



Aligning State and Market

China's Approach to Development Finance

Chen Yuan



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Foreword

Chairman Chen Yuan of China Development Bank here gives the world an understanding of the critical role that development finance has played in the growth of the Chinese economy.

People the world over both acknowledge and esteem the “Chinese miracle”, but too often fail to ponder the gargantuan scale of the capital formation that has been required to promote it.

Many understand that something special has happened in China: its rapid development cannot be explained simply by reference to central government financing or to the ambitious activities of commercial banks. There had to be another ingredient – and there was – the development of a unique layer of project and infrastructure financing of a kind that no single country has previously achieved. Chen Yuan’s book - *Aligning State and Market* tells this important story.

Importantly, the story itself is told not by a storyteller but by the progenitor of the transition from often ad-hoc policy lending to structured development finance. For this reason, if not for its insightful commentary, *Aligning State and Market* is a compelling publication.

Chen Yuan’s approach to the vexed issue of development banking has been informed by the moral clarity he has brought personally to this national undertaking. He makes clear in his text his ambition that policy-based banks should be “not merely subsidy-feeding lossmakers, but ... profitable and self-sufficient finance institutions.” In CDB’s case, he says, many considered it to be a policy-based bank in name but an extension of the treasury in fact; its loans were akin to fiscal handouts – as he termed it, a free lunch “to projects that left borrowers under no real obligation to pay.” A lesser CEO would have skirted that vast moral chasm, but he did not.

Under his leadership, CDB's ratio of non-performing loans fell from 33% in 1998 to under 1% in 2004 – a truly remarkable outcome. As a consequence, the nascent CDB transitioned to become an institution of great utility to the Chinese people and to its government.

CDB's unique development is an example of what China has done so well: looking at the manner in which western institutions operate – in this case, one like the World Bank – and then adapting it to Chinese national needs and conditions.

The scale of CDB's balance sheet perhaps best attests to the success of its adaptation: with assets over one trillion US dollars, it is now three times the size of its international cousin, the World Bank.

Few would have believed that a local development bank in China could have benchmarked itself against global best practice while at the same time creating markets where commercial banks feared to tread.

Chen Yuan's China Development Bank has done this. It is a testament to his and the Bank's galloping ambition and integrity.

Paul Keating

Former Prime Minister and Treasurer of Australia

9 January 2013

Mr. Chen Yuan's insightful new book, *Aligning State and Market*, is a compelling demonstration of how these two powerful economic forces can be effectively bridged by the successful application of development finance. It is well worth reading for anyone seeking an intelligent and thought-provoking perspective on these two forces at play in a market economy.

Development finance in China has its roots in policy-based lending. China Development Bank, established together with other policy banks in 1994 as an essential component of the country's financial system, contributed enormously to economic growth and progress in the financial sector, and has been a bold pioneer in the field of development finance. In a sense, the history of CDB's development and reform is a reflection of the ongoing efforts made by China's financial system in the context of building a socialist market economy. The approach that CDB has chosen is challenging, but wise; by drawing on global best practices fine-tuned to the Chinese context, CDB has emerged as a financial enabler of economic development and a complementary force in China's broader financial landscape and reforms.

CDB's experience shows that finance, the core of any modern economy, is rooted in and therefore must primarily serve the fundamental needs of the real economy. The financial sector and the real economy need to work in tandem to develop extensive synergies. As the global economy struggles along an uneasy path to recovery, growth in China faces downward pressure. To seek growth while maintaining stability, we need to have a robust real economy backed by a more effective financial system. Moving forward, CDB will continue to serve as a medium- to long-term financing provider as China transforms its growth model, achieves widespread

prosperity for its wider population, and promotes a global presence for its enterprise.

The author, Chen Yuan, has been both a witness and contributor to monumental reforms in the Chinese financial sector. His extensive experience in the financial sector includes serving ten years as a deputy governor at the People's Bank of China. Since taking the reins at CDB in 1998, Chen has gained valuable insight into and become a true champion of development finance. In *Aligning State and Market*, Chen offers a systematic and comprehensive review of development finance in China. It is a thorough, first-hand historical account, and contains penetrating analysis and critical reflection. This book is refreshingly unique in its seamless combination of economic theory and personal narrative; it is China's first such articulation of the theory and practice of development finance backed by a dedicated practitioner. I believe that this book will inspire many to reflect on the course of China's financial sector reform and development, and offer the necessary wisdom to promote further openness and soundness for years to come.

Zhou Xiaochuan

Governor, People's Bank of China

Beijing

July 5, 2012

Chairman Chen Yuan is someone I respect and honor as one of the foremost thinkers and practitioners in the finance industry in China today.

I first met him as the Deputy Governor of the People's Bank of China (PBoC), fresh from a senior position in the Beijing Municipal Government, where he was responsible for designing and planning what is today the Financial District in western Beijing. At PBoC, he was responsible for the implementation of China National Automated Payments System (CNAPS), and I was the World Bank project manager who helped support the design of the project, conceived in 1989 and today forming the payment infrastructure for the modern Chinese financial system. It was through this interaction that I began to admire Chairman Chen for his decisiveness, insight and in-depth knowledge of what needs to be done to move the Chinese financial system into the modern state.

More than two decades later, Chairman Chen has not only formulated his own perspective on Chinese financial reforms, but put it into practice through China Development Bank, which he has led from a relatively small policy-based bank to a leading financial institution with global reach and reputation. In 2011, CDB had an asset base of just under one trillion US dollars, almost three times larger than that of the World Bank, and had loans to emerging markets of 139 billion US dollars, over three times those of the World Bank. I am honored to serve as one of the advisors on CDB's International Advisory Council.

Chairman Chen's book *Aligning State and Market*, exploring policy-based finance, is an important practical and theoretical contribution to the little-explored literature on this subject. The Washington Consensus argued for the gradual withdrawal of policy-based lending on the theo-

retical basis that state subsidies and intervention would distort market prices and efficient resource allocation. However, the real question is: if the state does not take the risk in moving the economy into areas unknown to its citizens, would the “market” of private individuals or firms enter into these unknown risks? What is the proper role of the state in providing public goods, such as the risks of being “first mover”? Once the market matures, the state can withdraw to allow market forces to work.

This book brings many valuable first-hand practical lessons on what can be done, especially the importance of providing finance where commercial banks and foreign lenders may be unwilling to do so. CDB, under the leadership of Chairman Chen Yuan, and the overall Chinese reform experience suggest that state intervention under the right conditions does bring economic development.

Chairman Chen should be congratulated on his pioneering work and pathbreaking theoretical insights into a vital aspect of development policy – the role of policy-based finance to promote growth, employment and innovation.

Andrew Sheng

Former Chairman

Hong Kong Securities and Futures Commission

July 13, 2012

Preface

As this book goes to press, I find myself moved by a sense of both fondness and pride – for I do believe that this is indeed a very special book.

A book is not made special by its heftiness or length, of course, but rather by the weight that its words carry. This book is in many ways a record of the long and often difficult journey that has marked the progress of development finance in China. Many obstacles have been overcome along that path: skepticism and resistance from those unfriendly to change, and complex challenges from the market itself. Ultimately, it was firm conviction and great courage at each step along the way that allowed development finance to prevail in its quest.

This book attempts to examine development finance from a number of angles:

- CDB's transition from policy lender to development finance institution;
- bank-government cooperation in market development;
- financing models for urban development (the Wuhu Model);
- strategic planning;
- market-based approaches and government mandate;
- financing rebalancing of the economy;
- support for agriculture and rural development;
- inclusive financing for social well-being;
- win-win international cooperation;
- the future of development finance.

In each section, I share my personal account of CDB's experience with development finance, as well as a collection of essays and interviews that may offer some further illumination. As a whole, the book serves as a distillation of my insight into and reflections on development finance from over a decade of practice and exploration.

My lifetime passion for finance and economics was inspired by my father, Chen Yun, who dedicated his life to economic policy-making in the first decades of the People's Republic of China. My career in public service has taken me from local assignments in Beijing's Xicheng district and municipal governments, to senior posts at the PBoC, the central bank, and eventually at CDB; my work has ranged from local administration to financial policy-making and regulation and now to development finance. It is this trajectory – from local to global, from micro to macro, from theory to practice – that allowed me to bring to CDB a diversity of experience and understanding of China's broader circumstances, and inspired me to link CDB's financing capabilities with the government's strengths in coordinating resources. It is precisely this combination that lies at the heart of development finance's contribution to growth and social progress.

I realize that the very term “development finance” comes across as distant and abstruse to some, but the truth is that it's dynamic and alive, bursting with vitality and creative energy. For more than a decade, day in, day out, development finance has been reshaping the face of China's cities and countryside, strengthening its infrastructure, building partnerships around the world, benefitting countless small to medium-sized enterprises (SMEs), millions of students on financial aid, and tens of millions of low- and middle-income homeowners. Development finance touches everything around us in China, and it is a present and powerful force in all of our lives.

Development finance is a form and methodology of finance; it is a product in a uniquely Chinese context. It provides medium- to long-term financing in pursuit of a national development agenda. Using market-based practices, development finance leverages sovereign credit to break through bottlenecks in social and economic development while enhancing financial stability and economic competitiveness. At its core lies a joint bank-government effort to develop markets – turning market gaps and deficiencies into active, sophisticated market sectors, and thereby lay-