

# Current Trends and Thoughts

Perspectives in Some Fields of  
China's Social Sciences

Foreign Affairs Bureau  
Chinese Academy of Social Sciences

Social Sciences Documentation Publishing House

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## Preface

Under the guidance of Deng Xiaoping theories, China has been promoting social changes and progress since the reform and opening-up program were launched two decades ago. To match all this, the Chinese social-science scholars have also been engaged in the theoretical research and policy studies on the issues that the country is now facing.

The Chinese Academy of Social Sciences (CASS) is the most prestigious academic research organization in the fields of the humanities and social sciences in China. Its research projects cover economics, politics, culture, history and so on. In order to make the international academic circles understand the Chinese Academy of Social Sciences better, strengthen academic exchanges between China and the rest of the world and make China's reform and opening-up theories perfect and more profound, we have translated and compiled this book. Included in this book are mainly papers written by famed scholars of the younger generation, who have made impressive accomplishments in their own fields. The articles cover the economics, sociology, law, external relations of China today and therefore present a cross-section of research in the fields mentioned above by Chinese scholars.

Now on behalf of the Foreign Affairs Bureau of CASS, I would like to express our thanks to all the authors of the theses included in this book, to Ms. Cheng Xiaoyan and Fan Yin of Social Sciences Documentation Publishing House, who made painstaking effort designing the format and editing the book. Also, I would like to express my thanks to Mr. Chen Zhensheng and Ms. Jia Li who organize the work of compiling and publication. The majority of the translators of the articles are staff members of Foreign Affairs Bureau of CASS, the rest of the translators are the authors themselves. Responsibility for the viewpoints expressed in the theses and the level of translation rests exclusively with the individual contributors and translators.

**Dr. Pei Changhong**  
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# **China's Macroeconomic Stabilization and the Development of its Monetary Policy<sup>1</sup>**

*Yu Yongding*

## **Introduction**

For many years since reform, the main threat to China's macroeconomic stability was inflation, caused mainly by excessive investment demand supported by an accommodating monetary policy. To develop the economy as quickly as possible is a deeply rooted national aspiration of the Chinese people. To realize this goal, the key element is to mobilize resources for investment as fully as possible. In the pre-reform period, under economic planning, a very high investment rate was achieved through three elements: low household money wages, profit delivery, investment via the government budget. The low income and wage policy ensured that real resources would be made available for investment, profit delivery enabled the government to have a direct command of the real resources available. Under this system, financial resources were channeled via the fiscal system, the role of the banking system in resource mobilization and allocation was limited. However, the low income policy not only had led to serious efficiency problems, but also become politically unacceptable. The profit delivery stifled enterprises' incentives, which is essential for the vitality of an economy. Finally but not the least, the government had been proven to be not always very competent in investment decision-making. Reforms were aimed at overcoming these problems.

The essence of reform in a sense is to redistribute national income away from the government to enterprises, from the government and enterprises to households, and from the central government to local governments, so as to provide greater incentives to the latter. At the same time, the decision making power on investment to a large extent has been transferred from the government to enterprises and from the central government to local governments.

Owing to the abolishment of profit delivery, and the lack of an effective tax system, the share of government revenues in national income reduced



drastically. Due to the rapid increase in household money incomes, enterprises also failed to increase retained profits adequately. In order to maintain an adequate investment rate, the government and enterprises have no choice but to tap households' financial resources. Consequently, the banking system, instead of the fiscal system, has assumed the main role of channeling savings for investment.

The problem with bank lending under China's traditional system is that although the increase in bank credits will be matched by an equal increase in bank deposits, the level of balance between the bank assets and liabilities (the use of funds and the sources of funds) may be inconsistent with equilibrium of the real economy. In other words, owing to its money creation ability, the banking system can finance enterprises' investment by extending credit beyond the real resources available in the economy, and the effective investment demand may be greater than the availability of loanable funds (savings) in the economy. As a result, the price level and interest rate will rise to restore equilibrium. Until recently, due to the half-reformed nature of the Chinese economy, the investment hunger of enterprises and local governments was very strong. The demand for bank credits in China was virtually unlimited. For many years, the task of monetary policy was to control the total bank credit so as to control inflation on the one hand, and delegate banks and their branches more decision making power so as to improve the efficiency of funds allocation on the other hand.

Owing to the fundamental changes in the Chinese economy, monetary policy characterised by direct control has become increasingly ineffective. Great efforts have been made by the central bank to move towards indirect control of the money supply so as to improve the efficiency of resource allocation and to achieve a smoother management of the economy.

The second section of this paper will provide a brief account of China's changing banking system and the financial market. In the third section a brief description of the development of monetary policy in the Chinese economy will be given. The fourth section will introduce some important changes in monetary policy in recent years. In the fifth section two important issues of monetary policy will be discussed. The six section is about the short-term prospect of China's monetary policy.

## **I. China's Financial System**

### ***1. China's Banking System***

Before reform, China's banking system was similar to those in other centrally planned economies (CPEs), described as monobanks by Garvy and others (Garvy, 1966; Hsiao, 1971). Since 1979, the structure and functions of the Chinese banking system have been reformed gradually (Byrd, 1983; Santorum, 1989, World Bank Country Study, 1990b). The People's Bank of China (PBC) was restructured as a central bank and its commercial banking

functions were transferred to four specialised banks in 1984. Since then the PBC's role as central bank has been firmly established. Its independence was greatly strengthened by the Law of People's Bank of China passed by People's Congress in 1995.

As a part of efforts in restructuring China's banking system, a reserve system was established in 1984 in line with international practice. After several changes, the reserve rate was finally settled at 13% in 1988, which has been maintained up to date. The rate of required reserves is uniform for all types of domestic currency deposits. The required reserves must be held by each branch and subbranch of every financial institution and the deficiency in required reserves of one branch of a bank cannot be averaged against the excess reserves of another branch except through formal interbank market transactions. Required reserves are held as deposits in the branches of the PBC. On top of the required reserves, Specialised banks hold another 5~7 percent of deposits in PBC branches as excess reserves for the settlement of payments and as cushions for overdrafts. Since 1989, excess reserves deposited in PBC branches have been required to be transferred to the accounts with PBC headquarters (World Bank). Up till now reserve requirements in China's banking system is still as high as 20 percent.

Great efforts have been made in specialised banks' commercialisation. To facilitate the commercialisation of the four specialised banks, three policy banks were established in 1994, so that the four banks would be able to free themselves of extending policy loans and to base their banking activities solely on commercial consideration. Up to date the commercialisation of the four banks has made great head way. Besides the four dominating state-owned commercial banks, currently there are fourteen much smaller commercial banks and numerous urban cooperative banks and non-bank financial institutions. China's banking system can be summarised by the following figure (figure 1).

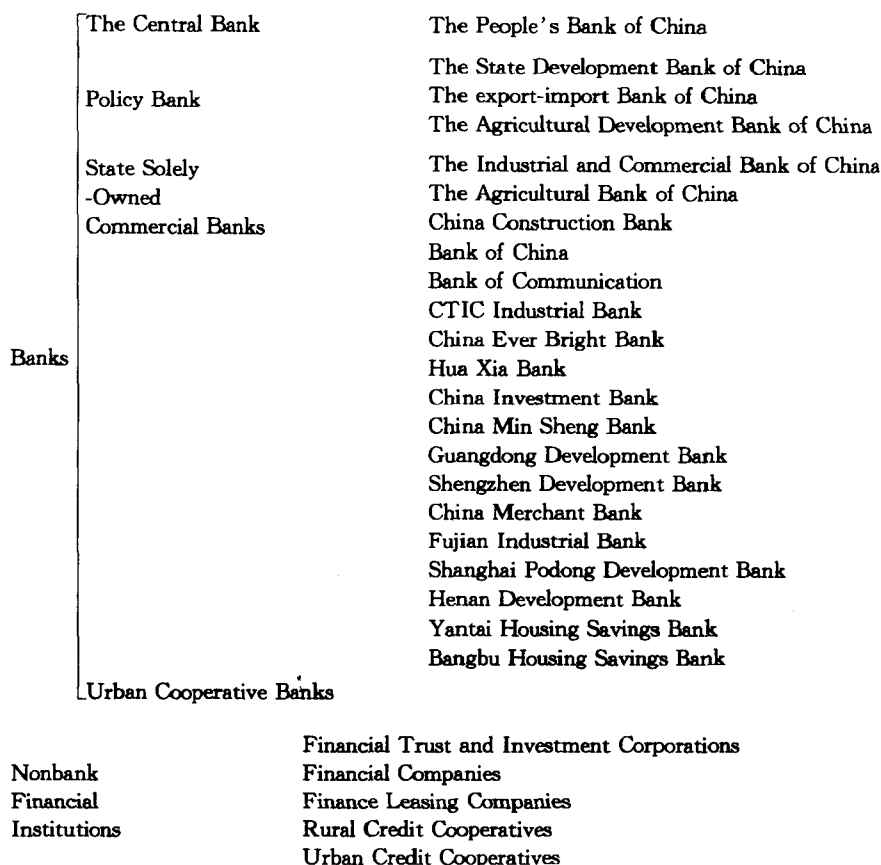
## *2. China's Financial Markets*

Since reform, China's financial market has been developing steadily. Currently China's money market consists of the interbank loan market, the bond repurchase market and the bill discount market. China's capital market comprises the government bond market and the stock market.

### *The Interbank Loan Market*

The first spring-shoot of the interbank loan market appeared in 1986. The participants of the market include nonbank financial institutions as well as banks. The interest rates in the interbank loan market, China Interbank Loan Offered Rate (CHIBOR) are determined by the supply of and demand for loans, which makes the market the most liberalized financial market in China.<sup>2</sup>

**Figure 1 China's Current Banking System**



### The Bond Repurchase Market

China's bond repurchase market is only three years old. The only instruments traded in the market are government bonds. The main borrowers on the market are security companies that use the market to raise short term funds; and the main lenders are commercial banks that use the market to earn a higher return.<sup>3</sup> The interest rate in the bond repurchase market, Repurchase Offered Rate (REPOR) is a market rate determined by the demand for and supply of government bonds in the repurchase market, which are closely related to changes in the stock market.

### The Bill Discount Market

The development of the bill discount market started in 1982. However, the market once was used to raise loans for illegitimate purposes, and the incidents of dishonor by non-acceptance and dishonor by non-payment

prevalent. The government closed down the market for a period of time. In 1994 the Law of Bills and Notes came into effect. And the market was revived again.

#### **The Government Bond Market**

The government bond market in China started in 1981 when the first Five-Year government bonds were issued. From 1981 to 1984 the main type of public bonds issued was 5~9 year long-term bonds. From 1985~1993 the main type was 3~5 year medium-term bonds. In 1994 the first batch of 5 billion yuan six month short-term bonds was issued. In 1996, three month bonds were issued. Besides government bonds, some corporation bonds are also issued.

#### **The Stock Market**

By the end 1996, the total value of floatation of stocks in Shenzheng and Shanghai Stock Exchanges was around Rmb 10 billion yuan,<sup>4</sup> and the total capitalization of the shares at the time when the share price index reached its peak in the second half of 1996 is about Rmb 350 billion yuan, less than 5% of the GDP in the same year. In the primary market, underwriters consist of large amount of securities companies and trust and investment companies. Investors in China's stock market are securities companies (funds), non-financial business entities and individuals or individual groups. Banks are not allowed to participate in the market.

## **II. The Evolution of China's Monetary Policy**

Since 1978, China's monetary policy has undergone various changes in terms of objectives, intermediate targets and instruments. Roughly in chronological order, we can identify several important stages of the evolution of China's monetary policy.

### **1. The Credit Plan**

Before reform, under the nonbanking system, like in other CPEs, China's monetary policy was passive. It was subordinate to the fulfilment of the economic plan both in aggregate and disaggregate terms. China's most important monetary policy instrument was the credit plan. Mirroring the material plan, the aggregate amount of "credit expenditures" (loans granted) and of "credit receipt" (deposits attracted) were estimated and decided in conjunction with the decision on cash issuance. The credit plan and cash plan were further disaggregated into units of tens thousand of targets for local branches to implement. The credit plan was a law and must be strictly observed. The credit plan had dual objectives of channelling funds in line with the material plan at the microeconomic level and keeping aggregate demand under control so as to avoid inflation at the macroeconomic level.

After the start of reform and until well into the 1990s, in the Chinese economy, money was also injected into circulation mainly via bank loans to

enterprises. Owing to the half-reformed nature of the Chinese economy (the existence of the "soft-budget constraint") and other causes, enterprise demand for loanable funds is not very elastic with respect to the loan rate. To avoid the adverse effects of a high interest rate on enterprises, the loan rate is usually set at an artificially low level by the government. As a result, the excess demand for bank loans once was one of the most important characteristics of the Chinese economy. The existence of the excess demand for bank loans and an inflexible interest structure means that to control inflation which is usually caused by excess demand fuelled by an excess supply of credit the government has to resort to credit rationing. Therefore, although there had been several attempts to replace the credit plan as the main instrument of monetary policy since the early 1980s, the credit plan was the single most important feature of China's monetary policy until recently.

## 2. *"Difference Control"*

In line with the basic trend of marketization of the Chinese economy since 1979, a new target of monetary control was introduced in 1980, to overcome the inflexibility of the credit and cash plans. Under the new system, detailed targets of the difference between "credit expenditure" and "credit receipt" were handed down by the PBC to its local branches and through them to local specialised banks. As long as the given difference is not exceeded, the more deposits a local bank attracted, the more loans it could make. It is assumed that as long as the difference between credit expenditure and credit receipt of individual bank branches does not exceed the quota assigned, total currency in circulation would not exceed the planned quota. The purpose of introducing the new targeting method was to shift the emphasis of bank activities from liability management (attracting deposits) to assets management, and to encourage local PBC and specialised bank branches to bring their initiative in attracting deposits and lending into fuller play while still keeping currency in circulation under control.

The expectations of implementing the new targeting method led to a wave of rushed lending by the specialised banks in the second half of 1984. Because the new quotas of the allowed "differences" were to be based on actual "differences" at the end of 1984, all banks tried to expand their credits so as to establish actual differences as great as possible before the new method came into effect. It is easy to show that the method is fundamentally flawed. The control of "differences" will not automatically lead to the control of the aggregate supply of money. The failure of this "difference control" method in controlling the money supply led to the introduction of a new method in 1985.

## 3. *Monetary Base Control*

The new method introduced in 1985 was called monetary-base control. The method was characterised by indirect control of the specialised banks' total

credit via manipulation of PBC's credit to specialised banks and of reserve requirements. Under the new method, the government would first estimate the credit demand of the economy, based on planned output and expected price level, etc. The government would then decide the corresponding cash issue by multiplying the estimated increase in total credit by the ratio of incremental cash to incremental credit (known as the "cash-loan" ratio in Chinese finance) that was estimated in accordance with historical experience. While the new cash issue was calculated, the planned or expected increase in deposits was also calculated independently. Finally, the results of the calculation were reconciled with each other. The final result thus compiled was called the "State Plan of Credit Receipt and Expenditure".

After determining total credit which the specialised banks should extend to enterprises and other sectors of the economy in line with the "State Plan of Credit Receipt and Expenditure", the PBC would determine the amount of reserve money which the specialised banks should hold in their accounts with the PBC. Having determined its sources of funds (liabilities), the PBC would then determine its uses of funds (assets): loans to specialised banks. Because the loans to specialised banks are the recycled funds from the reserve requirements and excess reserves, in China it is usually called central bank relending. The balance sheet of the PBC thus compiled was called "The Credit Plan of the PBC". It was expected that by controlling either reserve requirements or PBC loans to specialised banks or both, the specialised banks' liquidity and their lending activities would be influenced accordingly and the total credit and money supply would be thus put under the government's indirect control (Xie, 1989). It can be seen that the most important difference of the new method from the old credit plan is that under the new method, credit quotas would not automatically mean the availability of funds. In order to lend, the banks must have funds as well as quotas. It is worth mentioning that credit ceilings were not very strictly enforced during the time, and the emphasis was on controlling the monetary base to fulfil the credit plan indirectly, rather than enforcing credit quotas directly.

#### *4. The Re-asserting of Credit Ceilings*

The above-mentioned experiment was not entirely successful. The loss of control of the money supply in 1988 forced the government return to the old practice of direct credit control. Banks were given sectoral priorities and issued with separate quotas for fixed investment lending and total lending. Although the credit ceiling has re-asserted its dominating role as the major instrument of monetary policy, reserve requirements and control over PBC credits have also retained. As a result, specialised banks have become subject to a dual control system. They must still base lending on the availability of funds as determined by the deposit base, reserve requirements and central bank relending. With mandatory credit ceilings, expansion of reserve money

cannot increase the money supply beyond what is decided by the ceiling; reserve money growth will be reflected only in larger excess reserves of banks, and consequently in a reduced money multiplier which neutralises the impact of any increases in reserve money beyond what is needed to reach the credit ceilings. When the authorities carry out a policy of tightening fund availability below the credit quotas, monetary policy would be brought into line with credit quotas and would serve to reinforce them. Although required reserves play a weaker role in a system of credit ceilings than in the system of indirect control via the monetary base and the money multiplier, higher required reserves can reinforce the effectiveness of credit ceilings by reducing the aggregate liquidity of financial institutions and preventing bank reserves being used for new lending (World Bank, 1990b). A basic problem with the dual control system is how to match quotas with funding. Normally, if a bank has quota but no funds, it can borrow from inter-bank market or request for funds from the PBC. If a bank has funds but no quotas, the bank can lend through the inter-bank market. Bank branches that have quotas but no funds are the principle borrowers of PBC relending.

### **III. the Recent Major Changes in China's Monetary Policy**

Owing to the deepening of China's financial reform and the widening of its openness, some fundamental changes in monetary policy have occurred in recent two or three years.

#### *1. The Changes in the Objectives of Monetary Policy*

In February of 1995, the Law on People's Bank of China was enacted. The law explicitly stipulates that the sole objective of China's monetary policy is to maintain stability of the currency so as to promote economic growth of the country. It is the first time in more than 10 years since the establishment of the central bank in China that the objective of monetary policy has been enshrined by the law. Previously, monetary policy has dual objectives: to allocate funds to different regions and industries in line with economic plan set by the State commission of economic planning on the one hand, and control the growth of total bank credit so as to maintain price stability on the other. The credit plan's function of allocating funds at the micro-level more often than not would compromise the PBC's monetary control function. The dual objectives of monetary policy had contributed to the worsening of inflation in many occasions in the past. The Law of Central Bank enables the PBC to shed the responsibility for providing funding for targeted industries. The establishment of policy banks, the commercialization of the specialized banks, and a more lax and less detailed economic plan, mainly investment plan, by the State Commission of Economic Planning have provided favorable conditions for the PBC to concentrate on maintaining currency stabilization. The law also explicitly guaranteed the independence of the PBC and prohibited

any interference in its functioning by local governments and government departments.

## *2. The Shift of intermediate Target of Monetary Policy*

Previously, total bank credit was the intermediate control target of the PBC. In a resolution on the reform of the financial system made in 1994 by the PBC, it was decided that the PBC should shifted its intermediate control target from total bank credit to the total money supply. The PBC realized that the stable relationship between total credit and the money supply was no longer existing (table 1), due to some fundamental changes in the economy, which we will discuss later. Therefore, it was no longer possible to control the money supply via the control of total bank credit. To maintain currency stability in the long-run, the central bank should target the money supply directly rather than its counter-part, namely total bank credit. Starting from the third quarter of 1994, the Chinese monetary authorities formally took the money supply as intermediate target of monetary policy.

## *3. The Shift from Direct Control to Indirect Control*

After 1993, the Chinese monetary authorities' direct control over the money supply have weakened significantly. Firstly, owing to the rapid expansion of the financial institutions that are not subject to the credit plan, the coverage of the central bank's credit plan has been reduced drastically. Currently, only the four state-owned commercial banks: Industrial and Commercial Bank, Agricultural Bank of China, Bank of China, People's Construction Bank of China are still subject to credit ceiling. All other banks and nonbank financial institutions are free from such ceilings.

Secondly, until the early 1990s, both the share of commercial banks' loans in their total assets and the ratio of bank loans to M2 were very high. This means that the effective control of bank credit will lead to the effective control of their counter-part, the money supply. However, situation has changed in recent years (table 1).

It can be seen from Table 2 that the ratio of state banks loans to their total assets fell from near 90% to 75%, and the ratio of state bank loans to M2 (%) fell from 1993's 93.3% to 1996's 62.3%, which shows that the control of bank credit is no longer sufficient for controlling the total money supply.

Thirdly, the composition of PBC's assets has changed greatly. The share of the central bank's loans to banks in its total assets also fell significantly in recent year (table 2). This means that the central bank has lost its ability of controlling the monetary base via controlling its loans to commercial banks (relendings) (table 2).



Table 1 The Decreasing Importance of State Banks' Credit in the Economy

Year	The ratio of state banks loans to their total assets ( % )	The ratio of state banks loans to M2( % )
1991	87.5	93.3
1992	89.7	85.1
1993	88.6	78.9
1994	79.4	69.1
1995	76.7	64.8
1996	75.0	62.3

Sources: *Financial Outlook* 1997, the People's Bank of China.

Table 2 the PBC's Assets (RMB 100 million yuan) ^

	1993	1994	1995	1996
loans to banks	9562.5	9626.4	6925.9	5873.8
policy loans	-----	-----	4450.4	5226.9
foreign exchanges	741.2	4481.8	6774.4	8785.5
loans to the govt.	1688.6	1793.6	1688.6	1688.6
total	13350.0	17936.2	21071.3	22754.5

Sources: the PBC Monthly Bulletin.

Note: the figures for 1996 are figures at end of August.

It can be seen from Table 2 that the share of central banks' loans to banks in the central bank's total assets has fallen from 1993's 71.6% to 1996's 25.7%. This means that now not only the direct control of bank credit will fail to lead to an effective control of the money supply, but also the control of central bank's relending will fail to do so.

As a result, although the credit plan has not been abolished up to now, the formulation of the credit plan has become increasingly asset-liability ratios-based. More importantly, in recent years the monetary authorities' attention has been increasingly shifted to the control of the money supply via controlling the monetary base rather than its counter-part. We will return to this issue later.

#### IV. Some Current Issues in China's Monetary Policy

##### 1. The Macroeconomic Management of the Open Economy

Changes in the Central bank's Asset Structure Caused by the Increase in Foreign Exchange Reserves.

In a closed economy, the central bank can decide the monetary base independently. However, under an open economy with fixed exchange rates