

CHINA

Financial Reform: 1979-1994

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1

Introduction

A new world power is emerging.

China, the land of 1.2 billion "descendants of the Dragon," is impressing the whole world with its expedient growth in recent years. Media all over the globe attribute this to the economic reforms that have been taking place since 1978.

The reforms have brought a variety of new, market-oriented constituents into the previously sluggish economy. Private firms, collective enterprises, joint-stock enterprises, non-bank financial institutions, (i.e. urban/rural credit unions, mutual funds, insurance companies, stock exchange markets) and many other non-traditional economic entities have proliferated during this period. These new economic forms, along with the somewhat revitalized public sector have injected new energy into the old system. As a result, the country has been able to realize an average GDP growth of 9.5 percent per year (World Bank, 1990, p. xii) from 1978 to 1990, and has realized double-digit growth in the more recent years.

The impacts of the reforms are substantial and manifold.

Monetarily, it is not only the Chinese people who have benefited from these reforms, but a great number of foreign investors and entrepreneurs as well. A great many multinational companies have chosen China as their immediate target for investments. Medium and even small

sized investors from Hong Kong, Taiwan, and Japan rushed into the country to realize their dreams of immediate high returns. China has become the honey pot for investors all around the world. The reason is simple — China has a market of 1.2 billion people whose purchasing power is increasing rapidly. The Chinese government is also willing to put forward more flexible policies to attract foreign investments, according to the "open door" policy adopted since 1979. The amount of contracted foreign investment in 1992 was 68.5 billion U.S. dollars.

Politically, China is the only country (with the exception of Vietnam) that is still implementing socialistic economic reforms. With the breakdown of the former Soviet Union, China now stands as the strongest socialistic country in the world.

Ideologically, intense debates have been focused upon the definition of a socialist society. As the reforms went further, private enterprises, securities exchange markets, and other new markets have generally weakened the governmental controls over the economic system. The underlying foundation of a socialist structure were shaken when the ownership of resources became the center of debate.

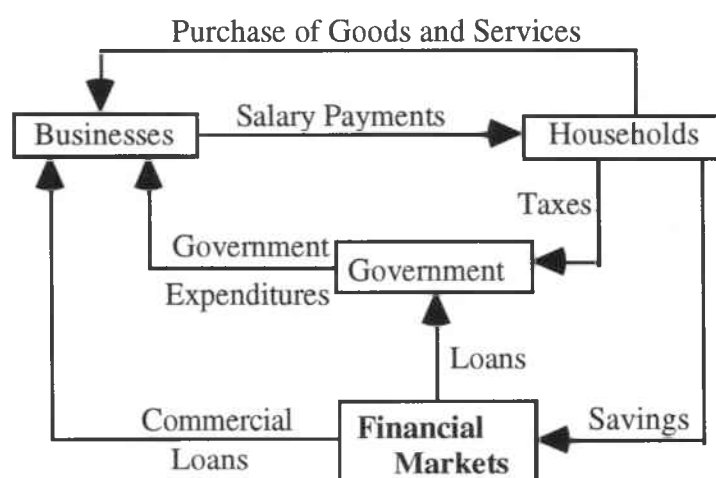
These impacts will surely reverberate throughout the future developments of the Chinese economy.

In the short term, there exist immediate threats to China's economy and the various investors. The double digit inflation in the 1988-89 period was a major attribute to the wide-spread social unrest in 1989. In 1994, inflation peaked at 27%; roughly 41% of the state-owned enterprises reported losses, and the combined losses had risen 28% from 1993.¹ In general, the reforms have been extensive rather than intensive and the

¹ Joseph Kahn, The Asian Wall Street Journal Weekly, week of Jan. 9, 1995: p. 2.

regional (east coastal vs. inland) and sectoral (urban vs. rural) imbalances are worsening. Crime rates in cities and general unrest in rural areas are rising. Many investors have also awakened from their dreams of getting "quick cash" in China, realizing that China is "... a country with a stubbornly high inflation rate, skyrocketing real-estate prices and a feckless legal system."² Although most observers are quite confident about the long-term perspectives in China, many investors have put a question mark beside China in their investment portfolio.

During this era of great changes, many excellent studies have been done on the general economic conditions in China, with most of them focusing on the "real economy"(Bowles & Gordon, 1993: p. 2). The reforms in sectors such as agriculture, industry and foreign trade certainly deserve close examination. Nevertheless, the financial system, functioning as a lubricant to the economic system as a whole, should require more concern as well. A "circular flow" diagram in a simplified economy would illustrate how important a reliable financial system is to the overall well being of the economy.



² Dan Biers, The Asian Wall Street Journal Weekly, week of December 26, 1994: p. 1.

Thus, the primary objective of this thesis is to analyze the financial reforms in the context of a more comprehensive set of regional and sectoral reforms in China, during the period of 1979-1994. It is also my objective to depict a possible future path for China's financial reform.

The entire text can be divided into three major bodies.

The first part, chapter 2, is a general description of the past - the pre-reform financial system in China. It serves to provide an overview of the practices involved in the financial system, the banking system in particular, during the period of 1949-1976.

The second part, chapters 3 and 4, focuses on the actual reform acts in the banking industry and securities markets from 1979 to 1992. My intention is to show the dramatic changes that have been made since 1979 and to analyze the outcome.

The third part, chapter 5, is a look into the future. The financial system will be superimposed onto the background of the economic reforms as a whole. I will try to reveal the relationship between the financial reform and reforms in other areas to determine the existing problems. Finally, I will show a possible future path of the financial reform.

2

The Pre-reform Situation

The pre-reform period (1949-1978) can be divided into 2 phases (Tsiang, 1968: p. 324). The first, which was from 1949 to 1951, is the Transitional Stabilization Phase. The second is the phase under central planning. We shall take a closer analysis in this order.

The Transitional Stabilization Phase 1949-1951

In October of 1949, the new country — The People's Republic of China was founded by the Chinese Communist Party (CCP). One of the urgent problems to solve at that time was the hyperinflation³ left over by the Nationalist Party (*Guo Min Dang*), which was one of the major reasons that the Nationalist Party had lost its popularity.

During its final years, the Nationalist regime was incompetent in its control utilization of monetary and fiscal policies. There were a few factors that eventually contributed to the occurrence of the hyper-inflation, such as inadequate funds to finance the civil war, but the monetary policies adopted by the Nationalist Party were theoretically wrong. As Mr. Tsiang, then a professor at the National University of Peking, wrote:

³ Hyperinflation can be defined as a rapid inflation, usually at more than 22 percent per month or 1000 percent per annum, experienced over one year or more.

The dominant view of the monetary authorities then in power was that the rate of interest is an important element of costs of production. Since prices are determined by costs, to fight the already rampant inflation, it was argued, the rates of interest must be kept low. . . The natural result of such a monetary policy, that pegged the interest rates charged by banks at a low level in face of rampant inflation, was that the banking system was totally unable to absorb any voluntary savings that might still have been generated by the emaciated economy. The banks, whose lending and deposit rates were controlled by the authorities, could not attract any funds for their lending operations, but must go periodically to the Central Bank to get their allotted quota of funds, which the latter, as the only bank of issue, generated out of the printing press (1968: p. 325).

Inflation can be defined as a rise in general price level. A common indicator used by most economists is the Consumer Price Index (CPI). It chooses a basket of consumer goods and assigns one particular year as the "base year", with an index level of 100. For instance, if we choose the year 1968 as the base year, then the price index for 1968 is 100. Let's further assume that the price index of 1993 is 150. The inflation between 1968 and 1993 is then 50%, according to the formula:

$$\begin{aligned} \text{Inflation rate} &= [\text{Price Index (1993)} - 100] / 100 \\ (1968-1993) &= (150-100) / 100 = 0.50 = 50\% \end{aligned}$$

If the price index of 1994 is 200, then the inflation rate between 1993-94 is:

$$\begin{aligned} \text{Inflation rate} &= \frac{\text{Price Index (1994)} - \text{Price Index (1993)}}{\text{Price Index (1993)}} \\ \text{(1993-1994)} & \\ &= (200 - 150) / 150 = 0.33 = 33\% \end{aligned}$$

There are usually two ways that an inflation can occur. The first occurs when there is a general increase in demand for all goods in the economy. This type of inflation is thus called "demand-pull" inflation.

Referring to figure 2-1, original equilibrium is reached at point E, where aggregate demand equals aggregate supply. When a general increase in aggregate demand shifts the demand curve to the right, a new equilibrium has thus been reached at point E'. As the graph indicates, the resulting price level P' is higher than the previous one at P and inflation has occurred.

A second type of inflation is caused by a contraction in supply. With increases in input prices, such as material costs, labor cost, the economy will produce less at each price. The resulting equilibrium would be of a higher price, and according to our definition, inflation has occurred. Referring to figure 2-2, a contraction in aggregate supply due to increasing costs will shift the curve to the left. Consequently, the new equilibrium is reached at P', a higher price level than P, and inflation has resulted.

FIG 2-1: Demand-Pull Inflation

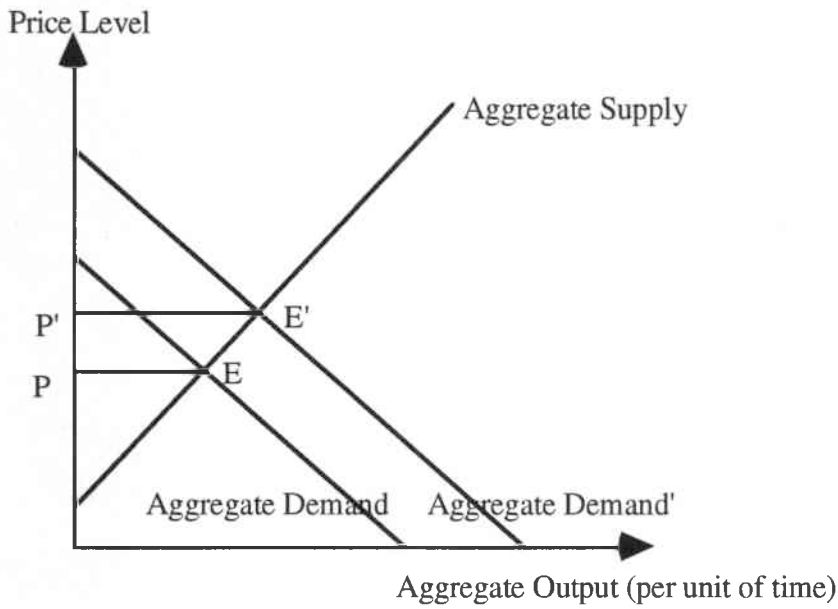
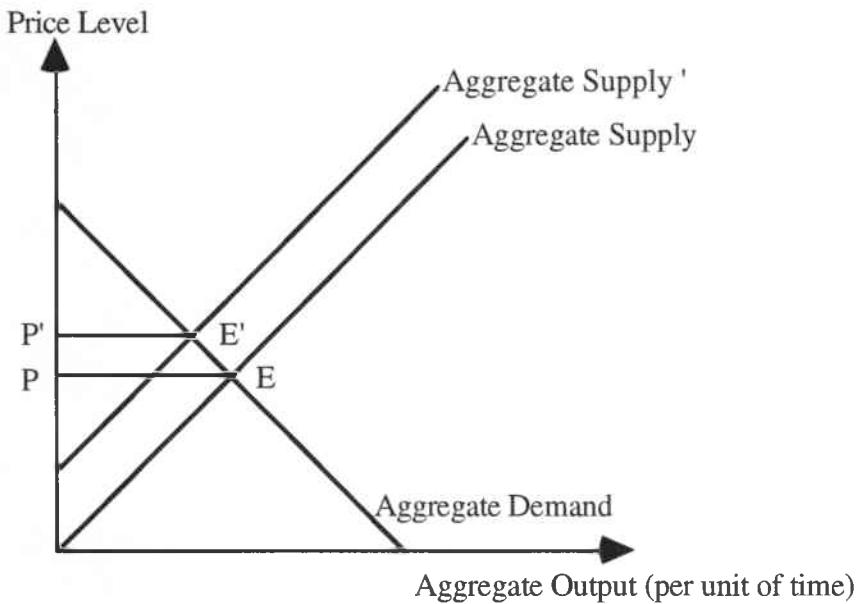


FIG 2-2: Cost-Push Inflation



The CCP extended its control over different areas of the economy after the take-over in 1949. The People's Currency (*Ren Min Bi*) replaced

the old currency in an attempt to restore the economy under the control of the new regime. Nonetheless, the inflation did not stop right then. The CCP leaders learned the lesson from the failure of the Nationalists. They understood the importance of savings in the time of inflation. In general, people hold currency for two reasons. One is to hold it as a transaction balance - to facilitate the purchase of goods and services. The other is to hold it as an asset balance - to keep it as a store of value. Inflation, or say, a general rise in price level, occurs when there is too much money in circulation and not enough goods and services to absorb the currency flood. Therefore, a decrease in currency in circulation would choke the inflation, at least temporarily. One way to achieve this is to attract savings, which tends to divert the currency away from the general public that is hungry to purchase goods and services (because they are afraid the inflation will erode away the purchasing power of the currency they are holding). Before, the banks had to rely mainly on the Central Bank for funds, which in turn relied on the issuance of more currency. The more currency in the economy, the more inflationary pressure there exists. Consequently, the increase in bank deposits can also enable the bank to make more loans to the business sector to use in the production, without exerting further inflationary pressure on the economy. The natural result of more investment by business enterprises is the increase in the supply of goods and services, which eventually would bring the price tags down.

One successful policy implemented by the CCP was the so-called "real goods savings deposits" (*ZheXian ChuXu CunKuan*) savings scheme, "These deposits were reckoned in terms of a 'real goods unit,' which consisted of a bundle of staple consumption goods that were daily necessities to most people"(Tsiang, 1968: p. 326). People then had the

incentive to put their money into the banks, because they did not have to worry about the rapid depreciation of their money under the high inflationary pressure.

Other ways to increase the flow of investments into the business sector included bond issuance. A bond is an instrument which governments or corporations use to raise funds to bridge their deficits or to raise capital. Bond holders usually realize an interest payment annually or semi-annually (one exception is the zero-coupon bond which is initially sold at a discount⁴). Through a similar chain reaction as the bank deposits, bonds can also partially relieve the inflationary pressures. The Chinese government issued 100 million real units of the "People's Victory Real Unit Bonds" in January, 1950 (Tsiang, 1968: p. 327). With the quick over subscription of the bond issues, the inflation was already brought to a halt by March 1950. The Victory bond continued to be issued between 1954 and 1957, National Economic Construction Bonds were issued annually. Table 2-1 shows the amount of bonds issued in these years.

TABLE 2-1: Domestic Bond Issues, 1950-1958 (million yuan, current prices)

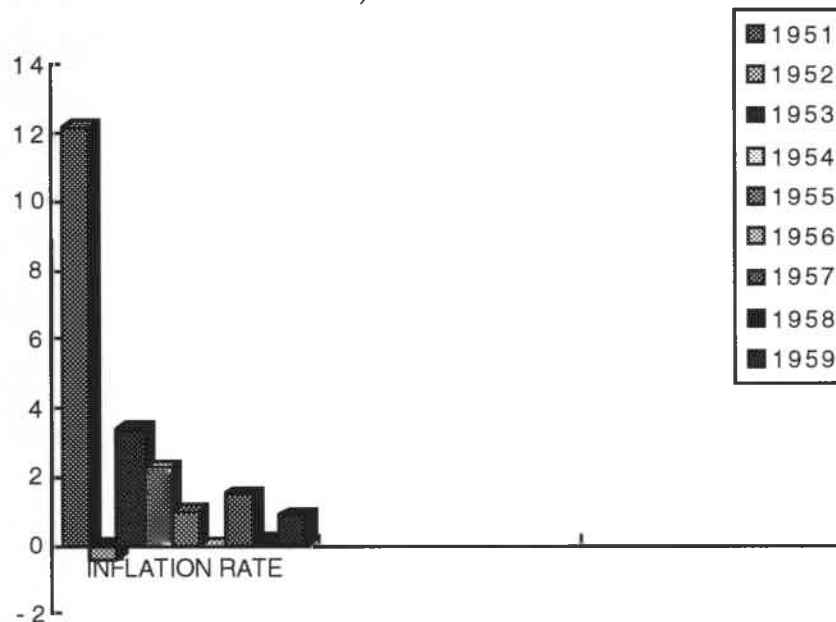
| | 1950 | 1954 | 1955 | 1956 | 1957 | 1958 |
|---------|-------|------|------|------|------|-------|
| Planned | n / a | 600 | 600 | 600 | 600 | 790 |
| Actual | 260 | 836 | 619 | 607 | 650 | n / a |

Source: Bowles & Gordon, 1993: p. 67

⁴ Bond, as a debt instrument, carries interest payments with it. Creditors would buy a zero-coupon bond at the face value due to this reason. Zero-coupon bonds are thus sold at a discount, which is the present value of the face amount due in the future, using the market rate at the date of issuance.

The over subscription might be attributed to both government persuasion and coercion. Tactics such as "political campaigns and social pressure exerted in the workplace and in neighborhoods by unions and other community organizations"(Bowles & Gordon, 1993: p.66) were used. After CCP's successful control of the rampant inflation inherited from the Nationalist regime, the general price level was quite stable throughout the 1950s.

FIG 2-3: Inflation in China, 1951-1959



Data adapted from Bowles & Gordon, 1993: p. 66

In conclusion, during this first phase of financial transition, the CCP mainly dealt with the tumultuous economic situation, namely the hyperinflation. The monetary authorities had not yet expanded its full-wedged power throughout the system, neither had it acquired the necessary expertise of control from the Soviet Union.

Central Planning Period : 1952-1976

The banking system in a planned economy differs substantially from that in a market economy. In a market economy, there exists substantial competition, among banks and between banks and other non-bank financial institutions (NBFI's), whereas in a centrally planned economy, traditionally, there is only one bank. It is virtually a monopoly, powerful and all-encompassing. The State Bank is the only institution that has access to the printing press and the sole source of short-term credit. It supervises all business transactions in the economy. Socialist countries love to attack their capitalistic counterparts for their inefficiency. Accordingly, one major factor that contributes to this inefficiency is the existence of monopoly—the worst nightmare of a healthy economy.⁵ The great irony here is that in a planned economy practically all enterprises, including the banking institutions, in one form or another, are state-owned monopolies. Competition was not promoted and there was no market whatsoever.

Institutional Framework

The great communist revolutionary leader Lenin, wrote the following passage several days before the October Revolution in 1917:

[w]ithout big banks, socialism would be impossible. The big banks are the 'state apparatus' which we need to bring about socialism, and which we take ready-made from capitalism A

⁵ Monopoly is a type of industry structure in which the entire industry only consists of one firm. The monopoly firm is then the sole provider of the particular good or service and has the ability to arbitrarily adjust its price. Since it could always increase price to cover its inefficiency in material usage or plant utilization, it does not have to be as watchful in terms of economic or allocative efficiency.

single State Bank, the biggest of the big, with branches in every rural district, in every factory, will constitute as much as nine-tenths of the socialist apparatus. There will be country-wide bookkeeping, country-wide accounting of the production and distribution of goods; this will be, so to speak, something in the nature of the skeleton of socialist society (Bowles & Gordon, 1993: p. 49).

In the early 1950s, following the early views of Lenin, China's banking system practically consisted of one bank - the People's Bank of China (PBC), with the exception of the Bank of China.⁶ A common characteristic of any project in a socialist country is the tremendously complex structure and the impossible perfection it has to achieve. The comprehensive planning is like the blueprint of THE MACHINE - the socialist economy as an integral body. The plan draws out each and every part of the machine, to an incredible preciseness. The banking system, or say the bank, serves to facilitate the functioning and to safeguard the realization of the goals set forward in the plan. These two parts are essentially the two arms of the socialistic economic giant.

The People's Bank of China is the most comprehensive banking institution in China. It was formed in 1948 and takes on the form Lenin has designed for The Bank—the skeleton of the economy. It is "[a]n independent, ministry-level entity that reports directly to the State Council"⁷ (Byrd, 1983: p. 7). It has numerous branches throughout the system, analogous to the circulatory system of a human body.

⁶ The Bank of China (BoC) was first formed in 1904 and now under the supervision of the PBC.

⁷ The State Council is the highest form of government entity in China.

The PBC expanded rapidly and came into supervisory position of all banks by 1952 (Bowles & Gordon 1993: p.55). By 1957, it had 20,000 branches and controlled over 100,000 rural credit cooperatives (Miyashita 1976: p. 117). Although there was some threat to the control of the PBC during the Cultural Revolution, as of the end of 1979, it was able to control—

. . . [o]ver 15,000 different subunits throughout the country, including 29 provincial-level branch banks, one for each province, autonomous region, and centrally administered municipality, ⁸ 148 municipal-level subbranches (in cities directly subordinate to the provinces), 220 central subbranches in prefectures, 2,777 county-level subbranch banks, and 2,883 offices under the jurisdiction of county-level subbranches (Byrd, 1983: p. 10).

The PBC was formulated after the model of banking system envisioned by Lenin. Nevertheless, certain variations did occur. The Chinese banking system was highly decentralized, in terms of the location of the personnel and the "dual leadership" exerted upon the branches. As of 1980, the PBC had over 300,000 employees, with only 1,200 at the head office in Beijing. The "dual leadership" refers to the control by the head office in Beijing and by the provincial party committees. This may have been the result of adverse impact by party interference at the provincial level.

Moreover, the PBC is not the only administrative jurisdiction. The Ministry of Finance (MoF), together with the PBC, constitutes the

⁸ There are three "centrally administered municipalities" in China, Beijing, Tianjin, and Shanghai.

institutional bifurcation. The PBC is the sole institution that facilitates, regulates, and supervises the various economic actors, whereas the MoF is the headquarters for fiscal policies.

The banking system has been charged with three major tasks.

Sectoral Development And Political Objectives

The primary task for the banking system then was to facilitate the State's realization of specific sectoral/ political objectives.

At the dawn of the new regime, the private sector still played a significant role in the economy. One of the major goals for the Chinese Communist Party(CCP) was to eliminate any form of capitalistic private ownership of capital. Therefore, the socialist transformation of the private sector, including private banks, private enterprises, and private farms, has been brought into the party's immediate agenda.

By 1951, the PBC had brought all private banks under its control. Functioning as the sole agent for the government to promote the socialization of industry and commerce, and the collectivization of the agriculture sector, the PBC introduced a variety of disincentives against the private sector, and an array of positive inducements for firms to become joint state-private enterprises. These actions did not aim to achieve any specific economic improvements in the short term, but had certainly enabled the state to exert much more control and supervision over the economic system. This would further enable the Central Planning Bureau to oversee the performance of the plan.

In terms of providing support for sectoral development, the PBC and the Special Banks had made sufficient loans to the favored sectors. For instance, heavy industry has long been treated as one of the most important

industries in the economy. The CCP believed that heavy industry served as the ultimate supplier of energy, raw materials, and machinery for virtually all industries within the economy. During the various Five Year Plans, the banking system had enabled the heavy industry to receive ample funds to make significant progress in its modernization. The agricultural sector was another example for this sort of loan preference. Success in the agricultural sector, especially the production level of rice and flour, had significant political impacts. In a socialist regime, the average citizen is not allowed to suffer from hunger. Moreover, with the rapid expansion of the Chinese population, in accordance with Mao Zedong's promotion⁹, the agricultural sector was under heavy burden of supporting Beijing. The banks thus became the tool with which the Central Government exerted preferences for specific sectoral development.

Plan Fulfillment

The relationship between the plan and the banking system was one as such. The Central Planning Board (CPB) makes a comprehensive plan for all sectors in the economy concerning input level, output level, price level, labor requirements, and so on. Then the plan is communicated to the financial system, namely the Central Bank (PBC). The PBC is charged with providing the enterprises with the funds (usually short-term) for the use of working capital, in accordance to the planned budgetary constraints. Thus, the financial system was NOT a channel through which money capitals are allocated as under the rules of a market system. Rather, the banks were the passive allocators under the direction of a detailed and overly ambitious

⁹ Mao Zedong believed in the dominant role of 'manpower' in war. He thus advocated the popular slogan, "Ren Duo Li Liang Da" – "Many people, great power."

plan. The banks had only a very passive role in its credit-allocation function, due to the limitations imposed by the plan. On the other hand, for the enterprises, the banks were the only supplier for short-term credit, and were thus in a potentially powerful position. Nevertheless, as Bowles and Gordon had stated, "In practice, however, this power has seldom been exercised"(1993: p. 60).

In the economic recovery period of 1949-1952, and during the first Five Year Plan, it was argued that the banks should provide any credit as desired to the enterprises. The objective was to recover production and to reinforce the socialistic success. Therefore, any government deficit was financed by public and bank coverage. The "balance of financial receipts and expenditures system" lending policy of 1953 required the PBC to cover all losses incurred to enterprises. China's banking system was essentially the treasurer for the government and all the enterprises in the economy.

After the credit reform of 1955, the PBC followed the "real bills doctrine." This doctrine stated that bank credits are non-inflationary as long as the extended credit was matched with a flow of real goods. The only burden exerted on the enterprises, then, was to show the purpose of the needed funds. As long as the enterprises could prove that the funds were to furnish inventory or to finance working capitals, the PBC had to extend the loans. Again, the banks had no discretionary power concerning the performance of the recipients of credit.

During the three years of "Great Leap Forward" (1958-1960), the people's ambition to "Catch up with the Great Britain and exceed the U.S.A." initiated a series of distortions upon the basic structure and sectoral development of the young and vulnerable economy. Following the Great Leap Forward came three years of ferment (1961-1963), during

which the majority of all agricultural loans were non-performing. As of the end of 1979, "the total value of agricultural loans which could not or would not be repaid when due exceeded 10 billion yuan. This was over half the total value of all loans to rural areas by banks and credit cooperatives outstanding at that time" (Bryd 1983: p. 42). Again, the PBC had to deal with the loss on these agricultural loans.

Macroeconomic Stability

The banking system was also a major instrument for the CCP to ensure macroeconomic stability.

In a typical market economy, such as that of the U.S.A., the Central Bank is empowered to adopt various monetary policies to alter the money supply in circulation, and thus to achieve macroeconomic stability. Although there have been schools that opposed any government interference in the economy,¹⁰ fiscal and monetary policies have been widely adopted by most capitalistic governments.¹¹

There are a number of ways in which the Central Bank can change the money supply and thus the overall level of economic activities in an economy. For instance, the Central Bank of the United States – the 12 Federal Reserve Banks (Fed), use three instruments in doing so. These are

¹⁰ The predominant school that advocates "laissez faire" is the Classical view which argues that supply automatically generates its own demand and ensures full employment in the economy. These scholars claim that macro stability is a built-in factor in a market economy. Any form of government intervention would essentially distort the overall well-being of the economy and its actors.

¹¹ The Keynesian School states that a certain degree of government control helps the economy get over the inevitable cyclical changes of any system. It would also act as a policeman, ensuring fair business practices. This view has been generally accepted in this country after the Great Depression of the 1930s, when the academia and the public realized the importance for government regulations.

the Federal Open Market Operations (FOMO), the discount window, and the reserve requirements.

The most commonly used instrument by the Fed is the FOMO. The FOMC (Federal Open Market Committee) can either buy or sell securities to expand or contract the money supply, respectively.¹² When the FOMC buys securities, it either pays by cash or by increasing the member banks' account balance. It has thus injected more liquidity into the economy.¹³

The discount window refers to the Fed's ability to alter the interest rates that prevail in the federal fund market. The member banks have to limit their lending in order to meet with the reserve requirements imposed by the Fed. Occasionally, a very profitable and safe loan project may cause the member bank to run short of funds. It can then go into the Federal Fund Market to borrow the amount for short-term usage. Therefore, by changing the interest rates charged on these short-term loans, the Fed can alter the member banks' ability to lend, and thus the total money supply in the economy.

The reserve requirement ratio is the amount of reserves which member banks keep at the Federal Reserve Banks as a percentage of their total deposits. It is found to be too powerful an instrument to use on a frequent basis.¹⁴

¹² The FOMC uses the Treasury Bond (T-bill) as the primary security in its trading.

¹³ Cash is certainly more liquid than a bond, because of the limited marketability of the bond. Crediting the member banks' account increases their reserves at the Federal Reserve Banks, and consequently results in their increased ability in lending, either to business firms or to individuals.

¹⁴ Reserve Ratio (m) = Required Reserves (r.r.) / Demand Deposits (d.d.)

Thus, Required Reserves = d.d. x m

Also, Excess Reserves = Actual Reserves – Required Reserves;

and the Banking system's lending constraint = Excess Reserves / m.

If everything else remains constant, when the Fed raises the Reserve Requirement Ratio (m), Required Reserves would increase and the Excess Reserves would thus decrease. The final equation, which states the total lending ability of the banking system, indicates the two-fold impact on the total money supply.

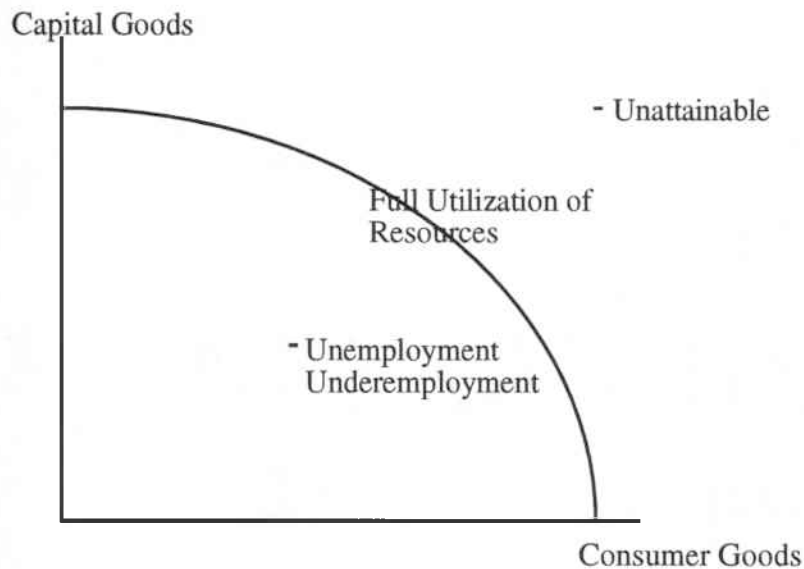
As mentioned previously, bank credits were extended freely to enterprises, and it is surprising to observe that China was able to enjoy a degree of constant growth and macroeconomic stability. The reason for this surprise is that the three instruments of monetary control were virtually useless under this system. For instance, when the monetary authority is trying to tighten the money supply to lower inflation, the banks are still granting loans to enterprises, and tend to offset the attempt of the retrenchment policies. In fact, as Bowles & Gordon noted:

The relatively high degree of price stability has been attributed to a number of factors not in fact connected with the banking system's control mechanisms. These factors include the insulation of the economy from world market price increases and the maintenance of balanced budgets. Given that the level of investment was determined by the central plan, the main task was to ensure a level of savings sufficient to meet this. The banking system was required, therefore, to mobilise a high level of savings. Whilst bank credit was passive, mobilising savings was the PBC's primary active function (Bowles & Gordon, 1993: p. 65).

Every economy faces a so-called production possibility curve, which illustrates the primary concern of economic studies – scarcity. All resources on this planet are limited, and are thus scarce. To use a resource efficiently and effectively is what people refer to as being "economical". Economists study the availability of resources in a nation, and graphically indicate the limitation on an economy's ability to produce the various categories of goods and services. Referring to figure 2-4, the points on the

curve imply full utilization of resources, or full-employment; those underneath the curve indicate unemployment and underemployment; and those above the curve suggest unattainability.

FIG 2-4: Production Possibility Curve



To achieve growth in an economy means to shift the curve to the right. Investment in capital goods is an important factor in determining growth. In our context, the ratio of investment to total GDP in China increased from 23% in 1957 to 31% in 1979. This ratio is considerably higher than average low-income nations. During the years when China kept its gates shut, this investment was entirely financed from domestic savings. As Bowles & Gordon suggested, although some of the savings might have had a coercive characteristic, the PPC certainly played a significant role in mobilizing this level of domestic savings (1993: p. 65).

Conclusion

During the first thirty years of consistent developmentalism, China established its economic and financial systems which had their origin in the

centralized planning system of the former Soviet Union. This root had defined the major characteristics of the system, although the Chinese model did differ to some extent from the Soviet one. The major contribution of the financial system was to assist the implementation of the central plan. However, it played a rather minor role in promoting enterprise efficiency.

3

The Banking Industry in Reform

The ten years of the Great Proletarian Cultural Revolution (1966-1976) was the most radical attempt to destroy a great part of human civilization. It clouded out all attempts to develop the economy and planted the root of class struggle deep into the citizens' lives. It left China with severe wounds to be healed. With the death of three great leaders—Mao Zedong, Zhou Enlai, and Zhu De in 1976, the entire country was in a state of chaos. Economic growth were seriously impaired, and the living standards of people were actually declining. Economic development had been halted for ten years, and the state missed the rapid advancement in science and technology taking place in the rest of the world at that time. After the devastating decade of class struggle, attention was again drawn towards economic development.

As early as in 1964, Premier Zhou Enlai had proposed a program for the Four Modernizations, in the areas of industry, agriculture, science-and-technology, and defense. The proposal was renewed in 1975, one year before his death. Deng Xiaoping was chosen to be his successor when Zhou found out about his cancer in 1973. After the down-fall of the "Gang of Four," the radical change from class struggle to rapid economic development eventually consolidated Deng's position at the Third Plenum in 1978.

Institutional Restoration : 1976–1979

As outlined in the previous chapter, China's banking system needed its independence to carry out its various functions. Consequently, the major concern in this period was to rebuild the banking system and to restore enterprise financial accounting practices in order for the PBC to acquire accurate information. As Bryd noted:

Bank auditing of enterprises was restored; attempts were made to instill better accounting procedures and detect and punish deliberate misuse of accounting categories or fraud. The status of accountants was raised, their independence guaranteed. Profits once again became an accepted indicator of enterprise performance, though not yet a source of material benefits for firms or their personnel (83: pp. 50-51).

In short, the policies made during this stage had little effect on the banking system's breaking away from the old system. The main objective was to restore the financial system from the ruins left over by the ten years of turmoil. By early 1979, the PBC had regained its independent, ministry-level status.

Banking Reforms, Phase I : 1979–1982

During this stage, the scope of financial reform was rather circumscribed. The policies were mainly focused to bring about changes in the structure and operations of the state-owned banking system. Although

there was a rapid growth in new NBFIs (Non-Bank Financial Institutions), such as trust & investment companies, urban credit cooperatives, and insurance companies, a true financial market was not yet attempted.

In most advanced market economies, a healthy financial system serves to bring greater efficiency into the economy as a whole. Its development can be seen as a prerequisite for a sound economic system. However, that was not the case in China. The banking system in China functioned as an appendage of the giant economic machine to fulfill the central plan by allocating funds to enterprises according to the plan and to monitor the circulation of money in the economy. Inevitably, it lacked autonomy. This was clearly perceived during the pre-reform situation, as well as in the stage of our concern. Thus to understand the reforms taking place in the period, I believe it is very helpful to first understand the economic reform in general.

One of the objectives of the economic reforms since 1979 was to readjust the composition of the Chinese economy. Severe imbalances existed as a result of mistaken policies of the past few decades. Bryd pointed out in 1983 that the implications of readjustment for the banking system were mixed. On the one hand, banks were used to support expansion of neglected sectors. On the other hand, banks must not place their independence about the goal of plan fulfillment. Furthermore, the banking system was expected to resist pressures from the localities (p. 52). Again, the plan was the priority, while the tasks and expectations for the banking system became increasingly complex and ambiguous. Consequently, autonomy was difficult to achieve.

The banking system was also trying to maintain a balance between its support to the local and national interests:

Though internal decentralization of the banking system appears to be a popular policy, there is more controversy over the role bank branches should play in serving local as opposed to nation interests. Greater decision making power for local banks in some ways only worsens the dilemma faced by an organization that is supposed to promote production at the same time that it supervises the activities of enterprises and watches out for the interests of the state (Bryd, 83: p. 55).

Bryd also summarized the five main currents in China's banking reform during this phase (83: p. 55).

One was reassertion of its independence and organizational integrity, as well as the establishment or restoration of certain NBF's.

The second was to redefine the relationship between banks and their clients. Banks should no longer be the "treasurers" of local enterprises, but instead, they would be given authority to use profitability and other economic criteria to grant or reject a request for loans. Banks were also allowed to implement "economic levers" such as interest rates to influence the actions of their clients.

The third current is the internal decentralization of the banking system. Banks were given more discretionary power and greater flexibility in constructing their loan portfolios. Banks had thus become economic units as well as administrative bodies. Bank branches became individual accounting units which were responsible for their profitability, and employees were given bonuses tied to performance.

The fourth objective was to improve the quality of the human capital of the banking system's workforce. Both short-term and long-term programs were set up by the PBC to increase the educational level of its employees.

The fifth current departed the most from the pre-reform system. Banks and NBFIs were given the role of financial intermediaries, functioning to channel leakages in the economy into investments so as to increase aggregate demand. While all other objectives were to restrengthen the existing banking system, this fifth current was an attempted reconstruction of the banking system into a true financial market. By the end of this period, the Chinese were still a little uncomfortable with the idea of a "market," which was perceived as the "tail of capitalism" during the Cultural Revolution ended just a few years back. Moreover, the central authorities were also trying to regain control over investment activities. As a result, the future of the banks' role as financial intermediaries was in strong doubt (Bryd, 83: pp. 56-57).

The first major reforms in the banking industry started off in 1979 with "The Four Transformations and Eight Reforms". It is important to note that these objectives "served as a blueprint for most of the concrete measures that followed" (Bryd, 83: p. 60). The "Four Transformations" include the following:

- (1) From customarily using purely administrative methods in work to using economic means to manage the economy and the banks.
- (2) From paying insufficient attention to organizing capital to concentrating on expanding the sources of funds and utilizing them well.

(3) From making loans solely on the basis of production plans and commodity circulation plans to gradually basing loans on economic contracts, given implementation of state plans.

(4) From a situation in which banks throughout the country "eat from the same big pot" to implementing enterprise-type management by banks at all levels with strict economic accounting.

The "Eight Reforms" are:

(1) There should be an appropriate rise in interest rates on savings deposits and an increase in the variety of accounts available.

(2) In making loans the policy should be "differential treatment, selection and fostering of the best" (enterprises), based on their implementation of the state plan, fulfillment of their economic contracts, and level of management competence and creditworthiness.

(3) Restoration of various specialized banks and corporations. The Agricultural Bank of China should be restored, and both it and the Bank of China should be placed directly under the State Council, managed on behalf of the latter by the People's Bank. Also advocated are establishment of a national-level printing corporation and restoration of the domestic insurance business of the People's Insurance Company of China.

(4) To fill in the gaps left by state plans, banks should be allowed to make short- and medium-term loans for equipment purchases. They should be used for construction of small hydroelectric and thermoelectric facilities and for individual items of equipment for existing enterprises.

(5) Change the existing system of credit planning (unified central control over all loans and deposits) to the method of "unified planning,

management at different levels, linkage of deposits and loans, with control over the difference."

(6) Internally, the banks should implement enterprise-type management with strict economic accounting. All People's Bank branches and specialized bank branches at or below the provincial level should become independent accounting units and should be eligible for enterprise funds according to regulations. Interbranch loans should carry a fixed rate of interest.

(7) Financial research organizations should be restored and work in this area strengthened.

(8) Management of bank cadres and personnel matters should be under the dual leadership of the Main Office of the People's Bank and local governments, with the former playing the primary role. Education and training of bank cadres should be strengthened.

(Zhongguo Baike Nianjian – China Encyclopedic Yearbook, 1980: pp. 297-298) adapted from Byrd, 83: pp. 58-60.

On a practical note, the "Four Transformations and Eight Reforms" initiated many policy implementation in the following years. The agricultural Bank of China (ABC) was restored to raise and distribute funds for working capitals in the rural areas. General Administration of Exchange Control (GAEX) was established to facilitate foreign exchange. The Bank of China (BoC) was given a higher status (Byrd, 83: p.60). China International Trust and Investment Company (CITIC) was set up in October of 1979 to facilitate foreign investment and joint ventures (Bowles & Gordon, 1993: p. 74).

The institutional changes were accompanied by other policy implementations as suggested by the "Four Transformations and Eight

Reforms." The interest rate system was reformed to introduce the concept of cost of capital. Some of these policy changes deserve more discussion.

Decentralization of Credit Management

One major impetus of the reform program was the incentive problem associated with the old system. The approach was to decentralize the credit management system. Formerly, bank branches could not use their own discretion in managing their loans. Higher levels would determine a particular bank's targets for loans and deposits. Any excess deposits over the targeted amount would be turned in to the supervisory division, and as a result, bank branches had no incentive to attract more deposits or to economize on loans. Under the new directions, the emphasis was put on the "difference":

Year-end total planned deposits are added to any credit funds appropriated from above for the bank's use, and total planned loans outstanding at year end are subtracted from this sum. The actual difference between deposits plus appropriations and loans at the end of the year must be greater than or equal to this planned difference (Bryd, 83: p. 72).

This new credit planning method to stimulate more efficiency is somewhat questionable. The rationales behind this method are first, banks may enjoy the extra profits as loans increase, and second, more loans means more support for local development. However, the profit margin was narrow due to the small difference between the rate banks charged on loans and that on deposits. Second, the increased loans were only allowed to

be used as working capital instead of fixed capital, with the latter being of greater benefit in terms of economic development.

Another problem is that this model might increase inflationary pressure. The reason for this is the multiplier effect associated with the institutional framework. According to western money and banking theories, a single bank can only loan out the amount of its excess reserves, because checks drawn on the bank are likely to decrease its reserves. While in the case of Chinese banks, such a problem did not exist. Banks were supposed to monitor all transactions in the economy, and to do so, each enterprise and its employees were required to bank only at a particular branch. As a result, the banking system is subdivided into many closed segments. To a local or provincial level bank branch, the only two leakages are currency that remains in circulation and enterprise payments to units outside the jurisdiction of the particular branch. Consequently, the loans create their own deposits. Enterprises would keep a proportion of their loans as deposits in their banks, and the part of loan that is used as salary payment would return (although not the entire amount) to the same bank as time deposits. Bank branches now can justify more loans with these deposits. Had there not been the two leakages, this circle of money creation would be infinite.

To state this multiplier effect mathematically, let us designate "s" as the marginal propensity to save (MPS). MPS measures the proportion of extra savings due to an unitary increase in income. Thus, the multiplier, M, would be

$$M = 1 / (1 - s).^{15}$$

¹⁵ MPS can be understood as the portion of one yuan that would return to the bank as saving deposit. If the bank receives one additional yuan, it would be able to loan the entire amount out. The amount of the size of

Therefore, the new decentralized system of credit management apparently enabled the banks to inflate their money supply. In a traditional socialist context, financial theories stated that bank deposits are not a part of the money supply and will not generate any inflationary pressure. According to western macroeconomic theories, both currency outstanding and deposits account for the total money supply.¹⁶ As Bryd noted,

[t]he purchasing power that economic units perceive as being available to them will exceed the quantity of goods and materials by a greater margin than before. Controls on the amount of currency in circulation will not dampen the multiplier effect. Active efforts to reduce the amount of currency outstanding for a given level of economic activity will actually increase the value of the multiplier. Direct or indirect quantitative restrictions on bank credit of course will prevent the multiplier from operating, but by their very nature they defeat the purpose of the decentralization measures (83: p. 74).

Interest Rates Changes

In essence, interest rates are the prices in financial markets. It is the price being charged on the right to utilize funds. It receives much attention in the western economies due to the important role it plays in monetary

s would return to the bank and would be loaned out again. Consequently, the amount of s.s would be returned and further loaned out. This circle would complete itself continually. Thus the potential loans created would be: $1+s+s^2+s^3+\dots = 1/(1-s)$.

¹⁶ There exist different classifications of money supply. For example, M1 includes currency, coins, and demand deposits (checking deposits); M2 consists of M1, time deposits (savings deposits), and small CD's (certificate of deposits under \$1000); and M3 contains M2 and large CD's. As a general rule, money supply and currency are two different concepts.

regulations. Nevertheless, this concept had been deliberately ignored in China, especially during the class struggles in the ten years of Cultural Revolution when interest rates were closely associated with capitalistic exploitation.

Fortunately, the new regime recognized its importance and put the concept into practice after 1976. Further adjustment took place since 1979 (Bryd, 83: p 75). Interest rates on individual time deposits were raised three times (in 1979, 80, and 82). Interest is being charged on interbranch deposits within the banking system and on certain other previously interest free accounts. Enterprises, government departments, and non-profit institutions are now allowed to put a portion of their funds in time deposits. In addition, banks could charge "[e]xtra interest on overdue loans, those financing excessive circulating funds and inventories, and those diverted to cover capital construction cost overruns or other unsanctioned activities" (Bryd, 83: p.75). Although interest rates are still set in a unified manner for the entire country, there were experiments which let local bank branches charge up to 20% more or less than the official rates on loans, depending on individual evaluations using economic criteria.

In spite of all of these new changes, problems existed in terms of returns on deposits of organizations and groups (Bryd, 83: p. 76). "Economic" units were only able to get 1.8% annual percentage rate as interest on their deposits, whereas government authorities, mass organizations, Party Committees, and non-profit state institutions, earn no interest at all. The interbank annual rate of 3.24 percent also seemed quite low. A general increase in rates paid on bank deposits of enterprises and organizations might not attract much more additional deposits, due to the

fact that these units were already required to deposit all of their funds at the bank, except for a small amount of cash reserves (Bryd, 83: p. 76).

Another problem associated with such interest rate structure is that interest payments on loans only accounted for a rather small fraction of the returns of certain capital investment. Also, interest payments are such a small proportion of enterprise output or profits that bank control over credit does not provide enough leverage in confining the actions of producers:

[i]n Chinese industry in 1979 the rate of profit on total assets (fixed assets and circulating capital) was 24.2%. In Shanghai the figure was 47.1%, in Guizhou 7.7%. Because raw materials in China are underpriced relative to manufactured goods, these figures may overestimate true economic rate of return. . . interest payments of the Inner Mongolian Autonomous Region's local industrial enterprises in 1978 amounted to only 1.1 percent of their total sales, or only 5.5 percent of their "accumulation". For local commercial enterprises interest payments were only 2.3 percent of total sales. On the national level, . . . in 1980 interest payments on loans other than those financing capital construction amounted to no more than about 0.6 percent of gross output value (Bryd, 83: p. 77).

Consequently, these changes are not sufficient enough to fully eliminate the "soft budget constraint" enterprises faced. The concept of "soft budget constraint" was first introduced by Hungarian economist Kornai in 1980. Kornai stated that a "centrally planned socialist economy is a shortage economy because of the way its enterprises respond to incentives

of the system" (Hsu, 91: p. 24). State-owned enterprises were expected to expand their production and were rewarded on this basis, whether they economized on their use of resource and thus reduced cost or not. Even if a firm incurred a loss for a prolonged period, the government would subsidize the firm in order to let it stay in business. Therefore, the budget constraint that these state-owned enterprises faced was essentially "soft".

The introduction of interest payments was an attempt to get rid of such "softness". However, the relatively insignificant proportion that interest expenses accounted for rendered such an attempt largely ineffective.

Financial Intermediation

The most important role that an effective financial system engages in is one that links the supply side of financial markets, mainly households, and the demand side, mainly businesses and government, together in order to convert all idle money capital into investments and thus to reach a higher level of economic development.

As mentioned earlier, the implementation of such a vision was by then the most significant departure from the past. The traditional approach did not consider enterprise bank deposits as true savings and promoted private savings mainly for macroeconomic stability purposes. However, the ability of banks to mobilize savings was highly limited due to the types of securities they could offer. Furthermore, various state credit policies also greatly restricted the categories and amount of investments banks could make. Thus, the banks' role as financial intermediaries was still limited.

Conclusion

In short, financial reform in this early stage was largely indebted to the reform experiences of the Eastern European socialist countries in the 1960s and 1970s. It contained a great deal of administrative jargon that effected little change to the existing financial system. Although some changes have been brought about in the banking system, no conceivable attempt was made to establish a true market.

Banking Reforms, Phase II : 1982-1984

Starting from 1982, more radical policies were made to prepare for further reforms. Changes were being made to establish a two-tier banking system. In 1982, banks took over the authority to allocate funds for working capital for the Ministry of Finance (MoF)– the main fiscal authority then. In January 1983, the Industrial Commercial Bank (ICB) was founded to raise deposits and distribute credits for working capital and technical renovation to urban industrial and commercial enterprises. This function was formerly performed by the PBC, which now became the central bank of China and began to specialize in taking charge of monetary control of the entire economy.

The PBC then became responsible for managing the government's finances and financial controlling of the entire economy. It was also in charge of supervising the loan activities of the four "specialized banks" (SB's), which included the Agricultural Bank of China (ABC), the Industrial and Commercial Bank (IBC), the People's Construction Bank of China (PCBC), and the Bank of China (BoC).

This resulted in a two-tier banking system where credit control and currency issuance were separated from loaning operations. The PBC was the central bank, the only bank that could issue currency. Hence, the SB's were no longer able to meet their clients' insatiable demand for credit. The SB's were also allowed to provide certain non-traditional services such as mortgage loans, consumer credit, trust business and bond issuance.

In 1984, the State Council formally established a branch-banking system. The People's Bank of China, now the central bank, was empowered to oversee its operations (Bowles & Gordon, 1993: p. 75).

The PBC would formulate a credit plan in consultation with the SB's and of course in accordance with the physical plan. PBC would set credit targets for the SB's. The targets for fixed assets were mandatory and were not to be exceeded although those for working capital were more flexible. In order to raise the SB's incentives to attract more deposits, PBC credited the accounts held by the SB's with amounts less than the planned expenditures. Another exciting change was the introduction of reserve requirements; the SB's must hold reserves at the PBC to stand against their deposits. The required reserve ratio was 10%, which means that for every hundred yuan of deposit, the SB's have to keep a 10 yuan reserve at the central bank. It was reasoned that the SB's would then be more cautious in allocating their credits.

A new type of financial institution was also set up to facilitate "trust work." These Trust and Investment Companies (TIC's) were either established by local governments or as trust divisions of local SB's (Bowles & Gordon, 1993: p. 76).

By the end of 1984, the system became more diversified and flexible, allowing an array of commercial practices. Central state revenue as a

proportion of the national income had also decreased considerably since 1978 (37.2% in 1978 and 26.6% in 1985). Nevertheless, competition for deposits was still greatly limited. The financial system was still a state monopoly and functioned more or less as an administrative appendage of the central government. Interest rates continued to be set up by central planners instead of through real market processes. Bank autonomy was still circumscribed.

In addition, there was a shift in favor from budgetary control to financial supervision in terms of overall economic control. Thus, the banking system "was required to be more active in racing, regulating and intermediating flows of financial resources, and ensuing enterprises use them efficiently" (Bowles & Gordon, 1993: p. 80). It is only logical that more operational autonomy of the banking system should be granted to meet these macro- and micro- level of objectives. However, pressures from the Ministry of Finance in the macro-level and from planned targets in the micro-level continued to hinder the banking system's process to obtain outright independence.

Other conflicts also urged the reformers to further the evolution of the banking system. For instance, the banking system and the budgetary system had claims on an enterprise's funds with conflicting interests. The SB's would like to have the funds as repayment on loans, while the fiscal side would rather take them as tax revenues.

In China, powerful political groups also had different stakes at the reform. Conservatives were already uncomfortable with the changes so far and wanted to roll back the wheels, while the reformers were striving to push the reform into a new stage. In 1984, the CCP regime celebrated its 35th birthday with the movement into an era of more radical change.

Banking Reforms, Phase III: 1985-1988

Reforms hitherto had been confined to moderate changes within the existing system. There are many reasons behind this. First, ideological uncertainty tended to slow down the reform process. No one was willing to walk across the "fine line" between socialism and capitalism. On the one hand, it was because the Cultural Revolution had left the people with too many horrible experiences. On the other hand, people were so convinced of the evil of capitalism that their conscience would hardly allow them to break through this type of mindset. Furthermore, the majority of the Chinese people, including most party cadres, political leaders, even economists had practically no experience in incorporating market mechanisms into the economy. The result, as shown, had been some rather gradual modifications of the old system.

Between 1984 and 1985, the Chinese economy experienced unusual inflationary pressure. Inflation in 1984 was 2.8% and was up to 8.8% in 1985 (World Bank, 1990: p. 168). The monetary and fiscal authorities endeavored to impose traditional methods to control the inflation which turned out to be unsuccessful.

It is important to note that the inflation in this period had a somewhat different cause than before. At this point, many state enterprises had been granted some autonomy in terms of their use of budgetary funds, as well as the profit they generated. Profit became one of the performance criteria, and it resulted in some irrational and irresponsible conducts by state enterprises. Instead of improving productivity, product quality, and exploring new markets, many state enterprises started raising prices, safeguarded by the near monopoly power they possessed. Many even

engaged in lowering product quality, speculative trading, black market activities, and fraudulent practices. Many state enterprises also continued to expand their unplanned investments and competed with planned state projects for materials in shortage. In other cases, enterprises distributed all of their profits as bonuses to the employees, thereby increasing "bonus inflation" while ignoring the need for retained earnings (Hsu, 91: p. 87).

One of the common problems associated with freedom is the abuse of it which impairs other parties' freedom. The autonomy (to a certain extent) that had been given to enterprises initiated various abuses. Intensive debates were taking place as to a solution. The conservatives stated that this game had already gone too far, and that further decentralization would endanger the CCP's control in many domestic areas. On the opposing side, the reformers argued that the problems rooted in the incompleteness of the reform and it was only through further changes that these problems would be solved.

The power struggle underlying the debates resulted in a shift of power to the side of the reformers. Zhao Ziyang, Secretary in General for the CCP, and Premier Hu Yaobang both advocated further reforms. The new authority spent much time trying to control the disequilibrium in 1985 and the new phase of reform did not start until 1986.

The new policies in this phase reflected the "micro-concerns" of the reformers (Bowles & Gordon). Many external influences were observed to affect the direction of the new paradigm. The World Bank was one of major external sources that helped the new leadership develop a program more towards the establishment of financial markets. The major objectives are as follows:

First, and again, the autonomy of banks. PBC, now the central bank, was believed to be saved from any political influence to ensure macro-stability in the economy.¹⁷ Greater autonomy was also promoted in individual banks to become true economic units, and in regional/local banks in relation to the head offices.

Second, financial authorities were also moving away from traditional methods of control. The call for different methods was necessary because of the altered nature of the problem. More indirect methods were developed, which included open market operations, reserve requirements, and interest rate controls to replace the old, direct methods of imposing credit ceilings and monetary sectoral targets (Bowles & Gordon, 93: p. 86).

Third, greater diversity of financial institutions were promoted. It went beyond mere differentiation within the state banking system by including non-state banks and NBFIs.

Fourth, competition between these diversified elements was advocated to establish a true financial market. Competition stimulates efficiency and is a prerequisite for any market system.

Fifth, new financial instruments were introduced and popularized. Again, intensive debates concerning the ownership system of the "reformed socialism" were attracting much attention.

Sixth, there was also a wider range of interaction with foreign capital markets. Deng's "open door" clearly stated the necessity of the

¹⁷ In the United States, there existed similar concerns during the establishment of the Federal Reserve Banks, the central bank of the country. Therefore, the seven members on the Board of Governors of the Federal Reserve Banks are appointed for a 14-year, nonrenewable term. Terms are staggered so that at least one new governor must be appointed every two years.

access to foreign capital and technological markets to China's economic development. The World Bank, IMF, and Asian Development Bank were some of the major banks and funds markets China cooperated with. Attempts were being made to develop a domestic market in foreign exchange.

As the reformers developed these strategies, they also had to ensure that the problems which occurred in the past did not happen again. Otherwise, the conservatives would be more aggressive and powerful in their struggle for the leadership. One of the major problems in the previous phase (82-84) was over investment and the resulting inflation on the macro-level. The other was the "perverse softening" of enterprise budget constraint on the micro-level (Bowles & Gordon, 93: p. 87).

New problems occurred despite the fact that the reformers tried to be cautious over the past and potential problems. For instance, black markets flourished as the controls were loosened. Bowles and Gordon saw this as caused by the lag in reforms in other areas.

Financial reforms achieved remarkable acceleration during 1986 and 1987. In early 1986, five experimental cities, Chongqin, Guangzhou, Wuhan, Shenyang, and Changzhou, were appointed as test sites for new financial instruments. By the end of the year, this had expanded to 27 cities and the entire Guangdong Province. The role of the PBC as the prime regulator of the financial system was well consolidated. It served to act against the over ambition of the Central Planning Board (CPB) and the MoF's continuous advocate on deficit spending. Moreover, the president of the PBC then was Chen Muhua, also a member of the CCP Politburo. His dual position tended to raise PBC's voice in the debates within the Party.

However, PBC remained a strategic division of the central plan and continued to struggle for further autonomy. PBC's council had representatives from the MoF, SPC, and Economic System Reform Committee.

Further diversification of the banking system was underway. The four Special Bank's (SB's) started branching out. Two international banks were established. One was the joint-stock, Shanghai-based, Communications Bank; and the other was the CITIC Industrial Bank. Also, the East coastal cities were able to enjoy a greater degree of diversification. SB's and joint Chinese-foreign banks were set up to facilitate foreign trade and investment in east coastal cities, including Shanghai, Guangdong, and the three Special Economic Zones (SEZ's) — Xiamen, Zhuhai, and Shenzhen.

Banks were also promoted to accelerate their "enterprisation" into "true economic units" (*JinJi ShiTi*). SB's increased their spectrum of services to include bond issuance and discounting commercial paper.¹⁸ Banks could also move outside their own sectoral boundaries to compete for deposits and loans. This tended to break down the segmentation of the market and eliminate the multiplier effect that had used to fuel inflation to a certain extent.¹⁹ SB's were allowed to make loans in excess of planned targets. For example, in 1986, the ICB made 30% more loans than its target. Banks also had more sources for funds. Traditionally, their fixed capital was financed by funds for the MoF and their working capital by the PBC. Now they had access to interbank loans, bond markets (with PBC's

¹⁸ Bond issuance enables a bank to raise more capital than granted by the central plan. Discounting commercial paper helps enterprises facilitate their tradings and enables the bank to earn a fee.

¹⁹ The break-down of segmentation would cause the banks to lose their reserves when a check was cleared in a different bank. Since banks were also subject to reserve requirements, they could no longer loan out more than their deposits.

permission), and could borrow directly from the PBC at the discount rate.²⁰ A system of penalty charges also came into play by charging higher interests on overdue loan payments (Bowles & Gordon, 93: p. 86).

Economic Impacts

TABLE 3-1 Inflation, 1979-1989

| | |
|------|------|
| 1979 | 2.0 |
| 1980 | 6.0 |
| 1981 | 2.4 |
| 1982 | 1.9 |
| 1983 | 1.5 |
| 1984 | 2.8 |
| 1985 | 8.8 |
| 1986 | 6.0 |
| 1987 | 7.3 |
| 1988 | 18.5 |
| 1989 | 17.8 |

Source: World Bank 1990, p. 164.

As Table 3-1 indicates, inflation soared in 1985 and reached a record high in 1988. Many politico-economists argued that the inflation during this period was largely due to the nature of China's politico-economic system. It also can be attributed to the lag of enterprise reforms behind the financial and wage reforms. Moreover, policy mistakes also accounted for some of this unusual inflation.

As a result of the reforms so far, decentralization of the decision making process exerted various pressures on the banking system. In order

²⁰ The discount rate is the interest rate the central bank (PBC in this case) charges the member banks for short-term loans. The purpose is to eliminate irrational expansion plans by introducing a cost to the branch banks.

to be able to increase wages and bonuses and thus to counteract rising price levels, enterprise managers turned to the specialized banks for additional loans. Decentralization allowed such an expansion of bank credits above their quotas. On the other hand, the loans to the SB's from the central bank (PBC) granted credits to the SB's based on their loans outstanding. Therefore, the incentive for banks to loan more, along with the rising enterprise demand, resulted in the rapid credit expansion of 1984.

TABLE 3-2 Annual Average Nominal Wage Level

| Year | Total Nominal Wage | Percentage Change p.a. |
|------|--------------------|------------------------|
| 1979 | 668 | 8.6 |
| 1980 | 762 | 14.1 |
| 1981 | 772 | 1.3 |
| 1982 | 798 | 3.4 |
| 1983 | 826 | 3.5 |
| 1984 | 974 | 17.9 |
| 1985 | 1148 | 17.9 |
| 1986 | 1329 | 15.8 |
| 1987 | 1459 | 9.8 |
| 1988 | 1747 | 19.7 |
| 1989 | 1935 | 10.8 |
| 1990 | 2140 | 10.6 |

Source: Bowles & Gordon, 1993: p. 104.

Decentralization also resulted in the expansion of enterprises' investment. For the same reason that they granted the loans to increase wages and bonuses, the SB's allowed credit for fixed asset investment.

TABLE 3-3: Total Investment in Fixed Assets

| Year | Total Investment | Total Investment As a Percentage of GDP |
|------|------------------|---|
| 1981 | 96101 | 20.1 |

| | | |
|------|--------|------|
| 1982 | 123040 | 23.7 |
| 1983 | 143006 | 24.7 |
| 1984 | 183287 | 26.5 |
| 1985 | 254319 | 29.8 |
| 1986 | 301962 | 31.1 |
| 1987 | 364086 | 32.1 |
| 1988 | 449654 | 32.4 |
| 1989 | 400000 | 25.4 |

Source: World Bank, 1990: p. 168.

The percentage of fixed asset investment through bank lending also soared to 23% (Naughton, 1991: p. 64).

The pressures that banks experienced at this point were different from before. Formerly, the PBC was mainly an administrative division of the central government and did not have any discretionary authority as of the amount of loans or their recipients. With the progress of the wide-ranged reforms in the early 1980s, the banking system started to have some autonomy and had also differentiated somewhat into a two-tier system. As decentralization allowed autonomy to a certain extent, it also created new pressures for the bank branches at a lower level. As a criterion for success and also a prerequisite for credits from the PBC, the amount of commercial loans that the specialized banks made was crucial for their survival. In fact, 20% of SB's fund source still came from the credit granted by the PBC. It was thus inevitable for the SB's to expand their loan portfolio.

Inflation and Monetary Policies

As the expansion of bank credits increased dramatically, it finally turned into the unwelcomed creature by the name of "inflation" (See table 3-1). Consequently, in 1985, the government adopted a nationwide

contractionary monetary policy to control the inflation. This was the first attempt to use the banking system to reach such a purpose.

In the early phase of such policy change, the only major effect was its ability to absorb the excessive liquidity in the economy. However, by the end of that year, enterprises started to have difficulties. Early on during the year, they could still finance various projects by drawing down their record high accounts at the banks. But as the year end closed in, their balances were drawn down. In addition, banks were extremely tight on credits, they found themselves in trouble with their ability to purchase needed inputs. As a result, investment and growth slowed down drastically. The industrial growth rate was even slightly negative in the first months of 1986 (Naughton, 1991: p. 65).

Such a monetary policy had finally proved its effectiveness to the Chinese leadership. However, the reformists who were also very concerned with economic development started to wonder if such a policy was too strict to allow any growth. As mentioned in the previous section, the power struggle between the reformers and the conservatives resulted in the victory of the former. Nonetheless, the reformers' position had not yet been consolidated and the representatives of this group were eager to control the inflation and to achieve an impressive growth rate simultaneously, with the latter being the bottom line of the reforms. Aggressive campaigns were promoted persistently and I recalled one of them being "target our GNP to increase four-fold (*fan liang fan*) by the year 2000". In April of 1986, Premier Zhao Ziyang intervened to reverse the contractionary policy. He did this by indirectly promoting "flexibility within contraction" (*JinZhong YouHuo*). Inevitably, this resulted in the rapid expansion of credit again. The Chinese economy experienced further

rise in the consumer price index in the following years. In conclusion, the failure of the monetary policies via the banking system can be attributed to the following reasons. First, as more loans were targeted to be a success indicator and with the introduction of inter-bank loaning, the excess reserves at the central bank (PBC) decreased considerably.²¹ Second, the banking system still experienced tremendous pressure from the localities. Third, although attempts had been made to insulate the banking system from political influences, this process was far from being completed. The banking system thus remained a secret weapon in the war of inner power struggle within the CCP Politburo and lacked its true economic identity.

Political Impacts

The Chinese populace had been able to enjoy a relatively stable economy from 1949 to 1984. The thirty-five years with little or no impact from inflation thus stimulated a nationwide dissatisfaction with the government, due to the high inflation rates since 1985. After the failure of the CCP leadership's attempt to control inflation in September of 1987 and the subsequent double-digit inflation in 1988 (18.5%) and 1989 (17.8%), widespread social unrest was then inevitable.

Banking Reforms, Phase IV: 1989-1992

The social unrest was settled down in the second half of 1989. With the death of Hu Yaobang ²² and the demotion and confinement of Zhao

²¹ Total money supply in the economy can be directly affected by the money created by bank loans. The banking system's maximum potential of money creation equals the amount of excess reserves multiplied by the monetary multiplier. As money is created through the form of a loan, excess reserves decrease.

²² Hu Yaobang was a former Secretary in General for the CCP. Despite his resignation from this position in the mid 80s, he was actively involved in political campaigns for the reform until his death in April of 1989.

Ziyang,²³ the power shifted back to the more conservative group of the CCP top leaders, such as Chen Yun, Li Peng, and Yao Yilin. They had the desire, power, and some popular support to exert more control over the macroeconomic stability and to slow down the pace of the reform. During the first part of this phase, the new leadership was mainly engaged in re-establishing stability before carrying the reforms any further.

Further contractionary / tight monetary policies were adopted. PBC increased the required reserve ratio to 13%.²⁴ Interest rates on various deposits were indexed to keep up with inflation. Restrictions on the spread of NBFIs were also being imposed upon localities.

Retrenchment, in spite of its unfavored image in the eyes of a reformer, succeeded in bottling up the inflationary pressure. Inflation was brought down to 2.1% in 1990, as compared to the record high of 18.5% in 1988. Gowles and Gordon attributed this success to the political resources from the central authorities and the cooperation of the local governments (1993: p. 96).

However, the Chinese ambition to regain its position as a major world power did not allow a prolonged implementation of such a retrenchment. Pressures from various sources were forcing the authorities to loosen the controls. The result of the reconciliation between control and growth was a continuation of the proliferation of the various market elements, although at a decreased rate. This led to a cool down in the growth rate of GDP and the excess demand.

²³ Zhao Ziyang was the Secretary in General for the Party in 1989. After the student movement and the subsequent riots, he was terminated from all his functions in the Party though he was allowed to keep his membership in the Party.

²⁴ Recall that required reserve ratio (m) is the most powerful tool of monetary control. When this ratio is raised, excess reserves at the central bank will decrease, and with a simultaneous decrease in the multiplier (the reciprocal of m), total money supply decreases sharply.

TABLE 3-4: GDP Growth Rate in Constant 1980 Prices

| Year | Growth Rate (percentage p.a.) |
|------|-------------------------------|
| 1979 | 7.0 |
| 1980 | 6.4 |
| 1981 | 4.9 |
| 1982 | 8.3 |
| 1983 | 9.8 |
| 1984 | 13.5 |
| 1985 | 13.1 |
| 1986 | 8.0 |
| 1987 | 10.5 |
| 1988 | 11.2 |
| 1989 | 3.9 |

Source: World Bank, 1990: p. 110.

The growth rates of 3.9% in 1989 and 4.6% in 1990 (Gowles & Gordon, 1993: p. 111) were not appealing to the policy makers. The State Council announced in early 1992 that this retrenchment policy was over. Although inflation had been brought under control, it was done at the price of regaining centralization of control, the opposite to the objectives of the entire reform program.

Conclusion

The various policies and reforms experimented in China since 1979 seemed like a pendulum swinging back and forth between growth and control. A certain degree of decentralization was realized, but was constantly interrupted by those attempts to control inflation in a traditional manner. The Chinese government has to understand that inflation is

generally inevitable in a rapidly growing economy,²⁵ and it is necessary to invent a mechanism that utilizes economic levers to fight inflation, so as not to halt the process of decentralization.

²⁵ Recall the concept of "demand-pull" inflation back in Ch 2.

4

The Securities Markets

This chapter will briefly discuss the stock and bond exchange markets in China during the reform era, including their first introduction, economic impact, as well as some of the ideological debate over their existence in a socialist context.

The financial reform in China has gone beyond the boundary of the banking industry. Other financial markets, such as that of bonds and stocks, have been developed simultaneously with the banking reform. For the same reason that China developed a two-tier banking system, the securities markets were established to stimulate more efficiency and diversity in the financial system.

Re-Introduction of Securities in the 1980s

The introduction of bonds had its first appearance in the 1950s (See Chapter 2). Bonds had been extinct from China's financial system for roughly 25 years, since they were perceived as a product of capitalism. In order to obtain capital, the state issued Treasury bonds again beginning in 1981. The accumulated issuance as of the end of 1991 reached 150 billion yuan. At the same time, many enterprises issued a large amount of bonds

to expand capacity, and many investors expanded their wealth by investing in various types of bonds.

In 1872, the first stock offering took place in Shanghai. Stocks had been with the Chinese people for 80 years before the last security exchange was shut down in 1952. To an average Chinese, it is neither familiar nor totally strange. The first stock issued after 1952 was the Shanghai Vacuum Devises, Inc. shares in 1986. As of the end of 1991, the stock portfolio included companies such as Feile Stereo, Yanzhong Realities, Aishi Electronics, and Yuyuan Mall. Currently, there are two major types of stocks available in the Chinese market.²⁶ The Class "A" stock is designed only for mainland citizens to invest in and the Class "B" stock is exclusively for foreign investors to purchase. As of May 1994, 155 state-owned enterprises had their stocks listed as Class "A" stock and the majority of the 28 Class "B" stocks was also issued by state-owned companies.

In total, 2700 enterprises issued securities of more than 10 billion yuan. Among the 13 million residents of Shanghai, 1.2 million became security investors (Wun & Yang, 1991: p. 3). Once again, securities became one of the most popular topics in the Chinese daily life.

In 1984, China's monetary authority decided to set up various exchange markets to facilitate security trading. By September 1994, there existed more than 700 securities brokerage firms in more than 100 cities.²⁷ The first Securities Exchange was set up in December of 1990 (in Shanghai).

²⁶ There also exists a Class "H" stock which is issued by mainland enterprises while only available in the HongKong Stock Exchange.

²⁷ Zhang Jialin, *Guiding China's Market Economy*, Current History, Sept., 1994.

The first Stock Exchange was also established in Shanghai in 1991, and the second one in Shenzhen Special Economic Zone (SEZ) during the following year. By May 1994, the total volume of capital channeled through the Shanghai Stock Exchange exceeded 50 billion yuan, and it had become the fastest growing Stock Exchange in the world.²⁸

Ideological Debate

As stated, stocks and bonds were discriminated against as products of capitalism. They were abandoned even before the advent of the "Great Leap Forward" and the following turmoil of the "Great Proletarian Cultural Revolution." As economic reforms in various areas were being pushed towards a new frontier, the renaissance of stocks and bonds finally took place.

Compared to stocks, the re-introduction of bonds was not perceived as much of an ideological threat. There are three reasons. First, bonds were issued during the 1950s under the communist regime, while stock exchanges of the "old world" had been completely abolished by 1952. Secondly, the introduction of bonds in the 1980s started off with the Treasury bonds as a way to gather capital for the modernization plans of the state as a whole. After the reform took place for five years, most people had a more liberal view than before. Finally, with the reformists' victory over the conservatives in the power struggle, the main stream way of thinking became a lot more tolerable in terms of debts instruments.

However, the rebirth of stocks did not have a smooth labor. As early as 1982, the No. 17 Textiles Factory in Shanghai had a public stock

²⁸ *Bears in the Market*, Economist, May 14, 1994, p. 75.

offer. The result was that the company had to take it back under the pressure of the public. The most furiously debated aspect of stock issuance was the ownership problem. As Karl Marx clearly spelled out in the *Communist Manifesto*, all enterprises should be owned collectively. With the constant flashbacks to the Cultural Revolution, the average Chinese citizen dared not to walk across the fine line between the two opposing social systems. All one could do was to wait. Finally, with further education and political campaigns, stock was accepted as a legal instrument for state-owned enterprises to attract more capital.

Macroeconomic Functions

The primary reason for the Chinese leadership to bring stocks and bonds back into the economy was, as hoped, that they could function to channel idle resources in the economy into investment in much the same way as the savings accounts do. The investment hunger of the state-owned enterprises had imposed much pressure on the banks to create more money, either by granting more credits or by printing new currency. It was believed that stocks and bonds could relieve a portion of such pressure and raise investment in a non-inflationary way. It was also argued that they would provide the monetary authorities with more instruments to sop up the extra liquidity in the economy at times of inflation.²⁹

²⁹ According to dominant Western money and banking theories, when the government purchases securities from the public, it substitutes the most liquid asset - cash with less liquid asset. As M1 denotes the narrow sense of money which only includes currency and coins, the money supply in the economy has thus decreased as a result. For the same reason, at times of recession, the government should buy in securities to increase the money supply and thus boost the economy.

However, to the disappointment of the authorities, these functions were not carried out efficiently. In most cases, the primary type of bonds for liquidity control was the Treasury bonds (*Guo Ku Quan*). Treasury bonds issued from 1982 on were all mandatory — quotas were assigned to units and individuals. What usually happened was that all individuals would receive part of their salaries in the form of Treasury bonds.³⁰ The coercive nature of the bonds have thus made bond issues into another form of income tax. Their nature as a marketable instrument in a free market has thus been lost. In other words, it is essentially another administrative way to achieve overall stability. Also, these Treasury bonds are not registered, which means that the person who physically holds the bond has title to it. This also made black market speculations possible. People in need of temporary liquidity would sell these bonds at a discount to black market speculators who would then redeem them at the government when the contractual date of repayment comes.

The total value of stocks outstanding is insignificant compared to the accumulated bond issuance. In addition, stocks available in the two exchanges markets (Shanghai and Shenzhen) lack diversity. The majority is issued by state-owned enterprises. Inevitably, as the profit of these firms have been going down the drain in recent years, investors could not satisfy their "investment hunger." Foreign investors face the same problem.

Microeconomic Objectives

Another important reason for the re-introduction of stocks and bonds was that they were believed to stimulate enterprise profitability. The

³⁰ For example, if Mr. Li earns 200 yuan per month, he would probably receive 180 yuan in cash and the rest in the form of Treasury bonds.

rationale was that as bank credits are tightened, enterprises had to go to the markets to finance their operations. Investors would not buy the stocks issued by inefficient firms and thereby urge enterprises to be more cost efficient.

Good intentions, but poor implementations. One would assume that audited, comprehensive financial statements of the firms would be available, but they were not. Some firms paid out all of their profits as dividends, hoping that this would attract more investors in the future. The government had imposed a maximum amount for dividend pay-out, and virtually all firms paid out this amount. Again, profitability has not been raised.

Although impressive achievements have been made during the course, China's security markets turned out to be highly unstable. It is true that all capital markets involve a certain degree of market risk, but that of China's securities markets are too high for risk averse investors. The Chinese people have not yet formed the correct view of stocks. In most advanced capitalistic economies, people treat stocks as a form of financial asset. But in China, stocks had become a major type of gambling — legal too. Stock Exchanges are filled with enthusiastic speculators instead of prudent investors. Once again, Shanghai has become the "paradise of speculators".³¹ The CCP leadership had attempted to set up tight regulations on the security markets, but no significant change has yet been observed.

³¹ Before the liberation of Shanghai in 1949, the metropolitan was filled with speculators from all around the world. This is a phrase frequently used by the CCP educational bureau to attack the speculative practices associated with capitalism.

Conclusion

The re-introduction of bonds and stocks in China has certainly received plenty of commentaries, appraisals, and enthusiasm, but the severe flaws in the exchanges has impaired the instruments' true nature as financial papers.

5

The Fate

Sixteen years of reforms have certainly changed China's outlook. Many Chinese had never even dreamed about such radical changes. In general, people's living standards have improved substantially. My father always tells me that it is due to Comrade Deng's open door policy and reforms that we are now able to enjoy such improvements. He is probably right. But what is happiness to the people in China nowadays? Popular mentality uses income, and income only, to judge success. Veneration has shifted from all higher values to entertainment celebrities — Western entertainment celebrities. I passionately vote for reform and development. However, what China is doing in recent years is in one way or another destroying its past — the Chinese culture, as well as the future — a socialist state that cares about its citizens instead of blind growth.

Chapter 3 and 4 outlined some of the major changes in the financial system of China's economy. But the analysis has been based entirely on Western capitalistic theories of money and banking. It lacks the so-called "Chinese characteristics." In addition, financial reform has been extracted from the rest of the picture and examined separately. The validity and usefulness of such an analysis is doubtful. This chapter is intended to fill in

the gaps left by these two major defects and to depict a future path for further reform in the financial system.

China's economic reforms so far have been extensive instead of intensive, sectoral instead of general, and regional instead of national. Imbalances pervade the entire economy. Resulting from such imbalances are a great number of existing as well as potential problems. Although it is beyond the scope of this paper to discuss the overall economic reforms in great details, there are three areas of concern that deserve further emphasis in this concluding chapter.

Revitalization of the State Sector

China's state sector, once a symbol of the communist victory, has become the major obstacle to further economic development. About two thirds of the state-owned enterprises are incurring sustained losses. The central government has tried in various ways to revitalize this crucial portion of the economy, and among them, financial reform hitherto has been primarily designed to stimulate efficiency in the state sector.

Bank branches, including those of the PBC and the four SB's, have been urged to be responsible for their own profitability by discriminating among loan applicants in terms of economic efficiency. However, state enterprises have found administrative, and sometimes creative ways to get around this. These companies have treated such policy implementation as another administrative tool from Beijing to stimulate production. Floating rates and penalty rates have been introduced to punish those enterprises that defer loan repayments. But what good does it do if these inefficient monsters refuse to respond to these rates? Can't the banks at least go to the

companies or the guarantors and seize the collateral ? Yes, but only theoretically. Once when a bank went to the guarantor of a loan, a local government, to liquidate the properties as loan payments, the police force protecting the government refused to grant entrance. The bank sued the local government, and the case is yet unsettled. No surprise — this is the Chinese way.

It is true that the Chinese government has started to impose specific legal constraints on its state sector, but no major money-losing companies has gone under yet. In 1988, the first bankruptcy law was passed and a few dozen state enterprises have since been shut down. Nevertheless, the biggest companies are not likely to go "south" any time soon.

When state-owned enterprises are stuck with loan payments, and if they do not have a strong "backup" (*Hou Tai*), they are likely to be the chicken on the death road.³² Thanks to stocks and bonds, these companies figured out the last possibility of escaping. They could now go to the public and obtain capital, not for capital investments, but to pay taxes and debts to stay "alive."

Conflicting Interests from the Fiscal Authorities

A lack of coordination exists between the financial and fiscal authorities. One symptom is the struggle for funds. Enterprises have trouble allocating their profit as whether to pay taxes first or to repay the loans first. China's tax codes are outdated and subject to constant changes.

³² The analogy comes from a popular Chinese saying, "*Sha Ji Jing Hou*", which means to kill a chicken to scare the monkey. Small state enterprises are the ones that the Chinese government loves to slaughter in order to threaten the rest. The biggest money-losing companies are usually the last ones to be cut open.

This renders the taxation quite arbitrary and makes it difficult for state enterprises to cope. Take a look at China's third largest enterprise, Anshan Iron and Steel Company, which hires 220,000 workers and is also responsible for its 110,000 retired workforce.³³ Needless to say, its cash expenditures have astronomical figures. It only seems reasonable that the huge revenue generated by such a plant should be able to keep the company out of the red zone. However, the company's huge tax burden and pressures from various local agencies have pushed the company under water. The most ridiculous thing about this company is that it hardly receives any cash payment for the sales it makes, but every time a "sale" is made, the Ministry of Finance records a sales tax and income tax. It does not take a master in finance to wonder what has enabled the company to be standing strongly in the middle of the Manchurian rust belt. The savior is, of course, the People's Bank of China. Anshan's current loan accounts for 11 billion yuan. What's happening with the state sector in China is that huge loans are being granted by bank branches, which determines the branches' eligibility for credits from the central bank, and a large portion of the loans goes straight into the MoF from the back door.

As highlighted in the previous chapters, financial reforms, particularly in the banking sector, has outpaced reforms in other areas, and has caused severe damages to the overall economic stability. In particular, as the state sector continues to be infected by the old bureaucracy, decentralization of financial authorities is inevitably translated into loosened credit control and subsequent inflation.

³³ *Bureaucratic Rot Imperils China State Sector*, Edead Steinfeld, The Asian Wall Street Journal Weekly, Week of February 13, 1995, p. 12

Macroeconomic Stability

Currently, heated debates are centered on how the financial system can be modified to be more efficient in controlling inflation associated with a double-digit growth. The attention has been focused on the structure of the financial system instead of on the coordination between various systems in the economy.

The problem in the root of Chinese thinking is its ambition to recover the superpower it had one thousand years ago. They have to realize that it took them one thousand years to lose it, and it is impossible to regain it in a few decades. Inflation, in the time of rapid growth is inevitable. It is not the financial system that has caused the problem; quite the opposite, it is the "Super Nation" mentality of the leadership that has contributed to the outbreak of rampant inflation in the recent years. In fact, the various monetary policies adopted in the recent years has proven to be highly successful. The problem is that the leadership is so obsessed with growth that retrenchment, and the resulting macrostability have never been tolerable over a prolonged period. Excess money supply has been poured into the economy to stimulate greater growth, and not surprisingly, inflation caught up. There have been ample examples. Zhao Ziyang intervened in 1986 to loosen the monetary control in order to achieve more impressive growth (see chapter 3 for more detail). A more recent case is one that happened during the second half of 1994. As inflation rate hit double-digit in 1993, Beijing adopted a tight monetary policy to curtail such rapid expansion. By the summer of 1994, the policy seemed to be effective. Output growth had decreased to 4% in June. A sharper decrease in demand had caused unsold inventories to account for 5%-6% of GDP,

and the so-called triangular debts among enterprises had grown by 60%.³⁴ The authorities clearly printed more currency to inject into the economy to stimulate demand. Consequently, cash issuance in August was 50% higher than a year earlier.



Source: The Economist, September 24th, 1994, p. 83.

Such obsession with growth can be understood as a manifestation of inner power struggles within the Party Central. To be more accurate, the entire reform is a product, NOT cause, of such conflicts of interests. After the ten years of Cultural Revolution, Chinese citizens became too exhausted to endure any more political clichés. In essence, economic reform as a whole is just another way of doing revolution. It might have a different name, a different form, but practically, it is nothing more than another set of political campaigns. The turbulent decade of 1966-1976 had made it necessary for the CCP to revitalize its economy. After all, the Marxist politico-economy theory states that "Economy is the basis of politics."

³⁴ *Turning On the Tap*, The Economist, September 24th, 1994, p. 83.

Reform and the outrageous growth it seemed to promise became tools for the reformists to prove their worth to the conservatives and to gain more support from the citizens. Although wealth itself does not ensure legitimacy, Chinese people have been too busy contemplating ways to get rich to talk about politics. The price of Beijing's obsession with growth was the record high inflation in 1988 and the subsequent social unrest of 1989. There have been some attempts from the central government to retrench the economy from the second half of 1992, but not for long. GDP growth rates rose to double digits in 1992, and inflation, the shadow of growth, caught up and even exceeded growth since 1993. Inner provinces, having a lot of rural areas, have also found it to be much harder to cope with inflation than their coastal counterparts do. Peasant unrests have not been rare in recent years. The Chinese Communist Party had won the hearts of millions of Chinese by stabilizing price levels, but the rampant inflation in recent years is undermining the foundations of the socialist fabrication. Something needs to be done urgently, before future social unrest turns against the CCP.

An Economic System with Chinese Characteristics

Deng Xiaoping, China's de facto leader, once said, "Planned economy does not equal socialism. Likewise, the market does not equal capitalism."³⁵ What China needs is a socialistic market with Chinese characteristics. Theoretically, this has guided China's reforms so far. Practically, external influences have diverted the reforms from the original path. As stated in chapter 3, the World Bank and the IMF (International

³⁵ *Guiding China's Market Economy*, Zhang Jialin, Current History, September 1994, p. 277.

Monetary Fund) both have significant impacts on China's policy-making process. The question is whether these organizations have helped China out of pure humanity. It is clear that advanced capitalist economies can only benefit from their globalization by improving the economic conditions in the so-called less developed countries (LDC's). Organizations such as the World Bank serve as an agency for such acts. Criticisms of the World Bank and of the IMF are not rare.³⁶ When the Chinese leadership was overwhelmed by the ambition to build a new hydroelectric dam, it decided to flood the "Three Gorges." The "Three Gorges," one of the most magnificent scenes in China, is a monument of history and culture. The World Bank granted a loan to the government.³⁷ I am not going to make any further criticisms on the World Bank, due to the topic of this paper and the limited amount of research. What I am trying to point out is that the Chinese government should not be innocent enough to define its path according the suggestions by these organizations with somewhat different interests.

Concluding Remarks

All in all, the current financial system is a much better model than the previous one. Despite all the governmental restrictions, and more importantly, the overly ambitious mindset of the policy-makers, the reformed system at least provides a **potentiality** to further advancement.

³⁶ A couple of examples would be the book *50 Years Is Enough: The Case Against The World Bank and The International Monetary Fund* edited by Kevin Danaher, South End Press, Boston, 1994; and *Perpetuating Poverty: The World Bank, the IMF and the Developing World* edited by Doug Bandow and Ian Vasquez, Cato Institute, 1994.

³⁷ Subsequent oppositions had forced the World Bank to call back the loan.

The success of the various monetary policies is undeniable, despite that the timing of their implementation has not been highly desirable for the Chinese people.

In the near future, the government should have greater concern over the macro stability of the economy, because the potential social unrest is very destructive to a healthy economic environment. Growth should be obtained, but not at the price of hyperinflation.

In terms of the financial system's positive influence on the state enterprises, I am afraid that decentralization and loosening of control will only lead to chaos, given that political reform does not match the pace of economic reform. Elimination of the excessive bureaucratic "red-tape" is equally necessary. Many of the elements in the current financial system are "capitalistic." They do not fit in with the current political regime. Using an antithetical analysis, such conflict will only result in turmoil. Financial systems can exert positive constraints on state enterprises only when these companies are being reformed at the same time. Unilateral stimulus from the financial system is not sufficient to revitalize the state-owned companies.

Again, financial reforms up to this date have only touched upon the surface of the gigantic, rusty machine of the Chinese economy. The financial system's function as lubricate in the flow of capital is far from being realized. In order to carry out their function as financial intermediaries, the banking system and all various types of NBFIs (including the securities exchange markets) need to be further developed. Unfortunately, a prerequisite for such development is the revitalization of the state sector, which is by far the most demanding task of China's

economic reform. A dozen obstacles are in the way, with socialistic ideology, social welfare of the unemployed among the most daunting.

The more I contemplate the future of China's financial reform, the more I believe in the necessity and urgency for the shift in attitudes of the leadership. The "Great Leap Forward" in the 1950s was towards communism, and reforms in the 90s appear to be a move towards the embrace of capitalism. Why can't the Chinese leadership accept the concept of gradual change? There are plenty of old and wise Chinese sayings about change and stability, but the current generation seems to have only learned how to be revolutionary and radical. Once they have discovered the inefficiencies in the socialistic system, they immediately started crying out loud "reform," and reform only. In essence, not in appearance, what form should China's economy take?

This concluding chapter is titled "The Fate", so what is the fate for China's financial reform ? There is a popular saying, "Half of your fate is with God, and the other half is in your own hands." In this case, a slight modification seems appropriate. Half of the fate of the financial reform is tied to the results of reform in other areas, and the other half is in the hands of the Chinese populace. That is to say, if the reform in the state sector fails, financial reform is likely to fail too. If that happens, the next logical step is up to the Chinese people.

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