

China's Financial Reform and Monetary Policy: Issues and Strategies

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Executive Summary

This paper presents a brief, critical review of the principal features of China's financial system and conduct of monetary policy. It shows that despite its impressive growth since 1979, the financial system in essence still functions as it did before reform. With centrally allocated credits and administered interest rates, it lacks a mechanism to assure efficiency in capital allocation. Moreover, a stop-go monetary policy combined with the inherent arbitrariness of the credit plan has produced frequent cycles of inflation alternating with growth recession.

Aware of the system's weaknesses, the authorities launched in 1994 a comprehensive financial reform program. This paper reviews the program's main elements and implementation to date. It points to several challenges of critical importance to the reform's success: policy loans, relation to enterprise reform, bond market reform, interest rate policy, and monetary policy. It also proposes concrete reform strategies, including a bond-for-policy-loan program, a gradualist approach to interest rate deregulation, a way to mop up excess reserves, and a choice between open-market operations and central bank lending as the principal tool of monetary policy.

I. Introduction

After seventeen years of widely acclaimed economic reform, by 1996 China finds itself still shackled by two vestiges of its pre-reform days: a large, inefficient state enterprise sector and an essentially unreformed financial system. The former continues to absorb and waste an enormous amount of the nation's resources, and the latter squanders the nation's precious savings in an arbitrary manner and generates recurrent bouts of rising inflationary pressures. Both are major hurdles on the nation's way towards attaining its goal of building a "socialist market economy" by early next century.

To describe China's financial system today as "essentially unreformed" may surprise many. The impressive growth of its financial sector from a mono-bank system of the Soviet command-economy type prior to reform to the large variety of financial institutions and markets today is an undisputed fact. What is "essentially unreformed" is the manner in which the system absorbs the nation's savings, creates money, and converts all these into credits for distribution to final users of capital. It is in the performance of this basic function of finance that China's financial system continues to be in essence more akin to the Soviet type than to that of a market economy.

Because of the central importance of finance in a national economy, this vestige of the past can be compared to a faulty cardiovascular system in an otherwise healthy human body. Parts of the body that are close to the heart receive a disproportionately large amount of the blood supply; terminuses or blocked areas must depend on newly grown bypasses that manage to siphon from the main arteries. What is particularly dangerous is an inherent tendency for the heart to beat too fast--and, if unchecked, increasingly fast--that routinely disrupts the normal functioning of the whole body and at times can lead to life-threatening conditions.

The rest of this paper attempts to substantiate this simile. Section II critically reviews the principal features of China's financial system, with regard to its microeconomic allocative efficiency and conduct of monetary policy in relation to macroeconomic stability. Aware of its many deficiencies, the authorities

launched in 1994 a comprehensive and thorough reform of the financial system. Section III examines the highlights of the reform program and its implementation to date. Section IV presents our thoughts on several major challenges in carrying out the reform program--policy loans, relation to enterprise reform, bond market reform, interest rate policy, and monetary policy--as well as our recommendations on reform strategies in these areas. Specifically, we propose a bond-for-policy-loan program, a gradualist approach to interest-rate deregulation, a way to mop up excess reserves, and the use of either open-market operations and central-bank lending as the principal instrument of monetary policy.

II. Performance of the Financial System

A. Micro-Efficiency

Since economic reform began in 1979, the financial industry has been one of the fastest growing industries in China. From 1979 to 1994, while nominal GDP grew ten times, bank deposits (BD) increased 18 times, so that the BD/GDP ratio rose from 0.33 in 1979 to 0.56 in 1994. Using a wider measure to include deposits in some nonbank financial institutions, the M2/GDP ratio increased from 0.58 in 1985 to 0.82 in 1990 and 1.00 in 1994.¹ These measures reflect the rapid "monetization" or "financial deepening" of the Chinese economy.

Financial deepening is also reflected in the rapid growth of a wide variety of financial institutions and markets in China. Starting from only one single bank, the People's Bank of China (PBC), in 1979, the system now consists of one central bank, four large state banks--which together accounted for 72 percent of total financial assets--16 other nationwide and regional banks, tens of thousands of rural and urban credit cooperatives, and scores of other types of nonbank financial institutions, such as trust and investment companies, insurance companies, finance companies, leasing companies, securities dealers, and mutual funds.² In addition, there are active money and capital markets. Together, the system offers households, businesses, and the government a much wider choice of channels and instruments in which to put their savings and from which to seek credits.

Yet, despite its phenomenal growth in size and form, China's financial system today is functionally faulty and incompatible with the vibrant market forces that have been released since 1979 by reforms in the rest of the economy. The root of the problem lies in the pervasive government control of the financial system.

The problem is manifested in several characteristics of China's financial system. First, virtually all the financial institutions are directly or indirectly owned and operated by the government. Bank staff carry out government directives and have little experience in assessing financial risks. The situation is further complicated by the decentralization of the government itself. Following a pattern mandated by former economic planning, the bank branch networks coincide with the political division of the country; and each local bank branch is under the "dual leadership" of its head office and the local government, as before reform. Where local interests are in conflict with the center's, as often happens, the local authorities usually have the upper hand, because the branches must rely on local support for their day-to-day operations. The result has been fragmentation of the financial system and sometimes local protectionism that impedes the development of nationwide financial markets and interregional fund transfers.

Second, until recently credit was allocated according to the old credit plan. Although the scope of the credit plan has been reduced and its mode of operation significantly altered (See Section III below), there are reasons to suspect that the change has involved only a shift in form, not in substance, and that the old credit plan continues to lurk behind in a changed form to dominate the functioning of the financial system. (See Section IV.1 below.) In any case, whether this suspicion is well founded, it is essential to have a clear idea of how the credit plan worked in the past in order to understand its pervasive influence in the financial system and appreciate the significance of the changes that are currently taking place.

Prior to 1995, each year the local branches of the PBC worked with the finance and economic planning bureaus of the local governments to draft credit plans that gauged the working capital and fixed capital needs of local businesses in the next year. These draft local plans were then submitted to the PBC head office in Beijing to work out a national credit plan in consultation with the Ministry of Finance and the State Planning Commission, before being submitted for the State Council's approval.³

There were two dimensions to the credit plan. The vertical dimension specified the total credit ceilings of the six nationwide major banks and other major financial institutions, and the horizontal dimension the total credit ceiling for each of the 29 provinces and autonomous regions and the two special municipalities, Shanghai and Shenzhen. The vertical dimension was monitored by the PBC head office, and the horizontal by the PBC provincial or municipal branches. The plan set separate credit ceilings for working capital and fixed capital.

Direct credit control has been used in market economies as well, but nowhere has it been as specific and detailed as in China, where the credit plan specified the credit ceilings not only for each bank and each province but also for each industry and each enterprise within the plan. Those that were included in the plan were assured of receiving the coveted credit; those that were left out must fend for themselves to seek financing from institutions and markets that are either not included in the plan or included but subject only to lax enforcement.

Third, interest rates have been used as a tool to attract and retain bank deposits, but thus far have played virtually no role in the allocation of credits. As prior to reform, they are still set nationally by the highest executive organ of the government, the State Council. The rates have consistently been below market-clearing levels and often, as in 1987-89 and again in 1993-95, below the prevailing inflation rate. Cheap credit means arbitrary allocation by the authorities nominally according to national and local priorities, but in practice often also the result of political influence or unadulterated corruption. Moreover, in many cases it leads to excessively capital-intensive production or investment with dubious returns. Anecdotal evidence suggests that in China today, even amidst a booming economy, there are factories with newly installed machinery standing idle, and fully-staffed luxury hotels more than half empty, because the expected market is not there.

Fourth, the banks are loaded with bad debts. Under the old credit plan, if an enterprise was included in the credit plan, its bank must provide it its allotted credit, regardless of its creditworthiness. Since no detailed audit has ever been conducted, no one knows the extent of nonperforming loans in bank portfolios. One official estimate is 20 percent, which may be too low. The World Bank calculates that the net worth of the four large state banks is probably negative.⁴

Fifth, there has been phenomenal growth of various types of financial institutions and markets outside the banking sector. Other countries that have experimented with direct credit controls have found that the market has marvelous ways to get around the controls. In China too, by-passes have developed through less-regulated nonbank financial institutions and informal curb markets which are not regulated at all.

Nonbank financial institutions developed in the late 1980s. Then, as now, local governments were anxious to have their regions participate in the rapid economic growth that was then just starting, but were frustrated by the tight control of the credit plan. This led the local branches of the state banks as well as local enterprises to establish urban credit cooperatives, trust and investment companies, and finance companies, in order to operate outside the credit plan. In the liberalizing environment at that time, these actions were looked upon with favor as innovations to broaden the scope and structure of the financial system.

By 1989, however, after the financial crisis of the summer of 1988, the political atmosphere changed, and all the nonbank financial institutions were brought into the folds of the credit plan.

Enterprises also raise funds through an informal channel called the curb market. For instance, an enterprise might distribute a handbill inviting its employees, their relatives and friends or acquaintances--in fact, anyone--to leave their money with the enterprise for, say, one year for a 20 or 25 percent return, significantly higher than the current one-year bank deposit rate of 9.18 percent.⁵ These informal channels are prevalent among developing nations with repressed financial systems. They are a part of what the authorities would call "leakages" in their credit controls, but perhaps have been an important factor in keeping the sectors that are left out of the credit plans growing rapidly even during periods of austerity and tight credit control.

Sixth, credit control and interest rate restrictions have also limited the development of money and capital markets. China's bond market is dominated by Treasury bonds, which accounted for 70 percent of the total capital market turnover in 1994.⁶ The Ministry of Finance began to issue these bonds in 1981, but because the terms were unattractive they had to be sold by compulsory subscriptions to enterprises and individual workers through their workplaces. A bond market has developed only since 1986 to include besides Treasury bonds also small amounts of enterprise bonds, financial institution bonds, and local government bonds.

Stock exchanges began operation in Shanghai in 1990 and in Shenzhen the next year. They are noted for their high price volatility. Despite the attention they have attracted both from abroad and domestically, by the end of 1994 the cumulative amount of capital raised in these markets was only RMB 64 billion, a minute amount compared to the gross domestic investment of RMB1.9 trillion in 1994.⁷

China's money market consists of an interbank market and markets for Treasury bills, commercial paper, and negotiable certificates of deposit. The interbank market has had some unusual problems, as unscrupulous financial institutions have used this market not for very short term liquidity management, but to fund long-term loans, and even for land and stock market speculations.⁸

All issues in the money and capital markets must be approved by the authorities. Besides prudential considerations, the principal motivation for controlled access has been a desire to protect the banks, which are the primary channel of credit control, against competition from the open market.

Seventh, a basic problem with China's financial system is the lack of the requisite social infrastructure to insure its soundness and stability. Basic essentials, which are taken for granted in market economies--such as dependable accounting systems, contract and securities laws, trained banking personnel, rules of bank supervision and regulation, a nationwide fund clearing and settlement system--are either still being developed or awaiting to be implemented. These problems are by no means unique to China, but there are worse in China than in other developing countries.

B. Macroeconomic Stability & Monetary Policy

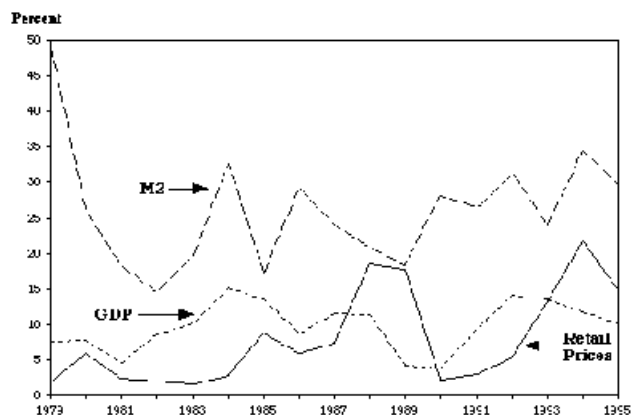
Allocating savings to their most productive uses is only one function of a financial system. Another is to provide an appropriate growth rate of the money supply to keep the price level relatively stable. In China, even if the price level were stable, the money supply would have to increase at a high rate, both because of the high growth rate of real income, and also because of the increasing monetization of the economy, which is a common feature of the early stages of economic development. Moreover, in China the demand for money is also increased by the shift from centrally-planned economic control to a market economy. Unless this growing demand is met by sufficient money creation, sales growth will be retarded, inventories will pile up, prices will fall, production will be cut back, and unemployment will rise.

In modern times, the management of the money supply, i.e. monetary policy, is a responsibility of the nation's central bank. The central bank creates money indirectly either by purchasing assets (e.g. gold, foreign exchange, bonds, commercial bills) or by directly lending to institutions (e.g. governments, banks, and other kinds of financial institutions). It finances these purchases and loans by issuing claims on itself, claims that take the form of currency in circulation and deposits of the financial institutions with the central bank. These claims, created by the central bank simply by making entries on its books, serve as reserves for banks and are used by banks for multiple deposit creation.

In China, this monetary policy function is the responsibility of the People's Bank of China. To see how well the PBC has performed this function, Figure 1 plots the annual growth rates of GDP, retail prices, and broad money (M2),⁹ for the years 1979-95.

Figure 1:

Annual Output (GDP) Growth, Money (M2) Growth, and Inflation
1979 - 1995



Sources: World Bank, 1996, Volume II, Annexes, for the following: GDP, 1979-94, Table 4, p.38; M2, 1985-95, Table 14, p. 48; retail price inflation,

Since besides monetary policy there are many other factors--such as the gradual lifting of price controls, foreign trade liberalization, and fluctuations in harvests--that could have affected output and inflation, a close association of the money growth rate with output growth and inflation is not to be expected. Indeed, Figure 1 shows only a weak relationship between changes in the money growth rate, GDP, and prices.

Nonetheless, Figure 1 does show an interesting pattern of association. During these 17 years, output, money growth and inflation all display a high degree of instability. But, since 1984, ignoring some erratic peaks and troughs, they have moved roughly together. Thus, the extraordinarily high M2 growth in 1979 and 1980 was accompanied by rapid GDP growth in those two years. Rising inflation then induced the authorities to restrain money growth tightly for three years (1981-83). It was in that period of low and relatively stable monetary growth that China enjoyed a rare episode of rising output growth coupled with low inflation. The abrupt leap of M2 growth in 1984 broke the spell. Thereafter, an unstable M2 growth rate has been followed by sharp fluctuations in output growth and inflation

Unstable money growth in China reflects a stop-go monetary policy that was practiced also in many other countries (e.g. Britain in the 1960s) and subsequently abandoned when it was discovered to be the principal source of macroeconomic instability. In China, too, the authorities, anxious for rapid output growth and job creation, tended to adopt monetary policies that were too expansionary, and then, in the face of rising inflation, to clamp down on credit and money creation. Disturbed by the resultant slower growth and rising unemployment, they then again relaxed credit and monetary controls, thus setting the stage for the upswing phase of the next cycle.

Operationally, there are three major channels through which the PBC funnel base money to the national economy. They are: lending to the government, purchase of foreign reserves, and lending to financial institutions. The central bank's balance sheet shows that fiscal access to the central bank was an important source of money creation prior to 1988, but since then has largely fallen into disuse.¹⁰ Purchase of foreign reserves has been a sporadic source, except in the last two years, 1994 and 1995, when it accounted for 71 percent and 63 percent respectively, of base money creation, reflecting the large foreign capital inflows in those two years. In contrast, lending to financial institutions has been the only consistent, major channel of base-money creation.

In China, base money creation is a by-product of the credit plan. The PBC, by lending to financial institutions, provides them with the reserves they need to make the loans required by the credit plan. As previously described, the credit plan is a vestige of the old central planning regime. Although reforms have reduced the physical production plan, its counterpart, to a mere shadow of its former self, until recently the credit plan has remained both the guideline and the principal instrument of monetary and credit policy in China.

The strictness with which the plan was enforced by the central government reflected swings of the pendulum between the government's policy of centralization and decentralization. Thus, in the heyday of decentralization from 1985 to 1988, the credit plan was administered in a way that gave local PBC branches much autonomy, which they wielded with considerable liberality. Moreover, in many cases the local authorities also took it on themselves to use their considerable political power to get the central authorities to raise the credit ceilings. In some years, credit ceilings were lifted so many times that the final quotas for the year were not firmly established until the end of the year. But, then, by the summer of 1988 when inflation accelerated to a dangerous point, the central authorities clamped down abruptly and demanded strict enforcement of the credit plan.

However, the cynics have learned from experience that tight credit inevitably inflict pain, and when pain becomes strong enough, credit will again be eased. Moreover, during such stop-go cycles, many channels, both legal and illegal, have been developed to circumvent credit control, so that even during times of tight control credits are still plentiful for those who know the ropes and can afford to pay.

III. The 1994 Reform

In November 1993, China unveiled a new and ambitious reform program, which was launched in early 1994. Unlike the tentative and piecemeal reform measures that had been successively adopted since 1979, this program was at once comprehensive and systematic, aimed at completing the extended reform process by early next century in order to have in place the overall structure, if not the details, of "a socialist market economy with Chinese characteristics." The program covers the reforms of a wide spectrum of economic sectors.¹¹ In this paper, we discuss only the reform of the financial system.

The financial reform program aims at a fundamental overhaul of the entire financial system: the central bank, commercial banks, nonbank financial institutions, and money and capital markets. Starting with the enactment of basic laws governing the mode of operations of each of these components, it seeks to develop an integrated, market-oriented financial system for attaining macroeconomic stability and allocative efficiency, while taking account of the government's policy objectives.

Implementation of the reform program has already started. In March 1995, a Central Bank Law was passed.¹² It has several especially noteworthy features: First, the aim of monetary policy is "to maintain the stability of the value of currency and thereby promote economic growth." Thus, China has become one of a small number of nations that have legislated price stability as the sole aim of monetary policy. Second, the central bank is prohibited from providing advances to the central government or direct subscription to government bond issues. Third, the law also prohibits the central bank from lending to local governments, nonbank financial institutions, other organizations or individuals--except as directed by the State Council. It expressly states that the central bank is to carry out its monetary policy and bank supervision-regulation functions "under the leadership of the State Council." The centralization of authority in conducting monetary policy is made even more explicit by stipulating civil and criminal penalties against local government officials, other organizations and individuals for forcing the central bank and its officials to provide credits against the provisions of the law; however, there is no similar stipulation on State Council officials.

In addition, the central bank has decided to shift gradually from the credit plan to indirect monetary policy measures. It plans to use open-market operations as the principal policy instrument, supplemented by changes in reserve requirements, discount rates, and administered interest rates.¹³

The reform also envisaged a complete overhaul of the banking system. In May 1995, a Commercial Bank Law was passed.¹⁴ It provides that after a transition period of unspecified duration all the state banks will be transformed into commercial banks operating according to market principles: that is, to maximize profits and minimize risks. Once transformed, the commercial banks will operate as corporations, observe internationally accepted prudential rules (such as meeting capital requirements and limiting lending to any single borrowers), establish internal auditing control procedures, and be subject to the central bank's supervision and regulations. Their present policy-lending responsibility will be shifted to three new policy-loan banks. Both deposit and lending interest rates will continue to be set by the central bank but may vary within prescribed limits. To ensure equal treatment, all deposit-taking institutions--including the 5,000 urban credit cooperatives, 50,000 rural credit cooperatives, and the 26,000 postal savings offices--will be considered as commercial banks.¹⁵

To protect depositors, commercial banks will not be allowed to invest in nonbank financial institutions, nor will they be permitted to engage in trust, stocks and real-estate investments inside China. They will be required to divest the large number of nonbank financial institutions they currently own.

Three policy banks were established by the 1994 reform. The State Development Bank is to provide low-interest, long-term loans for infrastructure and "key" industry fixed investments. The Agriculture Development Bank is to finance state procurement of agricultural products and agricultural infrastructural development projects. And the Import and Export Bank is to provide long-term funding of capital-goods imports and exports, especially for the machinery and electrical industries.

The financial reform program also envisions strengthening the regulation and supervision of nonbank financial institutions and of the money and capital markets. Laws were passed in 1995 to regulate financial and commercial bills, debt-instrument guaranties, and insurance. In January 1996, the previous regional interbank markets were unified into an integrated national market.

Lastly, the credit plan has been substantially changed. Information on the changes is scanty, as unlike in the case of other measures of financial reform, there has been no public announcement of the changes. The best we can make out from inquiries to sources within the PBC is that since the first half of 1995 only the six large nationwide state banks are still subject to direct credit control; all the other banks and nonbank financial institutions are subject only to PBC regulations on asset/liability ratios. Total credit quotas are assigned by the PBC to the head offices of the six large state banks, which in turn allocate quotas to their provincial branches. The PBC provincial branches supervise the implementation of the quotas but cannot interfere with their distribution within their respective jurisdictions.

IV. Policy Issues and Strategies

The 1994 reform is the most ambitious economic reform program China has undertaken since 1978, and financial reform constitutes a crucial part of this program. It embodies a well-conceived approach to transform the present backward, chaotic, and bureaucratic financial structure into a modern system guided by market principles and appropriate prudential regulations. However, its implementation will require careful sequencing, staunch and steady support at all levels of the government, as well as fundamental changes in thinking. We will examine some of these issues, discuss their inter-relationships, and propose a few specific reform measures, without any pretense of offering a comprehensive plan of action for the implementation of the reform program.

A. Policy Loans and the Credit Plan

It would be an illusion to imagine that the mere establishment of the three policy banks will solve the policy-loan problem of banks. Aside from the management problems of these three banks, which are enormous, a more fundamental question is how helpful to the rest of the banking system these banks can be. Without a complete and thorough audit of all bank portfolios, which we understand has never been undertaken, there is no way to determine how large a portion of total policy lending the three banks cover. The uncovered portion must be quite large, as all of the presently mandated bank lending to support loss-making state enterprises, promote the expansion of enterprises in what the authorities deem to be "key" industries, and help economic development in the nation's poor regions may fall into that category. Given the present state of the government budget, it is hard to see how the burden of the basically fiscal policy objectives of policy loans could be lifted off the backs of the state banks; yet, it is equally difficult to see how with that burden still on their backs these banks could become truly autonomous commercial banks operating on market principles.

The problem is rooted in the society's thinking. In both market and centrally-planned economies, the primary role of banks is to meet the economy's credit needs. In market economies, the needs are the general needs of the economy. But, in China the perceived needs are sector-specific, region-specific, and even firm-specific. The old credit plan was the policy instrument for meeting these needs and was clearly incompatible with the market approach to credit allocation.

The authorities' recent action to replace the old credit plan was a major step toward letting the market allocate credit. It has taken the central bank out of specific credit control. But, it would be naive to think that therefore specific credit allocation is dead. Within the bureaucracy in China, the action could very well mean only that the job has been passed on to the six large state banks. To reach a judgment on the action's true significance, one would have to wait and see how much autonomy the banks really have in managing their portfolios. Simple logic would suggest that so long as the perceived specific credit needs still dominate the functioning of the financial system--and there has been no sign of their decline in importance--the banks must continue to carry the burden of policy loans, and progress toward a market approach of conducting monetary policy would continue to be impeded.

Despite the recent action by the PBC, therefore, the financial system today is still confronted with two major challenges: (1) How to resolve the policy loan problem? and (2) How to develop effective indirect monetary control? The rest of this paper will explore these two questions.

B. Relation to Enterprise Reform

A major part of the policy loan problem has been the dependence on banks to bail out loss-making state-owned enterprises (the SOEs). Even in the boom year of 1994, about half of the 100,000 SOEs incurred losses. Though accounting for only about 40 percent of total industrial output, the SOEs absorbed two-thirds of total domestic credit that year.¹⁶ That is obviously too much. Seemingly, the government is caught in an unsolvable dilemma: refusing loans to loss-making enterprises would cause widespread bankruptcies and unemployment, which is politically unacceptable, but continuing to provide loans to them would wreck financial reform. Some have argued that therefore financial reform must be held off till enterprise reform is essentially completed.

The argument has a chicken-or-egg character to it. If loss-making state enterprises depend on continued supply of bank credit to stay afloat, indiscriminate credit supply also relieves them from pressures to improve their financial performances. Only by simultaneous reforms of both sectors could this vicious circle be broken. But, how?

One possibility is to replace bank financing by bond financing. The basic idea is to gradually shift the burden of policy lending from banks to the governments that sponsor the loss-making enterprises. If currently they do not have the means to bear the costs, they must borrow and be held financially responsible for their debts. To be able to borrow, they must possess taxing power. In China, only the central government or the provincial and special-municipal governments have this power.

The shift from bank financing to fiscal financing cannot be made overnight. Sufficient time must be allowed for all parties to make the necessary adjustments. During the transition period, say, over ten years, the sponsoring government of loss-making enterprises would be authorized to issue a special Enterprise Reform Bond to the full amount of the policy loans under its sponsorship. The bond would be backed by the taxation authority of the issuer. In the first year, the banks would be required to subscribe to the full amount of the bond issue in proportion to their shares of the policy loans. The bond issue would decrease

in subsequent years according to a pre-determined schedule, to zero after the tenth year.

During the first year, nothing is changed: the banks would continue to provide policy lending as they do now. But, everyone, including the sponsoring governments, would be put on notice that policy lending will be phased out as scheduled. In the meantime, the governments must work with the enterprises under their sponsorship to come up with schemes to reduce and ultimately eliminate the enterprises' losses or, if they wish, for the governments to assume the responsibility of subsidization.

This approach incorporates the principle of fiscal accountability and compels local governments to take responsibility for solving local problems. Too often, the central government takes it on itself to find solutions for problems of the whole nation. With a limited number of already overworked, competent staff members in the central government's ministries and commissions, and the diversity of conditions in a vast nation, it would be folly to expect the central government to design an enterprise-reform program and establish rules that would fit all localities. Under our combined financial/enterprise reform approach, all local governments that are the ultimate sponsor of the currently loss-making local enterprises within their respective jurisdictions would be called on to work with these enterprises in order to find their own solutions within the prescribed transition period. At the same time, the central government must set an example and not seek relief by pressuring the central bank to come to the assistance of failing state enterprises under its jurisdiction.

This approach does not represent a radical departure from the experimental enterprise-reform program the government has already begun. Under that program, in addition to the central government's own experiments with different forms of enterprise ownership, 18 major cities have been selected to design and experiment with their own plans for comprehensive reform of the state-owned enterprises within their respective jurisdictions.¹⁷

Our scheme, however, takes the program further by requiring each province and special municipality as well as the central government to take responsibility for the failing state-owned enterprises under its sponsorship and not leave the burden on the banks. It is explicitly stated, gradually hardening budget constraint that is lacking in the present segmented enterprise reform program, and characteristic of our integrated financial/enterprise reform proposal.

The transition period is a feature that requires highlighting. The scheme's success will depend critically on how well the time is used to effect the requisite changes. Given the prospect of being ultimately freed from policy lending, the banks can focus on preparing for their transformation into market-oriented commercial banks. The central and local governments will have time to strengthen their revenue base for servicing their enterprise-reform bonds, as well as to work with the failing state enterprises on stopping their financial hemorrhage. And the enterprises themselves facing gradually hardening budget constraints will be compelled to find ways to lessen their dependence on state subsidies.

In short, as already stated but is worth reiterating: the proposal gives explicit recognition to the close interdependence of financial reform and enterprise reform; the two must proceed together for either to succeed.

C. Bond Market Reform

Assuming no reform of the bond market, the financial/enterprise reform scheme just proposed would require banks to purchase the bonds and hold the bonds. With bond market reform, however, compulsory subscription could be replaced by voluntary holding, much to the benefit of the banks and the financial system as a whole.

China resumed bond issuance in 1981.¹⁸ At first, only the central government was allowed to issue bonds, and their purchase was forced upon local governments and enterprises as another form of taxation. A bond market began only in 1986 when a few banks and enterprises were authorized to issue bonds and purchases of all bonds became voluntary. Thereafter, the market developed rapidly. From Y40 billion at the end of 1986, outstanding bonds rose to Y300 billion by the end of 1993. The volume of issue tripled from Y38 billion in 1993 to Y113 billion in 1994, and was expected to reach Y150 billion in 1995. Secondary markets were opened in 1988. They developed even faster: trading volume rose from Y2.2 billion in 1989 to Y105 billion in 1993. Trading technology also improved rapidly. The facilities on the Shanghai and Shenzhen exchanges now are comparable to those in advanced countries, with screen-based, satellite-linked systems, continuous order matching, and the capacity for same-day settlement.

All the same, the development of the bond market has been hampered by the government's ambiguity toward the market. While appreciating its advantages, the government also views the bond market as a potential drain of funds from the banking system, hence from controlled channels of credit. Not only have bond issues been strictly limited, but also their interest rates have been pegged to long-term bank deposit rates in order to minimize their competition with banks for funds.

Although conditions are in general better in the secondary markets than in the primary markets, the former too suffer from a serious lack of liquidity, thus limiting the attractiveness of holding bonds. This lack of liquidity is due to the underdeveloped state of money markets for bond investors to move funds. And the underdeveloped state of the money markets in turn can, again, be traced to interest rate ceilings and the credit plan which controls short-term money-market issues.

Increasingly, though, the authorities have come to appreciate the importance of a well-functioning bond market. Their decision to ban the government's access to central bank credits has forced the Treasury into the bond market. It was the principal factor behind the tripling of bond issues in 1994 from 1993. The central bank, too, has decided to experiment with open-market operations as an instrument of monetary policy. Hence, for both fiscal and monetary policy operations as well as the general health of its financial system, China needs to strengthen its capital and money markets.

D. Interest Rate Policy

Under the credit plan, interest rates have been used only to attract bank deposits, but played little role in credit allocation.

As in all countries that use quantitative controls to allocate capital, interest rates are kept low in the mistaken belief that

this policy would stimulate capital investment and hence economic growth. However, other countries have found that low interest rates reduce domestic savings and encourage capital flight, hence in the long run do not add to domestic capital formation, but result in misallocation of capital.

In China, an additional consideration for keeping interest rates low has been the perceived dependence of state-owned enterprises on low-interest bank loans. It is alleged that through long-established tradition these enterprises have come to view low-interest bank credits as a right, and many have become dependent on them for survival. Those that are making losses do not service their debts in any case, and are therefore immune to changes in interest rates. Those that are profit-making loudly claim that they are already bearing most of the tax burden, and that interest rate deregulation would surely drive them into bankruptcy. The combined opposition of these politically powerful voices has made it difficult for the central bank to deregulate interest rates. Moreover, it is argued that

the banks have been accustomed to function only as loan-dispensing agents under the credit plan, and therefore are institutionally not prepared to evaluate credit risks and respond to changing market conditions. Thus, in the minds of many a vicious cycle has been created: control over interest rates cannot be eased because allegedly the market is not ready for it, but the market cannot be developed without the easing of interest rate controls.

Fortunately, the cycle exists only in the minds of men. It is broken as soon as one realizes that interest rate deregulation is not an on-off, yes-or-no matter. There are many kinds of interest rates. Deregulation does not necessarily mean lifting controls on them all at once. It is true that through arbitrage all interest rates are closely related to one another in market economies where funds are free to move across markets. But, in countries like China, where the markets are highly segmented through existing differentiated quantitative controls, gradual interest rate deregulation is still feasible with proper sequencing and coordination with other parts of the reform program.

Thus, if banks and their borrowers need time to adjust, then for the time being let bank lending and deposit rates be administered as they are now, but make sure that the banks and their borrowers work out transition plans to prepare for eventual interest-rate deregulation. What can be and should be quickly deregulated are money and capital market interest rates. Since early 1996, interbank rates have already been freed. Short-term rates should be the next. Money markets--such as those for commercial paper, Treasury bills, negotiable certificates of deposit--would develop quickly, once controls over issuance are eased and interest-rate limits are abolished or widened. Development of these markets is crucial for the central bank's open-market operations as well as for facilitating liquidity management of financial institutions and the government. Moreover, it would pave the way for the development of a well-functioning long-term bond market.

A concern about partial interest rate deregulation is that it would divert funds out of the banking sector and thus cause disintermediation. However, disintermediation has already occurred on a large scale as a result of bank interest-rate regulations, with financing outside the banks being conducted in a chaotic, unorganized manner. A program to develop money markets through interest rate deregulation and establishing rules of participation would bring order to what already exists. Moreover, competition may be what the banks fear, but it is only through competition that they would be pressured to reform and gain experience in the market. Also, concerns over "excessively" high money-market interest rates could be eased by the authorities' continued oversight. If necessary, they could adjust the volume of bond issuance to moderate the demand for credit in the market.

E. Monetary Policy

The People's Bank of China already possesses an almost full complement of indirect monetary control tools: reserve requirements, open-market operations, discount facilities, and loans to banks. However, though well equipped, it has conducted monetary policy in effect only through the credit plan. The result of this failure to use indirect monetary policy instruments has created a bewildering set of reserve requirements in China. 19 Banks are required to hold 13 percent of reserves and another 5 to 7 percent excess reserve against their deposits, for a total of 18 to 20 percent. Moreover, the 13 percent required reserves are frozen assets; only the excess reserves can be used to settle payments.

This peculiar arrangement came out of the operations of the credit plan. To meet the ever-rising funding requirements of the credit plan, the central bank has supplied a rising volume of reserves through lending to banks. This resulted in mounting bank reserves, which became excess reserves whenever the credit plan was the binding constraint in credit extension. To mop up the resultant excess reserves, the People's Bank of China froze the required reserves and slapped on top of them excess reserve requirements. Excess reserves continued to accumulate and exceeded the total reserve requirements to the extent of between 15 and 18 percent of the total bank deposits at the end of the three years 1989, 1991, and 1993.²⁰ Normally, in a market economy where a reserve-based, indirect monetary policy is operative, huge excess bank reserves would signal a monetary policy out of control and rising inflationary pressure. But, not in China, where the effective monetary control has been the credit plan, not any of the indirect monetary policy tools.

The planned shift to indirect monetary control, therefore, would necessitate a thorough house-cleaning to sort out the various existing hitherto unused policy tools and get them in shape for use. Specifically, means must be found to mop up the huge accumulated excess reserves. One way would be for the central bank to issue a bond to mop up the excess reserves. The bond issue could be sold by auction to banks only. It would be redeemable only when called by the central bank, and in amounts to be determined by the central bank as a means to inject reserves into the economy. Since the initial issue could be as large as desired, the central bank could use the opportunity to combine the present excess and regular reserve requirements and lower the total to, say, ten percent,²¹ without the expansionary effect on the money supply usually associated with a reduction in reserve requirement.

The bond would not be counted as part of reserves, but could be marketable among banks so that a bank with good lending opportunities could obtain additional reserves by selling its bonds to another bank with surplus reserves. To the extent that the bond is as transferable as bank reserves, this would turn into another interbank market parallel to the existing interbank funds market, to facilitate banks' liquidity management. Like the interbank funds market, the interbank bond market would not affect the total reserves.

In addition, the central bank should experiment with various indirect monetary control tools to see which one would serve best. From other countries' experiences, the choice is between open-market operations and lending to banks. Both provide the flexibility and effectiveness needed for monetary policy. Open-market operations might appear to have the advantage of non-arbitrariness in the distribution of reserves, but the same effect can be achieved if lending to banks were operated on an auction basis to achieve allocation through the price mechanism. Lending to banks has the advantage of minimal extraneous requirements, such as well-functioning money markets, which China presently lacks

Lending to banks by auction is quite different from the discount facility of most central banks, including China's, which makes reserves available on tap, that is, open to all qualified institutions that come with eligible paper. In contrast, lending to banks by auction would distribute reserves on a fixed schedule, say, weekly, for a pre-announced amount of reserves. The interest rate would be determined by the market, not set by the central bank as in the case of the discount rate. This new facility could exist side by side with a usual discount facility available on tap, such as used by the German central bank, with the former for adjusting the banking system's total reserves and the latter for assisting in individual banks' reserve management.

Whether open-market operations or lending to banks by auction is chosen as the principal monetary policy instrument, in either case interest rates must be allowed to vary and the banks must be truly market-oriented. Neither condition exists in China today. Both are challenges the monetary authorities must meet in the next several years if financial reform is to succeed.

Endnotes

1. World Bank, 1996, Annex, Tables 1, 14, and 16, pp. 35, 48, and 50, respectively; and World Bank, 1990, Annex, Table 1.1b, p. 132

2. World Bank, 1996, Vol. I, Table 3.1, p. 24.
3. World Bank, 1990, pp. 37-40; World Bank, 1995, Annex 3.1, pp. 116-117.
4. World Bank, 1996, Vol. I, p. 32
5. World Bank, 1990, p. 31; The People's Daily, May 1, 1996, p.1.
6. Almanac, 1995, p. 312.
7. Almanac, 1995, p. 312; and Yearbook, 1995, p.36
8. Mao, 1994, pp.179-183
9. The selection of broad money (M2) over narrow money (M1) and currency in circulation (M0) is based on the results of the vector autoregression (VAR) study in IMF, 1994, Appendix II, pp. 54-59, which indicates a superior predictive power of M2 over the other two for fixed investment, industrial production, and inflation during the sample period 1985-93.
10. World Bank, 1996, Annex, Table 15, p. 49.
11. For a comprehensive analysis of the reform program, see IMF, 1994.
12. Almanac, 1995, pp. 333-335.
13. IMF, 1994, p. 19.
14. Almanac, 1995, pp. 335-339.
15. Almanac, 1995, pp. 567 and 578.
16. IMF, 1994, p. 41.
17. IMF, 1994, p. 44; World Bank, 1996, pp. 16-17.
18. Data on this subject are from World Bank, 1995b.
19. World Bank, 1995a, pp. 41-42.
20. Ibid., Table 3.3, p. 42.
21. High reserve requirements weaken banks' competitive position in the market and thereby encourage disintermediation.

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