

Monetary Policy and the Design of Financial Institutions in China, 1978–90

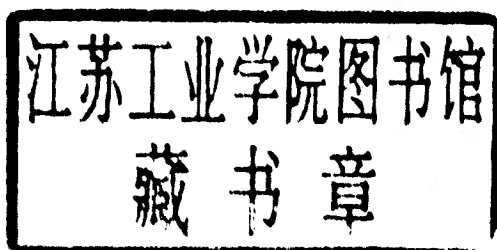
Leroy Jin

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Preface

China's growth performance has been remarkable since the development strategy was transformed and decentralisation- and market-oriented reform were introduced in the late 1970s. However, there is a wide concern about the stability and sustainability of growth in the future because (i) macro control is becoming less effective, and growth is still subject to stop-go cycles; (ii) improvement in efficiency is slow; and (iii) fragility of banks increases. In relation to these, one of the most controversial subjects on policy debate is the continuing monetary expansion. Despite the large attention it has attracted, sources, processes and underlying mechanisms of monetary expansion as well as its interrelations with other phenomena have not yet been clearly understood. As a result, confusion spreads. This itself has become a destabilising factor, i.e. it contributes to policy swings and the related stop-go cycles.

The central theme of this book is simple: monetary expansion could be attributed to partial economic reform – economic reform without reform of local governments' ownership and development of capital markets. It argues that the monetary expansion was driven by the banks' finance for fixed assets investment combined with lack of channels (other than bank deposit-lending) for financial intermediation in a situation where households have become the dominant savers. Excessive bank credit expansion was necessary in a centre-locality investment game under the decentralised Chinese economic system. In this game, local governments' investment was local border-constrained and biased towards setting up small processing industrial enterprises, causing lack of investment for technical transformation of existing enterprises and for infrastructure. At the same time, the central government was no longer the major saver. Unable to resolve these problems of investment allocation directly, the policy-makers turned to expansion of bank loans for priority investment in order to maintain high growth. Given that extra investment for priority activities was necessary, the underdevelopment of capital markets necessitated such investment to be financed by banks. In consequence, aggregate control had to be loosened, and extensive development and slow improvement of efficiency persisted. These in turn further increased the demand for credit from the inefficient enterprises, leading to growth of non-performing loans and

erosion of the banks' capital base. Although Chinese policy-makers have been lucky in generally avoiding unmanageable excessive demand thanks to households' long-term saving behaviour, the accumulated liquidity risk increases uncertainty. The problems could not be solved by tightening monetary control alone, as the latter is easily exaggerated under the Chinese economic system and causes recession in the short term and might be unable to stabilise the economy in the longer term.

However, the build-up of money balances is not a disaster. By contrast, the available money can be utilised to facilitate needed ownership reform. The thesis suggests that monetary policy, financial reform, ownership reform and design of corporate control should be coordinated with a focus on promoting industrial restructuring and competition. In this process, the second-best solution would be to internalise the externality problems at provincial level, and to put fiscal means to a more active use in macroeconomic management.

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LEROY JIN

List of Abbreviations

ABC	Agricultural Bank of China
bn	billion
BOC	Bank of China
Bocom	Bank of Communication
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
CITIC	China International Trust and Investment Corporation
COEs	Collectively-owned Enterprises
CPEs	The Centrally Planned Economies
EBFC	Ever Bright Finance Company
FOF	Flow of Funds
GDP	Gross Domestic Product
GDR	German Democratic Republic
GNP	Gross National Product
H	high-powered money
ICBC	Industrial and Commercial Bank of China
ICT	industrial and commercial taxes
LCH	life-cycle hypothesis
m	Month; i.e. 1985m1 means the first month of 1985
MB	monetary base
mn	million
MOF	Ministry of Finance
NICs	Newly industrialised countries
NMP	Net material product
OECD	Organisation for Economic Cooperation and Development
000s	thousands (e.g. ¥000s = thousands of yuans)
PBC	People's Bank of China, i.e. the central bank after 1983
PCBC	People's Construction Bank of China
PDC	Public Dividend Capital
PICC	People's Insurance Company of China
PIH	Permanent income hypothesis
Q	quarter; e.g. 1987Q4 means the fourth quarter of 1987
RCCs	Rural Credit Cooperatives
SBs	Specialised Banks
SEZs	Special Economic Zones
SOEs	State-owned enterprises

SSB	State Statistical Bureau of China
TFP	Total Factor Productivity
TICs	Trust and Investment Companies
TVEs	Township and Village Enterprises
UCCs	Urban Credit Cooperatives
Ventech	China Venturetech Investment Corporation
¥	Renminbi (RMB) yuan, the Chinese money unit.
	¥1 billion equals ¥1000 million in this book.

NB. This book uses the Pinyin system for romanising Chinese, with some exceptions for personal names that are familiar in the West (e.g. Sun Yat-sen according to the old Wade-Giles system, rather than Sun Yixian according to the Pinyin system). The Chinese surname appears first, followed by the given name, for instance, Zhao Ziyang, where Zhao is the surname and Ziyang is the given name.

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1 Introduction

Since 1979, China's economy has been undergoing major changes under the new development strategy and economic reform programme. The new development strategy emphasises increasing in living standards rather than industrialisation *per se*. It calls for the pattern of development to be transformed from heavy industry-dominated, unbalanced growth to more balanced growth with a considered regard towards agriculture and light industry; from extensive to intensive growth (i.e. from input-based growth to growth based on improvements in efficiency; from promoting inland development to promoting coastal development, and from self-sufficiency to opening up to the outside world.¹

The reform was initiated to support the transformation of the strategy for economic development. Despite sometimes serious disagreements among top policy-makers on the details and precise type of economic system most suitable to Chinese conditions, there has been and remains a broad consensus on the need to decentralise economic management and to introduce market mechanisms into China's economy to enhance economic efficiency.

The reform process has been gradualistic and experimental – a trial-and-error approach. It has been pursued in four main ways:

- (i) by decentralising economic management (e.g. investment control and the management of state-owned enterprises) to local governments;
- (ii) by gradually introducing market mechanisms (e.g. price liberalisation);
- (iii) by promoting the development of non-state sectors;
- (iv) by establishing macroeconomic management system based on indirect control.

Noticeably, the ideology of state ownership has remained virtually unchanged. In practice, successes and failures of the reform experiments have fed back into decisions on the development objectives and reform strategy.

With respect to macroeconomic control, reflecting the much weakened role of central physical planning and of the state budget in the mobilisation and allocation of resources, heavy emphasis has been placed