11] Civil society, a third important component of governance, is not elaborated.

A. The State and Governance of Bond Finance

In Chinese governance of corporate bond finance, the central state has imposed a regime of outright discretion with an explicit distributive allocation of access to bond finance.[12] Unlike state regulation in the equity-asset class, even the pretence of supervisory or regulatory neutrality has been ignored. The main purpose of government regulation is to prevent access to bond finance by firms for fear those firms will abuse the system. The National Development and Reform Council sets quotas for the value of corporate bonds that may be issued. Officials authorize corporate bond issues based on the "merit" of the applicants, not on the basis of compliance with issuance requirements. Ceilings are fixed for the interest rate that can be charged on the bond.[13] Finally, guarantees from state banks of all corporate bonds are mandatory. This is hugely important, as mentioned below in the discussion of bonds and property rights.

In India, since 2000, state regulation of the bond market has been increasingly clarified and rationalized. Jurisdictional confusion and rivalry between the central bank and the securities regulator has been clarified and most disputes resolved in favor of the securities regulator (SEBI). Issuance of and trading (primary and secondary markets) for corporate debt has benefited from reform of government securities market structures. These have been increasingly pushed to become competitive, demand-supply matched, and transparent. As the government securities market is the larger

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[12] Of course the entire notion of "corporate bonds" in China is tricky in the first place. The distinction of "public finance" from corporate finance can be a hard one to make. As we saw in the discussion of provincial government bonds, it is state-owned firms that issue bonds for the purposes of "public finance". This is why the Chinese category "enterprise bond" (*qiye zhaiquan*) elides the distinction. Data reporting and transparency on Indian "Public Sector Unit" bonds as distinct from "corporate bonds" or "state government bonds" is yet another manifestation of the scope and evolutionary pattern of Indian bond governance in contrast to Chinese bond governance.

[13] These regulations each come from different sources showing that there is yet to be uniform regulatory coordination in Chinese bond finance governance. The regime of bond governance is so blatantly of a distributive interventionist nature that members of the financial services community in China regularly go on record in the financial press decrying the practices (Caijing 2001).

market by far, reform of its structure puts pressure on and creates a benchmark for the development of corporate bond-market structure. Again, the Indian state is playing a positive developmental role in at once nurturing change while pressuring private non-state parts of the securities finance system.

The political importance of bond finance is most significantly reflected in the location of issuance authority. In India, this is now clear, and it is in the hands of two agencies that are widely regarded as independent executors of procedural supervision and risk containment – the Reserve Bank of India and the Securities and Exchange Board of India.[14] In China, by contrast, the authority structure for CBs in 2002 looks much like the authority structure for equity finance did in 1992. Agencies well known for their political allegiance to (as opposed to autonomy from) the central elite's main governing institution – the State Council – manage all aspects of corporate bond finance.[15]

B. The Market and Governance of Bond Finance

The market itself, as I've explained earlier, is an important component of securities finance governance. In earlier chapters I introduced yardsticks that measure market outcomes in a hybrid of qualitative-quantitative indicators: Scale and Scope. Data from any part of the two countries' corporate bond markets make clear the contrast, whether it is firms' use of bond finance, or the operation of exchanges, or

[14] Before 2000 the central bank, with its concern over credit and money supply, had a say in these decisions. The Department of Company Affairs (later the Ministry of Law Company Affairs) also tried to grab some jurisdiction. Ultimately SEBI emerged as the as the lead agency with some formal recognition and authorities (represented it its right to regulate Debt Mutual Funds) and informally too (as the lead agency on the issuance and trading of corporate securities). Today, companies that comply with the relevant requirements (under the Companies Act or the Securities Contract Act) can freely issue bonds for listing or private placement. There are delays with approval, but approval is not discretionary.

[15] As discussed earlier, China's central NRDC sets a quota for corporate bond issuance, the central bank fixes the pricing, and the securities regulator gets to be the traffic cop, checking up on the desultory secondary market trading (to the extent that such instruments are traded, which is very little).

other trading mechanisms for bond trading, or even the technical parameters of bond market activity.[16] China has *scale*, while India has *scope*. In terms of monetary value, China appears to have greater scale. In terms of components of the market (the way the market works and the diversity of its pieces) India has greater scope.

Firms' use of bond finance is one of the indicators that contribute to the broad variable "market outcomes" that I use to characterize Chinese and Indian securities finance. Indian firms use bonds as part of their generally balanced approach to corporate finance.[17] Particularly large ones use a range of financial sources Use of corporate bonds in India has varied over time as the business cycle, reform cycles, and tax and interest rate regimes have shaped the relative appeal of bond finance for firms.[18] While it is still not a significant source of funds for Indian firms today, as Figure 7-1 showed, it is nevertheless an option, available on a transparent, procedurally regulated basis.

One peculiarity of India's corporate bond finance is crucial to understanding the interaction of state regulation and market structures that produces India's distinct governance regime pattern. This is the large amount of corporate bonds that are "privately placed".[19] Private placements are not regulated as rigorously as public

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[16] In the financial services industry and among financial economists the common indicators include: number of issues (India more), turnover (the number of trades – India more), interest rate variability (an important indicator of the market's evaluation of the firm that issued the bond – India more), and the variety of bond types. These we can consider measures of scope (though turnover could also be considered a measure of scale). Measuring scale¸ the standard measurement is the very gross figure of the value of "corporate bonds" relative to GDP (China greater).

[17] It is reasonable to exclude firms whose business it is to deal with finance such as banks, insurers, and non-bank financial companies including trust and investment companies and asset management companies.

[18] Indian financial firms (particularly the so-called All Indian Financial Institutions) are the largest users of corporate bonds.

[19] In a "private placement" a bond with otherwise normal characteristics (interest paying coupons, maturity etc.) is issued to investors. The bond is not a "public issue" and is for "investment" and "not intended" for resale (though there is no law prohibiting such resale). Typically private placements are sold to large institutional investors like insurance companies. Until recently data on private placements were poor. Even the Reserve Bank of India did not have a clear regular reporting on the amount of private placement. Today, private placement makes up over ninety percent of corporate debt issuance.

issues. Disclosure requirements and issuance procedures are minimal making them easier and cheaper for issuers and investors alike. The use of private placement raised disclosure issues and concern over the difficulty of collecting data on the activity. Most of all it seems to defy the "norm" (global and domestic) favoring transparent listed securities trading on an exchange. On the liquidity spectrum discussed in Chapter Three, private placements lie somewhere between a bank loan (less liquid) and a publicly listed bond (more liquid). This is a market outcome that serves the needs of both the issuers and investors in these securities.

The response of the Indian state to this activity is telling. Naturally, official commissions were convened and reports written. The state did not prohibit the activity outright, thereby *not* violating the securities-related "property rights" of both issuers and investors. While both financial and political officials saw the practice as an aberration, there were no legal grounds to prohibit it. At the current size of India's corporate debt market (roughly 3.3% of GDP) there was little system risk, and so little "public goods" justification for proscribing the practice (Gyntelberg, Ma, and Remolona 2005).

From all three sides of the governance triangle, the way the regime of governance for private placement developed is typical of Indian securities finance governance generally. Markets shifted as the actors in the primary market for bond finance – firms – substituted or intensified their use of corporate debt through private placement.[20] As the nature of the private placement phenomenon became clear between 2002-2004 the state did devise a regulatory response of surprising subtlety. Rather than prohibit or regulate private placement head on, it took an oblique route, giving private placement an inferior grade in the classification hierarchy of bank

[20] Firms "substituted" equity for private placement and listed debt for privately placed debt (Shirai 2004). This is what financial markets are supposed to do; provide substitution options.

accounting standards required by the central bank.[21] And, most interestingly, a private firm filled the need of the public to know the levels of this debt by buying the data from banks and selling it to financial and academic analysts.[22] The intensive use of private placement by firms in the market for bond finance; the response of the state; and the opportunism of a market-cum-civil society reaction – these together as an ensemble form a telling case of how Indian authorities permit market-driven outcomes.

Chinese firms don't use corporate bond finance. Or rather, as with equity finance in China, only a few Chinese companies use a lot of it. Corporate bonds represent roughly 10% of GDP.[23] In China, large firms still use inter-firm sources,[24] banks, and other state-allocated sources of funds. What can firms' uses of corporate bonds tell us about market development and market outcomes in China?

Sometimes the good-faith questions of economists can seem naïve to political scientists. Interested in prices and microeconomic efficiency, economists who investigate Chinese securities finance often seem bewildered by market outcomes that are expected and consistent with the political perspective presented in this thesis. For example, one expert analyzed Chinese listed firms' uses of external funds.[25] His

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[21] This outcome was the result of intensive arguments among elite financial technocrats (with occasional input from politicians) in the High-Level Committee on Capital Markets (HCLM). As discussed earlier in the thesis, the HCLM is the interagency committee that coordinates the state regulation of securities finance in India. Its members include representatives from the Ministry of Finance, Reserve Bank of India, Securities and Exchange Board of India, Ministry of Company Affairs, and the Insurance Regulatory and Development Agency.

[22] Prime Database did this, and was for several years the only source of data on private placements. Once the RBI required disclosure of private placement under the standards of Basel II bank risk provisioning norms, the data became available through the Reserve Bank of India (a possible infringement of the privacy and competitive position of banks?).

[23] In the US, for example, corporate bonds represent 128% of GDP.

[24] "Triangular" debt and trade credit in which firms owe each other physical inputs or accounts payable is very different from a bonded debt security (Lardy 1998). This observation of unusually high levels of "triangular debt" and trade credit among Chinese firms fits my theory that the state favors any alternative arrangements (however perverse) that help avoid or prevent the development of clear creditor-debtor relations, lest the rights of non-state (or rival intra-mural state) creditors be clarified.

[25] Listed firms are those that have issued equity publicly in shares of stock listed on an exchange.

results caused him to wonder, "Why do Chinese firms have such a low long-term debt ratio?" Firms (use and misuse) bank funds for short-term debt. Listed firms can go back to the equity markets with some ease. Equity does not come with the requirements of bonds (repayment, default risk). Rather than consider the possibility that corporate bond finance is a political *persona non grata* many [some?] economists offer the banality that perhaps the "Chinese bond market is still in an infant stage of development" (Huang and Song 2002 p. 22).[26]

II. The Comparative Politics of Bonds, Public Finance and Federalism

Governments use bonds in a variety of ways.[27] In this section I consider only the role of bond finance in central-provincial relations. This relationship between bond markets and the character of federalism and center-local authority is often overlooked. Analysis using the insights and analytic tools devised for this thesis might examine how the regime governing bond finance shapes, and is shaped by, the political-institutional dynamics of center-provincial relations in China and India over the last twenty-five years. The conclusions drawn from such an analysis [will?] challenge the conventional comparisons of China and India in current scholarly work on fiscal federalism.

A common theme running through this mainstream research agenda suggests that China is a *de facto* federal state (despite a strong constitutional emphasis on unitary governance) while India is in practice failing to achieve the federal ambitions

[26] This is common among mainland economists with a career or family to think about. But any with a memory going back to before 1993 when the corporate bond market flourished, will know they are dodging.

[27] Governments of all kinds finance deficit spending through the use of bonds. Governments also use bonds to manage the money supply. This important use of bond finance is not discussed here.

written into its constitution.[28] Developments in bond finance suggest otherwise, confirming the view of other finance-sector analyses that, formally at least, there has been a powerful, persistent, recentralization trend afoot in China since 1993. In India, the evidence from the structure of bond finance reflects the broader decentralization trends in that country throughout the 1990s.[29]

The degree of autonomy a province has in accessing bond finance and the space for initiative a province enjoys in accessing bond finance are, together, an important indicator how "federal" center-provincial power relations are in a given polity.

Federalism is, of course, not an either-or matter. Even where constitutions profess a federal structure (as in India) Federalism is a matter of degree and can vary across countries and within a country over time (as in US history). We can easily imagine a "spectrum of federalism".[30] Using "access to bond finance" as one key measure of where countries fall on the federalism spectrum, I would argue that *China clearly lies toward the unitary end* of the spectrum and *India toward the federal end*.

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[28] See, for example Montinola et al, (1994) on China, and Parikh (1997) on India. The literature regarding what formal and informal characteristics actually shape the unitary nature of China's system of center-local relations is still indeterminate. See, Nathan (1996) and Lam, (2004). However, the 1982 constitution (and all constitutions since the 1950s) is clear that there are no "rights" enjoyed by subnational political bodies. Subnational governments are the expression of "state (guojia) power." It is a stretch to claim, as Lam seems to, that this "state power" represents some sub-rosa expression of local sovereignty as understood in any interpretation of federalism (even Mao's interpretation of Federalism). A draft constitution from the time of the Jiangxi Soviet considered a federal system. See, Apter (1994).

[29] In 1992 the 73rd and 74th Amendments to the Indian Constitution gave formal recognition to the rights of rural and urban local bodies. In 1996 the fifty-year Congress Party dominance of electoral policy was broken, ushering in electoral federalism of regional- and identity-based political parties. Finally, the fiscal crisis of the state forced the center to play a smaller role in direct grants to the states. See, Echeverri-Gent (2002).

[30] Unitary states like France and Thailand would lie toward the "non-federal" end of the spectrum and Australia and Canada toward the federal end. Many variables determine the degree to which a country's center-local relations are federal. Language and cultural policy, law making and law enforcement, cross-border commerce control are some of the important other variables determining a country's degree of federalism.

This simple indicator – access to bond finance – is deceptively narrow and technical. Beneath it lie two roads: Along one road provinces may find opportunities for prosperity and increasing autonomy. Along the other lie opportunities for profligacy and dependence. Though seemingly narrow and technical, the autonomy and initiative of a province in accessing *and* using bond finance is determined by its "rights" within the polity, and its ability to make credible the bonds that it issues.[31]

This idiom of "provincial rights" is fundamental to the politics of bond finance and federalism generally. Should provinces have the "right" to use their revenue raising (tax) powers, their ownership of other assets (real estate, land, and often businesses), and their powers of persuasion to convince investors to buy their bonds? State governments are close to the action and know their dominion better than far-away central authorities. Should they not be able to make choices about how to develop through investment in infrastructure, education, or industrial production capacity? Naturally such freedom means they also have the choice to bankrupt their state if they borrow and are unable to service their debt or pay back principal. They may also fail to invest wisely, e. g. use the borrowed funds in ways that don't produce public goods or produce the means to pay back their debt.

In a now-widely-cited *World Politics* article Barry Weingast and his collaborators claim that China is now a *de facto* federal system. On the strength of this article and its sequel research this claim is now taken nearly as an article of faith in the China literature, and even in the broader comparative politics literature. In

[31] That, after all is why bonds are a form of "credit". That credibility is in turn related to the constitutional, legislative, electoral (in India) and bureaucratic institutions of fiscal federalism. Important also (often critically so), are the informal institutions and dynamics of fiscal federalism. Revenue assignment shapes the ability of a province to service the financial obligations of bonds (or helps state-sponsored or state-aided issue through guarantees). On the flip side, a province's expenditure responsibilities lay claim to revenue resources and other capabilities that would otherwise be available to "enhance" the credibility of the bonds.

contrast to China, Weingast has claimed that India, a *de jure* federal system, fails to meet its formal federal aspirations.

Weingast and his collaborators portray China and India as mirror images of each other and mirror images of each country's own *de jure* constitutional arrangements. Their arguments are based on an *economic* analysis of competition among (state-owned) firms and subnational governments at various levels. The near-hegemony of these controversial claims about a fundamental structure of political life in the world's two largest polities is puzzling. These claims seem impervious to new research on Chinese political economy since the middle of the 1990s research that has shown that there has been a recentralizing tendency in many sectors.[32]

The structure of bond finance in these two country cases discloses important untold stories of the current and past structure of center-local power relations in large multi-layered polities. Extending my argument about Chinese and Indian regimes of securities governance offers a clear and easily testable rebuttal to Weingast's comparative thesis. The evidentiary base for the rebuttal would be the nature of center-local (state- and province-level) relations in the domain of bond-based public finance.

Looking at the available evidence, the national patterns identified in equity securities finance seem again to be evident in on the governance of bonds in fiscal federalism: Chinese government bond securitization in the 1990s was producing *discretionary involution* and India's producing *constrained evolution.* If we look at the broad role of the central state in governing subnational bond finance the outcomes are clear. A schematic summary is presented in Table 7-1.[33] Provincial borrowing in

[32] See, particularly Gallagher (2002). For banking see Sehrt (1999) or Shih, (2002). For large state-owned enterprises and the petrochemical sector see Lin (2003). And, for labor see Hurst (forthcoming).
[33] So much of the activity in China happens informally that the World Bank researchers had to leave much of the Chinese case empty.

China is legally prohibited, but allowed in India. [34] In India, permission is not necessary under all conditions, but is required under current conditions and for the foreseeable future (i.e. state indebtedness).

There is no doubt that China's political economy during the 1990s experienced great dynamism and loosening. Whether this lead to an informal regime of federalism is another matter. Regional economic growth accelerated and with it economic independence expanded. Much of this had to do with low-level developmentalism, the so-called "local-state corporatism," and municipal, provincial and regional economic dynamism. Tax sharing arrangements were decentralized, as were credit provisions and industrial policy. The 1994 provisions for tax sharing reshaped the structure of revenue assignment in China. However, in the mid-1990s the inflationary and other disruptive effects of this opening process provoked a centralizing backlash.

In Chapter Six I discussed how the greedy rivalry between Shanghai and Shenzhen in the period between 1992 and 1996 was destabilizing for China's financial and political systems and was introducing dangerous levels of risk through financial leverage. Favoritism in equities finance access leading to excessive promotion of local companies was another problem. The center, of course, feared a repeat of this behavior in state-level bond finance. They had had a taste of it with the flourishing of enterprise bond finance that eventually lead to dangerous excess provoking a stern reaction. But, the immediate motivation of reigning in the emergent economic disorder obscured another motivation.

[34] In China, the "work around" system of "transmuted bonds" is the route through which provincially-owned firms issue bonds for "their" province. These bonds thus become "enterprise" or corporate bonds (see Figure 7-1). They therefore require all the same permissions discussed earlier in the section on corporate bonds, which is to say that there are powerful political constraints on the permission to issue bonds.

Table 7-1:
Regulatory Framework for Sub-national Borrowing

	Allowed?	Sub-national Borrowing Controls /1		Institutional setup for capital market access	Numerical or other constraints on borrowing?	Constraints on the use of loan proceeds?	Is borrowing approved by the center?
		Domestic	Foreign				
China	Formally, no	Prohibited	Prohibited	Commercial banks or financial institutions set up by local governments to raise money for investments.			
India	Yes	Market/ administrative	Prohibited	States can borrow from the central government and from the market	No	No	In case the state is indebted to the center, states can only borrow from the market if it is approved by the center. All states are in fact indebted to the center, so in effect there is a strong central control with borrowing.

Source: World Bank. Qualitative Indicators: Regulatory Framework for Sub-National Borrowing

China's central elite had reasons other than financial risk and economic disorder in mind as they developed a highly centralized regime of government bond finance. The center was concerned about what would happen if sub-national economic authorities began to translate their economic independence into political independence. One official told me that, "autonomy in province level finance would lead us down the road of the former Soviet Union. Disintegration. Through a step-by-step process provinces and municipalities," he added, "would slowly develop an independent political identity. Also, we would be unable to manage regional inequality."[35]

Outcomes in the market for provincial bond finance governance fit the country patterns In China. Rather than let provinces borrow for themselves, the center issues bonds and then hands over the money raised to provinces.[36] This means the government is the only issuer and faces no competition from state borrowing. This serves two purposes. It prevents state borrowers from becoming financially autonomous. It also prevents profligate states from spreading "poor credit" contagion to other provinces or even the center.[37]

Indian states increasingly use bond finance directly or through the "public sector undertakings" that they own in full or part; so much so, in fact, that many states built up crushing levels of debt. This is the downside of federal autonomy and initiative (and a negative example Chinese interlocutors pointed out to me).[38] This

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[35] Confidential interview, Beijing, 2000 #20.

[36] About half of the annual central domestic bond borrowings (not including central bank bonds) are given to provinces (Cui 2003).

[37] The 1998 failure of Guangdong International Trust and Investment Company (GITIC) did precisely this. Fujian International Trust and Investment Company, a solvent and well-run concern, suffered calls on its debt and the skeptical regard of investors in what became a contagious, "guilt by association" dynamic. Chinese central authorities are fastidious about their own credit rating, going so far as to issue sovereign bonds even when the money is not needed, just so they maintain a recent "benchmark" for their credit.

[38] Critics of Indian federalism argue that this excessive state-level debt is the consequence of soft-budget moral hazard. According to this view, state's believe they will be bailed out by the center and therefore do as they please. However, even so, profligate states know they will not be bailed out rupee-

profligacy is not without costs. In the past, under the patrimonial phase of India's Nehruvian developmental state (with its unitary tendencies), state-level governments might have believed there were few costs to being an irresponsible debtor. However, this is changing. Today, states can sell up to 35% of their bonds at a competitive auction, paying interest rates as low as the market will bear.[39] More dramatic still is the hardening of budget constraints in the market itself. First, states are now rated by credit rating agencies that are willing to give bad grades to irresponsible borrowers.[40] A second order consequence is that in bond trading on the secondary market poorly rated, riskier states' bonds are suffering.[41]

To the degree that Weingast is correct about the economic vigor of "local state corporatism," competition and experimentation in product, service, and labor markets in China, I would argue that there is an *even* greater political imperative for China's single party state elite to maintain central control of money and finance. Weingast and his collaborators see states and markets in a zero-sum rivalry. They do not consider the possibility that the Chinese state is *using* the financial markets they create for their own ends. This is a form of "internal mercantilism". Markets are just one "tool" the central elite uses among others such as economic growth, nationalism, the legal system, and *force majeur* to maintain political and economic control in the country. Central dominance of bond finance – particularly public finance – is evidence of this.[42]

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for-rupee and the moral hazard arguments are often overwrought. Recent policy initiatives laid out in the Twelfth Finance Commission Report harden budgets and will change the incentive structure facing states.

[39] Soon, states with fiscal responsibility track records and legislative constraints will be able to issue all their bonds this way.

[40] As happened to even the mighty state of Maharashtra in October of 2002.

[41] These premia are measured by yield to maturity rates and indicate that an issuer is a higher risk and therefore that its bonds should be cheaper to buy. For example, the state of Orissa, a poorly rated, bad credit risk faces a higher risk premium than does Karnataka, which has an A+ rating from the Indian credit rating agency CRISIL (Shivkumar 2000).

[42] The center's recapturing of control from localities of the soft budget discretion in state-owned banks in the period after 1994, would be other proof.

The broad regime of bond finance in China does not seem federal. It appears highly centralized. And the reasons are much the same as those that explain the central control of equity securities finance. On the property right's side, greater autonomy and initiative in provincial access to finance would establish a provincial right to access bond finance. It would also create creditors who might make claims against provinces; claims that might rival the center's claims. On the state autonomy side of my analytic framework, greater provincial freedom and initiative in accessing bond finance would also challenge the center's ability to control the flow of credit in ways that help it to manage the "intramural coalition".

Weingast and his collaborators claim that "federalism, Chinese style" is the "political basis for economic success in China". Similarly they claim that insufficiently federal center-provincial relations are the basis of Indian economic failure. They are answering an economic question: What is the basis of Chinese (or Indian) economic success (or failure)? But, they rely on an inadequately conceived political variable – "federalism, Chinese style". Extending the research begun in this thesis, I ask instead a political question: What is the institutional basis of political authority in the economic life of China and India? My answer for China, phrased in the idiom of Weingast and his colleagues, is that 'central political discretion in securities finance' is the basis of a 'unitary state, Chinese style' in the contemporary People's Republic. My answer for India is that 'constrained political dispersion' is the basis of 'evolving formal and informal Indian federalism".

III. Conclusion

The state is present and active in regulating corporate bond finance in both countries, in the same ways we saw in equity finance. Toward what ends is state

authority over bond finance directed? How is that authority used? As described in the preceding discussion, an analysis of some evidence observed in regulatory structures and their effect on market outcomes reveals different state objectives in the two countries with respect to the governance of corporate bond finance.[43]

In China, state regulation of securities finance assures that securities markets can be manipulated by the central elite in an instrumental fashion. The objective is economic growth, creation of an additional instrument for state management of economic activity, and (most importantly) preventing the growth of a creditor class or any substantial corpus of non-state creditors. Early analysts of Chinese securities finance were wrong in their assessment that stock market development was a dire threat to the CCP state (Bowles and White 1993; Schell and Lappin 1992). It was not shares that challenged the ownership system and property rights system most fundamentally. Segmentation and state dominance of the stock exchanges and equity ownership took care of that. It is corporate and local government use of bond finance, and the related issues of bankruptcy and creditor rights that are the major challenge. The Chinese developmental state is reproducing instruments of distributive intervention in the public finance and corporate finance uses of bonds. This pattern of *discretionary involution* recreates the old directed-credit system of finance by facilitating discretionary allocation of access to finance through bond securities (of governments and enterprises).

In India, state regulation of bond finance is moving toward procedural supervision. The objective is to create markets that provide diversity of choices and greater autonomy to firms and subnational governments. The Indian pattern of *constrained evolution* is again seen in bond finance for firms and subnational

[43] I have focused here largely on the property rights variable in both countries and on China's coalition politics. More can and should be said about coalition politics in India.

governments. The developmental state shifts toward procedural regulation and a mode of supervision.

When applied to bond finance, the argument and framework presented in this thesis can be extended to provide comparative insights into the politics of bonds both in government-business and inter-governmental relations (particularly federalism) in China and India. As with equity so too with bonds, the framework devised in this thesis, and the variables it has identified, can be used to extend comparative political analysis to securities finance in other developing and transitional economies (DTEs).

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Chapter Eight

CONCLUSIONS

I. Summarizing the Evidence

In chapter five I argued that the contrasting conditions of Chinese and Indian profiles of external exposure produced very different political incentive structures from which central-state elites derived their preferences for how to deal with securitization. Within these contrasting conditions they fashioned the political strategies they would use to manage the coalition and property rights struggles produced by increasing securitization. India's external profile of precarious scarcity produced an acute political imperative for Indian policy makers to reform the structures of governance within the securities sector in order both to improve domestic financial allocation (to promote industrial investment and pressure obstreperous banks) and to attract foreign currency in the form of portfolio investment. Chinese policy makers faced no such imperative of adversity. The Chinese profile of benign abundance produced a distinct range of liberty. Institution builders instead were left with a large margin to maneuver in the development and regulation of securities finance. Chapter 6 then presented a case study of how central-state-elites formulated and executed strategies to pursue these preferences in the domestic context of each country's prevailing coalition politics and property rights structures. Changes in the design and governance of these countries' stock exchanges were one area where evidence on the development of the central states' strategies could be found and traced with the guidance from the asset-class/financial-position matrix.

Empirically, these chapters together provided evidence for the claim that China and India responded very differently to the process of securitization. In the Chinese case, the congruence of international economic felicity and a relatively constrained central-state operating in a rigid state-socialist property-rights structure determined the impact of the dual imprint on China's securities governance regime. Domestically, the relative lack of central autonomy in conjunction with the rigidity of state-socialist property-rights sculpted the discretionary involution of China's securities governance regime in a number of ways. These conditions obliged the state to service the distributional political imperatives of provincial, sectoral, and popular support (by those employed in the SOEs). They circumscribed the degree to which the state could "harden" the claims of investors in financial assets, creating a bias in favor of the issuers of securities. And, finally, they forced the state to limit non-state and sub-national governments' access to bond-finance (not discussed here). Thus, the Chinese combination of economic opportunity and political constraint produced a regime of securities governance exhibiting significant formal change. At the same time it encouraged the central state to reproduce the old system of state-controlled discretionary financial allocation through an issuer-biased manipulation of securities-related property-rights. That was discretionary involution.[1]

In the Indian case, the congruence of economic adversity (the precarious scarcity EEP) and relative state autonomy was critical to the dual imprint's impact on India's SGR. This Indian combination of economic constraint and political opportunity shaped a regime of securities governance exhibiting substantive changes.

[1] China scholars have done a poor job explaining the "weaknesses" of the China's "strong" central state. Using the guidance provided by the asset-class/financial-position matrix, the process-tracing presented in the China case materials throughout this thesis has begun to illustrate how struggles over the nature of financial governance involve local level governments (or regional and sectoral authorities) – which are, of course, also parts of the state structure – more than "interests in society." We do not have to give up our general belief that the Chinese state (as a whole) is more insulated from societal interests than is the Indian state; but we do have to realize that the Chinese state cannot insulate itself from its own internal contradictions or countertendencies. Once understood properly as internally- or self-generated, the constraints on the Chinese state's central policymakers referred to here are not so surprising.

These reversed the "dependent capital" system of Nehruvian socialism and began to evolve new means of allocating finance and controlling property rights.[2] This was constrained evolution.

These contrasting responses to securitization do not fit well with the globalization theories popular in the 1990s. These theories posited convergence among countries' market and regulatory institutions, and expected this convergence trend to be strongest in sectors such as finance where cross-border activity was easy, and in which the volume of transactions was high and rising. Some formal indicators discussed here, such as trading practices and market growth present an appearance of convergence; but in terms of substantial institutional and market outcomes, the two countries' systems of securities finance developed in very different ways over the 1990s. This diversity of governance regimes amid the convergence in the forms of securities finance is summarized in Figure 8-1.

Three conclusions may be drawn from these empirical findings. First, at the very least, the evidence presented here suggests that the deductive expectations and empirical assertions of these globalization arguments are probably exaggerated, and certainly inconclusive in the near term. Second, the thesis also shows that, in contrast to the scholarly depiction of China's authoritarian system as superior to India's democracy in the reform process, in the area of finance, Indian and Chinese reform patterns are mirror images: reform *with* substantive change in India, reform *without* substantive change in China. India's securities sector reform has out-performed relative to other Indian sectors and relative to Chinese securities reform. Chinese securities reform has under-performed relative to other Chinese sectors and relative to Indian securities reform. Third, the research presented here extends the empirical base

[2] The result is a remarkable forced march in which the development of a "world class" securities market was compressed into ten years, an achievement remarkable in any country, and particularly remarkable in India, a political economy well known for slow and incomplete reform.

for arguments that consider financial organization and reorganization to be important circuits of social power. In China securities finance was reconfigured to preserve the state's dominant position in the society and economy. In India, the central state prevailed over organized interests and its own institutional legacy to reshape securities finance in order to address a potentially fatal threat to state stability and legitimacy.

Table 8-1:
What is Securities Finance For?

	China	**India**
Diversity	State control of firms Coalition management - SOE life support *Not* allocative efficiency - Socialist social contract Expression of property rights - Calibrate changing property rights? Not for avoiding high opportunity costs of closure in finance (serial 1990s financial crises lowered those perceived costs)	Manage balance of payments - Attract foreign exchange Improve allocative efficiency by: - Pressuring banking system - Improving enterprise finance Improve corporate governance Not for avoiding high opportunity costs of closure in finance (serial 1990s financial crises lowered those perceived costs)
Convergence	Modernity and statehood in world society Enterprise finance (but for different reasons in each case) *Some* acceptance of the ideas (episteme) of neoliberal economic doctrine	

The remarkable success of the Chinese economic growth in 1990s led many outside analysts of Chinese political economy to regard the professed commitment of that country's leadership to a "socialist market economy" as duplicitous or at least

unintentionally ironic, believing the Chinese economy headed toward an essentially capitalist end point. The argument in this thesis is that the Chinese leadership's commitment to the "socialist market economy" is very real, and has been astonishingly successful – even in the era of securitization – in precisely the way Hilferding suggested. That is, the commitment to the socialist market economy is based on a *state*-socialist model of the economic system in which the party-state maintains a dominant role based on its control of finance. Though there is a strong urge to discount the propagandistic posturing surrounding the official aspirations to a "socialist market economy," the evidence presented here strongly suggests that in the case of securities finance, as elsewhere in finance, this is precisely what has happened. Moreover, considering the documents and policies presented earlier in tracing the progression toward the regime of discretionary involution, it is evident that the *functional consequences* of that regime were largely the result of pre-meditated political intention, even if the details and specific content of that outcome were contingent results of strategic interaction between the central state and intramural coalition members within the structure of the state-socialist property rights regime.

Establishing the discretionary involution system of securities finance was, for the Chinese, a remarkable achievement in that the central-state succeeded in squaring a circle. The CCP state managed to reproduce a directed credit-system of economic governance within a realm often considered to be quintessentially capitalist and resistant to state control – securities finance. This is something many developing and transitional states might like to do. But, few enjoy China's uniquely advantageous economic position in the world economy and are therefore unable to do so. From today's perspective, the conclusion of China maven Orville Schell regarding this aspect of Chinese securities finance in the early period (circa 1992) is striking as a historically precocious analysis. "China," wrote Schell, "may have succeeded in breathing new vigor into its system of one-party rule by cloning capitalist institutions

into its mutant system of socialism. While it seems probable that in the long-run these institutions (of securities finance) could help destroy the Communist Party's grip on the Chinese government, in the short run they have had the paradoxical effect of strengthening the party and prolonging its survival" (1992, 738).

II. Analytic and Conceptual Innovations

At a theoretical level, the thesis highlights the political consequences of the securitization shift for state authority in the economy, arguing that the old regimes of directed-credit, 1) enhanced state discretion in the management of distributional coalitions; 2) facilitated the perpetuity of poorly specified property rights; and 3) mitigated the consequences of the country's position with respect to external trade and investment. The development and regulation of securities finance is politically and institutionally demanding, provoking struggles over the property rights implications of securitization within the dominant political coalition, encouraging a shift in the way state authority is exercised in the economy, and requiring the capacity for procedural supervision in place of the developmental state's old institutions of distributive intervention.

The thesis makes several analytic points that contribute to our understanding of globalization, market development, and comparative politics. First, I accept that global forces encourage convergence in market forms and policy institutions. I further agree that the opportunity costs of access to transnational capital flows and the improved allocative efficiency that securitization offers (domestically and internationally) are a crucial background force that set in motion the changes I observe in Chinese and Indian securities finance. However, states, particularly large and stable states like China and India, are not passive price-takers in the globalization game. During the 1990s, the perceived structure of opportunity costs for Chinese and

Indian central-state-elites did not uniformly favor of openness in domestic and international securities finance. The ideas and practices embedded in particular forms of economic action, such as securities finance, do have independent effects. This is what I've called "the global script." But, technology, market forces, and norms do not operate only through price signals and coercive-competitive isomorphism.

Second, in a conceptual modification to the common understandings of globalization based on techno-market and sociological explanations of how global forces promote convergence in market forms and policy institutions, this analysis of securitization suggests that even while the script may exercise its own independent convergent logic, there are also a range of different ways in which market forms and policy institutions can be used domestically. Powerful local actors *enact* that script, modifying it to suit their political objectives and to accommodate domestic conditions like coalition politics and property rights. The securities finance script – a defining element of contemporary global finance – is thus a code that guides (but does not determine) the ways in which countries build or reshape the regimes that govern economic action in the large organized industrial sector of their economies.

A. From Strong Thumbs to Nimble Fingers: Reconfiguring State Authority

Financial economists evaluate cross-country variations in financial structure with an interest in how those variations affect allocative efficiency. A political approach to financial structure should ask what are the implications of various financial structures for the exercise of state authority in the economy. Proponents of various theories of "market transition" impute a universal, unidirectional logic to the expansion of markets that (they believe) should transcend the local, geographic, cultural, and institutional specificities of individual countries. Examining both the democratic, private property-based Indian system, and the once-fully socialized, party-

state-controlled PRC system in the same analytic perspective is an important way of evaluating such theories. The analysis in previous chapters bears on the argument that market growth leads to the retreat of the state.

The example of India's constrained evolution regime of securities finance indicates how important the state can be in cultivating the market development and the exercise of new forms of state authority in the economy. The example of China's discretionary involution indicates how market growth can be accompanied by the expansion of state power and discretion. The identification of these two patterns in the Chinese and Indian responses to securitization confirm the value of comparative sectoral (or factor) analysis, reminding us of the dictum that, while local market penetration may indeed favor "direct producers" vis-à-vis the state, financial development may often favor authority holders whoever they may be (Szelenyi and Kostello 1996).

In the early 1990s mainstream economists and those inspired by them in economic sociology considered the proposition that marketization empowers non-state actors at the expense of the state to be self-evident. For example, economic sociologist Victor Nee argued that in transition there is a zero-sum, unidirectional process in which entrepreneurs' and consumers' power waxes as the state's power wanes (Nee 1989). This is partially true, and overly simplistic. The problems observed in the Russian experience, in particular, provoked some serious reconsideration of this proposition. What these views ignored was that the process of delegating allocative power to markets and market actors requires the construction of a new institutional environment (Fligstein 1996). Analysis of economic transitions is now more nuanced in its characterization of the interaction between marketization and state power. Disagreeing with Nee, his colleague in the field Andrew Walder pointed out that there may be a middle zone of positive-sum interaction between states and markets, and that in transition, political actors undertake to structure economic

institutions in ways that both facilitate and constrain markets (Walder 1996). The research presented here bears out Walder's claim, and suggests that it is important to recognize that *there is significant variation across types of markets* in this regard. That is to say, state-market relations vary by sector or factor in important ways. The first move in introducing this nuance is to recognize that in many sectors, and particularly in finance, the alleged retreat of the state in DTEs may best be understood as a *reconfiguration* of state authority in the economy.

The Chinese and Indian responses to securitization analyzed in previous chapters raise an important question about how developmental states exercise authority in the economy in the era of securitized finance. A securities governance regime is not merely the sum of its parts (state, market, and civil society). Moreover, the governance of securities finance affects the rest of the economy and society both in the financial and real sectors. Those effects operate in a number of key areas including the process of privatization, the structure of industrial organization, the conduct of economic adjustment, firm-level organization (including "corporate governance"), fiscal policy, monetary policy, federalism, and the degrees of economic inequality and volatility. In this section I begin to move beyond the question of why Chinese and Indian securities governance differed in the 1990s, to the questions of how and why state authority in finance is exercised in different ways.

By encouraging the expansion of markets in areas such as securities finance, China and India face a contradiction. More flexibility in financial markets will decrease obstacles to entrepreneurship and efficient allocation of resources, helping to spur growth and innovation. These potential benefits to general welfare must be balanced against the costs of potential "public bads" that these changes may also bring. Along with their salutary effects, greater financial openness and flexibility also introduce the possibility of dangerous failures in the financial sphere such as fraud,

scams, and crises (particularly boom-bust-crash cycles).[3] The experience of recent and historical financial crises suggests that the frontiers of financial activity can be unpredictably volatile, and seem always to extend beyond the regulatory capacity of even the most capable states.[4]

The messianic view of securitization emphasizes growth and innovation. Advocates of securitization focus on its contributions to productive and allocative efficiency gains that may be vital for countries' long-term welfare prospects. The commodification of finance via securitization holds out the promise of efficiency gains through wealth realization in asset capitalization and through the less costly and more competitive allocation of finance, ownership, and control. For the first reason (allocative efficiency and faster growth), some analysts and countries applaud securitization and seek to promote it (as in the UK, US, and Singapore).

The skeptical view of securitization emphasizes equity and stability. Critics of securitization focus on two potentially related characteristics of securities finance – inequality and volatility – and the threat they pose to the social and political bases of countries' long-term welfare prospects.[5] First, consider the issue of inequality. The tendency of securities finance to facilitate the accumulation of wealth and power through the concentrated control of financial assets increases the likelihood of growing inequality.[6] Second, consider the issue of volatility. Swift changes in market conditions, or outright market failures in finance (such as financial crises) disproportionately affect weaker and poorer members of society.[7] For these reasons

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[3] In the category of crises we should count the sequences of events that Kindleberger (1978) and Minsky (1982) both consider close to inevitable in financial markets – " mania, panic, crash"

[4] I have in mind the Latin Debt crisis and the U.S. Savings and Loan failure in the 1980s, and the Peso crisis, Asian Flu, and Russian crisis of this decade.

[5] Fraud and scams fall under the category of inequality because it is typically wealthy actors with special knowledge and access who undertake such activities.

[6] These were discussed in Chapter 2.

[7] For those living in marginal conditions, even small negative movements in the purchasing power of their wages, the loss of savings or fixed income payments (such as pensions invested in securities), can have large consequences for their living standards. These dynamics may be further exacerbated when such changes are sudden, offering little time to adjust.

some analysts and countries are wary of securitization and seek to constrain it (as in Germany and France). Critics of securitization also add that the dangers of volatility and concentration may be even more acute among "young" markets such as those in many DTEs.[8]

The controversy between these rival messianic and skeptical views of securitization is a magnified expression of the universal problem that Polanyi identified with respect to the expansion of markets generally in the modern era. That expansion, he argued, posed a paradox. The expansion of markets introduces a tension between the welfare goals of social stability and economic growth. In a statement that could easily serve as the summary epigram for East Asia's experience in the 1990s, in which the "Asian Miracle" was followed by the "Asian Crisis," Polanyi remarked that while markets seemed to increase productivity, failure to properly regulate their operation threatened society as surely as did "floods and droughts in primitive society" (1957, 76). The simultaneous "double movement" toward markets *and* toward regulation was the outcome Polanyi foresaw. His framing of this market paradox has been elaborated upon in the contemporary consensus that market capitalism is good at production but bad at distribution (Barber 1995).

The promise of increases in economic efficiency from marketized finance relates to a central question in the theory and periodization of late economic development: The relative importance and institutional challenges of generating "extensive" and "intensive" growth. These challenges can be thought of as a contrast between "the Gerschenkronian growth dilemma" and "the Kaldorian growth dilemma."[9] The resolution of Gerschenkronian growth dilemmas requires institutions that facilitate the capital accumulation required for large investments in heavy industrialization. The centralized state and directed-credit political economy systems

[8] For a thorough study of this see, Owen et al (2000).
[9] This distinction comes from Waldner (1999).

of late developers were a historical solution to this dilemma. The resolution of Kaldorian growth dilemmas requires institutions that facilitate innovation and efficiency gains, increasing micro- and macro-level productivity, and advancement up the product cycle. A variety of solutions to this dilemma have been tried historically, but the most common have been export competition in world markets, and the increasing use of competitive capital markets to reward or punish firm-level innovation and productivity.

In the past China and India (like many other DTEs) relied on distributive intervention to resolve the Gerschenkronian growth dilemma that was most acute in the post-World War Two period when heavy industrialization was a priority. Today, as these countries move up the product cycle they increasingly face the Kaldorian growth dilemma confronting them more starkly than ever with Polanyi's market paradox. To improve productive and allocative efficiency they must rely increasingly on markets. At the same time that they are building these markets, often from scratch (as in China) or from an archaic legacy (as in India), they must also regulate them. This is why we so often see cycles in which periods of exuberant and unruly growth are followed by periods of severe constraint. Balancing the potential benefits and costs of an increasing reliance on the securitization that will help address the Kaldorian growth dilemma is the challenge now facing developmental states in the era of securities finance. The central role of securities finance in a country's economic life – as the source of investment, and the arena in which ownership and control are determined – makes it the ultimate battleground in the contest to determine the trade-off between economic efficiency and equity-stability.[10]

[10] The priority that the Chinese and Indian states seem to be giving to stability in the process of financial reform reflects an intuitive recognition on their part of Polanyi's dilemma and the "double movement." Such recognition is evident in both countries persistent policy bias favoring capital control and urban employment.

The economist Charles Lindblom attended to these dilemmas in his comparison of economic systems. Recast in my conceptual idiom, Lindblom's analysis draws a distinction between what he calls "authority-based economic systems" governed by what I call "distributive intervention." These systems are good at resolving Gerschenkronian dilemmas. Lindblom's contrasting "market-based economic systems" governed by what I call "procedural supervision" are good at resolving Kaldorian dilemmas. In one of his typically colorful formulations, Lindblom, writing in the mid-1970s, characterized the difference thus:

> If the absence from authority systems of specialized devices for rational calculation and economic choice, as well as for fine-tuned incentives (all of which can be found in markets), makes the hand of authority look like all thumbs, no figures, the thumbs are nevertheless powerful. And they're strong enough…to account for the high growth rates of communist systems and for Soviet achievements in space technology. They are strong enough too to account for such diverse accomplishments as, on the one hand, China's health care system and, on the other hand, massive feats of American worldwide military organization in World War Two (1977, 75).

In Lindblom's formulation there is a clear yet crude distinction between the statist, hierarchical "hand of authority″ with powerful thumbs, and the decentralized, horizontal "hand of markets" with nimble fingers. Such a formulation implies that authority is absent from market systems, which is obviously not true. The analytic challenge is to identify what distinguishes the type of authority powering strong thumbs from the type of authority enlivening nimble fingers. The different Chinese and Indian securities governance regimes provide an empirical base from which I induce contrasting ideal types of state authority in the economy: *distributive intervention* and *procedural supervision*.

The defining characteristic of the type of state authority operating in hierarchical, strong thumb solutions to the Gerschenkronian development dilemma was *discretion* with regard to state *intervention* to *distribute* economic resources or

gains: distributive intervention. The defining characteristic of the type of authority operating in decentralized, horizontal, nimble fingers, solutions to the Kaldorian development dilemma was the capacity to supervise the procedures and rules that constrain and regulate economic activity among independent and competitive actors in the market: procedural supervision.[11]

Change (or lack of change) in the nature of state authority, as evidenced in its exercise over securities finance has been a large part of the dependent variable in this study – the securities governance regime. I have been looking for the emergence of a governance regime in which the role of the state is characterized by a "supervisory" mode of political power (Foucault 1979 (1978); Mitchell 1991).[12] The essential difference between a distributive -interventionist state and a procedural-supervisory state turns on where economic decisions are made.[13] The authoritative mode of procedural supervision is based on establishing and enforcing rules that define the arena within which market actors make decisions. Procedural supervision operates in a monitoring capacity that seeks to increase transparency in markets, and enforce exogenously determined rules and constraints.[14] Political economists commonly think of dismantling a state's regulatory and distributive functions as leading to a lower requirement for state capacity. But deregulating in a transitional economy requires *re*regulating under a different form of political authority.[15] The design of domestic

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[11] This formulation commits me to Krugman's view of the "ICOR debate" that the "Asian Miracle" was a Gerschenkronian development dynamic driven by persistent capital investment, not by innovation and technology driven efficiency gains (1999, 21-37).

[12] Foucault's French term *surveiller* has infelicitously been translation as "discipline" (Foucault 1979). State action in the surveillance mode therefore has no natural English term. "Supervise" is the closest English usage I have found.

[13] It is easy to draw an artificially distinct line between regulatory behavior and decision-making. In securities regulation, for example, margin requirements, credit provisioning requirements, and even settlement schedules can easily shade over into the domain of allocative decisions.

[14] This is akin to James Scott's notion that the authority of the high modern state is based on producing "legibility" within society and economy (Scott 1998). However, in his typology, many high modern states were also *dirigiste* distributive interventionists.

[15] Recent research suggests that deregulation, even in advanced market economies, requires larger states, and greater state capacity (Rodrik 1996) Vogel 1996).

capital markets and their cross-border links are an important part of this *re*regulation process. The form of political authority is embodied in the institutions that govern the newly designed markets. Operating as a complement and restraint to markets demands more capacity of state and civil institutions than does the mere replacement of markets by planners.[16]

In order to enjoy the increased potential for allocative efficiency that markets offer, large measures of freedom (entry and exit), predictability, and "transparency" are necessary. Regulation and the rule of law can help ensure the provision of these conditions. Regulation can also mitigate the effects of volatility and limit the excessive concentration of economic power that are both common tendencies in securities finance. To achieve these goals of preventing market failure, containing volatility, and curtailing concentration, rules and constraints must be enforced. The procedural supervision mode of state authority in the economy can thus be defined as the monitoring and enforcement of rules and constraints that diminish market failures and preserve an exogenously determined trade-off point between equity-stability and allocative efficiency. From this perspective, the politics of regulation is this *exogenous determination* (the political process of adjudicating the economic efficiency vs. equity-stability trade-off point). The political process of determining this trade-off point has a high normative content shaped by the power, ideas, and culture of those involved in that political process. However, once the trade-off point is established, the implementation and enforcement of the rules and constraints devised to maintain that trade-off can be carried out by a capable and autonomous set of governance structures in a process that has a low normative content. Those governance structures

[16] John Echeverri-Gent uses the term "procedural regulation" in much the same way as I use procedural supervision (Echeverri-Gent 1998). I prefer *supervision* instead of *regulation* because the expression regulation has been used to refer to state and non-state action in the economy ranging from highly intrusive distributive behavior such as price setting in the U.S. airline industry before the 1980s, to completely non-intrusive monitoring such as verification of truth in advertising. In contrast to such a broad range of meaning, supervision more specifically connotes an absence of *dirigisme*, emphasizing instead surveillance and enforcement.

would include the same elements of the state, market, and civil society laid out earlier in the definition of the governance regimes.

Distributive intervention is itself a means of managing the political struggle over this trade-off between economic efficiency on the one hand and social stability and equity on the other hand. With distributive intervention, however, the struggle over the trade-off is endogenous to the means of exercising authority. By contrast, procedural supervision of economic action (such as securities finance) requires that the political struggle over this trade-off be exogenous to the exercise of state authority in the economy.

Distributive intervention may persist for two reasons. A state may be either unable or unwilling to exercise its authority in the mode of procedural supervision. First, a state may be unable to exercise its authority in the economy through procedural supervision because it lacks the capability itself, and because other elements of the economic governance regime (the market or civil society components) are insufficiently developed. Procedural supervision's nimble fingers, enlivened by painstakingly cultivated perquisites in law and various governance regime components, are much harder to develop than are the crude muscles that power the strong thumbs of distributive intervention. Second, distributive intervention can also persist as result of a political failure to re-adjudicate the equity-stability versus allocative efficiency trade-off. In the absence of a new settlement providing the practical (material and institutional) and political bases for a reasonably durable settlement the legitimacy of the ultimate decision may be clouded. This is a problem that China's single party monopoly political system faces.

In India, during the 1990s, the precarious scarcity profile of external exposure forced a re-alignment of the trade-off favoring greater, albeit still significantly constrained, emphasis on the securities finance elements of market-inspired growth. This realignment provided the practical *and* political basis for the kind of political

authority that facilitated greater reliance on securities finance. In China during the 1990s Deng's two-decade-old post-Mao realignment favoring the liberalization of product markets and the encouragement of foreign-invested export-led growth continued to provide growth. This meant that even as securities finance was introduced into the Chinese economy, there was little pressure to force a re-adjudication of the equity-stability versus allocative efficiency trade-off. The development of discretionary involution permitted the state to exercise authority in securities finance in the *dirigiste* fashion based on old practical and political bases.

B. The AC/FP Matrix and Debt Politics

The asset-class/financial-position matrix used to guide the analysis in chapter 6 helps to solve a serious problem that has plagued the study of securities finance in developing and transitional economies: How to untangle and map the identities and interests of actors involved in the development of securities finance. Using that matrix we can now begin to answer the question: What and where are the domestic politics of securities finance in DTEs? This thesis has used the matrix to guide conceptually the process tracing of political interaction in the domain of stock exchange development, exploring the issues of enterprise finance, wealth capitalization, and (briefly) shareholder rights. There are other areas of equity finance where further analysis is needed such as privatization and industrial organization.

Another area for further analysis is the debt asset class. Typically, in older capitalist economies bond finance is even larger and more politically powerful than stock finance. This power is embedded in the legal and institutional structures of older capitalist systems, but also in the very logic of securities finance itself. The computational or accounting "grammar" of securities finance relies on the stability and durability of the rates of return on fixed income instruments, particularly the bonds of

governments or very reliable firms, in order to assign value instantaneously and over time to all other securities. This is the "benchmark" property of bonds.

Debt and Coalitions: With respect to debt assets, the distributional politics of access to and use of bond finance focuses our attention on the relationship between public and private finance (see tables and figures in Chapter 3). In the standard securities market script, the largest player in any bond market is the government itself. Like any borrower, governments prefer to buy their funds cheaply. Unlike most other actors, however, the state has the ability to constrain its competitors or trump them with its creditworthiness. Often these competitors are the state's own subnational political units. Thus, in distributional terms, the state also has the power to control the securities markets through its domination of the debt market. On the one hand, government paper becomes a benchmark for measuring the risk and return on other securities, and on the other hand it furnishes a near-money substitute for transactions and storage in the financial system.[17] This last step further augments the state's distributional power to the extent that it controls debt flow through open market-like operations in the conduct of monetary policy.

Debt and Property Rights: Chapter 7 explains how, from an institutional perspective, the bond market tells us about the nature of the federal system and relations between the center and subnational units. What "property rights" are accorded to subnational units? This includes the nature of tax-based developmental incentives in the country. Again, the standard securities market script stipulates that the use of debt securities invites tax benefits for private issuers of bonds and for private investors in many forms of public debt.[18]

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[17] The depth of the government securities market enhances inter-bank and money markets, portfolio management, and financial trading.

[18] In China the use of debt enjoys no tax benefits, as the Ministry of Finance jealously guards all sources of revenue, discouraging any competition with its own debt issues and those few issues that SOEs are permitted to float.

Another institutional element of debt politics is related to default. Whereas the risks of equity finance are generally limited to the individual firm, debt default can be contagious and can have magnified reputation effects for the political jurisdiction or economic sector in which the defaulting debtor is located (an industrial sector, or a firm, city, or province).[19] The institutional politics of debt assets thus involves the quality of contracts embedded in the property rights and legal regimes, and directs our attention toward the systems for default and bankruptcy.

Bondage: In Chapter 7 an analysis of the politics of bond finance in China and India reveals much about the present and future disposition of economic power in these developing capitalist systems. It is also likely to disclose important untold stories of federal structure and federal power in such large multi-layered polities.

Controlling the allocation of credit is an important source of power and a way to reduce the cost of funds to those who have such control. At the same time, an important driver of economic development is the ability to make large, long-term investment. This requires access to credit. Who gets credit? And, under what conditions? The structure of bond markets influences the answers to these questions, and affects the fiscal capacity, developmental prospects, and ultimately the political autonomy of sub-national governments at various levels. This relationship between bond markets and the character of federalism and center-local authority is often overlooked. Future analysis using the insights of the analytic tools devised for this thesis (the dual imprint and the AC/FP matrix) should compare changes in the institutions of bond finance in China and India over the last twenty-five years. I believe such analysis will demonstrate that, contrary to arguments that there is an emerging *de facto* federalism or localism in China (Montinola, Qian, and Weingast

[19] The defaults of New York City, Orange County, or Enron are good examples in the U.S. A good example in China is the wave of defaulting trust and investment companies that began in October of 1998.

1994), developments in bond finance suggest otherwise, confirming the view of other finance-sector analyses that, formally at least, there has been a powerful, persistent, centralization trend afoot . In India, the evidence from the structure of bond finance reflects the broader decentralization trends in that country. Using these analytic tools it should be possible to offer a political explanation for these outcomes, based on differences in: 1) international variables (these countries' external macro-economic positions), and 2) domestic variables (the configuration of dominant coalitions and the structure of property rights).

III. Policy Debates

Many observers believe China has successfully exploited the benign abundance of its external profile, applauding its economic policies for having produced a superior (to India at least) development strategy (Lau, Qian, and Roland 2000). At the same time, in the Indian case, many observers lament India's inability to sustain the reform momentum of the early 1990s. Generalizing across the entire range of economic sectors and political institutions can be misleading. Based on the preceding analysis of governance in the securities finance sector in these two countries, the point I wish emphasize is that many analysts have generalized too broadly about the success of Chinese economic reform, missing the problematic dynamics developing in the securities finance core of its emergent variety of capitalism. At the same time many have ignored the potential medium- and long-term benefits of the institutional evolution in securities finance that resulted from India's response to its dire circumstances.

Some researchers are coming to recognize these differences. Two professors of business administration – Huang Yasheng and Tarun Khanna – recently wrote that,

"India is not outperforming China overall, but it is doing better in certain key areas." In accord with the thrust of the arguments I have presented here, they believe that "the speed with which India is catching up (to China) is due to its own efficient deployment of capital and China's inefficiency, symbolized by all the money that has been frittered on SOEs. And China's misallocation of resources is likely to become a big drag on the economy in the years ahead." They conclude that if India catches up to China "it will not only demonstrate the importance of homegrown entrepreneurship to long-term economic development; it will also show the limits of the FDI-dependent approach China is pursuing" (Huang and Khanna 2003, 78-81). As I argue below, I agree that the FDI-dependent approach has limits, even though it worked well – economically and politically – for over two decades. But, I go further, arguing that the FDI-dependent approach is likely to have significant medium- and long-term costs. Furthermore, these authors' micro-economic emphasis on entrepreneurship in the Indian case ignores the important effects of the broader structural context of the financial regime in which those entrepreneurs are located.

A. The Contrarian View Presented Here

The conclusions offered here present a distinctly different picture from that drawn by some prominent analysts of Chinese finance. British political scientist Stephen Green, for example, argues that Chinese securities finance will "improve" for four reasons. First, foreign trained securities experts who have returned to China – known as the *haiguipai* ("sea turtle faction") – play an increasingly powerful role in the CSRC and this will lead to more rational and market oriented securities finance. Second, Green argues that the industrial policy of supporting large urban SOEs is coming to an end, and that therefore the issuer-bias of China's involuted securities governance regime will no longer be needed. Third, government debt is rising,

forcing improvements in the structure of the government bond market. Finally, the need to develop a pension system to replace China's fading cradle-to-grave *danwei*-based (work unit) "iron rice bowl" social security arrangement requires the development of an alternative system for managing large volumes of savings and financial assets over a long period of time.

Yet Green himself concedes that the *haiguipai* have lost key battles in recent years and that, "ultimately, whether the market improves and the agenda of the *haiguipai* is supported is a political decision for the senior leadership" (2003, 174). The same may be said for the other three reasons Green offers as the basis of his argument for "why China's stock market will improve." While China's recent World Trade Organization commitments to reduce subsidies, and the poor health of many SOEs do indeed augur well for changes in the way the state treats organized industry, this by no means insures that the ownership structure and mechanisms of discretionary involution will not be redirected toward as yet unforeseen uses in preserving central state power over the economy. It is very possible that the state will continue using the regime of discretionary involution to guide the fashioning of competitive national champions in a modified version of the Korean *Chaebol* model, even while continuing in the medium term to service the various coalition participants among urban heavy industry and inland provinces with continued privileged treatment of securities issuers. As long as the political incentives of China's benignly abundant external profile persist, and there is no dramatic shift in the configuration of coalition dynamics or the structure of property rights, none of the reasons Green gives seem likely, even in combination, to trump the political dynamic of the dual imprint effects identified in this thesis in the near or medium term.

Political scientist Yang Dali agrees that by the late 1990s, the Chinese state had the securities “regulatory apparatus in place.” However, Yang argues that not only have things changed, but he believes they are getting “better,” by which he means

the Chinese financial system increasingly resembles Anglo-Saxon capital markets, and that it is developing U.S.-like regimes of securities governance. "China's securities regulatory authority had by 1999," he writes, "teeth that bite" (2000, 2, 20). Agreed, but for whom do these teeth bite? Yang asserts that, as a result of these newly formidable regulatory mandibles, "China's regulators today are tackling issues that are remarkably similar to those found in mature markets such as New York" or other "international counterparts" (2001). Suggesting that Chinese and American securities regulators share a "similar" concerned with improving disclosure and enforcing existing laws misses the big picture – reform without real change in China. In a long essay documenting many formal developments in Chinese securities governance, Yang neglects to mention the segmentation of shares and the quarantine of foreign ownership And though he discusses the quota system of share issuance and the year 2000 plans to reform it, he takes these proposed statutory modifications largely at face value. He does not mention that foreign listings approval procedures remain as opaque and tightly controlled as ever (Yang 2001). Few if any of the modifications he discusses do anything to reduce state discretion in the governance of securities finance. The teeth to which he refers bite on behalf of a state that continues to use *dirigiste* instruments of political authority to exercise its discretion through distributive intervention in finance to preserve its own political power.

Business professor Huang has carefully studied China's FDI-dependent experience (2002). He is interested in what he calls the "demand-side perspective" of China's high FDI inflows. He concurs that FDI was overabundant, explaining that many SOEs and regions really have no use for or did not deserve the FDI flows they received. But for Huang, "high" FDI is indicated by the ratio of FDI to domestic investment (DI) or the ratio of FDI to contractual arrangements.[20] According to him,

[20] FDI/DI ratio in China in 1994 and 1997 were, respectively, 17 and 12 percent. The average developing country FDI/DI ratio is 5 percent (Huang 2000). In a contractual arrangement a foreign

misguided institutional design and incentives resulted in economic and policy "imperfections" that created a "political pecking" order of firms, with SOEs and foreign invested enterprises (FIEs) enjoying favorable attention at the expense of private local firms (71, 3). This institutional design and the special incentives that accompanied it favored FIEs through advantageous tax treatment, convenience in licensing, retained earnings dispensations, and export assistance.

For Huang, then, the "large absorption of FDI is a sign of some substantial weaknesses in the Chinese economy" (2002, xv). Those weaknesses, Huang contends, are a symptom of imperfections mentioned earlier. *So, whereas for Huang high FDI is a consequence, in my argument high FDI is a cause.* Huang's is largely a microeconomic, firm-level account explaining how policies and institutions produced high levels of FDI that did not deliver the benefits typically ascribed to FDI. Mine, on the other hand, is a macroeconomic account of the consequences of China's high FDI dependence on securities governance, corporate finance, and the financial system more broadly. We both agree, however, that China's high level of FDI is a problem.

While there is no gainsaying Huang's careful demonstration of the failure of FDI to deliver promised improvements to domestic manufacturing in the areas of technology, skills, and management, one wonders why he did not draw out more fully the political implications of his independent variables. In his argument those independent variables – an institutional design encouraging FDI, favoring state owned enterprises, and discriminating against local private firms – were significant defining components of China's reform-era political economy. On this, he and I also agree. If these components produced high FDI (and I believe he exaggerates the degree to which they did), one must wonder why and how both the cause (the policies and institutional design favoring FDI) and the consequence (high FDI) were politically

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company secures a local firm's agreement to manufacture a product for export without ever taking an equity stake in that local firm as would happen in an FDI arrangement.

useful to the central-state elite who designed and implemented them. By taking high FDI as a cause, and a different but related set of institutions as the outcome – those in the regime of securities governance – my argument shows how those institutions reflected the central state's opportunities, political exigencies, and biases. This in turn explains what Huang ignores: Why the policies and institutions supporting high FDI and involuted securities finance dominated other priorities and policies such as improved financial allocation, better corporate governance, shareholder rights, and market-based decisions regarding industrial organization.

While my argument does not contradict Huang's, there are three important areas of difference that matter very much for our understanding of the political causes and consequences of high FDI in China, and for our understanding of the political economy of Chinese and Indian finance in the recent past and in the medium-term future. These areas of difference include; 1) the causes of high FDI, 2) the political and economic uses of high FDI, and 3) the consequences of the high FDI-benign abundance circumstance for institutional development in China.

First, Huang emphasizes the domestic causes of high FDI, or what we might call the "pull factor."[21] In doing so he probably overstates the "endogeneity" of high FDI to the Chinese system. It is true that Special Economic Zones and preferential treatment stimulated FDI, and favored it over domestic investment, and even "internationalized" a lot of domestic investment in the form of the "roundtrip" funds discussed in chapter 5. But, Huang probably overestimates this effect. It will be difficult to ever know for sure due to problems with Chinese statistical accounting, but two simple counterfactuals suggest the heavy burden of evidence Huang faces in making his case. First, had China not benefited from the powerful appeal to *all global investors* of its large domestic market and low cost disciplined work-force, and had it

[21] I am grateful to Lin Kunchin for highlighting this element of Huang's argument and for suggesting this term.

not enjoyed the special regard of overseas ethnic Chinese, could the high FDI levels have been reached relying solely on the special domestic incentives and institutions highlighted by Huang? Second, and related, how high would Chinese FDI have been had it been based solely on its structural advantages in the absence of special domestic stimulants to FDI? Given the large volumes of FDI involved, even if we take reasonable, but aggressive discounts for "roundtrip" FDI, Huang faces a significant burden of proof in parsing the endogenous domestic policy determinant of high FDI from the exogenous structural determinants. As I pointed out in chapter five, marginal differences in this distinction do not affect my argument as long the absolute levels of FDI were reasonably high (which they were even with the most aggressive estimates of "roundtripping") and as long as foreign invested enterprises ("real" or "fake") generated economic growth and foreign exchange (which they did).

Second, Huang does not recognize that together, high FDI and the involuted securities finance regime it spawned "worked" both economically and politically.[22] Looking first at the economics, one must remember that neoclassical economic equilibrium assumptions may misfire in a developing and transitional economy. As with the problem of "rent-seeking," under the right circumstances "perverse" incentives (such as the FDI policies Huang identifies) can still lead to dramatic improvements in prosperity (Smart 1998).[23] Analyzing much of the same reform era evidence as Huang, economist Thomas Rawski concludes that the recent economic history of China "shows that achievement of a full market system, or anything remotely approaching a full market system, is not a prerequisite to accelerated economic growth, structural change, and technical development." Again, turning to a counterfactual: Would China have been better off had it not attracted FDI, particularly

[22] In this instance it does not matter whether the high FDI was endogenously or exogenously driven.
[23] Neoclassical equilibrium assumptions eschew any but the most minimal role for the state and its "distorting" policies. Rent seeking is here defined as directly unproductive activity.

expatriate FDI? One is inclined to doubt it. Furthermore, turning to the politics, it was never politically viable to undertake the reform of domestic finance first (Lardy 1998; Shirk 1993).

Third, in focusing on the micro-economic, firm-level issues, Huang neglects the political and macroeconomic effects of the high FDI regime, particularly on the governance of securities finance. While it worked well in the short term, the reliance on FDI is a "fix that fails" for the financial system. By identifying how China's external financial profile interacted with distributional concerns and property rights structures in the securitization process, I have helped reveal why key elements of China's apparent successes – namely FDI and export-led growth – might also be construed as important causes of structural weakness. From this perspective FDI and export-led growth are not measures of competitiveness and success, as many China bulls claim. Instead, they are a form of dependence – even addiction – that caused China to neglect the intensive development of its domestic financial sector, specifically its securities sector. Neglect is bad enough, but the dependence actually encouraged the gradualism and involution in the securities governance regime documented in this thesis. Like an addiction to caffeine, the benign profile provided wakeful productivity in the short term, but may wear down the system in the long run. The durability of discretionary involution in the securities governance regime was one important consequence of this addiction to high FDI in the external profile.

In conclusion, I accept Huang's arguments that there were important endogenous incentives that magnified FDI flows into China but consider his argument to have achieved only a downward revision of the impact of China's benign external profile, not a negation of its impact. Regardless of the precise relative mix of causes, however, I argue that these high levels of FDI have created a positive feed-back effect that first provoked the development of the discretionary involution regime of securities finance, and then preserved it once it came to dominate the political economy of

organized large scale industry in China. In my argument, as in Huang's, high levels of FDI provide liquidity and financial intermediation to firms that need them. FDI itself brings in hard currency that is deposited in non-interest bearing accounts as part of FIE paid-up capital adding to foreign currency reserves. Finally, the exports of FIEs drive growth, contributing to the positive trade balance, and bringing in hard currency. All of which means there is little need to improve financial intermediation, improve the balance of payments, or attract foreign currency in other ways.

IV. Going forward

Finally, let me move from evidence, conceptual innovation, and policy debates to prediction. I consider first what future possibilities may be inferred from my argument for the Chinese case.

A. China

Massive foreign exchange reserves, world-topping volumes of foreign direct investment, and remarkable growth gains from exports are viewed as confirmation of China's economic strength and effective institutional design. The argument in this thesis accepts much of this common view, especially the recognition that Chinese policies have been particularly salutary in the product, infrastructure, and petrochemical sectors. However, this analysis of governance in the securities finance sector raises serious questions about the future costs of these earlier successes. The benign abundance external profile meant that the Chinese central-state was at liberty to implement policies and institutions designed to exploit the benefits of that profile in securing its own privileged and dominant position. This liberty permitted the central-state to do two important things at once. First, the combination of the permissive

external profile with the institutions of involution it encouraged, enabled the central-state-elite to deliver economic gains sufficient to provide a base of popular political legitimacy in in the post-Mao period when the other sources of ideological and charismatic legitimacy were waning.. Second, that combination simultaneously furnished the central-state with both the discretion and the resources (material and institutional) needed to :1) accommodate the demands of the intramural coalition, and 2) assure continuing control of organized economic assets by calibrating property rights to the state's own advantage. But, the "liberty" of abundance produced by this combination of permissive profile and involuted governance has the potential to become instead an "affliction" of abundance. This shift from the liberties of abundance to the affliction of abundance is akin to the institutional challenges that afflicted oil producing *rentier* states for whom the "price of wealth" was reckoned when the political institutions fashioned during a period of prosperity supported by high old oil prices came under stress when oil prices fell (Chaudhry 1997). Viewed from this perspective, the affliction of abundance for China is an unhealthy economic and *political* dependence on foreign investment and export-led growth that has enervated the financial system, leading to deep and durable inefficiencies in the mobilization, allocation, and governance of finance.

Huang Yasheng, has predicted that as the policy incentives and institutional biases favoring FDI decrease, so too will FDI decline.[24] If the argument that I make here is correct, the medium-term trajectory of Chinese securities finance development will depend crucially on the degree to which the previous high levels of FDI persist, and the degree to which the inflow of foreign currency associated with FDI and export-led growth remains stable. These macroeconomic issues, in conjunction with

[24] This is consistent with Huang's emphasis on the endogenous "pull-factor" motivating Chinese FDI and growth. Like the causality driving the growth and sustained high levels of FDI in the past, the causality implied in this prediction will be very difficult to parse out. As wages rise, as the markets saturate with exploited opportunities, and as China's business climate becomes more competitive, there will also be less structural (exogenous) appeal to China as an FDI destination.

the stability of the dominant coalition (the balance between sunset and sunrise sectors and their ministries, and the continued purchased quiescence of the disadvantaged provinces) maintain the involution pattern of securities finance I have identified. This pattern treats securities as another form of directed-credit and therefore locates Chinese central-state-elite securities finance policies and institutions somewhere between the (relatively benevolent) old developmental state and the (relatively predatory) "political capitalism" of other post-Socialist transitional states.[25]

Stability in the variables that comprise China's benign external profile will mean a continuation of involution, punctuated by occasional genuflection to world financial markets and world financial norms. Such gradualist measures would, over a very long period of time (fifteen years or more), transform the Chinese pattern of discretionary involution in securities finance with attendant implications for the character of China's variety of capitalism. However, in the near and medium term, such measures will not erode the discretionary involution regime through which the state controls finance (and through it the economy and society). We may witness a "rise of the regulatory state" relying on a procedural supervision mode of state authority in other Chinese sectors, but in finance, the veneer of this "regulatory state" burnished by the existence of ambitious sounding statutes, the use of state-of-the-art technologies, and the presence of foreign trained officials will obscure the persistence of discretionary involution.

China's gradualist approach to reform and transition has enjoyed the approval of a wide range of economic analysts. Gradualism in the Chinese case refers to the deliberate, incremental, pacing of reform. This is a distinct pattern when compared, for example, to the wholesale transformation of property rights and economic institutions in certain former Soviet and East European countries. Many of these

[25] For an application of this Weberian concept of "political capitalism" in other post-Socialist cases that is complementary to the "discretionary involution" notion I use here, see Ganev (forthcoming).

analysts have rightly recognized that gradualism as deployed in the Chinese case is as much a political strategy as an economic one, intended to delay the costs of change to potential losers, while maximizing the support of potential winners (Lau, Qian, and Roland 2000; Rawski 1999). Indeed, the persistent, high growth that China has enjoyed for the last twenty years has meant that the gradualist changes in other sectors have been able to offset the lack of substantive change in securities finance. In this way gradualism has worked well economically and politically for the central Chinese state.

One of the points I wish to stress, however, is that sectoral variation matters. The Indian state's ability to act with relative autonomy in finance and not elsewhere is contrasted to the Chinese state's inability to act autonomously in finance even as it enjoyed relative autonomy in other sectors. Thus I disagree with the views of analysts who extend the gradualist thesis of Chinese reform to the securities finance sector. Stephen Green claims to see a substantive shift away from the discretionary involution pattern having already begun in 2000 and likely to gather momentum with the changes in personnel, industrial policy, and pension reform mentioned earlier. Such views of Chinese politics and institutions changing through gradualism seem to me valid in many sectors. But in finance generally and securities finance particularly, I see behind the formalistic changes of the recent past significant threads of continuity. In many sectors there has been reform with change. In securities finance there has been only reform without change. Based on the argument presented in previous chapters, I believe this continuity will persist as long as the variables I've identified remain roughly stable.

Yang Dali contends that gradualism has begun to usher in modernization without Westernization (meaning democracy), and that this trend is continuing with a transformation of the Chinese state toward greater decentralization and development of a regulatory state. I argue in contrast that the involution pattern is likely to persist

in securities finance even as modernization (such as improved money markets, trading systems, and financial product proliferation) proceeds. This line of reasoning leads to a particularly provocative prediction: If the external exposure profile continues to be permissive *and* alternative sources of political power continue to diminish, *the control of finance may become even more vital to the central-state*. Political scientist Susan Shirk persuasively argues that the *hard* reforms always come last in China (1993).

The intramural coalition supporting CCP control of the central-state and the property rights structure together form the 'hard core' of CCP power. They are the hardest reforms of all. Changes in these areas are still too threatening, and evolution of securities finance in China would disrupt them. So, the more reform moves ahead on other economic and political fronts, the more we should look for discretionary involution in finance, and particularly in securities finance. A valuable proxy indicator of the "squeeze" from discretionary involution on the financial system at large is the size of "underground" financial asset management services (Rudolph 2002).

What could change all this? Were there to be a sudden change in any of the variables that comprise the dual imprint (external profile, coalition dynamics, property rights structure) I would expect change in the pattern of China's securities finance governance regime. For example, if FDI and export-led growth dry up, then I would expect to see more aggressive securities finance "evolution" somewhat akin to the Indian case. Changes that occurred in this way could be seen to confirm my argument. It is easy to identify developments that would undermine my explanatory framework. For example, the argument presented here would be seriously challenged if while Chinese FDI and exports continue to rise there were also substantive changes made to the discretionary involution regime. Such changes might include, *inter alia;* 1) the state unifying the currently segmented structure of share types; 2) the state permitting

unmediated private litigation of securities finance disputes;[26] 3) the state relinquishing its ability to control access to equity and debt finance;[27] 4) the state reducing its controlling ownership stake in the country's largest productive enterprises and concentrated employers.

With regard to securities finance, India's past may be China's present. China's current discretionary involution regime of securities governance is not unlike securities finance under India's Nehruvian system of dependent capitalism. That system harnessed securities finance to state purposes using the Unit Trust of India and marginalizing the securities enclave of *badla* and the Bombay-Calcutta brokers. But, India's present is not necessarily China's future. This analysis may seem to present a bleak picture of Chinese securities governance. While I certainly intend to strike a tone of critique and even warning, there are important positive implications as well. The Chinese state's control of the share-capital structure and its discretionary power in securities finance together put China's central-state-elite in a position where they enjoy a range of choices regarding the type of capitalism China may develop in the future. I think this is reason for both concern and hope.

I believe the regime of discretionary involution is at once an obstacle and an opportunity. As an obstacle, the institutions of discretionary involution now stand in the way of developments that would encourage state agencies to increasingly orient the exercise of state authority toward procedural supervision. The state cannot develop and regulate a large and healthy financial system alone. A regime based on procedural supervision requires a host of non-state institutional capacities that I have here referred to as the realms of markets and civil society. Self-regulation and the participation of non-state actors are crucial. Discretionary involution has retarded and

[26] Currently the securities regulator must first provide official notification to the court of "possible" grounds for legal proceedings against a firm or its promoters (Hutchens forthcoming).
[27] I'll be wrong if, *ceteris paribus*, China begins moving toward allowing sub-national governments the power to borrow. The first move in this direction would be permitting them greater freedoms in the power to tax.

subverted the growth of precisely those capacities in civil economy that are a necessary complement to the legal and bureaucratic structures that are as yet incomplete. However, such control is not exclusively malignant or avaricious, and we must resist hastily concluding that the discretionary involution policy pattern serves only the narrow interests of a Leninist party seeking to preserve its hold on power.

During the 1990s, relative stability was maintained at the possible cost of increases in efficiency. This is not trivial. The institutions of gradualist involution, among them the range of domestic and transnational capital controls, protected China from abrupt dislocation in the short term following the Asian Financial Crisis. Furthermore, though the primary consequence of the discretionary involution pattern was the retarding and coopting (some call it "state corporatism") of markets and civil society to serve the purposes of distributive intervention, there were also latent "developmental" crosscurrents. To some extent, the regime of discretionary involution served as an incubator, providing time and political space for some subtle yet important advances at the institutional level. These advances include the development of major prerequisites for a more balanced, less-state dominated governance regime that in the future might enable the exercise of a procedural supervision mode of state authority. The prerequisites that were developing in these contradictory developmental crosscurrents included much-needed legal and bureaucratic infrastructure, independent associational life, as well as media quality and independence. The segmenting of shares, and the quarantine of foreign capital were largely a tactic of discretionary involution. But, to a lesser extent they were also a form of "training wheels" of particular use in calibrating the transformation of property rights in Chinese securities governance.[28]

[28] As with the infant industries argument, there comes a time when the adolescent elements of a sectoral governance regime must be ushered out of the nursery into the bracing environment of self-reliance and competition, or else become stunted, perpetuating their reliance on their governess – the state.

B. India

The contrasting nature of the Chinese and Indian patterns of securities governance means there are different implications in the Indian case. The precarious scarcity external profile meant that the Indian central-state faced an imperative to implement policies and institutions designed to offset the adversity of that profile and to avert macroeconomic failure and the associated political disruption. To accommodate this imperative the Indian state was obliged to evolve the elements of securities governance in order to attract foreign portfolio investment, pressure the obstreperous domestic banking system, and improve enterprise finance. The Indian state was able to accommodate this imperative because; 1) in the realm of securities finance it enjoyed a comfortable margin to maneuver within the dynamics of the dominant coalition, and 2) the property rights structure of the Nehruvian "mixed-economy" did not constrain the policy and institutional innovations needed for evolution. India may have succeeded in making a virtue of its weakness, taking the "imperatives" of adversity produced by the constrained profile and, by way of the evolutionary governance regime they provoked, turned them into an "advantage" of adversity. India succeeded in developing, over the course of just one decade, a regime of securities governance that has encouraged the development of scope in the markets, a procedural supervision form of state authority, and an increasingly independent governance role for the institutions of civil society. This rich tapestry of securities governance institutions, while vulnerable to the fraudulent, volatile and inequality-producing tendencies of securities finance, has been successful in attracting the much needed foreign portfolio investment and in providing scope and depth to India's financial system, provoking improvements in the banking system and expanding the options for enterprise finance.

A significant reversal in the nature of India's external profile – a shift to high FDI inflows and a stable source of growth and forex from exports – would very likely slow the evolution of Indian securities finance governance. However, since India's constrained evolution pattern was developed in order to offset adverse conditions rather than to exploit advantageous ones (as in the Chinese case), I suspect the orientation and organization of the constrained evolution institutions are less vulnerable to external changes than are the institutions of China's discretionary involution regime.

In a dynamic that is somewhat similar to the provocative prediction I made regarding the conditions under which we might see a persistence or deepening of involution in the Chinese case, I also believe that even as reform stalls on other fronts in India, as long as that country continues to face some problems with its external profile – most particularly its inability to develop a competitive export sector – we will see contradictory trends in that case as well. That is, even as India becomes less secular and more nationalist, constrained evolution is likely to persist. The central-state-elite of the BJP and its partners recognize the effectiveness of the evolutionary pattern for macroeconomic management, for industrial performance improvement, for local development, and for managing the ongoing transition to a more federalized polity.

C. Governance Regimes and Capital Controls

In recent analyses evaluating the East Asian Crisis of the 1990s, a key a conclusion is that countries with more developed domestic financial institutions are less vulnerable to exogenous financial shocks (Kawai, Newfarmer, and Schmukler 2001). The result is an emerging consensus that inverts the prescriptions that were

common before that crisis. Those prescriptions emphasized opening financial markets in order to stimulate institutional development domestically. Along with Malaysia, China and India are often cited as examples of the benefits of relative closure and gradual, protected development of domestic institutions of financial governance.

One obvious indicator of how the governance patterns of securities finance are likely to change in China and India is the domestic debate over further opening of finance to outsiders. Two key issues in this current debate are the admission of hedge funds and capital account convertibility. China will almost certainly not admit hedge funds any time soon, and India probably will not. The hedge fund debate reveals how deeply the lessons of the 1990s have influenced Chinese and Indian financial policy makers (Iyengar 2003). The Rubicon for these countries will be capital account convertibility (CAC) including a floating exchange rate. As discussed in Chapter 5, this shift offers benefits in the form of attracting more investment, but also comes with risks of increased vulnerability to international financial crises. Today, though there are strong reasons to open, the perceptions of risk, if not the actual probabilities of economic damage from a crisis, are still significant. Moreover, the evidence so far does not clearly confirm that open capital accounts even help deliver more growth.[29]

China and India could go the way of mainstream OECD countries with full capital account convertibility and access for hedge funds. They could revert to strict closure of the early 1990s. What is most likely is a combination of the Chilean and Korean models of capital account control. I predict there will not be full CAC in either case any time in the medium run. Both countries will maintain in the medium term semi-porous capital control regimes, and that the patterns of securities

[29] Rodrik argues that the case for the benefits of CAC is not even clear. Based on his own research, Rodrik concludes, "the data provide no evidence that countries without capital controls have grown faster, invested more, or experienced lower inflation. Capital controls are essentially uncorrelated with long-term economic performance" (1997, 61). He provides a vivid analogy, urging readers to "think of capital flows as a medicine with occasionally horrific side effects. The evidence suggests we have no good way of controlling the side effects. Can it be good regulatory policy to remove controls on the sale and use of such a medicine?" (60).

governance discussed here will be reproduced in their regimes of capital control. That is, Indian capital control will resemble Indian securities governance. It will have controls that will be of a procedural supervision nature – not always implemented or enforced comprehensively – but consistent with the elements of constrained evolution, including market scope, institutional density, and a recognition of private property. China will have a discretionary and involuted regime exploiting the appeal of its market and the interest of the overseas Chinese networks. The appeal of China's market may diminish as wages rise but its size will continue to be attractive continuing the benign abundance determinants of its financial involution.

D. Varieties of Asian Capitalism?

In the Nehruvian era, the Bombay Stock Exchange was an exchange "of, by, and for" the Bombay Stock Exchange, snug in the securities finance enclave.The establishment of the National Stock Exchange changed all that. China's stock exchanges today are "of, by, and for" equity issuers under the discretionary involution pattern of securities governance consolidated during the Zhu Regime. In pursuing the preferences inspired by China's benign abundance external exposure profile, the strategy of the central Chinese state emerged as a classically mercantilist one. It emphasized the commercialization of securities finance as national policy in a fashion, as Polanyi famously put it, "exactly contrary to the market economy" (Polanyi 1957, 73).[30] The result was a pattern of market-miming practices within a policy trajectory that maximized government discretion and capacity for intervention, and favored

[30] The goal of servicing the distributional coalition, and providing life-support to the large SOE-sector, interior provinces, and sunset sectors is best expressed in the guiding industrial policy admonition of the late 1997-2001 period that coincided with the cementing of the discretionary involution SGR: "*Zhuada, Fangxiao"* [seize (meaning control and preserve) large firms, let small firms go (meaning let them whither or privatize)].

issuers of securities. The securities "enclave" of India's past resembles the involution and political capitalism prevailing in China's securities governance regime today.

Does intention matter? Are these states *trying* to create specific forms of capitalism? It would seem that if the different paths are a product of default and not design, the form is likely to be shorter-lived. Accidental formations seem less durable than economic arrangements that are the result of a carefully cultivated political support and a consciously erected policy ensemble such as the Nehruvian system of dependent capitalism in India, the New Deal edifice in the U.S., or the varieties of Keynsian welfare systems in Europe.

The priority that the Chinese and Indian central states seem to be placing on stability and equity in the process of financial reform perhaps reflects a benign cognizance of the "double movement" and a conscious intent to balance the costs and benefits of financial markets. Yet, it is not clear that the two countries' are equally concerned about inequality and instability. Within the Chinese state it is difficult to distinguish between two different sets of motives for mitigating the dangerous, socially disruptive tendencies of securitization. One set of motives is the more altruistic emphasis on the priority of harmony, and the fear of chaos (*luan*) that is a durable attribute of Chinese political culture across historical periods. The other set of motives is the more self-interested emphasis on preserving the party's control on power and the access to security, status, and privilege that accompany such power. The Indian political culture that has produced what economist and former U.S. Ambassador to India John Kenneth Galbraith once called "functioning anarchy" has a relatively high tolerance for crisis and instability. In this context, the "public bads" that accompany greater reliance on markets in the governance of finance, and particularly the increasing use of securities, are today probably more acceptable to central-state-elites and to the public in India then they are in China. Perhaps this also

helps explain why India has already moved more quickly to open finance and is likely to continue to do so.

While it is unclear if the world is witnessing a diminution or proliferation of forms of capitalism, it is certain that the durability of the characteristics that differentiate these forms certainly varies. The models represented by India's constrained evolution and China's discretionary involution are likely to occupy the medium-term end of the durability spectrum. The New Deal and Post-War arrangements in the U.S. and Western Europe lasted for over thirty-five years. With regard to how profoundly and durably the Chinese and Indian patterns of securities governance will influence these two important varieties of Asian capitalism, I am inclined to agree with Thomas Rawski that, "eventual convergence with US-style arrangements may turn out to be the best long-run option for China and other Asian nations. Whether or not this happens, Asia's twentieth-century economic history shows that the long run is long indeed, and that vast progress is possible with institutional arrangements that differ immensely from the (hypothetical) long-run optimum" (Rawski 1999, 154).

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