Government borrowing and financial reform in China

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GOVERNMENT BORROWING AND FINANCIAL REFORM IN CHINA

by

Wu Xiao-Tang (B. A.)

See ADDENDUM inserted after TABLE OF CONTENTS

Thesis Submitted to
University College
The University of New South Wales
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for the Degree of
Master of Arts (Honours)

June, 1992.

Dedicated to My Motherland---China

STATEMENT

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person nor material which to a substantial extent has been accepted for the award of any other degree or diploma of a university or other institute of higher learning, except where due acknowledgment is made in the text of the thesis.

Wu Xiao-Tang
Department of Economics and Management

June 1992

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I take full responsibility for any mistakes that may been made in this thesis.

ABSTRACT

There has been an increasing number of studies on the financial reform process of formerly centrally planned economies (CPEs). The reform of China's financial system has also been the subject of many studies by Western and Chinese researchers. However, the role of government borrowing in such a process has not received much serious attention despite the importance of such borrowing activities to the development of the reform. This thesis is an attempt to shed some light on this subject by analyzing China's government borrowing activities and their impact on the country's financial reform.

Based on the theoretical studies on and experience of LDCs, the thesis analyzes the methods of government borrowing through the central bank, specialized banks, nonbank financial institutions and capital markets in China. In particular, the common borrowing methods being adopted in the transitional period from a CPE to a market-oriented economy are analyzed. This study examines the more complex relation that links various forms of government borrowing to the operation of the financial system. It shows how the Chinese government's financial imbalance is funded through an innate system which blurred the functions between the state budget and state banks.

The thesis concludes that, despite the twelve-year financial reform in China, its financial system is still rather repressed and financial resource allocation in China is far from optimal efficiency. Government borrowing has imposed some significant yet negative impacts on the financial reform, because the Chinese government has abused the administrative methods to

borrow from the financial institutions and capital market. To promote the effectiveness of its economic reform, it is necessary for China to deepen its financial reform and achieve a better separation of fiscal and monetary functions.

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Addendum

1. The examiners commented on the hypothesis of the thesis (p. 8) and suggested that "...greater impacts on the financial reform process than indicated by the nominal quantities" should be changed to "...negative impacts on the financial reform process than indicated by the nominal quantities". As discussed in the thesis, I do not think all the impacts of Chinese government borrowing are negative although the negative impacts are probably more obvious than the positive impacts . Hence, the author would like to retain the original sentence.

2 The sentence of the second last line of Page 174 is corrected to read "A system of reserve requirements intended to function as an instrument of monetary policy had been in place in China since 1984. It had been mainly used to control the four specialized banks' liquidity until 1988 when the system of credit ceiling was imposed."

Xiao Tang WU

Xiaotong Wu

14 September 1992

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ABBREVIATIONS

ABC	-	Agricultural Bank of China
BOC	-	Bank of China
BOCOM	-	Bank of Communications
CPEs	-	Centrally Planned Economies
ICBC	-	Industrial and Commercial Bank of China
LDCs	-	Less Developed Countries
MOF	-	Ministry of Finance
NBFIs	-	Nonbank Financial Institutions
PBC	-	the People's Bank of China
PCBC	-	People's Construction Bank of China
PICC	-	People's Insurance Company of China
RCCs	-	Rural Credit Cooperatives
SPC	-	State Panning Commission
TICs	-	Trust and Investment Company
TVEs	-	Township and Village Enterprises
UCCs	-	Urban Credit Cooperatives

Chapter 1

Introduction

1.1 Introduction

The 1990s will be a critical period for the Chinese government to realize its objective of raising China into a middle-income country by 2000. To achieve this objective, a high level of investment and an efficient mechanism for financial resource mobilization and allocation are required. Uncertainty of adequate supplies of foreign capital makes it more important for China to rely on its domestic savings, in the same way as other less developed countries (LDCs) have experienced.

An efficient financial system can greatly help promote savings and investment. What is more important, it provides a necessary condition for China's transition to a market economy. A fully developed financial system consists of a wide range of institutions, instruments and markets. Before the economic reform, the financial system of China was characterized by a monobanking system, through which the central bank monopolized commercial banking. The bank was almost exclusively a fiscal and monitoring agent for the execution of the production and investment plans. Absence of financial intermediaries was buffered by the state budget. Therefore, reform of the financial sector is required as a key element of economic reform and development in China.

China has been undergoing a market-oriented economic reform since 1978. The reform process has established a base and a demand for carrying out financial reform in China. The economic reform has brought the following changes into the economy:[1]

- the relaxation of direct planning controls, and the establishment of market mechanisms in areas of increasing economic activities;
- the increased reliance on market forces in setting prices and output;
- the decentralization of economic decision making;
- the development of non-state-owned economic entities;
- the opening of China's economy to the outside world.

The marketization process is reforming the Soviet-stye system of centralized planning and control. The coverage of mandatory plans is being reduced step by step with the enforcement of more guidance plans.[2]

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1. For detailed discussion of China's economic reform, see, for example, D. H. Perkins, (1988), "Reforming China's Economic System," Journal of Comparative Economics 26, June, pp..601-45; B. L. Reynolds (ed.), (1988), Chinese Economic Reform: How Far, How Fast? (Academic Press, INC., 1988); D. G. Johnson, (1988) "Economic Reforms in the People's Republic of China," Economic Development and Cultural Change, 36, pp.225-246; J. C. H. Chai (ed.), (1987), China's economic Reform, (Hong Kong: Center of Asian Studies, University of Hong Kong, 1987); Lin Wei and Arnold Chao (eds) China's Economic Reforms, (Philadelphia: University of Pennsylvania Press, 1982.) Wu Jinglian (1986) "Economic Fluctuation and Two Types of Economic Systems," Caimao Jingji (Finance and Trade Economies), Vol.6, pp.1-8; Ma Hong (1983), New Strategy for China's economy, (Beijing: New World Press, 1983.); World Bank (1983), China: Socialist Economic Development, Vol.2, (Washington, D. C: The World Bank, 1983.)

2. For discussion on these subjects, see, for example, W. A. Byrd, (1987), "The Impact of the Two-tier Plan/Market System In Chinese Industry," Journal of Comparative Economics 11, pp.295-308; P. W. Wong, Christine (1987), "Between Plan and Market: The Role of the Local Sector in Post-Mao China," Journal of Comparative Economics 11, pp.385-398; Wu Jianglian and Zhao Renwei (1987), "The Dual Pricing System in China's Industry," Journal of Comparative Economics 11, pp.309-318; Yuang Qixian (1986), "Learning Guidance Plan to Manage

Enterprises have been granted certain decision-making powers and have also been given rights to sell above-plan products in the market at market prices after the state plans and their contracts with the government at various levels are fulfilled. The inroad of market economy has been marked: in the total value of retail sales, the volume sold at state mandatory price was 97% in 1978, and declined to 29.7% in 1990; the volume sold at market price increased from 3% in 1978 to 53.1% in 1990; and the amount at state guidance price was 17.2% in 1990.[3] It should be noted that the non-state enterprises, especially the township and village enterprises, have been considerably expanded in terms of their market scale.[4]

The decentralization of financial resource follows the process of marketization in China. Money is no longer just a counterpart to physical transaction specified in the plan.[5] It is now a medium of exchange for coordination of the unplanned market transactions. The banking system has become the focus of financial intermediary, allocating a large share of investment towards the more market-oriented economy, with a corresponding

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Economy," Jingji Ribao (Economic Daily), 19 April, p.1.

3. Cheng Yuan (1991), "Greater Achievement in Price System Reform During the Last Twelve Years," Renmin Ribao, (People's Daily), September 27, p.2.

4. W. A. Byrd,and Lin Qingsong (1990), China's Rural Industry: Structure, Development and Reform, Published for the World Bank (Oxford University Press); Wu Xiang (1986), "On the Development of Rural Enterprises," Almanac of China's Economy, pp.11-15. Chen Xiaowei (1985), "New Patterns of the National Economy and the Development of Township Enterprises," Jingji Yanjiu, (Economic Research), October. pp.31-36; Zhang Zhongchuan (1987), "Township Enterprises Make Significant Contribution to Economic Development," Jingji Ribao (Economic Daily), 31 July, p.1.

5. For discussion on this counterpart relation, see, for example, P. H. Cassou, (1974), "The Chinese Monetary System," The China Quarterly, No.59, pp.559-566; G. N. Ecklund (1967), Financing the Chinese Government Budget, Mainland China 1950-59, (Edinburgy University Press); K. H. Hsiao, (1971), Money and Monetary Policy in Communist China, (New York: Columbia University Press).

reduction in the role of the state budget. More significantly, financial reform necessitates development of institutions and instruments for more efficient allocation of financial resources, and for the effective use of indirect macro-economic policies to replace administrative directives by central authorities. The use of instruments of indirect monetary policy will enable authorities to manage macro-economic aggregates more efficiently, with less intervention in micro-level economic decision-making.[6]

The objective of financial reform in China, as in other LDCs, is to gradually reduce bureaucratic controls over prices and financial resource allocation, to permit market forces to exert a greater influence over financial activities, and thereby improve efficiency and equity of the whole economy.[7] As the whole market-oriented economic reform does not have a blueprint to fall back on, hence, there is no clear guidance in the development of financial instruments, establishment of capital market and reforming of banks and non-bank financial institutions (NBFIs). As in most other LDCs, in practice, financial reform in China has focused mainly on the restructuring banking system.[8]

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6. For discussion of China's financial/banking system reform, see, On Kit Tam (1986), "Reform of China's Banking System," The World Economy, Vol.9, No.4, pp.427-440; On Kit Tam (1987), "The Development of China's Financial System," Australian Journal of Chinese Affairs, No.17, January, pp.93-113; L. de Wulf, (1985), "Financial Reform in China," Finance & Development, December, pp.19-22; L. de Wulf and D. Goldsbrough, (1986), "Evolving Role of Monetary Policy in China," IMF Staff Paper Vol.1, No.33 June, pp.209-242; World Bank (1988, b) China Finance and Investment, (Washington, D.C.: the World Bank).

7. D. C. Cole and B. S. Yaser, (1989), "Reform of Financial System," Development Discussion Paper No.325, (Harvard Institute for International Development, Harvard University).

8. For more detailed discussion of this argument, see, for example, Tam (1986) *op. cit.;* Tam (1987), *op. cit.*

In October 1984, the Third Plenum of the 12th Central Committee of the Chinese Communist Party endorsed a "Decision on the Issues of the Reform of Economic System". In the decision, financial reform is to be strengthened in the context of fostering the autonomy and dynamics of enterprises, the establishment of an indirect macro-economic management system, and market development. As a matter of fact, the newly established banking system, which consists of the central bank and specialized banks, has not performed efficiently in financial resource allocation. Losses of macro-control occurred at the end of 1984 after the central bank was established. It was attributed to the fact that the "big rice bowl" mentality and practices had not been broken between the central bank and specialized bank, and between the specialized bank and state enterprises.[9] Apart from the absence of capital market development, lack of autonomy for specialized banks as intermediaries and for the central bank in monetary policies is the key problem in financial reform.

The autonomy of China's new banking system is limited in the following areas. Firstly, the macro-financial decision power is not yet in the hands of the PBC. The scale and structure of financial flows have to be determined by the State Planing Commission (SPC) rather than the central bank. As a result, the central bank is not independent of government intervention in the formulation and implementation of monetary policies. Secondly, specialized banks also do not operate independently. They have only limited power to use their allocated credit funds and retained profits. This forced the specialized banks to eat from " a big rice bowl" with the central bank. Thus, they are not fully responsible for the safety and liquidity of the credit funds. Finally, the government still has a great influence over the decision-making power of the state banks. The government deficits are still

9. Wu Jieshi (1987), Explorating Financial System Reform in China, (Beijing: China's Economic Publishing House).

automatically financed by overdrafts from the central bank. Most importantly, the government continually directs the banking system to ensure that resources are allocated in accordance with its development plans. Therefore, a prerequisite for China's financial reform should be to promote the autonomy of the financial system in the field of financial resource allocation.[10]

1.2 Objective and Hypothesis

One striking characteristic of the China's financial reform process is that it has been affected considerably by government borrowing activities since the beginning of the reform. The total state budget revenue (consolidated) has fallen from 37.2% of national income in 1978 to 22.2% in 1989 (See Table 3-1). The state budget has been annually in deficit since 1979 (in official figure, the state budget was in surplus in 1985). Hence, following the decentralization of the financial resources, the Chinese government has also needed to borrow from other economic agencies to finance its deficits.

According to the established theories of financial liberalization, government borrowing is often an important factor in causing financial repression in a country.[11] To keep the cost of government borrowing low,

10. Ja Chanju (1985), "The Central Bank Should Have Its Power and Law," Jinrong Yanjiu (Financial Studies), Vol.6; Zhang Guile (1985), "Issue on the Relationship Between the Central Bank and the Specialized Banks," Jinrong Yanjiu (Financial Studies), Vol.2; Yang Peixin (1985), " Introductory Remarks on the Situation of China's Financial System Reform," Tianjin Jinrong Yanjiu (Tianjin Financial Studies), Vol.2; Editor, (1986) "Summing-up Issues on China's Financial Reform," Jinrong Yanjiu (Financial Studies), Vol.11.

11. See, for example, P. J. Drake, (1977), "Securities Market in Less Developed Countries," Journal of Development Studies, Vol.13, no.2, January, pp.72-91; R. I. McKinnon and D.J. Methesion, (1981), "How to Manage a repressed Economy," Essays in International Finance, No.145, December, (Princeton Press), pp.1-25; R. I. McKinnon (1982), "The Order of Economic Liberalization: Lessons From Chile and Argentina," Carnegie-Rochester Conference Series on Public Policy, Vol.17, pp.159-186; M. J. Fry, (1982), "Models of Financial

governments generally restrict real interest rates at a low or negative level in both bank operations and securities markets. Low or negative interest rates may reduce aggregate savings, diminish the savings available for investment, and distort allocation among investment alternatives. Hence, an interest rate ceiling by government is the key factor causing financial repression. Furthermore, government borrowing may also create other problems. The typical problems are: placing high reserve requirements, excessive money creation and thus causing inflation, restricting portfolio selection of commercial banks, limiting enterprises' issuing of securities in financial markets.[12]

However, government borrowing may also have some positive effects on financial reform, in particular, on the development of a country's securities market. When the government borrows through issuing securities, the public may be encouraged to hold securities , which in turn, can help build up capital markets. Further, through buying and selling government securities, open market operation becomes possible; commercial banks can also enhance their asset liquidity through holding government securities. In the process, the regulation and institutional development of capital markets will be generated along with the development of government securities market. For instance, the financial institutions' operation can begin to be regulated and the techniques will be improved; transaction costs can be lowered and standardized; limitation to certain types of speculation are made effective; and brokers and

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repressed Developing Countries," World Development, Vol.10, No.9, September, pp.731-750.

12. For discussion of these problems, see, U. T. Wai and H. T. Patrick, (1973), "Stock and Bonds Issues and Capital Markets in Less Developed Countries," IMF Staff Paper, Vol.20:2, pp.253-317; P. J. Drake, (1986), "The Development of Equity and Bond Markets in Pacific Region," In A. H. H. Tan and B. Kapur (eds) Pacific Growth and Financial Interdependence; A. W. Agtamel, (1984), Emerging Securities Market, (London: Euromoney Publications Limited).

other specialists become more professional.[13]

The introduction of government borrowing during China's financial reform, therefore, raises the following questions.

1) Did Chinese government borrowing restrict or stimulate financial reform in China ?

2) How did government borrowing affect one of the main objectives of China's financial reform: the separation of the fiscal and banking functions in financial resource allocation?

This study will attempt to shed some light on the above questions. As will be discussed in this thesis, government borrowing may have done more harm than good in the actual process of financial reform in China. The hypothesis of this study is as follows:

Administrative rather than market-based methods have been adopted by the Chinese government in its practice of borrowing from the financial system. The methods employed by the Chinese government for domestic borrowing have produced significantly greater impacts on the financial reform process than indicated by the nominal quantities. As a result, government borrowing in its current form has reduced the benefits created by financial reform and may have retarded the process of economic reform in China.

It is generally accepted that the macro-economic effects of a budget deficit depend heavily on its methods of financing.[14] The different methods of

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13. World Bank (1989,a), World Development Report 1989, (New York: Oxford University Press); M. M. Hutchison, (1986), "Financial effects of Budget Deficit in the Pacific Basin," In Cheng Hangsheng (ed) Financial Policy and Reform in Pacific Basin Countries, (Lexington Books); Wai and Patrick, (1973), *op. cit.*

14. Anibal A Cavaco Silva (1986), "Macro-economic Impact of Debt Financed Fiscal Deficits: Non-sceptical Consideration," In B. P. Herber (ed) Public Finance and Public Debt, (Wayne State University

deficit financing affect the pattern of financial development and reform. A budget deficit is usually financed by public borrowing, foreign loans, printing money, or by a mixture of the three. Theoretical and empirical studies indicate that an excessive strain on any of these sources of finance can create macro-economic imbalances.[15] Hence, the mode of deficit financing is crucial. Theoretical and empirical studies have also proved that prices will rise when a deficit is financed by printing more money than the public wants to hold. However, this effect does not seems to be so strong on the surface in China's economy because prices have not been totally responsive to changes in the market. Budget deficits, which are financed by excessive domestic borrowing, can lead to higher interest rates and crowd out private investment. Such an effect is also not important in China as interest rates are still set administratively and private business still accounts for a small part of investment.[16] In domestic borrowing, the Chinese government relies more on borrowing from the banking system. Hence, it affects the central bank's monetary policy implementation, the portfolio of the specialized banks, the level of interest rates, and the development of NBFIs. Government borrowing also largely determines the scope of the capital market development.

The Chinese government has mainly adopted the following methods in financing its activities and fiscal deficits when it borrows from its

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Press, Detroit, 1986), pp.71; World Bank, (1988, a), World Development Report 1988, (New York: Oxford University Press), p.55.

15. See, R. Goode, (1984), Government Finance in Developing Countries, (The Brookings Institution, Washington, D.C.); World Bank, (1988, a), *op. cit.*

16. It was reported that the total registered investment in private business was only 2.3% of total registered investment of state and collective enterprises. Employees in private business accounted for 4% of total the labor force in the whole nation. See, Fu Gang (1990), "Good Trends in Private Business Development," Renmin Ribao (People's Daily), 10 March, p.1.

domestic sources.[17]

1. Government borrowing through issuing securities:

Since 1981, Treasury Bonds have been issued annually by the Ministry of Finance (MOF) to state enterprises, local governments, public institutions, and urban and rural individual households. The MOF also issues quasi-bonds. For example, Fiscal Bonds were issued in 1988 to finance government deficits and priority projects. Some ministries, such as the Ministry of Railways, have issued government agency bonds. The funds raised are used to finance key state projects.

2. Government borrowing from the financial system:

The Chinese government has borrowed annually from the central bank (PBC) to finance fiscal deficits (official figures). The government also instructs the central bank and specialized banks to extend directed credits to key state projects and enterprises. Bank loans are diverted by state enterprises to fiscal uses. For instance, state enterprises use working capital loans to buy Treasury Bonds, or pay taxes. Specialized banks are required to hold and buy Treasury Bonds and government agent bonds. Non-bank financial institutions are required to place high ratios of deposit with the central bank and their supervising banks.

Therefore, the Chinese government's borrowing from the market and the financial sector has helped to finance the fiscal deficit as well as a variety of state projects and enterprises. As will be discussed later, state enterprises are

17. The fiscal deficit calculated by the Chinese government is different from international convention. For instance, the debt income from issuing Treasury bonds is recorded as a fiscal revenue. The statistical treatment of the government deficit will be discussed in detail in Section 1.3 and Section 3.5.

one of the main factors in causing government deficit and government borrowing from the financial system. The real scope of the Chinese government deficit, which is different from official definition of deficit, will be discussed in Section 3.5.2.

In studying the above government borrowing activities in the context of the financial reform, government borrowing can be defined to consist of "market borrowing" and "'protected' borrowing". Market borrowing refers to government borrowing from capital markets, either organized or unorganized. "Protected" borrowing, on the other hand, refers to funds obtained by the government through taking advantage of the legal restrictions or requirements which the government itself places on financial institutions.[18] According to this definition, Chinese government borrowing should include "market" borrowing and "protected" borrowing. It should be noted that the two kinds of borrowing do not always have a clear-cut demarcation line between them. Sometimes market borrowing may be changed into "protected" borrowing. For instance, when the government instructs financial institutions to subscribe to all government securities, market borrowing becomes "protected" borrowing with the emergence of a captive market.

1.3 Research Scope and Problems

This study focuses on the analysis of Chinese government's domestic borrowing in the last twelve years. Domestic borrowing, as defined above, includes "market" borrowing and "protected" borrowing. This study focuses

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18. For detailed discussion in this two definitions, see, R. L. Kitchen, (1986), Finance for the Developing Countries, (Chichester, England: John Wiley & Sons), p.111.

Table 1-1

Surplus and Deficits of the Chinese Central and Local Governments During 1979-1988

(In Billion Yuan)

Year	Consolated State Fiscal Budget	Central Government Budget	Local Government Budget
1979	-17.07	-13.33	-3.37
1980	-12.75	-14.55	1.80
1981	-2.55	-1.19	-1.36
1982	-2.93	-4.63	-1.69
1983	-4.35	-8.40	4.05
1984	-4.44	-3.00	-1.45
1985	2.16	0.08	2.08
1986	-7.06	-9.68	2.36
1987	-7.96	-9.68	1.72
1988	-7.86	-10.65	2.80
Total	-64.81	-74.76	9.95

Source: China Finance Statistics (1950-88), p.149

on the central government's borrowing activities, because local governments (in the aggregate) are in surplus fiscal balance in most years (See Table 1-1) and borrowing from the public is not allowed. Although, in reality, local governments' borrowing did occur, the amounts of borrowing were not large (no available data on such activities). Hence, the definition of government borrowing in this study means domestic borrowing of the central government.

By broad definition, government borrowing in this study includes: 1) overt government borrowing to finance deficits. For instance, issuing Treasury bonds and borrowing from the central bank. 2) covert borrowing used to increase indirectly the current year's fiscal resources or decrease the expenditure. For instance, the Chinese government could and has dictated the central bank and specialized banks to extend directed loans to those projects which should otherwise be financed by the state fiscal budget.

The process of China's market-oriented economic reform will be reviewed as a background of this study. The economic reform has resulted in decentralizing significant decision-making power to the economic agents. The increasing monetization of economic activities has changed the patterns and mechanisms of savings and investment. Hence, reform of the banking and financial system is called for allocating financial resources efficiently and introducing economic levers to guide the economy at the macro-level.

Recent theoretical studies of financial reform related to centrally planned economies (CPEs) indicate that financial reform is a fundamental component of economic reform, and necessary for the more efficient use of capital in the socialist system.[19] However, the appropriate nature and model

19. For theoretical discussion of this subject, see, for example, E.

of the financial system in the context of socialist economy, including capital market, banks, interest rates, and fiscal and monetary policies, remain a subject for much more exploration and further examination.

There is an expanding literature on financial development in LDCs. The emphasis of studies has switched from a concern with the lack of basic investment to the removal of financial repression in LDCs.[20] The theories of "financial repression" and "financial liberalization" have become a new orthodoxy in the literature.[21] The relatively well-developed theories concerning financial reform and development in LDCs, can in most cases be usefully adopted in the study of financial repression and financial reform in CPEs, as their economic and financial development shares common characteristics. The financial development and repression literature, though not written in the special context of China, still provides a useful basis for analysis and for interpreting various problems inherent in China's financial reform.

The theory of financial repression and financial liberalization emphasizes the elimination of interest rate ceilings and the fostering of free

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G. Furobotn, (1980), "The Socialist Labor-Managed Firm and Bank-Financed Investment: Some Theoretical Issues," Journal of Comparative Economics 4, No.2, pp.184-191; D. M. Nuti, (1987), "Financial Innovation under Market Socialism," EUI Working Paper No.87/285, (EUI, Florence); D. M. Nuti, (1988), "Competitive Valuation and Efficiency of Capital Investment in the Socialist Economy," European Economic Review 32, pp.2-6; R. Portes, (1983), "The Theory and Measurement of Macro-economic Disequilibrium in Centrally Planned Economies," Discussion Paper, (Birkbeck College, London), October, No.161.

20. V. Galbis, (1977), "Financial Intermediation and Economic Growth in Less-Developed Countries: A Theoretical Approach," Journal of Development Studies 13, No.2, pp.58.

21. Y. J. Cho, (1986), "Inefficiencies from Financial Liberalization in the Absence of Well-Functioning Equity Markets," Journal of Money, Credit and Banking, Vol.18, No.2, pp.191.

competition among banks, non-banks and capital markets.[22] However, there are more debates as to how to carry out efficient financial reform in LDCs. It is generally agreed that a correct sequence is necessary for an efficient financial reform.[23] It is stressed that the role of the government in financial resources allocation should be taken into account,[24] because "nearly all of governments considered it necessary to intervene in the financial sectors in order to channel cheap credit towards the sectors that were to be at the forefront of development."[25] Hence, governments paid inadequate attention to regulatory and prudential matters, to the detriment of financial system. A similar situation can be found in China and other CPEs where financial resources allocation is highly regulated by government planning.[26] The need to maintain a high level of government borrowing is believed to be a main factor in causing government intervention in the context of interest rate ceiling--which is the core of the theory of financial repression. Governments' borrowing activities

22. R. I. McKinnon, (1973), Money and Capital In Economic Development, (Washington, D.C.: Brooking Institution); E. D. Shaw, (1973), Financial Deepening in Economic Development, (New York: Oxford University Press); M. J. Fry, (1988), Money Interest and Banking in Economic Development, (The Johns Hopkins University Press); Cho, (1986), *op. cit.*

23. S. Edwards, (1990), "The Sequencing of Economic Reform: Analytical Issues and Lessons From Latin American Experiences," The World Economy, Vol.13, No.1, pp.1-12; McKinnon, (1982), *op. cit.*; Cho, (1986), *op. cit.*

24. For study of the role of government in financial resource mobilization and allocation, see, for example, D. Landau, (1986), "Government and Economic Growth in the Less Developed Countries: An Empirical Study for 1960-1980," Economic Development and Cultural Change, Vol.35, No.1, October; R. Wade, (1988), "The role of Government in Overcoming Market Failure: Taiwan, Republic of Korea, and Japan," In H. Hughes (ed) Achieving Industrialization in East Asia, (Cambridge University Press); Galbis, (1977), *op. cit.*; World Bank, (1989, a), *op. cit.*

25. World Bank, (1989, a), *op. cit.*, p.54.

26. P. Collier and J. W. Gunning, (1991), "Money Creation and Financial Liberalization in a Socialist Banking System: Tanzania 1983-88," World Development, Vol.19, No.5, pp.533-538; B. Fedorov, (1989), "Reform of the Soviet Banking System," Communist Economies, Vol.1, No.4, pp.455-461.

have other impacts on financial repression and reform, as mentioned above. However, there are no systematic studies of the impacts of government borrowing on financial liberalization in those countries undergoing transition from a CPE to a market-oriented economy. This thesis will, based on investigations of Chinese government borrowing activities, attempt to explore the major issues and to draw some meaningful lessons for further financial reform in China, and also for those countries which are in a transition from CPEs to market-oriented economies.

The study of Chinese government borrowing and its impacts on the financial reform is made difficult by the fact that hard data are often incomplete or unavailable. Chinese and Western economists and academics are fully aware of the data problem. Statistical information on China is often poor in terms of quantity and quality. Although the Chinese statistical system has improved with greater availability in recent years, information and data on certain financial and monetary flows are still limited as sensitive Chinese officials still regard them as state secrets. Moreover, Chinese definitions and coverage are often unclear and confusing. For instance, the Chinese definition of government deficit is not in agreement with the international convention. The official figures of the government deficits are the consolidated balance between the current year's fiscal expenditure and the current year's fiscal receipts for all levels of governments. The Chinese government treats its external and domestic debt income as fiscal revenue. Government's prices subsidies are treated as a write-off on the fiscal revenue side. No distinction is made between the capital and current account in China's budget. Therefore, official data of fiscal deficits still fails to reflect the true state of the Chinese government finance.

Another difficulty with Chinese financial data stems from the incomplete statistics system of both central bank and specialized banks. For instance, data on the government borrowing from the central bank in the bank's balance sheet is the outstanding balance on 31 December each year. The flow amount is not available from the source of bank's statements. Hence, it is a tough job to estimate the impact of the government borrowing on the increase of money issue and inflation. Another example is that no clear distinction between "policy loans" and nominal commercial bank credits is made in Chinese bank statements, hence, it is difficult to show how much credit funds of the state banks has been diverted to fiscal use. Such data as the amount of treasury bonds discounted by the state banks, the total amount of government quasi-bonds and government agent bonds bought by the four specialized banks and two comprehensive banks are not given in the banks' balance sheets [See Table 5-5 (a), (b), (c), (d)].

To some extent, the lack of standardized, systematic and consistent statistics in government borrowing may be offset by searching for data scattered in official publications, newspapers, journals and magazines. The publication of the Zhongguo Jinrong Nianjian (Almanac of China's Finance and Banking), which is the first and most authoritative financial statistic year book issued, proves a valuable data source. In recent years, the World Bank and some Western academics have also carried out research on various area of the Chinese financial reform. Their discussions and evaluations help to alleviate the data problem.

1.4 Outline of the Thesis

Chapter 2 of this thesis aims at establishing a theoretical framework for the study. The theoretical literature on financial deepening and development will be reviewed and discussed in relation to China's financial reform. Although the issue of how to carry out financial reform efficiently is still under debate, the main elements required by an effective financial reform process are addressed in a different perspective. Then, the argument that a correct order of financial reform which varies with different countries is emphasized. Major studies on government borrowing and financial repression in LDCs are also reviewed. The chapter shows that the existence of government borrowing will induce government interventions in financial system reform in a broad context.

Chapter 3 provides an economic background for the study on the subject matter of the thesis. A brief sketch of the program of economic reform shows how China perceives the deficiency of its centrally-planned traditional model, and how market elements have been re-introduced into production, consumption, savings and investment. Then it looks at how the over-centralized financial system operated in China before the reform. It is argued that as market forces are suppressed and disregarded, Chinese banking operation and monetary policies are dominated by the dictates of the state budget. The examination of the decentralization process of financial resource allocation demonstrates the traditional problems which have been tackled in the reform, and the problems which remain or have cropped up in the course to affect the reform. It is concluded that the new financial system still lacks autonomy to ensure operation efficiency. Currently, it conforms largely with the government financing requirements imposed by the government. The chapter will also analyze the trends in the state budget outcome so as to show the reasons and problems which cause the budget deficit. The findings indicate that government imposes far more borrowing requirements than the officially published figures show. Hence, with underdeveloped capital markets, Chinese government borrowing has exerted great pressure on the financial sector reform, and on macro-economic control. The Chinese government's deficit financing is the main reason for the government's continuing interventions in banking system operation.

In Chapter 4, the impacts of the government borrowing on financial reform are firstly analyzed from the perspective of market borrowing activities. In terms of market structure, market instruments and market price, two major questions are discussed: whether the Chinese government has established a market for Government borrowing to raise funds efficiently; and what are the effects of the government's market borrowing activities on financial reform, and specifically on the development of capital markets. The findings suggest that, although market elements have been introduced into the government's borrowing activities, government borrowing is still conducted mainly by administrative directives and interventions. The consequence created by the government's administrative methods in market borrowing has been outlined in association with the financial reform. Black market trading of government bonds is finally discussed as a case study to show the failings of government policy in the financial reform process.

The activities of the Chinese government's borrowing from state banks and NBFIs are investigated in Chapter 5. The main issue of this chapter is that, in practice, the bank credit flows are in response to the dictation of government fiscal requirements rather than financial market conditions and discipline. The Chapter will firstly look at the government borrowing from the central bank. It argues that China's central bank does not operate autonomously and independently in the context of implementing monetary policy. Therefore, the central bank cannot ensure effective financial reform and stability in macro-economy. The chapter then analyzes government borrowing from the specialized banks. The discussion shows that the specialized banks still operate as an organ of the Chinese government. The credit activities are mainly dominated by the government dictations in form of directed loans. Interest rates are still set administratively. Seeking profits by banks thus become unnecessary and impossible. The discussion also reveals how government borrowing from the specialized bank has contributed to the increasing money supply. Finally, the chapter looks at how the government borrowed from NBFIs to mobilize financial resources. Limitation of development of NBFIS has weakened the competition among financial sectors, therefore, the efficiency of financial reform is reduced.

In Chapter 6, it will summarize the main findings from proceeding study of the government borrowing activities. The summary indicates that China's financial system is still quite repressed in developing a broader capital market, liberalizing interest rate system and efficient promoting the economic growth. Hence, some policy implications and strategies for deepening financial reform will be raised.

Chapter 2

Theoretical Review and Main Analytical Issues

2.1 Introduction

The aim of this chapter is to review the literature and to establish a theoretical basis for this study. Relevant issues are raised to develop the discussion in the following chapters.

The theories on and experience of LDCs in financial liberalization provide a useful basis and point of departure for studying the financial reform in China and other CPEs. Based on the level of economic development, some common characteristics of financial repression can be found in both LDCs and CPEs. For instance, low or negative real interest rates, shallow financial institutions, underdeveloped capital markets, absence of financial instruments and long-established informal financial sectors. The aims of financial liberalization are also basically similar: to stimulate economic development through promoting efficiency in financial resource mobilization and allocation.

Since the mid-1970s, developing countries have taken steps towards financial liberalization. The experience of LDCs indicate different paths can lead to financial liberalization. For instance, some countries, following the McKinnon-Shaw Model, had taken steps to fully liberalize their interest rates. For some countries, interest rates were managed more flexibly than before.

Many countries had curtailed their directed credit programs, few had eliminated them entirely. Competition among financial institutions had been triggered by opening domestic markets to foreign banks and nonbank financial intermediaries. However, only a few countries' financial liberalization have been comprehensive.[1] For example, Argentina, Chile, and Uruguay, carried out extensive reforms in the middle-1970s, including that interest rates were decontrolled, constraints on capital flows were reduced, directed credit programs was eliminated, and exchange control were relaxed.[2] Several Asian countries have also moved towards deregulation of their financial system, but the reform were less comprehensive.[3] However, the financial liberalization in three Latin Americ countries ended in disarray: the government of Argentina had to re-impose controls, and all three governments had to deal with widespread bank failures. Evidence also suggests that countries have to take appropriate paths to carry out the financial reform.[4]

There are some key theoretical issues related to the early stages of the transition from CPEs into market-oriented economies. The major theoretical and policy issues in economic reform include three aspects. One concerns the economic implications of a policy sequence: will one kind of reform achieve its

1. World Bank, (1989,a), *op. cit.*, p.4.

2. V. Corbo, J. de Melo and J. Tybout (1985), "What Went Wrong with the Recent Reform in the Southern Core," Economic Development and Cultural Change, Vol.34, No.3, pp.607-640.

3. D. C. Cole,(1988), "Financial Development in Asia," Asian-Pacific Economic Literature, Vol.2, No.2. pp.26-47; D.C. Cole and H. T. Park, (1986), "Financial Development in the Pacific Basin Market Economics," In A. H. H. Tan and B. Kapur (eds) Pacific Growth and Financial Interdependence, (Sydney: Allen and Unwin)

4. S. Edwards, (1985), "Stabilization with Liberalization: An Evaluation of Ten Years of Chile's Experiment with Free-Market Policies, 1973-83," Economic Development and Cultural Change, 33 (1), pp.233-54; S. Edwards (1990), "The Sequencing of Economic Reform: Analytical Issues and Lessons from Latin American Experiences," The World Economy, Vol.13, No.1, pp.1-12.

objectives while other economic distortions remain? Another question is political: will a mounting opposition derail reforms scheduled near the end of the sequence? Finally, there is technical feasibility. New legal, accounting, and financial systems will require greater technical expertise and longer gestation periods than reforms which include only price deregulation.[5]

Specifically, financial reform is considered as being one of the control pillars of the economic reform programs aimed at transforming CPEs into market economics.[6] The appropriate nature of a financial system, however, including such issues as capital markets, banks, interest rates, and fiscal and country politics during the transition, is a subject of intense debate among policy makers and economists.[7] The systemic issues have focused on the model for a fully reformed financial system, the system limits to financial reform and the necessary characteristics for an efficient financial reform.[8] The sequence and speed for the financial reform are also a subject of much contention. As to the distorted economic system, the argument is whether an economic and financial reform should be conducted gradually or sped up as a

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5. For discussion of the main issues on the transition from a centrally planned economy to a market economy, see, World Bank (1991), *op. cit.*, pp.145.

6. See, G. A. Calvo, and J. A. Frenkel, (1991), "From Centrally Planned to Market Economy: The Road from CPE to PCPE," IMF Staff Papers, Vol.38, No.2. pp.268-299.

7. D. M. Nuti, (1987), "Financial Innovation under Market Socialism," Working Paper No.87/285 (Florence: European University Institute); D. M. Nuti, (1989), "Remonetization and Capital Markets in the Reform of Centrally Planned Economies," European Economic Review, 33, North-Holland pp.427-438; G. Grossman, (1986), "Inflationary, Political and Social Implications of the Current Economic Slowdown," In H. H. Hoehmann (ed) Economic and Politics in the USSR: Problems of Interdependence, (Boulder: Westview).

8. For an intensive study of the financial reform in the transition from CPEs to a market economy, see, C. Kessides (et, al), (eds), (1989) Financial Reform in Socialist Economics, EDI Seminar Series, (The World Bank, Washington, D.C.)

"shock therapy". The experience of LDCs in financial liberalization suggests that unstable economy and prices systems that do not reflect the scarcity of resources, their financial resources have to be deregulate gradually. It is also argued that without reforms in the price and enterprises management systems, financial reform itself involves an inconsistency in its objectives in a transition period.[9] It is generally agreed by policy-makers and economists that macroeconomic stability is a prerequisite for the financial reform in a transitional periods.[10]

Governments in developing countries play a major role in financial resource allocation. Theoretical and empirical studies on developing countries indicate that the financial system has been used by governments in an attempt to direct the investments process. However, government intervention in financial operation has frequently led not only to inefficient allocation of resources, but also to an increasingly repressed and ineffective financial system.[11] It has also been generally accepted that financial repression in LDCs is mainly the result of government intervention in financial resource allocation. Because governments keep interest rates low partly to encourage investment, partly to redistribute income, and partly because they themselves wish to borrow cheaply.

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9. For the discussion of the impact of price system and enterprises management on a financial reform, see, Lipton, D and Sachs, J (1990), "Creating a Market Economy in Eastern Europe: The Case of Poland," Brooking Papers on Economic Activity, Vol.1, pp.75-147; R. L. McKinnon, (1991), "Financial Controls in the Transition from Classic Socialism to a Market Economy," Journal of Economic Perspectives, Vol.5, No.4, pp.107-122.

10. C. Sokil and T. King (1989), "Financial reform in Socialist Economies: Workshop Overview," In C. Kessides (et, al), (eds), (1989), *op. cit*, pp.1-27.

11. D.C. Cole, and B. S. Yaster, (1989), "Reform of Financial System," Department Discussion Paper, Harvard University.

The decline in foreign capital flows means that governments in LDCs have to rely more on their domestic resources to finance their deficits. However, the fact of underdeveloped capital markets means that governments have to turn to their central banks and other financial institutions to finance deficits. The result is, when governments borrow from the central bank, that inflation rises. Interest rate controls and inflation will retard financial reform by setting back financial liberalization. In order to channel cheap credits to the sectors of state priority, governments also adopt some indirect ways to increase their spending. For instance, governments specify preferential lending interest rates for priority sectors which are usually state-owned enterprises. Some governments ask banks to place a high percentage of their funds on reserve requirements and to hold government bonds at below market price. Even though governments borrow through market methods by issuing government bonds, government may resort to administrative method to ensure that bonds are issued at below market interest rates. Therefore, government's borrowing has broad impacts on financial reform in the context of interest rates, central bank operation, monetary policy, bank lending activities, capital market development, etc. It largely determines the efficiency of financial resource allocation.

In the following, the significance and the difficulty of financial liberalization in both LDCs and CPEs will be discussed in Section 2.2. The relationship between government borrowing and financial repression, liberalization will be outlined in Section 2.3. Some conclusions will be made in Section 2.4.

2.2. The Significance and Difficulty of Financial Liberalization

To provide a theoretical basis for understanding the significance and problems of the financial reform in China, the process of theoretical development on the study of financial liberalization in LDCs is reviewed in this section. It will highlight the main characteristics, experiences, and lessons of financial liberalization in LDCs. The major issues on the sequencing of a efficient financial liberalization are discussed. The theoretical studies and issues related to China and other CPEs are also dealt with.

2.2.1 Theory of Financial Development in Developing Countries

Although the systematic analysis of the relationship between financial development and economic growth is a relatively new field of research, the importance of this relationship has been well recognized and emphasized in economic and financial development literature.[12] A financial system provides essential services in a modern economy. The use of a stable, widely accepted medium of exchange reduces the cost of transactions. It facilitates trade and, therefore, specialization in production. Financial assets with attractive yield, liquidity, and risk characteristics encourage savings in financial development. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries promote the efficient use of resources. Access to a variety of financial instruments enables economic agents to pool, price and exchange risk. Trade, the efficient use of savings, and risk taking are

12. For study of the relationship between financial development and economic development, see, for example, J. G. Gurley and E. D. Shaw (1955), "Financial Aspects of Economic Development", American Economic Review 45, September, pp.515-538; J. G. Gurley and E. D. Shaw, (1960), Money in a Theory of Finance, (Brooking Institution, Washington, D.C.) H. D. Patrick (1966), "Financial Development and Economic Growth in Underdeveloped Countries," Economic Development and Cultural Change 14, January, pp.174-189; R. C. Porter (1966), "The Promotion of the 'Bank Habit' and Economic Development," Journal of Development Studies 2, July, pp.346-366; R. W. Goldsmith (1969), Financial Structure and Development, (New Haven, Conn.: Yale University Press, 1969.) D. R. Khatkhat ,(1982), "National and International Aspects of Financial Policy in LDCs: a Prologue," World Development, 10 (9), pp.689-694; P. J. Drake (1980), Money, Finance and Development, (Martin Roberston, Oxford)

the cornerstones of a growing economy.

1. Financial Repression and Financial Liberalization

Despite a large literature which stresses the importance of financial development in the process of economic growth, theories and studies concerning the impact of financial development on developing economies were scarce until the publications of McKinnon[13] and Shaw[14]. The two works offer two views. The view of 'financial repression' considers low real interest rates, caused by arbitrarily set ceilings on nominal interest rates and high and variable inflation rates, to be the major impediment to financial deepening, capital market formation and growth. The 'financial structuralist' or 'financial deepening' view maintains that a widespread network of financial institutions has beneficial effects on the savings investment process, and hence, on growth.[15]

The concept of financial liberalization, a la McKinnon and Shaw, states that liberalization of the financial sector from interest rate ceilings and other restrictions facilitates economic development and growth because higher interest rates lead to both increased savings and greater efficiency of capital allocation.[16] Negative real interest rate may reduce aggregate savings, diminish the savings available for investment, and distort its allocation among

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13. R. I. McKinnon, (1973), Money and Capital in Economic Development, (Washington, D.C.: Brookings Institutions 1973).

14. E. D. Shaw, (1973), Financial Deepening in Economic Development, (Oxford: Oxford University Press, 1973).

15. R. W. Goldsmith, (1969), Financial Structure and Development, (New Haven: Yale University Press); K. L. Gupta, (1984), Finance and Economic Growth in Developing Countries, (London: Croom Helm).

16. Y. J. Cho, (1986), "Inefficiencies from Financial Liberalization in the Absence of Well-Functioning Equity Markets", Journal of Money, Credit and Banking, Vol.18, No.2, May, pp.190.

investment alternatives. Financial liberalization usually leads to moderately positive interest rates.[17]

The McKinnon-Shaw model has been subsequently extended by other researchers.[18] Several countries have attempted McKinnon-Shaw type programmes of financial liberalization and development. The results were varied and mixed. Positive results can be seen from Malaysia in the 1980s,[19] the outcome was far less satisfactory when tried in Chile, Argentina and Uruguay in the 1970s,[20] and Philippines, Indonesia[21] and Turkey in the 1980s.[22]

In view of the failure of the program of financial liberalization in South America, many scholars begun to investigate how the theory of financial liberalization is incomplete and how financial liberalization could be more

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17. D. J. Mathieson, (1980), "Inflation, Interest Rates and Monetary Aggregates During a Financial Reform", International Monetary Fund, Washington, D.C. (mimeo) April; Fry (1982), *op. cit.*, M. J. Fry, (1988), Money, Interest and Banking in Economic Development, (The Johns Hopkins University Press).

18. See, for example, V. Galbis, (1977), "Financial Intermediation and Economic Growth in Less-developed Countries: a Theoretical Approach," Journal of Development Studies, Vol.13, No.2., pp.58-72; V. Galbis, (1979), "Inflation and Interest rate Policies in Latin America, 1967-1976," IMF Staff Papers, Vol.26, No.2, pp.334-366; B. K. Kapur, (1976), "Alternative Stabilization Policies for Less Developed Economies", Journal of Political Economy Vol.84, No.4, pp.777-795. M. J. Fry, (1978), Money and Capital or Financial Deepening in Economic Development?", Journal of Money, Credit and Banking, Vol.10, No.4., pp.464-475; Fry, (1982), *op. cit;* Mathieson, (1980), *op. cit.*

19. Y. J. Cho and D.R. Khatkhate (1989), "Lessons of Financial Liberalization in Asian: A Comparative Study," Discussion Paper No.50. Washington: World Bank, April.

20. McKinnon (1982), *op. cit.*, Edwards, (1985), *op. cit.* Corbo, Melo and Tybout (1985), *op. cit.*

21. Cho and Khatkhate (1989), *op. cit.*

22. World Bank, (1989,a), *op. cit.*

effectively implemented. It was argued that "the literature on financial liberalization has emphasized eliminating interest-rate ceilings and fostering free competition among banks. It has largely overlooked the possibility that endogenous constraints in the credit market, such as imperfect information, could be significant barriers to efficient credit allocation even when banks are freed from interest rate ceilings."[23]

Lack of development in capital markets is a the common characteristic of LDCs.[24] It is stressed that, to achieve full efficiency of capital allocation in a liberalized financial system, it is necessary to develop an equity market.[25] Equity capital can finance the risky, productive borrowers, for whom asymmetric information is acute while banks concentrate on other well-established, safe borrowers. However, for those financial markets which are composed only of such debt financing institutions as banks, the market also "fails to achieve efficient allocation of capital because of shortcomings of debt finance in the presence of asymmetric information."[26] In a word, to establish a security market is a necessary component of financial liberalization.

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23. Cho (1986), *op. cit.*, pp.191.

24. The problem of capital market development in LDCs has been discussed by several scholars. It is generally accepted that capital market development in LDCs are obstructed by the limited supply and demand for corporate securities, low income, absence of a well-established legal framework, and lack of confidence of the public, etc. See, Wai and Patrick, (1973), *op. cit.*; P. J. Drake, (1977), "Securities Market in Less Developed Countries", Journal of Development Studies, Vol.13, No.2, pp.72-91; P. J. Drake, (1985) "Some Reflections On Problems Affecting Securities Market in Less Developed Countries," Savings and Development, No.1, Vol.IX, pp.5-15; N. I. Leff, (1976), "Capital Market in the Less Developed Countries: The Group Principle," In Ronald I, McKinnon (Ed.), Money and Finance in Economic Growth and Development , (New York: Marcel Dekker, Inc.), pp.97-122.

25. Cho (1986), op. cit., pp.194.

26. *Ibid*, pp.198.

2. Financial Deregulation

One of the major new themes of financial development has been that of financial deregulation: the reduction of bureaucratic interference in the price, allocation or provision of financial services. The deregulation programs experienced by the Pacific Basin Asian countries were designed to preserve the stability of the financial system by restricting competition and controlling the price, quantities and functions of financial institutions. Some developing countries went further to engage in direct allocation of cheap credit in an effort to foster greater investment in growth-promoting economic sectors. This mix of policies segmented the financial system and retarded financial development in ways which were thought to discourage saving, cause misallocation of investment and thereby reduce the overall rate of economic growth.[27] "Deregulation in most countries includes relaxation of interest rate and credit controls, reduction of the functional barriers between different types of institutions, opening up domestic money and capital markets, reduced restriction on international transactions and on the domestic activities of foreign financial institutions."[28] Intensive studies indicate that these countries differ in their pace and degree of deregulation. The deregulation experience of Pacific Basin Asian countries help further develop the theory of financial liberalization.

In light of the experience of South Korea which has excessive regulation of its financial system with a high degree of repression and segmentation of the financial market, some scholars have stressed that the informal unregulated market has played an important role in substituting for the over-regulated financial institutions.[29] They have also pointed out that the unregulated

27. Cole, (1988), *op. cit.*

28. *Ibid*, pp.29.

institutions generate market-determined interest rates that serve as a reference rate, an opportunity cost of capital, for prospective investors. The informal financial market is generally a market-based system, however, it also has some imperfections in its operation. For instance, lack of information, and absence of government protection and legal framework. The experience of South Korea has indicated that "if the formal part of the system is failing to perform one or several of the financial functions effectively, then it is almost inevitable that the informal part will move in and try to fill the void."[30]

It has been suggested that financial development should place greater reliance on market financial instruments and flexible interest rates, because such measures can give the interest rate and liquidity risk to financial institutions. These measures can also contribute to the safety and soundness of a financial system. However, the blurring of boundaries between different types of financial institutions and instruments increase the risks of default of institutions and breakdown of the payment system.[31] To introduce an efficiency-promoting reform, it is also suggested that some government supervision is needed to strengthen balance sheet requirements and assure quick and decisive actions of central banks.[32]

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29. For discussion on informal financial market in South Korea, see, for example, D. C. Cole and Y. C. Park, (1983), Financial Development in Korea, 1945-1978, (Cambridge, Mass.: Harvard University Press); W. Hong and Y. C. Park, (1986), "Financing Export-oriented Growth on Korea," in A. H. H. Tan and B. Kapur (eds), Pacific Growth and Financial Interdependence, (Sydney: Allen and Unwin).; Cole and Park, (1986), *op. cit.*

30. Cole and Yaster, (1989), *op. cit.*

31. J. Tobin, (1986), "Financial Innovation and Deregulation in Perspective," In Y. Suzuki, and H. Yomo, (eds), Financial Innovation and Monetary Policy: Asia and the West, (Tokyo: University of Tokyo Press.)

32. M. Yumoto (et al), (1986), "Financial Innovation in Major Industrial Countries," In Y. Suzuki and H. Yomo, (eds), Financial Innovation and Monetary Policy: Asia and The West, (Tokyo: University of Tokyo Press).

Therefore, comprehensive programs of financial liberalization are the key for many countries, to enhance both the quantity and quality investment. To achieve an efficient financial liberalization, it is tempting to assume that all the above reform measures should be implemented simultaneously. As a matter of fact, it may not be practical. Hence, comes the need for sequencing.

3. The Sequence of Financial Liberalization

The drawbacks and inadequacies in the theory of financial liberalization are also recognized by McKinnon himself. With the lessons of liberalization program of Argentina in the late 1970s, McKinnon has come up with a new issue in the theory of financial liberalization. His concern for the "correct order" of financial liberalization has given rise to further discussions.[33] In recent years, the theoretical issue of appropriate sequencing, particularly in financial liberalization, has attracted increasing attention.[34]

The major issues of sequencing of financial liberalization are related to the internal and external financial liberalization, e.g. liberalization of the domestic capital market and relaxation of capital controls over foreign capital

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33. McKinnon (1982), *op. cit.*

34. It was the earliest sequencing theory raised in 1970s. The theory is more related to political considerations in economic structural reform. The basic argument is that structural reform should be carried out gradually. The reason of this resides in the role of adjustment costs, and the opposition to the reform policy that the cost generating. It is also argued that a fast-spaced and comprehensive reform is best even though the costs may be high in the short run; but it is better to pay these costs quickly than drag out the reform to pay heavier costs over an extended period.
See, See, I. T. Scitovsky and M. Scott (1970), Industry and Trade in Some Developing Countries: A Comparative Study (London: Oxford University Press); A. O. Krueger, (1984), "Problems of Liberalization", In A. Harberger, (ed), World Economic Growth, (San Francisco: ICS Press), pp.403-423.

flows.[35] It has been argued that impediments to capital movements (both inflows and outflows) should not be relaxed before the domestic financial sector is liberalized. The theory assumes that in inflation, the reform of the domestic financial sector poses an extra additional sequencing problem. That is, the liberalization of the domestic financial market cannot be fully undertaken unless the fiscal deficit is placed under tight control.[36] Evidence from Argentina suggests that the interest rate reform is damaged by a high rate of inflation. And inflation results from a large government deficit financed by money creation. Hence, one principle of financial reform sequencing is that international capital controls should not be lifted until after the domestic financial market has been reformed, regulations over domestic interest rates lifted, and the real rates established. In turn, interest rates should be liberalized only after the fiscal deficit is under control.[37]

Cross-country evidence also suggests that an effective sequencing usually includes political considerations, and a host of other factors, both economic and non-economic.[38] These factors include diverse historical

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35. The issue of the concept of internal and external financial liberalization, see, M. Blejer and S. Sagari (1987), "The Structure of the Banking Sector and the Sequence of Financial Liberalization," in M. Connolly and C. G. Gonzalez-Vega (eds) Economic Reform and Stabilization in Latin America, (New York); S. Edwards, (1984), "The Order of Liberalization of the External Sector in Developing Countries," Princeton Essays In International Finance, No.156, Princeton: Princeton University Press; S. Edwards, (1989), "On the Sequencing of Structural Reform," NBER Working Paper No.3137; D. Villanueva and A. Mirakhor, (1990), "Strategies for Financial Reform", IMF Staff Papers, Vol.37, No.3.

36. McKinnon and Mathieson (1981), *op. cit.*

37. Edwards, (1990), *op. cit.*, pp.3

38. For theoretical discussion of other factors of economic liberalization, see, J. A. Frenkel, (1982), "The Order of Economic Liberalization: A Comment," in K. Brunner and A. Heltzer, (eds.), Economic Policy in a World of Change, (Amsterdam: North-Holland); G. A. Calvo, (1987), "On the Costs of Temporary Liberalization /Stablization Experiments," in M. Connolly and C. Gonzalez, (eds.),

backgrounds, economic, legal and political institutions, entrepreneurial traditions, as well as attitudes toward the role of the markets and incentives. Under such disparate circumstances, economic reform programs of different countries may differ in their areas of vulnerability.[39]

2.2.2 Theories of Socialist Financial Reform

Studies of the theory of financial liberalization in LDCs call for an appropriate approach in each country's financial reform. Although China shares many characteristics with other LDCs in financial and economic development , its different background in history, economy, legal code and politics requires the Chinese government to seriously consider its own strategy of financial reform. As in other CPEs, theatrical study of financial liberalization is still a relatively new area. To implement financial reform, China as well as other CPEs undergoing a transition period should extend their theoretical research so as to establish a framework for the design of an appropriate strategy.

1. Theoretical Development in CPEs

Academic discussions of financial reform in CPEs are scarce in both Western and socialist literature. The role of money and financial institutions under market socialism has been conspicuously neglected in the classical

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Economic Reform and Stabilization in Latin America, (New York: Praeger); A. O. Krueger, (1984), "Problems in Liberalization," In A. C. Harberger (ed), World Economic Growth, San Francisco:ICS Press; R. Wade (1988), "The Role of Government in Overcoming Market Failure: Taiwan, Republic of Korea, and Japan," In H. Hughes (ed) Achieving Industrialization in East Asia, (Cambridge: Cambridge University Press, 1988).

39. Calvo and Frenkel, (1991), *op. cit.*, pp.297.

literature on market socialism.[40] The importance of money in the reformed socialist model began to draw attention in the mid 1960s.[41] A pioneering exploration and analysis of the early stage of this process in the 1960s can be found in Garvey and Grossman.[42] From the 1980s, researchers began to pay greater attention to monetary imbalance and the definition and measurement of "repressed inflation' in Eastern Europe.[43]

Recently, the scope of research concerning financial liberalization in CPEs has been extended.[44] With the discussion of financial reform and economic restructuring, attention has been paid to "revamping of money and monetary policy, followed or to be followed by a more or less developed capital market."[45] Development of capital markets is generally accepted to

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40. The concept of "market socialism" has no clearly and commonly accepted definition. It basically means that the system relies on market force along with social ownership of the means of production. See, C. Sokil, and T. King, (1989), "Financial Reform in Socialist Economies: Workshop Overview," In Kessides (et al) Financial Reform in Socialist Economies, EDI Seminar Series, The World Bank. pp.1-27.

41. W. Brus (1964), "Ogoline Problemy Funkcjonowanina Gospodarki Socjalistycznej," (PWE, Warsaw). English trans. "The Market in a Socialist economy. (Routledge and Kegan Paul, London).

42. G. Garvey (1966), "Money, Banking and Credit in Eastern Europe," New York, (Federal Reserve Bank of New York); Grossman, G. (1966), Money and Plan, (University of California Press, Berkeley and Los Angeles, CA.) G. Grossman, (1966), "Gold and the Sword: Money in the Soviet Command Economy," In Industrialization in Two Systems, Henry Rosovsky (editor). (New York: Wiley)

43. R. Portes, (1986), "The Theory and Measurement of Macro-economic Disequilibrium in Centrally Planned Economics," Center for Economic Policy Research Discussion Paper No.91; R. Portes, (1983), "Central Planning and Monetarism: Follow Travellers?" In P. Desai, (ed), Marxism, Central Planning and the Soviet Economy, (Cambridge, MA: MIT Press), pp.149-65. R. Portes, and D. Winter, (1980) "Disequilibrium Estimates for Consumption Goods Markets in Centrally Planned Economies," Review Economic Studies 47, pp.137-159; G. Grossman, (1986), *op. cit.*

44. See for example a collection of wide-range studies on financial reform in CPE countries in 1989, in European Economic Review 33. (1989).

help the centrally planned economy in stimulating saving, engaging risk capital, improving the investment structure and promoting the engagement of foreign capital, etc.[46] The systemic constraints to CPEs' financial reform are in agreement with the fact that public ownership is a significant ideological obstacle to financial market development, particularly in the subject of share ownership. Theoretical studies have indicated that there is no model for a financial reform in CPEs. As to the necessary characteristics for a successful financial reform in CPEs, the following issues have been discussed in recent works: turning banks into "self-responsible enterprises", separating the functions of the central bank from those of commercial banks, strengthening the independence of the central bank, developing monetary policies as an instrument for macro-economic management, introducing foreign joint-venture banks to stimulate competition.[47]

2. The Sequencing of Economic and Financial Reform in CPEs

The appropriate speed, sequencing, timing of economic reform in general, and of financial reform in particular, constitute major issues of reform in CPEs. These issues are more pertinent because the characteristic of CPEs in the transformation period are a distorted economic system.[48] Therefore, greater attention has been given to macro-economic and micro-economic aspects of financial reform in the transitional period. From the microeconomic

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45. Nuti, (1989), *op. cit.*, pp.428.

46. Jaral, (1989), *op. cit.*, pp.448-451.

47. For detailed discussion in those areas, see, K. Christine (et, al), (1989), *op. cit.*

48. The highly distorted economic system has been concluded as: prices do not represent real social cost, incentive system is absent, losses of unprofitable state-owned enterprises are automatically financed, legislation vital to the functioning of markets is not in place, private ownership and property rights are underdeveloped, markets are missing, shortages prevail and, occasional, inflation is high. See, Calvo, and Frenkel, (1991), *op. cit.*

viewpoint, the stressed issue is the question of what economic reforms (e.g. price reform, property relation, etc) are needed prior to a financial reform; however, in respect of the macro-economic side, the issue is whether some degree of macro-economic stabilization is a prerequisite to a financial reform.[49] Thus, the approach of financial reform in CPEs has largely dependent on the scope, speed and sequencing of the whole economic reform.

Recent debates address the issues of the general sequence and pace of reforms in the CPEs. There is relatively little disagreement to the necessity of a transition, but there is a lot of controversy about the theory, timing, scope, speed and sequencing of reforms. The contention is whether "a fast-paced and comprehensive reform is best even though the costs in the short run may be high" "because it is better to pay these costs quickly than to drag out a reform to pay a heavier cost over an extended period."[50] Transforming a centrally planned economy to a market economy requires a complex reform which has no parallels in history. There is no experience to fall back on in a transition of the current magnitude.

China, different from countries of Central and Eastern Europe, has adopted gradualism in implementing in both economic and financial reforms.[51] As the reforms occur under distorted economic conditions, macro-

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49. Sokil and King, (1989), *op. cit.*, pp.15.

50. Socialist Economic Reform Unit, Country Economics Department, the World Bank, (1991), "Transition" The News Latter About Reforming Economies, Vol.2, No.7; Lipton and Sachs (1990), *op. cit.*

51. Gradualism in implementing reforms is defined by the World Bank as reform spread out over more than two years. Indonesia, the Republic of Korea, Morocco, and Turkey have used a gradual approach. Trade liberalization through the general agreement on tariffs and trade is also a steady but gradual process. See, the World Bank, (1991), *op. cit.*, p.117.

economic stability should be addressed in the reform process.[52] Hence, China's experience with reforms suggest that piecemeal, partial, incremental, sequential, often experimental reforms, dragged out over a decade, do indeed work, even if they create other distortions and problems.

3. Theoretical Research in China

Although China has introduced various forms of new financial institutions and instruments more extensively than other CPEs,[53] the reform still lacks an adequate theoretical framework to guide it, due to the fact that formal theoretical research on financial reform began only after the economic reform in China. Besides, Chinese theoretical development has been hampered by limited access to Western literature (and limited language proficiency). Therefore, China began its theoretical research from the beginning. The short history and lack of reference material mean that a well-established theoretical framework cannot be formed immediately. An increasing number of theoretical works has emerged in the course of the financial reform.[54] One main argument concerns the breakthrough in conducting an efficient financial reform in China. The major issues are as follows.

1) Development of financial markets (both short-term money market

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52. Micro-economic Situation Analysis Group (1986), "Economic Growth under Retrenchment--- A Report on the Analysis of the Macro-economic Situation in the First Half of 1986," Zhongqingnian Jingji Luntan (Economy Forum of Young and Middle-aged), Vol.6, pp.9-14; Macro-economic Research Office, Economic Structure Reform Research Institute of China (1987) "An Analysis of the Economic Situation in 1986," Zhongguo Fazhan Yu Gaige (China's Development and Reform), May; pp.36-44.

53. Nuti, (1989), *op. cit.*

54. Liu Hongru (1980) Issues of Socialist Money and Banking, (Beijing: Chinese Financial and Economic Press.); Huang Ta, Chen Kung, (et al) Issues of Socialist Finance and Money, Vol.I, Vol.II, (Beijing: People's University Press); Wu Jieshi (1985), " Exploring Financial System Reform in China, (Beijing: China's Economic Publishing House).

and long-term capital market) to deepen China's financial reform.[55] Some economists believe that development of financial markets can increase the efficiency in financial resource allocation through bringing competition into the financial sectors and generating market interest rates. Further, financial markets can provide a basis for the implementation of market-oriented monetary policies. Hence, it helps the central bank use indirect monetary instruments in macro-control.[56]

2) Some economists declare that, for a bank-based financial system, it is very important for China to promote the efficiency of the banking system. The "enterprization" of the four specialized banks provides a breakthrough for the deepening of a financial reform in China.[57] Operating like an ordinary government administrative unit, the specialized banks have so far assumed no real responsibility for their profits and losses.

3) It is also suggested that improving the functions of the central bank should precede the development of capital markets and the "enterprization" of the specialized banks.[58] Such a view is based on the argument that effective

55. In May, 1984, the Second Conference of the Chinese Finance Institute was held in Hefei, capital of Anhui Province. At this conference, some economists expressed the view that development of financial markets was required to deepen China's financial reform. It was the first time the development of financial market had ever been advocated in China since 1949. See, Li Yuanfu (1988), "The Problem of Financial Market Development in China," Jingji Kexue (Economic Science), Vol.4, pp.1-6.

56. Chai Chuizhi (1984), "Explore the Strategy of Financial Reform," Jinrong Yanjiu (Financial Studies), Vol.10; Liu Hongru (1987), "Emerging Financial Market in China,"; Jingji Yanjiu (Economic Research); Vol.7; Yang Penxin (1986), "On Building a Socialist Capital Market in China," Renmin Ribao (People's Daily), 7 April, p.5.

57. Cheng Haowu (1984), "The Breakthrough of Banking System Reform," Zhongguo Jinrong (China's Finance), vol.10, pp.28.

58. Wu Nianlu (1986), "Some Suggestion About the Financial Reform," Jinrong Yanjiu (Financial Studies), Vol.10.

monetary policies are a necessary condition for developing financial markets and the enterprization of the specialized banks. Otherwise, the activities of the financial markets and specialized banks will get out of control and cause financial disasters.

4) Reforming the rigidly regulated interest rate system is also considered by some Chinese economists to be more important than other elements. It is stressed that the rigidly controlled interest rate structure can not be a tool to efficiently mobilize and allocate financial resources. Financial reform will fail to use the interest rate as an indirect monetary policy instrument to replace the administrative methods.[59]

5) It has also been argued by some Chinese economists that an effective financial reform requires coordinated system reforms in other areas. For instance, if state enterprises still operate under the "soft budget" constraints, financial discipline will not be effective.[60] A local government's excessive intervention is believed to exert great restrictions over the portfolio selection and competition of the banking system.[61] The imbalance in China's state budget will influence the banking system's credit flows.[62] The distorted price

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59. Fan Li (1985), "The Principle of Current Financial Reform," Zhongqingnian Jinji Luntan (Economy Forum of the Young and Middle-aged), Vol.2.

60. Ye Lin (1988), "The Fundamental Reason of Over-supply Money is the Incomplete Enterprises System," Zhongguo Jinrong (China's Finance), Vol.6.

61. Zhou and Zhu (1987), *op. cit.*; Du Weihua (1990), "On the Necessity of Reform in the Fiscal and Financial System for Coping with Inflation---on the Problem Existing in the Establishment of China's Fiscal Distribution System and Banking System," Caizhen Yanjiu (The Public Finance Research), Vol.1.

62. Wang Songqi (1987), "Ten Contradictions Faced by the Financial Reform," Jinrong Yanjiu (Financial Studies), Vol.9, pp.26-31.

system can not lead to efficient investments.[63]

The issues raised by Chinese economists have demonstrated the main problems related to China's financial reform. As in the economic reform, the financial reform is also conducted under an ideological dictum that the reform should be implemented step by step, or as Chinese economists described, "cross the river while groping for the hidden rocks". In 1984, the financial and banking reform was started by restructuring of the banking system. The new banking system consists of the central bank and four specialized banks. Since then, a series of reforms have been conducted to expand the bank's business scope, and strengthen bank's management.[64] In January 1986, a conference on Financial Reform Experiments in Five Cities (Guangzhou, Shenyang, Zhongqin, Wuhan and Zhangzhou) was held in Guangzhou. At the conference, the plan for experiments of an inter-bank money market was determined. After the conference, 12 cities opened their money markets in the end of 1986.[65] On 5 August 1986, the Shenyang Trust Investment Company was approved by the PBC's provincial branch of Shenyang, to trade in eight local enterprises' equities.[66] Following Shenyang, Shanghai re-established its stock markets.[67] China began to issue state treasury bonds in 1981. On 1st April 1988, state treasury bonds were allowed to be traded openly on an

63. Yao Lin, Zhou Bin and Yuan Shi Min (1985), "Issues On the Impact of Price Reform on Savings Deposits, " Zhongqinnian Jingji Luntan (Economy Forum of Yourg and Middle-aged), Vol.1; Yuang Lu (1985), "Coordinating between the Stable, Flexible Price System and the Reform of Fiscal and Banking System," Chengben yu Jiage Zhiliao (Reference of Cost and Price), Col. 5.

64. Zhang Zegu (1987), "Financial Reforms Fare Well in China," Beijing Review, No.1, January 5, pp.16-17.

65. Liu Hongru (1987), *op. cit.* pp.47-52.

66. *Ibid*, pp.48.

67. Han Guojian (1989), "Shanghai: Stock Market Re-established," Beijing Review, September, 18-14, pp.19-23.

experimental basis in five cities--Shanghai, Guangzhou, Wuhan, Chongqing and Shengyang.[68] Currently, the trade of Treasury bonds has extended to about 400 cities.[69] Therefore, the process of China's financial reform fully reflects the gradualist ideology of the Chinese government in the financial reform.

It should be noted here that the financial reform of China has been studied in recent years by Western scholars and the World Bank. Their main focuses are on the monetary policy implementation, banking system reform, capital market development and macro-control.[70] Their research provides a useful basis for investigating China's financial reform.

2.3 Government Borrowing, Financial Repression and Financial Reform

The aim of the financial reform in China is to promote the efficiency of financial resource allocation through a decentralizing process in financial distribution. However, this reform has been accompanied by a persistent

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68. Jin Jiandong (1989,b), "China's Stock and Bonds Market," Beijing Review, October, pp.20-23.

69. Qian Fengyuan (1992), "1992's Treasury Bonds Start to Issue from April," Jingji Ribao (Economic Daily), 31, March.

70. For detail discussion of China's financial/banking system reform, see, Tam (1986), *op. cit.;* Tam (1987), *op. cit.;* (1991), *op. cit.;* de Wulf and Goldsbrough (1986), *op. cit.;* P. Bowles and G. White (1989), "Contradictions in China Financial Reforms: The Relationship between Banks and Enterprises", Cambridge Journal of Economics, Vo.13, pp. 481-495; Sandro Siderl (1987), "China's Financial System and Economic Development," Savings and Development, No.1, pp.72-92; B. Naughton (1989), "Monetary Implications of Balanced Economic Growth and the Current Macro-economic Disturbances in China," in Dieter Cassel, Gunter Heiduk (ed), China's Contemporary Economic Reforms as a Development Strategy, (Nomos Verlagsgesellschaft: Baden-Baden). The World Bank, (1988,b), *op. cit.*

fiscal deficit ever since its beginning. The growing government deficit implies that China's reform will become more complex and encounter more problems.

Government borrowing is often a main factor causing financial repression.[71] Low, fixed nominal institutional interest rates together with high and rising inflation are the common characteristics of financial repression. The main reason of interest rate ceiling and a rising inflation is that governments attempt to obtain cheap financial resources to finance the expanded public expenditures.[72] However, negative real interest rate is associated with slower growth in savings and investment. Inflation, like tax, which operates more slowly, reduces the value of financial assets. Moreover, inflation, by causing uncertainty and instability in prices, makes long-term investment more risky and difficult to finance.

The World Development Report 1989 shows how central government deficits were financed in twenty-four developing and eleven high-income countries between 1975-85. The contrast between the two groups is striking. In the developing countries, 47% of the deficit was financed by borrowing from the central bank, 15% by borrowing from domestic financial institutions and markets, and 38% by borrowing from abroad (although foreign financing declined from 44% in 1975-82 to 26% in 1983-85). High income countries, in contrast, relied mainly on non-bank financial institutions and markets to finance their deficits, borrowing less than 12% of the total from the central bank.[73]

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71. Wai and Patrick, (1973), *op. cit.*; Fry, (1982), *op. cit.*; Dooley and Mathieson, (1987), *op. cit.*

72, Fry (1982), *op. cit.*; Fry (1988), *op. cit.*

73. The World Bank, (1989, a), *op. cit.*, p.62.

It can be seen that the governments of developing countries rely mostly on their central banks to finance their deficits, because for most LDCs, their domestic financial markets were too shallow to meet their needs. When the banking system is a main source of public sector financing, the governments of LDCs generally adopt those methods to obtain cheap funds: borrowing through low interest rate ceiling, inflation tax, high reserve requirements to raise quasi-tax revenue, sale of treasury bonds to the captive market, etc. With an underdeveloped capital market, the Chinese government also relies on borrowing from the banking system. Although securities markets have emerged in recent years, they still can not satisfy the requirements of the Chinese government's borrowing.[74]

As discussed in Chapter 1, all methods and techniques of government borrowing can be divided into two basic approaches: market borrowing and "protected" borrowing. In the following, the characteristics of each kind of borrowing and their impacts on financial reform in LDCs will be separately discussed. The general situation of Chinese government borrowing is also introduced.

2.3.1 Government "Protected" Borrowing

When governments borrows from the banking system and NBFIs, the following common approaches can be found: placing ceiling on banks' interest rates, directly borrowing from the central bank, imposing high reserve deposits

74. Liu Hongru (1987), "On Development of China's Financial Market," Jinrong Yanjiu (Financial Studies), Vol.1, pp.47-52; Jin Jiandong, (1989), *op. cit.*; Jin Jiandong (1988), "Market that Attracts the Country's Attention," Jinrong Shichang (Financial Market), Vol.1, pp.6-9. Tam, On Kit (1991) "Capital Market Development in China," World Development, Vol.19, No.5, pp.511-532;

and directed loans, borrowing from a captive market.

1. Ceiling on Bank Interest Rate

The financial repression syndrome identified by the McKinnon-Shaw model includes that government fiscal deficits are financed by interest rate ceilings that discourage saving.[75] Most governments are concerned with the cost of credit to the government sector. A high interest rate policy is considered by governments as raising the cost of their borrowing, and governments are concerned that financing the government debt will be a burden on the budget.[76] Fiscal deficits result in financial intermediation between savers and investors being carried out by the government via forced savings mechanisms (including taxation of profits and of the banking system) rather than by the financial system. And because savings which are assumed to be interest-sensitive are low as a result of administratively determined interest rates, nonprice rationing of investable funds occurs. Interest rate ceilings also discourage risk-taking by financial institutions, who opt for traditional low-yielding investments because they appear the safest to finance.[77]

The interest rate system of China is generally characterized by low (or negative) real levels and a rigid structure. Low interest rates are usually set by the government whose main aim is to maintain a high rate of investment. The interest rate is also rigid because the price system is still partly rigid. If interest rates are not rigid, the cost of products will be affected. Moreover, because

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75. McKinnon (1973), *op. cit.*, Shaw (1973), *op. cit.*

76. Wai and Patrick, (1977), *op. cit.*, pp.283.

77. Fry (1982), *op. cit.*, pp.723.

financial resources are allocated by administrative means, changes in interest rates are not necessary for mobilizing and allocating financial resources. Interest rates are only for covering the service cost of bank operations. Before the economic reform, the Chinese government occasionally incurred fiscal deficits, but the amounts were insignificant.[78] The deficits were financed automatically by the prevailing system of unseparated fiscal and financial operations.[79]

The significance of interest rates in mobilization and allocation of the financial resources has been gradually recognized by Chinese policy-makers and economists. Since 1980, interest rates on both bank deposits and bank loans have been adjusted several times by the People's Bank of China (PBC). The interest rate on long-term individual savings deposits has been linked to the rate of inflation since 1988.[80] In view of bank lending rates, the interest rate of each working capital loan can be set by the specialized banks to be 20% higher than those stipulated by the PBC.[81]

As will be discussed in Chapter 5, the extent of interest rate reform in China is still rather limited. The Chinese government likes to place a ceiling on interest rate at a level, which ensures that most enterprises are nominally profitable, and the planned budget revenues of government can be collected. Following this logic, the reformed interest rates in both deposits and bank

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78. see, China's Finance Statistics 1950-88, p.11.

79. During 1959-78, the Chinese government did not borrow either domestically or from overseas, see, China's Finance Statistics 1950-88, p.48.

80. See, "Circular of PBC for Holding Price Index Long-Term RMB Savings," Almanac of China's Finance and Banking 1989, pp.526.

81. See, The Almanac of China's Finance and Banking, 1988, p.120.

loans are still lower than the equilibrium interest rate in China.[82] The real negative interest rates have continually contributed to over-heated investments in China.

Most importantly, the effect of reforming interest rates is weakened by the growing use of directed credits in China. Directed bank credits are required by the government to fund key state projects and enterprises at a low interest rate, which is estimated to account for about one-third of the total bank loans.[83] Hence, the efficiency of bank operation is also affected significantly and it will be discussed in detail in Chapter 5.

2 Direct Borrowing from the Central Bank and Inflation Tax

An alternative method of government borrowing is to resort to the inflation tax, which means the government places pressure on the central bank to finance its deficits by money creation. This appears to be a cheaper way than otherwise from the point of the view of Ministry of Finance, because money creation involves little or no direct or explicit debt service cost to the government. However, the deficits financed by monetization will create increasing liquidity and credit in the economy. Ultimately, rising inflation will be fueled by such an approach. With a spiral inflation, financial restrictions tend to turn into financial repression.[84] Deliberate reliance on revenues from

82. At the present stage of China's financial reform, the consequences of interest rates seem to be more effective in influencing the demand for deposits than in affecting either the demand for, or in particular, the allocation of credit. See, M. Blejer, (et al) (1991) "China: Economic Reform and Macroeconomic Management", IMF Occasional Papers, No.76. (January);

83. Gao Zhengguo (1990), "On the Environment for Interest Rate Reform," Caimao Jingji (Finance and Trade Economics), Vol.19, pp.38-41.

84. Fry, (1988), *op. cit.*, pp.14-16.

inflation in effect makes little economic sense under any condition. First, high inflation tends to reduce revenues in real terms from other taxes because of delay in tax collection. Second, high and volatile inflation retards economic growth.[85]

As will be discussed in detail in Section 3.5, the officially-announced Chinese Government budget deficit is calculated differently from international convention. The debt incomes (both internal and external) count as the fiscal revenues. Therefore, the official figure of deficit posts as "hard" deficit which can only be financed by borrowing from the central bank. There is no doubt that the PBC resorted to money creation to finance that part of government borrowing.[86] Government borrowing financed by money creation has generated controversial debates in the course of the financial reform in China. Since the introduction of the economic reform, monetary policies have been emphasized by the Chinese government as a tool of macro-economic management. Chinese economists who have discussed this subject have focused mainly on the loss in controlling the macro-economy and the rising inflation.[87] However, the failure to implement effective monetary policies has

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85. A. Harberger and S. Edwards (1980), International Evidence on the Sources of Inflation , (Chicago: University of Chicago), A. O. Krueger (1981), "Interaction between Inflation and Trade Objectives in Stabilization Programs," In W. R. Cline and S. Weintraub (eds) Economic Stabilization in Developing Countries, (Washington, D.C.:Brookings Institutions).

86. Wan Jianhua and Wang Xiaoyan (1987), "Overdraft by the State Budget Should not be Systematized and Prolonged," Jinrong Yanjiu, (Financial Studies), Vol.10, pp.14-15; Blerjer (et al) (1991), ***op. cit.***; B. Naughton, (1991), "Why Has Economic Reform Led to Inflation?" AEA Papers and Proceedings, (May).

87. Zhu Delin (1989), "On the Mechanism of China's Money Supply: the Direct Contributing Factor of Inflation," Jinrong Yanjiu (Financial Studies), Vol.9, pp.8-12; Yu Ruixiang (1990), Macro-thinking of Fiscal and Monetary Policies," Jinrong Yanjiu (Financial Studies), Vol.4, pp.11-15.

been Stressed to be a result of government borrowing from the central bank.[88]

The expanded aggregate demand often forced the PBC to adopt restrictive monetary policies in response to rising inflation.[89] As a result, during 1984-90, an easy monetary policy stance and a tight stance were alternatively adopted four times by the PBC. In each retrenchment, direct credit rationing was used as the main monetary instrument. The increased reliance on administrative and planning mechanisms at such times entailed significant costs, especially through damage to the credibility of the reform process.[90]

3 Reserve Requirements and Directed Credit

Adjusting bank reserve requirements and directing credits are the common ways in LDCs to divert bank credits to the government and specific sectors.[91] For example, in Pakistan in 1986, 70% of new lending by the national banks, which dominate the banking system, was targeted by the

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88. For discussion on this subject, see, a intense study in Jinrong Yanjiu (Financial Studies) in 1987, Vol.10.; for example, Wang Guomin (1987) "Inquires on the Borrowing and Overdraft by the Finance from Banks," pp.3-5; Ren Junyin (1987),"'Overdraft is Reasonable' and China's National Conditions," pp.9-10; Xiu Yapin (1987) "Overdraft by the State Budget and Straightening out the Fund Relations," pp.18-19; Zhu Suzhen (1987), "Feasibility Analysis and Countermeasure Option on the Policy of the Overdraft by the State Budget," pp.23-25; Wang Jianhua and Wang Xiaoyan, (1987), *op. cit.*, pp.14-15;

89. Wan Jianhua and Wang Xiaoyan, (1987), *op. cit.*, pp.14.

90. Cheng Yaoxian, (1988), "The Option of Monetary Policy and Macro-economic Adjustment", Caimao Jingji (Finance and Trade Economies), Vol.4, pp.45-47; Lang Yu and Zhang Jianhai (1991), "On Macro Control Over Finance," Caimoa Jingji (Finance and Trade Economies), Vol.3, pp.32-38.

91. For discussion on this subject, see, Edwards (1985), *op. cit.*; McKinnon and Matheison (1981), *op. cit.*; M. J. Fry, (1991), "Domestic Resources Mobilization in Developing Asia: Four Policy Issues," Asian Development Review, Vol.9, No.1, pp.15-39.

government, although this proportion was reduced substantially by 1988. In India about one-half of bank assets had to be placed in reserve requirements or government bonds, and 40% of the remainder had to be lent to priority sectors at controlled interest rates. In Yugoslavia in 1986, 58% of short-term loans were directed credits. In Brazil in 1987, government credit programs accounted for more than 70% of the credit outstanding to the public and private sectors. In Turkey in the early 1980s, roughly three-quarters of all financial system advance were made at government directive or at preferential interest rates, or both. In Malaysia directed credit has accounted for an estimated 30% of bank loans.[92].

Therefore, commercial banks and other financial institutions are often required to place high reserve requirements with central banks in LDCs. With this substantial resource flow at its disposal, the central bank channels cheap credits to various specialized banking agencies (The general process can be portrayed in Figure 2-1.), who in turn lend at low, disequilibrium rates of interest to promote exports, extend credit to small farmers, subsidize certain industrial projects, and so forth. Other central-bank credits can flow directly to the MOF to cover explicit current account deficits in the government budget.[93] Such methods of government borrowing suggest a fiscal root to the implementation of monetary policies.[94]

The negative consequences of taxing the monetary system are pointed out by McKinnon and Mathieson. One consequence is that it reduces the monetary tax basis and the flow of loan funds in the economy.[95] The second is

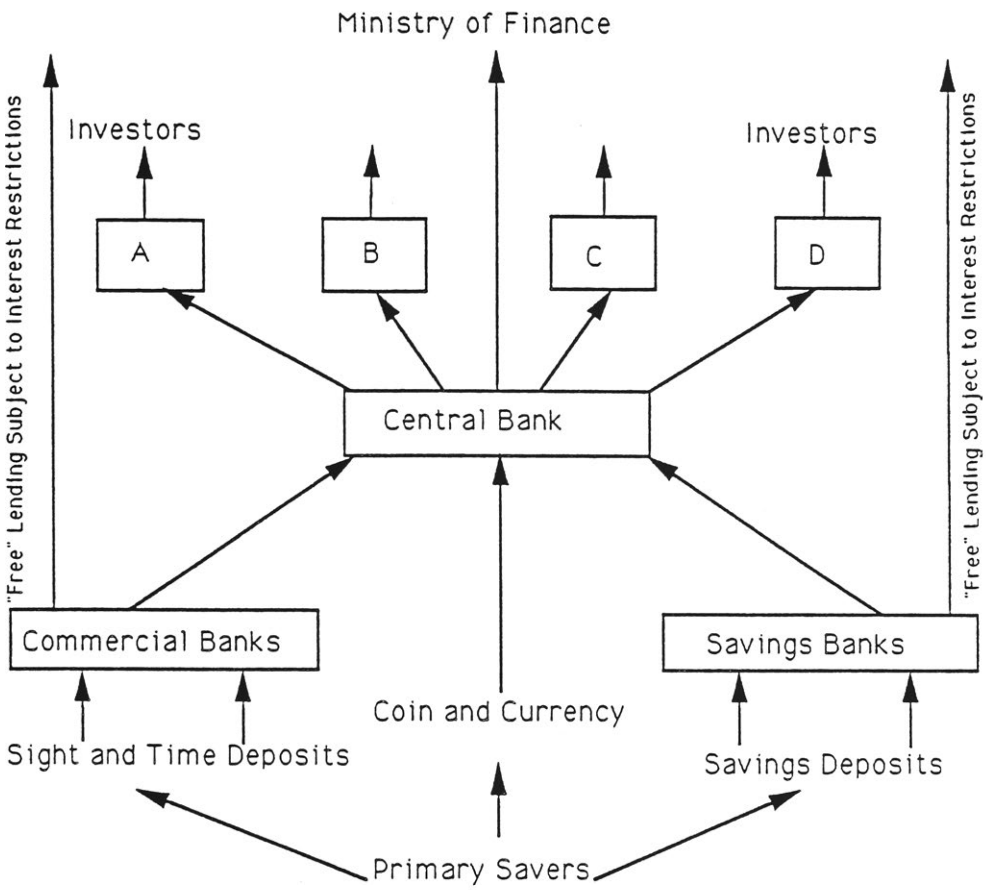
92. World Bank, (1989,a), *op. cit.*, pp.56.

93. McKinnon and Matheison (1981), *op. cit.*, pp.5

94. *Ibid*, pp.4. 95. *Ibid*, pp.5.

Figure 2-1

Bank Intermediation in Less Developed Countries



Note: A. B. C. D. and so on are specialized credit agencies (banks) that get cheap finance from the central bank. A could be the export-promotion fund, B the agricultural bank, c the central mortgage bank, and D the industrialdevelopment bank.

Source: R. I. McKinnon and D. Mathieson (1981) "How to Manage a Repressed Economy," Essays in International Finance, (Princeton University Press), No.145, pp.7.

that "investors favored by the official agencies may borrow at negative real rates that often reflect all too accurately the poor quality of their investment projects, whereas other potential borrowers with high-yields projects are severely rationed."[96] However, those projects favored by governments are usually those large firms whose domestic markets are protected by trade restrictions. Small and medium-sized enterprises are then forced to seek out credit from the informal financial markets or, in the absence of access to both domestic and international financial markets, rely increasingly on self-financing. For such firms, the true opportunity cost of obtaining credit is far in excess of published loan interest rates. Moreover, in a regulated market, bank managers and loan officers face such a large excess demand for credit that they may not be forced by competition to market their product or to select among competing projects on the basis of rates of return.[97]

In the case of to China, reserve requirements have been imposed by the PBC since 1984 for more efficient control of bank liquidity. Compared with other LDCs, the ratio of reserve requirements is not high in China (to be discussed in Chapter 5). Hence, the technique of using higher reserve requirements to finance government-favored enterprises and projects has not been actively applied by the Chinese government.

In fact, China's national priority projects and enterprises are largely protected and designated to obtain cheap funds directly from state banks. Typically, cheap funds are channeled through directed credit dictated by the government. The reason for the Chinese government use of directed credit to

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96. *Ibid*, pp.6.

97. Dooley and Mathieson (1987), *op. cit.*, pp.31.

finance some projects is that the government attempts to resolve the distorted situation created by the regulated price system. Such an action by the government may avoid one distortion but add another. For instance, many directed credits have become non-performing loans. The ability to borrow at low rates encourages less productive investments. Those who borrow for projects with low financial returns cannot repay their loans. Moreover, the distorted allocation of resources and the corruption in maintaining financial rules and regulations have rendered intermediaries unprofitable and, in many cases, insolvent. Further, by encouraging firms to borrow from banks, directed credit programs have impeded the development of capital market.[98]

A certain degree of intervention may be useful during the early stage of financial development. Many countries have come to recognize that this policy has an adverse effect on industrial and financial development. The evidence suggests, in particular, that directed credit programs have been an inefficient way of redistributing income and of dealing with imperfection in the goods market.[99] In some countries, such as Japan and Korea whose experiences have been relatively successful, their approaches have been temporary, well-designed and narrowly focused on support of "sunrise" or export sectors, or designed to deal with specific market failure in the financial sector, such as lack of risk (venture) capital.[100]

However, the real solution should improve the profitability of these projects and enterprises by adjusting the controlled prices. Higher prices

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98. For discussion of the impacts of directed credit programs of financial system in LDCs, see, World Bank, (1989,a), *op. cit.*, pp.59-62.

99. See, Edwards, (1988), *op. cit.*, pp.185-194.

100. See, the World Bank (1989,a), *op. cit.*, p.128.

reduce enterprises' borrowing needs by raising their retained earnings. Moreover, the gradually liberalized price system generates a price signal for efficient allocation of resources through distinguishing between "good" and "bad" enterprises. By contrast, directed credits which are designed to reduce economic distortion may give rise to further economic distortion.[101]

4. Borrowing From A Captive Market (Commercial Bank and NBFIs)

Forcing commercial banks and NBFIs to hold government bonds is one of the common methods of government borrowing. Such activities fall under the category of "protected borrowing" by the government. This means that the government takes advantage of legal restrictions or requirements on financial institutions.[102] The option is often accompanied by an interest rate which is well below the market equilibrium level. Such borrowing usually creates a captive market so that the financial institutions have to absorb a given share of government debt as it is issued.[103] During 1970-1986, captive markets were very common in several Pacific Basin countries, including Malaysia, New Zealand, Japan and South Korea.[104]

In view of liquidity management, financial institutions should hold a portion of their reserve in the form of market-rate short-term negotiable treasury bills. However, forced investment in government securities limits the

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101. Calvo and Frenkel (1991), *op. cit.*, pp.287.

102. Kitchen, (1986), *op. cit.*, pp.111.

103. Hutchison, (1986), *op. cit.*

104. For example, one of the largest single holders of government securities in Malaysia invested more than 90% of its portfolio in government securities. Similar cases can be easily found in other financial institutions of Malaysia after 1970. See, Hutchison, (1986), op. cit., pp.322.

ability of financial institutions to invest in other financial instruments, such as equities, and thereby discourages the growth of capital markets. The ability of the private sector to raise fresh capital through stock markets (or even by placing shares directly in financial institutions) is therefore restricted.[105] This approach has a big risk in that it will open the door for forced placement of government paper, at below market-clearing interest rates, among financial institutions, undermining their financial integrity and forcing substantial increases in the banks' lending rates for non-preferential borrowers. A more negative consequence may be that it tends to undermine the autonomy of financial institutions and the desirable separation of fiscal and financial sector functions.

In China, as will be discussed in Chapter 5, the nominal amounts of government securities held by each specialized bank and NBFIs are not large. However, such borrowing activities have caused some problems. One is that most Chinese government securities are long-term with no provision for early redemption. Hence, the potential for developing open market operations for the central bank is limited. Another problem is that the secondary government bonds market is still closed to the financial institutions. Thus, government securities flowing into the banks' portfolio have to be kept by the banks until maturity. Such a situation reduces the banks' loanable funds and also profitability.

2.3.2 Government Market Borrowing

When a government obtains financial resources through market

105, Kitchen (1986), *op. cit.*, p.112; The World Bank (1989,a), *op. cit.*

borrowing activities, it is generally believed to be non-inflationary. The advantage of government market borrowing is that it may encourage the holding of securities, and thereby the growth of the capital market.[106] Therefore, in financing its government deficit and stimulating financial reform, the Chinese government should rely more on borrowing through market activities.

With organized capital markets, a government can use these markets as means of issuing bonds. Bonds may be advertised for sale at a fixed price, sold by tender, "placed" in financial institutions, or sold by auction.

A common problem for government borrowing in LDCs is that securities markets are less developed. However, some experiences of LDCs have indicated that with fragmental, unorganized, securities markets, the government can still borrow through market activities. The related problem is that the lack of an organized secondary market may restrict interests in bonds. The other problem is that securities cannot readily be sold until maturity. To issue more bonds, some governments may have to raise the returns to attract investors.[107]

Evidence from developing countries of Asia and the Pacific shows the above problems of government borrowing. Government securities on issue in those countries are often in larger amount than private enterprises issues, but the trade activity in them is quite limited. "Governments are eager to borrow funds by issuing domestic securities, but the market is usually not eager to

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106. Kitchen (1986), *op. cit.*, p.110.

107. See, Wai and Patrick, (1977), *op. cit.*; Drake (1977, 1985, 1986), *op. cit*; Kitchen, (1986), *op. cit.*

oblige them,"[108] especially where governments expect to borrow at below market interest rates. In such a situation, the captive market is created, in which financial institutions have to subscribe to government debt instruments under official pressure. More importantly, to protect its borrowing, many governments limit enterprises' equity issues through ceilings on interest rates and amounts. As a consequence, market prices cannot emerge and capital market cannot be developed.

The Chinese government Treasury bonds have been issued annually since 1981. Currently, Treasury bonds and other government debt instruments (for example, Fiscal Bonds, Key State Enterprises Bonds) account for about 60% trading volume in the new issue market, and 90% in the secondary market.[109] Such a situation results from the government policy which discourages the issuing of other securities. The interest rates of Treasury bonds are also set by the government administratively. Thus, Treasury bonds are less attractive to investors in China. Until 1991, the Chinese government began to experience the underwriting system in issuing Treasury bonds.

2.4 Conclusion

This chapter has reviewed the theories of financial repression and financial liberalization in LDCs. More recent works relating to financial reform in CPEs and in China are also highlighted.

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108. Drake (1986), *op. cit.*, pp.101.

109. Li Jianxin (1991), "100 Billion Yuan of Treasury Bonds Has Been Accumulatively Issued in Ten Years in China," Renmin Ribao (People's Daily), 2 August, p.1.

A repressed financial system cannot promote a country's economic growth. Financial liberalization aims at giving more market forces to influence over interest rates, banking system and NBFIs operations, and financial markets. Improved official supervision is also needed. Moreover, an effective financial reform "calls for some strong initial steps against the most costly distortions, taking care to avoid back-and-forth movements."[110] Therefore, a correct sequence has to be designed in accordance with a country's economic environment.

China's financial reform started from liberalization of the domestic financial markets. Like other LDCs, soon after, the reform was challenged by the question of how to carry it out efficiently. China's financial reform, which differs from the McKinnon-Shaw model of interest rate liberalization, started from the restructuring of the banking system. Although the reforming of the banking system has provided a wider range of financial services, the efficiency of China's financial reform is still far from adequate. The theoretical research and experience of LDCs indicate that the reforming of only interest rates and the banking system is too narrow to achieve an efficient financial reform. More deregulation measures are needed for the development of financial institutions, financial instruments and financial markets. The absence of financial market development reduces the efficiency of financial liberalization and development. A well-developed financial market will improve competition and provide better information for financial resource allocation.

The expanding financial liberalization literature indicates that a regulated banking system will give rise to the development of nonbank financial institutions and an informal financial sector, which will try to fill the

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110. World Bank (1989,a), *op. cit.*, p.118.

void of the formal part constrained by government regulations. The development of NBFIs will widen the financial services for economic development. What is more important, it boosts competition between the bank and nonbank sectors for an efficiency of the financial reform. The creation of informal financial sectors may stimulate the financial reform because, in general, they are a market-based system.

The theoretical review shows that the program of government borrowing affects financial liberalization not only through interest rate ceilings and raising inflation but also restricting banking system operation, repressing financial market development and limiting the introduction of new financial instruments. The methods adopted by governments in LDCs in financing their budget deficits and the impacts of government borrowing on financial liberalization can be summed up as follows:

- To obtain cheap funds, governments place interest rate ceilings at a low nominal (or real negative) level in both banks' activities and capital market. As a result, interest rate as a monetary policy instrument is weakened.

- To acquire cheap funds, governments place pressure on central banks to increase money supply so as to finance deficits. Controls over the macro-economic condition will be lost and rising inflation will lead to further financial restriction.

- To divert bank credits to the government-designated areas of spending, the commercial banks and other financial institutes are required to hold high reserve requirements with the central bank. Hence, establishing a reserve requirement facility is a response to the fiscal requirements rather than monetary policy implementation.

- Central banks and commercial banks are compelled to hold government debts at low interest rates. As a result of the repressed rate of return on government securities, banks' profit abilities will be reduced.

- The state banks are asked to issue directed credits which usually target state-owned enterprises. The administrative allocation of resources and the erosion of financial discipline make financial intermediaries unprofitable, and in many case, insolvent.

To play its role efficiently, China's financial system is in need of further deepening. The deepening reform mainly implies the reducing of the government's role in the allocation of credit, the determination of interest rates, the daily decision-marking of financial system, and the operation of NBFIs and capital market. Due to the fact that the government budget is annually in deficit, China's financial reform is more complex.

Like most LDCs, the Chinese government has to rely more on domestic rather than overseas sources to finance its deficit. As the domestic financial market is too shallow to meet its borrowing needs, the Chinese government cannot help but borrow from the banking system. Hence, how the Chinese government finances its deficit, without harming the financial reform is a key question. To ensure the efficiency of both government borrowing and the financial reform, the Chinese government should adopt more market borrowing methods, which may prove positive effects in the financial reform. For instance, relying more on market borrowing activities to stimulate capital market development, to generate a market interest rate, to enhance competition among financial sectors, etc. In other words, if the Chinese government's borrowing is financed through interest rate ceilings, issuing directed credits and money creation, it will create more negative effects on China's financial reform and its economic transition as well.

Chapter 3

Financial Resource Allocation, Financial Reform and Government Deficits in China

3.1 Introduction

This chapter aims to provide an overall background of China's economic and financial reform for the study of government borrowing and financial reform in the country. It will examine the significance, characteristics and main problems of China's financial reform.

Firstly, the economic reform process is reviewed to detail the major elements of its contents. Since China began to reform its economic system from a highly centralized planned economy into a market-oriented economy, its economic activities have been gradually monetized and re-monetized. As a result, the economic reform poses two challenges in financial/banking system reform: one is that the decentralized flow of financial resources requires the development of an efficient and well- functioning financial system; another is that the financial system should enhance monetary policy in macro-economic control.

The objective of financial/banking system reform of China can be seen from the review of the relationship between the state budget and the monobanking system before economic reform. To support the forced-draft economic development strategy before the economic reform, the state budget dominated the financial resources allocation to directly finance the unified physical plan. Hence, the monobanking system acted as a "cashier" of the state treasury. All other investment channels, such as individual investment, enterprises investment, were restricted. As a result, the role of money, bank and financial market were insignificant.

With the economic reform, the role of the financial/banking system has been promoted. Such a situation results from the decentralized power of decision-making and monetized economy. The changes in the patterns of savings and investment have fully responded to the economic reform and fiscal budget reform. As the investment share of the state budget declines in national income, the share of state bank has been increased. The banking system has become the focus of financial intermediation, corresponding to a reduction in the role of the state budget.

In its transition from a centrally planned to a market-oriented economy, the economic environment and remaining distortions mean that China's financial reform cannot be carried out fully in accordance with market signals. Section 3.4.3 outlines the main institutional limitations for an efficient financial reform. These limitations include the outcome of the state budget, the expanded power of the local government in investment, the state enterprises which continue to operate without the imposition of effective financial discipline and restraint. These elements determine that the characteristics of China's financial reform are not profit-oriented.

The situation of the state budget reform has a close link with the financial reform in China. The analysis of trends in fiscal revenue and expenditure provides a basis upon which to understand the main problems inherent in China's fiscal reform. The discussion reveals that the state budget reform has created more serious problems with the government fiscal budget than indicated by the nominal official deficits.[1] With an underdeveloped capital market, the government has to borrow from the state bank to finance its deficits. Hence, one of the financial reform objectives to separate clearly the functions of the state budget and the state banking system has been almost thwarted. The official data on fiscal deficits in China is not calculated in terms of international conventions, so it gives a misleading picture of fiscal budget problems. What is worse, the true extent of China's government borrowing cannot be reflected, and the impact of government borrowing on financial reform and economic reform is even more unpredictable.

3.2 General Review of Economic Reform of China

The economic reform in China since 1978 is intended to break the deadlock of low efficiency in a centrally planned economy, through decentralization and deregulation. Producers receive greater material incentives, and are given increasing autonomy to organize their inputs and outputs. In response to the above reform, producers have to take responsibility for their productive results--both profits and losses. Hence, the principle of economic reform is, through decentralizing the decision-making process, for the producers to achieve efficient economic development.

The economic reform in China first started in the rural areas in 1978 by the introduction of the household-responsibility system. The reform has given farmers increasing autonomy in deciding the prices and the composition of

1. The adjusting principle of the Chinese government official deficits is outlined by the World Bank which reflects calculating problems of Chinese government deficits. For detailed discussion of this subject, see, Section 3.5.2.

their produce. The results of the reform are impressive.[2] The reform was rewarded by a 26% increase in the annual total agricultural product during 1978-85.[3]

Encouraged by successful experimentation on the production-responsibility system in the rural areas, the Chinese government indicated in 1984 a willingness to accelerate urban reforms.[4] The reform chiefly seeks to redress inefficiency in the state-owned industrial sector. The purpose of the reform is to modify the economic environment so that enterprises can operate independently as economic entities, responsible for their own profits and losses.

To "invigorate" state enterprises to make them function like profit-oriented units, several policies have been introduced: (1) delegating and relinquishing revenues (Fang Quan Rang Li), granting some autonomy in decision-making and financial resources allocation to the state enterprises; (2) introducing competition into state enterprises so as to remove administrative controls gradually. Two approaches have been gradually undertaken in state enterprises reform. One is to install the contract-responsibility system which

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2. For study of the reform in rural areas, see, Justin Yifu Li (1987), "Household Farm, Cooperative Farm, and Efficiency : Evidence from Rural De-collectivization in China," Working Paper No.533, (Yale University, Economic Growth Center, 1987); Y. Y. Kueh, (1985), "The Economics of the 'Second Land Reform' in China," The China Quarterly 101, pp.122-131; Y. Y. Kueh, (1983), "Economic Reform in China at Xian Level," The China Quarterly 96, pp.665-688; Wu Xiang (1986), Rural Reform In China, (Beijing: Guangming Ribao Publishing House,, 1986)

3. Chao Linru and Zhang Fongbo (1988), "The Structure and Developmental Tendency of China's Agricultural Economy," In Zhang Fongbo (ed) The Structure and Policy of Macroeconomy of China, (China Finance and Economy Publishing House, 1988)

4. The Third Plenum Session of 12th Central Committee of the CCP was held on 20 October, 1984. It made a "Decision on the Issues of the Reform of Economic System,"

allows enterprises to benefit from what they produce beyond the output quotas. The other is to modify the state ownership of enterprises into joint-stock ownership which offers allow enterprises more independence in decision-making.[5] It should be noted that the urban reform has also stimulated the boom in the collective and private sector, strengthened managerial decision-making power and led to experiments with leasing and share-holding practices.[6]

The economic reform in China has brought about a high rate of economic growth. Real GNP grew by an average of almost 9 percent per annum during 1979-88, compared with the 4 percent in the preceding two decades. Living standards have increased substantially in both rural and urban areas. Exports have diversified and grown rapidly, more than doubled their share in GNP.[7] The rapid growth in income has been accompanied by a substantial increase in household savings, which allows a high rate of investment without excessive reliance on foreign borrowing.

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5 Hua Shen and He Jiacheng (1986), "Restructuring the Base of Microeconomy," Jingji Yanjiu (Economic Research), Vol.3; Wu Jinglian (1987), "Thinking of the Choice of Reform Strategy," Jingji Yanjiu (Economic research), Vol.2; Li Yinin (1986), "Tentative Idea of Property Right Reform in China," Renmin Ribao (People's Daily), 26, September; H. Chao and Yang Xiaoping (1987), "The reform of the Chinese System of Enterprises Ownership," Stanford Journal of International Law, Vol.23, Summer, pp.20-23.

6. The detailed study of this area, see, World Bank (1990), China: Macro-economic Stable and Industrial Growth under Decentralized Socialism, (Washington: D.C).

7. For a discussion of China's international trade and its expending role in the world trade, see, for example, Y. Y. Kueh and Christopher Howe, (1984) "China's International Trade: Policy and Organizational Change and Their Place in Economic Readjustment," The China Quarterly 100, December, pp.811-848; Friedrich Wu, (1981) "From Self-Reliance to Interdependence? Developmental Strategy and Foreign Economic Policy in Post-Mao China," Modern China 7, October, pp.445-482. N. R. Lardy, (1987), China's Entry into the World Economy: Implications for Northeast Asia and The United States, (Lanham, Maryland: University Press of America, 1987)

The achievement of marketization is remarkable in China. The mandatory price coverage in total agricultural products fell from 67% in 1978 to 25.2% in 1990. In industrial production, about two-thirds of product prices are now decided by the producers.[8] In response to these changes, the pattern of financial resource allocation has changed. For instance, the contract-responsibility system enables enterprises to create and retain more revenues; the diversified ownership structure opens a lot of new avenues to private businesses for ventures and profits; the relaxation of income policies provides individuals with more opportunities to make money and deal with their income. Furthermore, the decentralized fiscal distribution leaves local governments with more funds.

Many problem exist in the urban reform. In September, 1985, the Chinese Communist Party approved "the Proposal on the Seventh Five-Year Plan for Economic and Social Development, 1986-90". The plan points out that the establishment of a new economic structure in conformity with the needs of the "planned commodity economy" on the basis of the public ownership calls for the success of three aspects of reform: 1) Strengthening the dynamics of enterprises and, particularly, the large and medium-size state enterprises to turn them into "socialist commodity producers" and enterprises that are relatively independent, operate on their own and are responsible for losses and profits; 2) Developing gradually the socialist "planned commodity markets" to bring market systems to perfection; 3) Reducing gradually the direct control of the government over enterprises and setting up an indirect control system, in which most economic and legal measures, and some necessary administrative measures, are used to control and regulate the functioning of the national

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8. Zhang Pinli (1992), "Some Fundamental Changes on the Price System in China," Renmin Ribao (People's Daily), 21 January, p.3.

economy. However, how to "invigorate" the large- and medium-sized state enterprises is still the main task of the 8th Five-Year-Plan.[9] This indicates that the urban economic reform will take a longer time than the rural economic reform. The key words of this reform are still state enterprises, market and indirect guiding mechanism.

3.3 Financial Resources Allocation Before the Economic Reform

Before the economic reform, financial resources were mainly mobilized and allocated through two channels in China: the state budget and the monobanking system. The state budget, in effect, determined the level and composition of the country's savings and investments through "unified receipts and expenditure" (Tong Shou Tong Zi). The monobanking system acted as a cashier for the government, supplementing the state budget and carrying out financial plans. Other economic agents, such as enterprises and individuals had no authority in the field of investment.

The highly centralized investment system in China was to serve the government's planning and economic development objective, which were modelled on Soviet development strategies of developing heavy industry as a top priority. The characteristics of the "socialist industrialization" can be outlined as follows:[10]

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9. People's Daily Editor (1991), "Pay a Special Attention to Large and Medium-Sized State Enterprises," Renmin Ribao (People's Daily), 7 October, p.1. Li Peng, the Premier (1991), "On the Problem of the Current Economic Situation and Further Improving State-Owned Larger and Medium-Sized Enterprises," Speaking on the Central Working Conference, Renmin Ribao, (People's Daily), 11 September, p.1.

10. See, Dong Fureng (1988), "Development Theory and Problems of Socialist Developing Economies," In G. Rannis,and T. P. Schultz (eds)

- High-speed growth was regarded as the objective in expanding the socialist economy;

- As the leading task in the economic development, the development of heavy industry claimed top priority;

- Extensive (not intensive) development was adopted as the chief approach to high economic growth. It aimed to achieve economic growth mainly by building new enterprises;

- Development of the economy was aimed at achieving basic self-sufficiency, thereby reducing dependence of the economy on non-socialist countries and satisfying the financial, material, and technological needs of economic development by using indigenous resources as extensively as possible.

In order to attain the above economic development targets, capital, technological facilities, raw materials, and labor force etc., were all centralized by the government to be allocated through a unified physical plan.

3.3.1. The Highly Centralized State Budget

Before the economic reform, the state budget was characterized by "unified receipts and expenditure". About one-third of the national income was dominated by the state budget, as shown at Table 3-1. All fiscal revenues were allocated to the productive units according to the government's unified investment plan. Hence, the state budget was made to be a main vehicle for the high-speed economic development strategy in alignment with central planning.

The State of Development Economics: Progress and Perspectives, (Basil Blackwell, 1988)

1. Unified Receipts

"Unified receipts" came mainly from enterprises which had to submit all their profits and a large share of depreciation allowances to the central Treasury. The receipts from the enterprises as a source of budget income, which had provided the largest share of revenue during 1955-1978, can be seen from Table 3-2.[11]

One characteristic of the state budget revenue was that budget receipts came mainly from state-owned enterprises from 1955 onwards, when the socialist transformation was being completed. This is reflected by data in Table 3-3, showing that the amount contributed by state-owned enterprises peaked at 92% of total fiscal revenue in 1960. It means that the state enterprises have dominated the national economy since then.

Among the different types of state enterprises, (industrial, commercial, communication and transport, etc.), fiscal revenue mainly came from industrial enterprises. The size and proportion of budget receipts from industrial enterprises are shown at Table 3-4. Column 1 of Table 3-4 shows clearly that industrial enterprises provided the major and growing share of the total receipts from all enterprises before the economic reform.[12] Such a situation resulted from the government economic development strategy which treated industrial enterprises as a top priority.

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11. During 1950-55, the private enterprises and joint state-private enterprises were in abundance, these enterprises were obliged to remit their profits through taxation. Hence, the revenue from taxation were considerable in this period.

12. For detailed discussion of the financial relationship between state budget and state enterprises before economic reform period, see, B. Naughton (1992), "Implication of the State Monopoly Over Industry and Its Relaxation," Modern China, January.

2. Unified Expenditure

Parallel to "unified receipts", the expenditures of the state budget were also uniformly arranged to carry out the government's growth-oriented economic policy before the economic reform. The major items of expenditure related to economic development were as follows:[13]

- Basic construction appropriations;
- Renovation capital and funds for experiments on new products;
- Addition to enterprises' working capital;
- Funds to support agriculture;
- Commodity reserves;
- Ad hoc appropriation for special purposes.

The ratios of the above items in total expenditure are shown in Table 3-5. The most significant item among the expenditure for economic development was that of basic construction, which included spending on productive as well as nonproductive fixed assets.[14] In reality, about 40% of fiscal expenditure was spent on fixed capital investments in basic construction of state-owned industrial enterprises before the economic reform (See Column.1 of Table 3-5). This data fully reflects the strategy of the Chinese government in economic development.

The supply of working capital to state enterprises, which is one of the main areas of investigation in this study, came mainly through state budget

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13. Those not directly related to economic development items in fiscal expenditure included: (1) expenditures for cultural, educational, scientific and health affairs; (2) national defence spending, and (3) administrative expenditure.

14. The nonproductive fixed assets including such units as hospitals, schools and residential buildings, can be considered as investments in public facilities.

Table 3-1

<u>Total State Budget Revenue and Its Proportions in National Income</u>

(In Billion Yuan)

Year	(1) Total State Budget Revenue	(2) As % of National Income	Year	(1) Total State Budget Revenue	(2) As % of National Income
1952	18.37	31.2	1972	76.66	35.9
1953	22.29	31.4	1973	80.97	34.9
1954	26.24	35.1	1974	78.31	33.4
1955	27.20	35.4	1975	81.56	32.6
1956	28.74	32.6	1976	77.66	32.0
1957	31.20	34.2	1977	87.45	33.1
1958	38.76	34.7	1978	112.11	37.2
1959	48.71	39.9	1979	110.33	32.9
1960	57.23	46.9	1980	108.52	29.4
1961	35.61	35.8	1981	108.95	27.7
1962	31.36	33.9	1982	112.40	26.4
1963	34.23	34.2	1983	124.90	26.6
1964	33.95	34.3	1984	150.19	27.4
1965	47.33	34.1	1985	186.64	27.4
1966	55.87	35.2	1986	226.03	28.8
1967	41.94	28.2	1987	236.89	25.4
1968	36.13	25.5	1988	262.80	22.4
1969	52.68	32.6	1989	291.92	22.2
1970	66.29	34.4			
1971	74.47	35.9			

Source: Col.(1)- <u>Statistical Yearbook of China 1990,</u> p.229
Col.(2)- calculated from <u>Statistical Yearbook of China 1990</u>, p.34

Table 3-2 (1)

Sources of the State Budget Revenue

(Percentage of Annual Total)

Year	(1) Taxes	(2) Enterprises* Income	(3) Debt Income	(4) Energy and Transportation Funds	(5) Others	(6) Subsidies to State Enterprises
1950	75.1	13.4	4.6		6.9	
1951	60.9	22.9	6.2		10.0	
1952	53.2	31.2	5.3		10.3	
1953	53.7	34.4	4.3		7.6	
1954	50.4	38.0	6.5		5.1	
1955	46.9	41.1	8.4		3.6	
1956	49.0	46.7	2.5		1.8	
1957	49.0	46.5	2.3		1.3	
1958	48.3	48.8	2.1		0.8	
1959	42.0	57.3			0.7	
1960	35.6	63.9			0.5	
1961	44.6	53.7			1.7	
1962	51.7	46.6			1.7	
1963	48.0	50.5			1.1	
1964	45.6	53.3			1.1	
1965	43.2	55.8			1.0	
1966	39.7	59.7			0.6	
1967	46.9	52.1			1.0	
1968	53.0	46.2			0.8	
1969	44.7	54.4			0.9	
1970	42.4	57.2			0.4	
1971	42.0	57.5			0.5	
1972	41.4	58.1			0.5	
1973	43.1	56.4			0.5	
1974	46.0	52.0			2.0	
1975	49.4	49.1			1.5	
1976	52.6	43.5			3.9	
1977	53.6	46.0			0.4	
1978	46.3	51.0			2.7	
1979	48.7	44.7	3.2		3.4	
1980	52.7	40.1	4.0		3.2	

Table 3-2 (2)

Sources of the State Budget Revenue

(Percentage of Annual Total)

Year	(1) Taxes	(2) Enterprises* Income	(3) Debt Income	(4) Energy and Transportation Funds	(5) Others	(6) Subsidies to State Enterprises
1981	57.8	32.5	6.7		3.0	
1982	62.3	26.4	7.4		3.9	
1983	62.1	19.3	6.3	7.4	4.9	
1984	63.1	18.4	5.1	8.2	5.2	
1985	109.3	2.3	4.8	7.9	2.8	-27.1
1986	92.5	1.9	6.1	6.9	6.9	-14.3
1987	90.4	1.8	7.2	7.6	9.0	-16.0
1988	91.0	1.9	10.3	6.7	6.7	-17.0

Source: <u>China Finance Statistics (1950-1988)</u>, p.19

* Before 1980, all profits of state enterprises were submitted to the state budget in the form of "enterprises income" (the figure of taxes was big before 1958 due to the fact that the income of private enterprises was taxed by the budget); since 1980, the profits remission has gradually changed into profits tax in form. As to detailed discussion in this field, see, <u>CaiShui Gaige Shinian</u> (Ten Years of Fiscal and Taxation Reform).

Table 3-3

<u>Enterprises' Contributions to Budget Revenue</u>
(Percentage of Annual Total)

Year	(1) State-owned Enterprises	(2) Collective Enterprises	(3) Individual Enterprises	(4) others
1950	33.4	0.3	34.5	31.8
1955	71.3	6.1	12.9	9.8
1960	92.0	7.6	0.4	
1965	86.1	12.8	1.1	
1970	87.9	11.7	0.4	
1975	86.1	13.4	0.5	
1980	85.4	14.0	0.6	
1981	84.4	14.7	0.9	
1982	81.6	15.1	3.3	
1983	80.1	16.0	3.0	
1984	78.9	17.2	2.8	1.1
1985	71.6	23.1	4.3	1.0
1986	77.1	16.9	4.1	1.9
1987	74.4	18.4	4.5	2.4

Source: <u>China Finance Statistics (1950-1988)</u> p.25

Table 3-4

<u>Sectoral Contributions to Budgetary Revenue</u>
(Percentage of Annual Total)

Year	(1) Industry	(2) Agriculture	(3) Commerce	(4) Transportation	(5) Construction	(6) Others
1950	30.0	39.2	16.0	1.5	0.6	12.1
1955	43.6	15.1	20.2	7.1	0.7	13.3
1960	63.4	6.2	16.3	11.1	0.6	2.4
1965	73.4	7.3	6.7	8.9	0.1	3.6
1970	73.1	5.3	12.4	7.4	-0.1	1.9
1975	76.8	3.7	8.0	7.9	-0.1	3.3
1980	82.7	3.0	1.5	6.5	-0.1	6.2
1981	81.9	3.5	0.3	5.8	-0.1	8.6
1982	84.0	4.4	-3.7	4.6	0.1	10.6
1983	86.0	5.4	-7.9	5.7	0.9	9.9
1984	77.8	4.1	-0.8	8.3	0.4	10.2
1985	64.0	4.7	7.7	7.0	0.4	16.2
1986	56.1	3.6	14.7	5.4	1.0	19.2
1987	56.9	5.1	11.5	5.2	0.4	20.9

Source: <u>China Finance Statistics (1950-1988)</u>, p.33.

Table 3-5

Budgetary Expenditure on Economic Development
(Percentage of Annual Total)

Year	Basic Construction	Working Capital	Renovation capital and Funds for New Products Expenditure	Funds in Support of Agriculture
1953	32.0	6.3		1.3
1954	34.2	10.7	0.7	1.6
1955	32.9	11.4	1.1	2.2
1956	45.7	3.5	0.8	2.5
1957	40.7	6.8	0.8	2.6
1958	56.0	6.3	0.2	2.3
1959	54.7	9.8	0.4	4.0
1960	54.2	10.3	0.4	5.2
1961	30.0	8.0	0.7	8.4
1962	18.2	15.7	4.8	6.3
1963	23.6	10.8	5.4	6.5
1964	31.0	5.9	5.2	5.2
1965	34.0	5.9	5.4	3.7
1966	35.3	7.4	5.1	3.5
1967	36.5	6.6	2.3	3.6
1968	32.8	3.3	1.6	3.6
1969	39.2	5.1	2.0	2.8
1970	45.9	4.8	2.3	2.5
1971	42.3	4.8	3.6	2.7
1972	40.3	5.6	3.3	3.3
1973	39.2	6.7	3.2	4.4
1974	39.6	5.7	3.4	4.8
1975	39.8	5.1	3.8	5.2
1976	38.6	5.6	4.2	5.7
1977	35.7	7.8	4.7	6.0
1978	40.7	6.0	5.7	6.9
1979	40.4	4.1	5.6	6.7
1980	34.6	3.0	6.6	6.8
1981	29.7	2.0	5.8	6.6
1982	26.8	2.0	6.0	6.9
1983	29.6	1.0	6.5	6.7
1984	31.6	0.6	7.2	6.2
1985	31.6	0.8	5.6	6.5
1986	28.8	0.4	5.6	5.3
1987	25.7	0.5	5.1	5.5
1988	23.4	0.3	5.6	5.9

Source: <u>China Finance Statistics (1950-1988)</u>, p.74.
Notes: Annual total does not add up to 100 per cent as other items are not included.

grants under the "unified expenditure" system.[15] Working capital was divided into two parts before the economic reform. One was "quota working capital" that was assessed to be required by a state enterprise for its normal and regular operations. Another was temporary or seasonal needs of extra working capital, called "above quota working capital". Before the economic reform, quota working capital was determined and supplied according to the fiscal budget. However, the above quota working capital was supplied by the banking system through loans.

In summary, the state budget occupied a pivotal position in the mobilization and allocation of financial resources before economic reform. The system of "unified revenue and expenditure" was responsible for low efficiency in using financial resources. Because the government did all the decision-making and engaged in financial investments for enterprises, there were little financial responsibility and initiative at the enterprise level. It meant that the state budget assumed responsibility for the profits and losses of state enterprises. Granted both working capital and fixed capital investments from budget grants, the state enterprises were reluctant to compete for and assume responsibility for capital and the cost of investments. To fulfill or overfulfill the allocated production task, the state enterprises usually strove to achieve the targets at the expense of excessive inputs. Further, guided by the highly centralized plan, investment flows created a disproportionate economic structure which favoured heavy industry.

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15. The working capital is opposite to the fixed capital. It means those funds are invested in liquidity assets, and the time is less than one year.

3.3.2 Monobanking System

With the flow of financial resources dominated centrally by the state budget, the banking system development was therefore repressed in China. Financial development in both institutions and financial functions was made unnecessary and impossible. The banking system was a monobanking system in which the People's Bank of China (PBC) acted as both the central bank and the commercial bank.[16]

The monobanking system had little financial intermediary function. Each enterprise had one bank account with the monobank, which was supposed to supply it with working capital. When a deal was made between two industrial enterprises, the bank simply deducted the amount from the buyer's account to add it into the seller's account. Limited personal savings deposits was a main source of liability of the bank. The main financial activity of the bank was to supply working capital beyond the quota needed by state enterprises for seasonal and temporary requirements. The monetary policy was simply an adjunct or enforcement mechanism for what was primarily a physical planning system.[17] However, for most of the time, the PBC was

16. The monobanking system is mainly characterized by its three aspects. First, banking is monopolized by the government. This means the government could determine all activities of banking, including the volume of credit and hence the money supply. Second, the banking system is subordinated to the economic plan. It serves as an instrument of control through the verification of planned transactions. Banks specialized according to their economic sectorial functions. Third, the monobanking system performs a number of functions. It acts as the fiscal agent of the government in that it receives all fiscal revenues and pays out budgetary appropriations to enterprises and institutions. It is responsible for granting short-term credit to all types of enterprises. It carries the account of all business enterprises in the country. It is responsible for the preparation of the credit and cash plans which are part of the financial plan prepared by the MOF. It is also responsible for issue of currency and for holding all precious metals and foreign currencies owned by the government. See, M. C. Schnitzer, and J. W. Nordyke (1971), Comparative Economic Systems, (Ohio: Southern-western Publishing Co.)

"responsible primarily for cash-less settlement between enterprises and for accounting the supply and receipt of funds among enterprises and government units under national credit plan. It acted as government cashier for collecting and disbursing funds under the budgetary process."[18] The monobank system was generally described by the Chinese economists as the center of cash (Xian Jin Zhong Xin), center of credit (Xin Dai Zhong Xin), and center of settlement (Jie Suan Zhong Xin). Moreover, the monobanking system in China was administratively dominated by the state budget. During the cultural revolution period, the banking system was even a branch of the MOF. All monobank activities were under the supervision of MOF.

3.3.3. The Relationship between the MOF and the Monobanking System

The above discussion reveals that the function of the state budget and that of the state bank was mixed in China before the economic reform. The state budget played a dominate role in financial resource mobilization and allocation, and monobanking only played a supplementary role to the state budget. Monetary policies were also insignificant in macroeconomic management. Such a situation was described by Chinese economists as "a big MOF and a small bank". (Da Cai Zhen, Xiao Yin Hang).[19]

The relationship between the big MOF and the small bank can be

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17. See, World Bank (1988,a), *op. cit.;* Luc. de Wulf and D. Goldsbrough, (1986), *op. cit.*

18. Tam (1987), *op. cit.*, pp.100.

19. Duan Yun (1983), "Strengthening and Improving the Comprehensive Plan Between the Fiscal Budget Funds and Credit Funds," <u>Zhonggou Jinrong</u> (China's Finance), Vol.5, pp.5-8; Yang Zheshen (1984), "Well-balancing the Fiscal Budget and Credit Funds," <u>Zhonggou Jinrong</u> (China's Finance), Vol.1, pp.13.

outlined as follows:

- the bank acted as a fiscal agent for receiving all fiscal revenue and paying out budgetary appropriations to enterprises and institutions;
- MOF automatically overdraft from the bank;
- MOF provided credit funds to the bank;
- the banks remitted all their profits to the MOF.

The low efficiency of the fiscal-dominated system in financial resource allocation has been shown by experience of three decades in China. The low efficiency arose from the ineffective use of public resources and from the over-extension of the government into many areas, which were better left to the markets. Hence, reducing government intervention in financial resource allocation is a prerequisite for an efficient market-oriented economic reform.

3.4 Financial Resource Allocation Under the Economic Reform

As demanded by its market-oriented economic reform, China has to some extent reformed the system of centralized financial resource allocation so as to introduce market forces. Breaking the system of "unified revenue and expenditure" has created a series of changes in both the fiscal budget and state bank system.

3.4.1. Reform of State Budget

The objective of the state budget reform is to raise the efficiency of financial resource allocation through decentralizing more decision-making to the producers. The decentralization in both the revenue and expenditure will be analyzed to indicate that some problems have cropped up during the decentralization process, affecting the functioning of the fiscal budget reform.

1. Decentralization of Fiscal Revenue

As noted above, the unified receipt system was mainly supported by income from state industrial enterprises. Hence, the fiscal decentralization program affects the financial relations between the state budget and state enterprises. However, changes in fiscal relations between the central government and the local governments are also a key element of that program.[20] In view of the scope of this study, the discussion will focus on changes between the state budget and the state enterprises.

The main measures of fiscal reform involving state enterprises included the retention of a certain proportion of profits by enterprises and giving certain financial incentive for technical innovation.[21] In 1983, a scheme was implemented for practically all enterprises to change a system of direct profits remission to the delivering of enterprises income taxes to the state budget. The principle of profit taxation is that enterprises pay 55 percent income tax and some " income adjustment tax" to the state.[22] The after-tax profits retained by

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20. For studies on the reform between the central government and local government, see, On Kit Tam and K. Forster, (eds) (1991) "Chinese Fiscal Reform," Chinese Economic Studies, Vol.24, No.1., No.2. A. Donnithorne (1983), "New Light on Central-Provincial Relation," Australian Journal of Chinese Affairs, pp.97-104; P. Ferdinand (1987), "Central-provincial Relation in the People's Republic of China Since the Death of Mao: Financial and Political Dimensions," University of Warwick Working Paper, No.47, December; M. I. Blejer and S. Sagari (1989), "The Evolving Role of Fiscal Policy in Centrally Planned Economies under Reform: the Case of China," IMF Staff Paper, JEL Classification Numbers: 124,320,052.

21. The Chinese government began to experiment with profit retention schemes and profit taxation for some selected enterprises in 1978. The reform was intended to give some financial incentive to the state enterprises. See, Caishui Gaige Shinian (Ten Years of Fiscal and Taxation Reform), *op. cit.*, pp.34.

22. Besides paying 55 percent income tax, if the retained profits of an enterprise were considered too high, state enterprises would be

enterprises are used by the enterprises themselves under certain guidelines. This is a major change in the financial resources distribution between the state's fiscal budget and enterprises. The state enterprises can use their retained funds to expand production capacity and improve the welfare of employers.

It should be noted that the contract responsibility system for state enterprises was introduced in 1984 to increase efficiency by granting greater decision-making autonomy to enterprises managers. The system which has been extended to most state enterprises since 1987, involves a contract agreement between the managers of an enterprise and its owner---that is, the central or local government.[23] The management contracts generally cover a period ranging from three to five years and stipulate a minimum amount of profit to be gained and/or tax to be paid to governments each year.[24] However, the profits above the contracted amount may be fully retained by the enterprises. Currently, about 90% of large- and medium-sized state enterprises are operating under the contract responsibility system.[25] As the result of the above reform between the state budget and state enterprises, in 1988, the after-tax profits retained by state industrial enterprises were 42.6 times that of 1978 (See Table 3-6).

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further subject to an income adjustment tax (sometimes called adjustment tax). This tax has no fixed rate; it is flexible and varies under circumstances surrounding each enterprise.

23. In China, the central government owns many large state enterprises, but most state enterprises at the provincial, municipal and county levels, are owned by the local governments.

24. See, World Bank, (1989,b).

25. To the end of March, 1991, 95% of the enterprises had fulfilled their first contracts and switched into their second-round of contracts. See, Niu Genying (1991), "An Economy Regulated by a Combination of Plan and Market Force." Beijing Review, Oct.7-13, pp.18.

Meanwhile, the Chinese government has also undertaken a series of measures to encourage the productive activities of enterprises. One measure is to allow state enterprises to repay their fixed asset loans and technical renewal loans before taxation. It means that the state foregoes part of its fiscal revenue as a result of the losses of enterprises income tax. The amount of increased subsidies in this program is presented in Column 3 of Table 3-6. Compared with the officially declared fiscal deficit, the part of subsidies was about 137.59% of the deficit in 1986, 168.34% in 1987, and 245.48% in 1988. Such a substantial amount of subsidies was a main reason causing the decline of state budget revenue in recent years in China, as will be discussed in Section 3.4.

To encourage state enterprises investment in fixed assets and technological innovation, the government has raised the rate of depreciation for enterprises' fixed assets. The ratios of depreciation funds retained by the enterprises have also been increased. The average depreciation rate was raised from 4.1% in 1981 to 4.7% in 1985 and 5.2% in 1988. The ratios of depreciation funds retained by enterprises had also raised from 70% in 1985 to 100% in 1987. Hence, depreciation funds have become a considerable part of financial resources of enterprises after the economic reform. The figures are shown at Table 3-7.

As the result of the above changes, state enterprises have obtained certain financial resources of their own. The funds retained by state enterprises are basically used for three purposes: productive developments funds, workers' welfare funds, and incentive funds. All funds are required to be deposited in the state banks before being used. As a result, the bank's liabilities have been considerably increased by the increasing enterprises deposits since 1981, as indicated by Column 1 of Table 3-8.

Following the decentralization between the state budget and state enterprises, there have been corresponding changes in the flow of financial resources. First, the revenue of the state budget has declined in terms of national income. This question will be discussed in greater detail in the section 3.5.1, where the trends of fiscal revenue and expenditure are studied. Second, as the state enterprises have the right to invest in both fixed capital and working capital on the strength of their production development funds, a large share of development funds was in fact invested in fixed assets. Other areas of investment, such as technical innovation, supplement of working capital, are seldom given due attention. Here lies the reason why the government intervenes in credit allocation. Third, enterprises incentive funds, which have increased faster than other funds, were mainly used for worker's bonuses.[26] Along with the wage system reform, individual household income has grown at a rapid speed. As a consequence, the level of bank savings deposits has been rising rapidly in an environment where there are few other financial investment instruments. The saving trends of the fiscal budget, enterprises and individuals are presented at Table 3-8.[27] It can be seen that state budget's

26. For example, bonuses paid to workers and managers are within the limit of up to three months of basic wages. In 20 enterprises in the World Bank listings, bonuses averaged 5 months of basic wages at several firms. The average share of retained earnings spent on bonuses was 29%; an even greater share, 33% was spent on work benefits. See, G. Tidrick and C. Jiyuan (1987) "Characteristics of the Twenty Firms," In G. Tidrich and G. Jiyuan. (ed) China's Industrial Reform, A World Bank Research Publish (New York: Oxford University Press, 1987). It was also reported that in the increasing individual income, the bonuses and other non-money income was accounted for 14.0% of total income in 1978, and it rose to 45.2% in 1989. See, Fu Gang (1991), "The Wage Income of the Urban Citizens: An Annually Increase of 3.8% During Last Twelve Years," Renmin Ribao (People's Daily), 12 September, P.1.

27. One of the objectives of the economic reform of China is to improve people's living standard through increasing personal income. The reform in wage systems of state enterprises reform started in 1979. The money income of urban citizens increased from 668 yuan in 1978 to 2140 yuan in 1990. It increased at about 3.8% in real income annually. The growth rate was ten times that during 1952-1978 (an annual increase of 0.38%) See, Fu Gang (1991), *op. cit.*

Table 3-6

Retained Profits and Pre-tax Profits Used for Debt Service By Industrial Enterprises

Year	(1) Profits Retained by Industrial Enterprises (Billion yuan)	(2) Enterprises Retained Profits as % of Gross Profits (Percent)	(3) Pre-tax Profits Used for Debt Service and Amortization (Billion yuan)
1978	0.78	1.7	0.19
1979	4.06	7.9	1.45
1980	6.92	12.6	1.70
1981	8.49	16.3	2.03
1982	11.20	21.6	2.70
1983	15.43	27.0	3.85
1984	18.84	30.7	5.23
1985	24.05	38.3	7.78
1986	25.22	43.1	9.70
1987	27.49	44.6	13.40
1988	33.63	47.9	19.27

Source: China Finance Statistics (1950-1988), Col.(1), Col.(2) --p.145, (a), Col.(3) --p.145, (b)

Table 3-7

Depreciation Rate and Depreciated Value of Fixed Assets of State-Owned Industrial Enterprises

(In billion yuan)

Year	(1) Net Value of Fixed Assets of State-Owned Industrial Enterprises*	(2) Depreciation Rate (%) on Fixed Assets	(3) Depreciation Value [(1) x (2)]
1978	211.45	4.1	8.67
1979	224.48	4.2	9.43
1980	236.65	4.2	9.94
1981	249.14	4.3	10.71
1982	269.31	4.3	11.32
1983	296.69	4.4	13.05
1984	310.19	4.6	14.28
1985	342.87	5.0	17.14
1986	392.52	5.1	20.02
1987	445.10	5.2	23.15
1988	514.28	5.3	27.26

Source: Col.(1) and Col.(2) Statistical Yearbook of China 1990, p.30, p.31,
Col.(3) Computed from Col.(1) and Col.(2)

* The net value of fixed assets equals the fixed assets of enterprises at a cost minus the depreciated value, which has been included in the cost of products.

Table 3-8

1952-87 the Composition of Deposits of China's State Banking System (%) *

Year	(1) ED	(2) FD	(3) HD		(1) ED	(2) FD	(3) HD
1952	35.4	20.9	9.2	1971	29.5	24.6	9.6
1953	29.6	30.9	11.3	1972	30.8	22.2	11.0
1954	22.6	40.2	9.4	1973	32.3	18.6	10.9
1955	22.9	25.5	11.9	1974	36.2	15.3	11.8
1956	33.6	12.2	16.7	1975	37.2	14.4	11.8
1957	24.0	12.4	16.9	1976	39.8	10.0	12.2
1958	26.3	16.9	11.9	1977	36.2	14.3	12.7
1959	17.6	20.6	11.9	1978	32.5	16.5	13.7
1960	18.7	31.9	11.1	1979	35.0	11.1	15.1
1961	23.8	35.7	8.0	1980	33.9	9.9	17.0
1962	37.2	19.5	7.7	1981	33.3	9.7	17.4
1963	42.7	16.3	8.6	1981	42.0	11.7	17.5
1964	35.5	19.3	10.2	1982	42.4	9.2	18.9
1965	37.8	15.4	10.9	1983	40.9	8.7	20.5
1966	33.4	17.3	10.4	1984	45.7	6.4	21.7
1967	34.7	11.7	10.4	1985	40.7	8.6	20.4
1968	33.9	14.8	10.0	1986	41.9	5.8	27.5
1969	33.6	18.6	9.5	1987	41.0	4.7	31.7
1970	32.1	25.1	9.2	1988	39.6	3.7	44.8
				1989	34.2	4.9	49.4

Source: Almanac of China's Finance and Banking 1990, pp.48-53

* the annual totals do not add up to 100 per cent because other items are not tabled. Statistics on the state banking system refer to the consolidated balances of China's central bank, the four specialized banks and two comprehensive banks (after 1988);

ED--Deposits from the enterprises
FE--Deposits from the fiscal budget
HE--Deposit from the individual households

savings deposits have been reduced yearly since the economic reform. Savings deposits of both enterprises and household have increased, with individual household savings increasing continually and considerably. The increase in individuals income has given rise to an investment class for the development of capital market in China. As will be discussed in Chapter 4, individual household buyers are already one of the main investors in government bonds.

2. Reform of Fiscal Expenditure

In conformity with the changes in fiscal revenue, the system of unified expenditure has also been changed. One of the main changes is that, since 1983, all of working capital of the state enterprises has been supplied by the state banks. This amendment was based on two considerations: one was that the government recognized that the financing capacity of the banking system had greatly increased; another was that the government believed that management and control of working capital by one channel would be more efficient than that by two channels.[28] Therefore, the state budget is not directly involved in supplying working capital to the state enterprises. It only grants "Working Capital Funds" to the state bank to meet the demand of working capital caused by expanded production. In reality, the amount of the state budget spending on "Working Capital Funds" is getting smaller and smaller, which can be seen from Table 3-11. In 1989, the expenditure of the state budget on the working capital accounted only for 0.3% of the total fiscal expenditure. Whether the government has achieved its expectations or not is difficult to tell because the government is still intervening in the supply of working capital loans (to be discussed in more detail in Chapter 5).

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28. Zhu Tianshun (1983), "Full Utilization of the Banking System in Working Capital Management," Zhongguo Jinrong (China's Finance), Vol.8, p.9-12.

The pattern of the state budget spending on economic construction has also been revamped. The funding for the basic construction of state enterprises has changed from appropriation via the budget to loans by the People's Construction Bank of China since 1979. The reform aims at improving the efficiency of financial investment through the imposition of interest rates and repayment obligations. Since 1985, about 90% of basic construction funds used by productive units has been in the form of bank loans.[29] Therefore, the share of state enterprises' investments financed by the state budget has been gradually reduced since the fiscal reform. By contrast, there has been an increase in investment by the state bank.

3.4.2 Reform of Banking System

The development of the financial system in its financial intermediary role was required corresponding to the reduced role of the state budget in financial resource allocation. To meet the new requirement, the monobanking system was firstly restructured to separate the function of the central bank and the commercial (specialized) bank. As a central bank, the People's Bank of China (PBC) is charged with the responsibility for monetary policy and supervision of four specialized banks' credit activities. The four specialized banks, with the newly established People's Insurance Company of China (PICC), have assumed a different role in some designated financial areas.[30]

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29. The public institutions which lack the repayment ability for bank loans, for instance, research institutions, schools, universities and hospitals, still obtain appropriations from the state budget. See, Caishui Gaige Shinian (Ten Years of Fiscal and Taxation Reform), *op. cit.*, p.236.

30. For detailed discussion in this area, See for example, Tam, (1986), *op. cit.*, Tam, (1987), *op. cit.*, Zhou and Zhu (1986), *op. cit.*, Jian Rong (1987), "The Theory and Practice in Diversified Financial Institutions," Jingji Gongzuozhe Xuexizhiliao (The Research Reference for Economists), Vol.44, pp.40-72. .

Soon after, two comprehensive banks, International Trust and Investment Bank (ITIB), and Bank of Communication (BOCOM) were established. The structure of new banking system is presented in Figure 3-1.

At the administrative level, the new banking system, similar to the MOF, is directly subordinated to the State Council. Such an institutional set- up is intended to demonstrate the absence of MOF's authority to supervise banking operations at the administrative level. However, as will be discussed later, the MOF is still interfering with the bank's operation for a variety of purposes through various administrative methods.

The intensified role of the financial/banking system is reflected by the rising proportion of enterprises' investment financed by the banking system. The expanded business is primarily linked with the supply of working capital. Working capital loans increased rapidly during 1983-86. In this period, the amount of working capital loans granted was four times the total amount of the previous 33 years.[31] However, low efficiency in the utilization of the working capital as a major cause of expanded bank loans in this period cannot be ruled out.[32]

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31. Wan Jianhua and Wang Xiaoyan, (1987), *op. cit.*.

32. To indicate the efficiency of the working capital used by enterprises, the state bank adopts several assessments: For instance, the repayment period, the amount of working capital loans per unit of output value. It was reported that for the state enterprises in Hebei province, 100 yuan of output was needed 44.39 yuan working capital investment in 1986, however, 65.45 yuan in 1989. If the scale of production was unchanged in 1989, 5.87 billion yuan working capital was excessively invested than 1986. For another example, the state enterprises in ShiJiaZhuang, the Capital City of Hebei Province, the repayment period of the total working capital loans was 83 days in 1984. In 1989, it became 144 days. Due to slow circulation of working capital, the industrial and commercial enterprises had to increase 1.25 billion yuan working capital to these enterprises. See, Jian Xuebin and Zheng Xiaodong, (1990) "Retarded Economic Development: Shortage of Working Capital" Chengshi Jinrong (City Finance) Vol.7, pp.34-35; Wang Jinsheng (1991) "Reflections on the Situation of Own

The banking system also expanded its lending for long-term fixed capital investments, which was restricted before the economic reform. As can be seen in Table 3-9, the share of fixed capital loans has increased in the total bank loans. The figure at Table 3-10 shows that bank loans have accounted for about 20% of the total national fixed capital investments in recent years. However, the share of budgetary investment in fixed capital declined from 23.75% in 1983 to 8.26% in 1989.

The decentralized flows of financial resources are required not only to develop financial intermediaries, but also to enhance the monetary policy in macrocontrol in China. With more financial resources in the hands of enterprises and households, and with greater freedom of choice over how these resources should be used, money is no longer just a counterpart to physical transactions specified in the plan. Especially with the increase in unplanned market transactions, money is being widely used as a medium of exchange. Liberalization of the price and the trade have required monetary policy to play an independent and major role in macro-economic management. As will be discussed in the government borrowing from the PBC in Chapter 5, the monetary policy in China has not functioned effectively. For instance, the interest rate policy is a significant monetary policy instrument. Interest rates in China are still regulated by the government because the investment plans are still a tool used by the government to direct investment. Hence, the Chinese government persists in using direct administrative methods rather than monetary policy instruments to influence investment decisions and investment costs.

Working Capital of Enterprises," Chengshi Jinrong (City Finance), Vol.1, pp.26-27.

Table 3-9

The Ratios of Fixed Capital Loans to Total Bank Loans

(As Percent)

Year	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Ratio	0.4	2.3	4.7	7.5	8.6	9.5	11.9	13.2	14.2	13.5	13.1

Source: Almanac of China's Finance and Banking 1990, p.53.

Table 3-10

The Financial Source of Fixed Capital Investment In China

(As Percent)

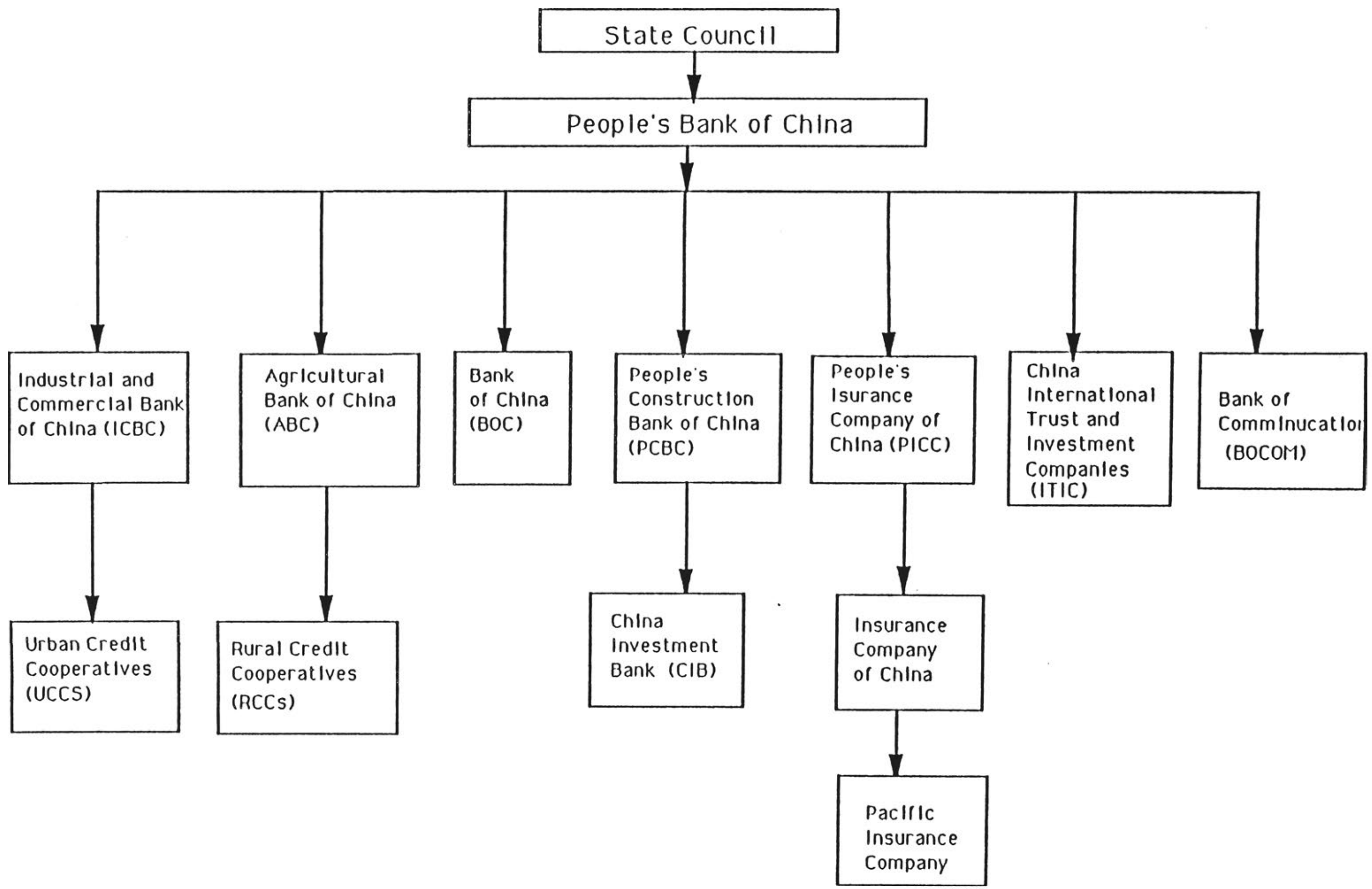
	1983	1984	1985	1986	1987	1988	1989
State Budget	23.75	22.97	16.03	14.59	13.06	8.96	8.26
Bank Loans	12.27	14.10	20.06	21.14	22.96	20.34	17.31
Foreign Investment	4.56	3.86	3.59	4.38	4.82	5.66	6.63
Enterprises' Own Funds*	59.42	40.93	60.32	59.89	59.16	65.04	67.80

Source: Statistical Yearbook of China 1990, p.154.

* including retained profits, and the funds raised by issuing enterprises securities.

Figure 3-1

The Structure of China's Banking System



The financial/banking reform has stimulated the development of financial markets in China. The short-term money markets for interbank lending and borrowing were first organized in a number of major cities in 1986.[33] More recently, interbank lending takes place through the intermediary of local financing companies established in most major cities. The securities markets have also developed in recent years. The Chinese government has begun to issue Treasury bonds (for at least three years) since 1981. Since 1985, Bank Bonds have been issued by the specialized banks for raising extra credit funds, Quasi-fiscal Bonds and Government agency bonds were also issued after 1987 by some ministries.[34] Meanwhile, many enterprises, including state enterprises, urban and rural collective enterprises and township enterprises, have issued enterprises equities to raise funds for self-investment.[35] Hence, there are several financial instruments in the securities markets. The fact is that the securities markets are mainly dominated by the government's Treasury bonds in both primary markets and secondary markets, as will be discussed in detail in Chapter 4.

3.4.3 Operation of the Financial System in the Transitional Period

With new saving patterns, investments in China are now being undertaken by the central government, local governments, enterprises, individuals and state banks. As a consequence, the investment share funded by the state budget has declined, and the share of state banks has increased.

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33. The money market, defined as that involving debt of less-than-one year original maturity.

34. Liu Hongru (1988,b), Financial Market, (Beijing: Xueyuan Publishing House, 1988)

35. As to the detailed discussion in this area, see Tam (1991,a), *op. cit.*

The problem raised here is whether the financial resources can be efficiently allocated by the state banks.

As mentioned in theoretical studies, the financial reform of CPEs are affected by various factors in a transitional period. In China, the economic environment for the financial reform is that the central planing is weakened, while a market-oriented mechanism is not fully established. In this climate, the financial reform in China entails the following problems.

An efficient financial reform will be adversely affected by an incomplete fiscal reform. The main problem of a fiscal reform is that, while the decision-making and financial resources allocation have been decentralized, the government still owns all the property of industrial state enterprises. Thus, the investment responsibility of these enterprises still rests with the government. When the state enterprises are in financial difficulties, the government has to help them out of it. In practice, it is a common occurrence that the government directs credit funds to solve financial problems of state enterprises. As a consequence, the autonomy of the banking system is reduced because of government's intervention in the practice of extending loans. The state budget has other problems, which affect bank operation. For instance, to subsidize the loss-making enterprises, the government directs the state bank to extend directed loans. Hence, the blurring of these two resource allocation processes (fiscal and financial) makes it impossible for the state banks to manage their operation in light of market conditions and financial discipline.

Second, the state banks run a major risk in dealing with the state enterprises. The principle of bank credits, which is different from the grants from the state budget, is that bank loans should be repaid in time along with the interest. The repayment is the basic condition for an efficient bank operation. As the state enterprises continue to use bank credit funds with low efficiency, the repayment rates of the bank loans are low. Loss-making enterprises (which are mostly rooted in the administrated price system), generally have no capability to repay their loans. Instead they often require regular new credits just so as to maintain operation. Moreover, many state enterprises strive to fulfill their contracted tax obligations by whatever possible means because they can give bonuses to the workers after the payment of the taxes. As a result, the state bank loans are often diverted to pay their taxes. Hence, the state enterprises can operate under the "soft credit" constraints, despite "great and chronic financial trouble, without any real hope of repayment of the debt."[36] Therefore, the efficiency of the financial reform is closely linked to the progress of state enterprises' reform.

Currently, there is also a close relationship between the state banks and the local governments in China. Since the local governments have obtained certain autonomy in investment decisions and investment ability, local governments have a greater investment drive. Since 1980s, many local governments at the levels of province, county and township have competed to set up cigarette factories, small breweries, textile mills, etc. However, such rapidly expanding and duplicated projects have caused many "battles" for material, greater demand for funds. The local governments often turn to the local banks for more bank loans in these exercises.

As the banking system is still set in accord with the geographic and sectorial management system, as well as the political and economic management system (See Figure 3-2), it has created opportunities for the government at various levels to interfere with the bank's operation. Especially

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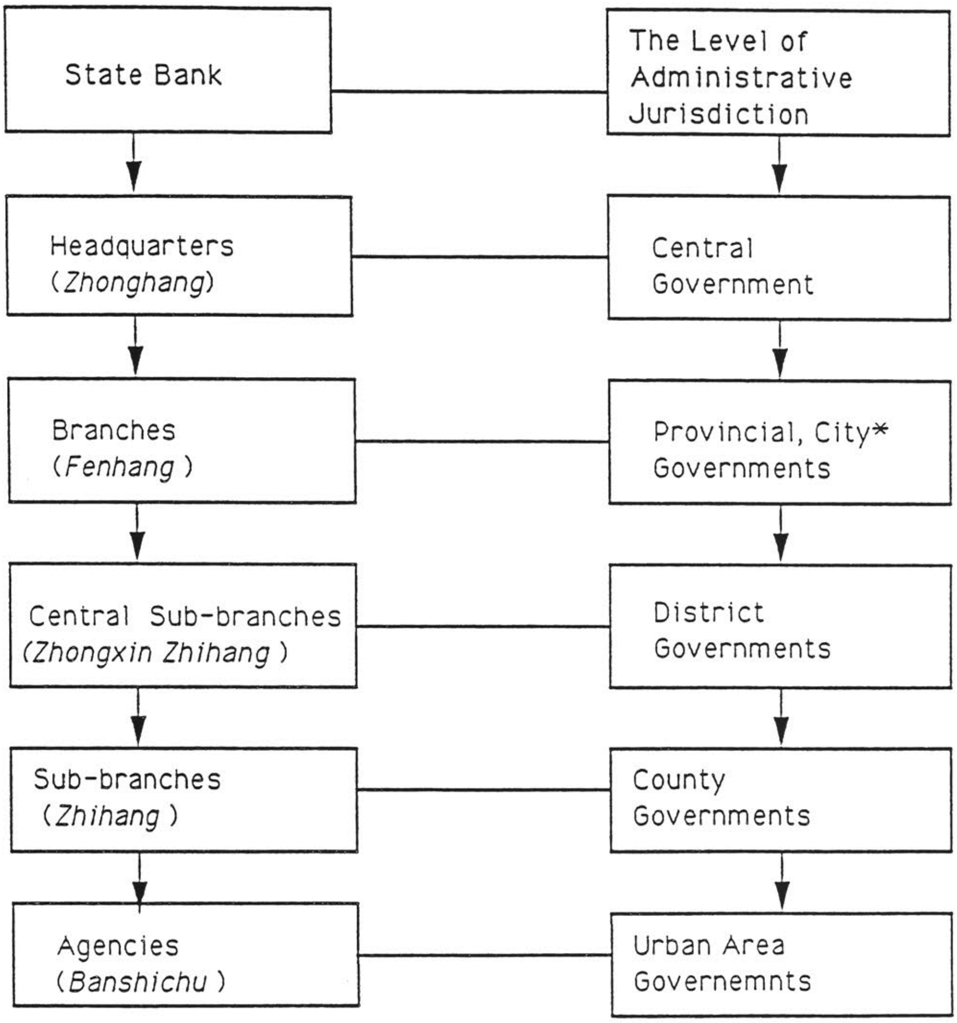
36. J. Kornai (1986), "The Soft Budget Constraint", Kyklos, Vol.39, Fasc.1, pp.6.

Figure 3-2

The Organization of the Banking System
Under China's System of Administration



* Here, "city " means those three cities (Beijing, Tianjin and Shanghai) which are directly under the central government and are equivalent to provincial level government.

Sources: Almanac of China's Finance and Banking 1986, 1987 1988, 1989, 1990.

in a situation where the government domination in overall sectorial activities remains unchanged, the local bank branches have many requirements from the local governments. For instance, the development of a bank network, employment, housing, and even education of workers and employers' children are all concerns of the local governments. Hence, in reality, when the local governments deal out a number of mandatory loans with degrees of priority, the specialized banks at various levels have to obey and even accommodate them.[37] On some occasions, the banks are fully aware that the borrowers have little repayment ability. Hence, the practice to satisfy the local government's over-investments is a main factor leading to credit expansion and the imbalance of the economic structure. Although the activities of the local government are beyond this study, in China, it is necessary to note that it is one of the important factors affecting the financial reform.

Under the above situation, the state banks have to waste much time in dealing with the central government, local governments and state enterprises. As a result, the banking system is responsive to the various administrative directives rather than market signals. Such a situation greatly limits the efficiency of the financial reform in China, as will be studied in Chapter 5.

3.5 Government Deficit and Borrowing Requirement in China

Since 1979, the state budget has been in deficit every year except 1985 according to official statistics. Large fiscal deficits are often the root cause of both external and internal macro-economic imbalance.[38] Most importantly,

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37. Zhou and Zhu, (1987), *op. cit.*
38. World Bank, (1988, a), *op. cit.*, p.1.

the reform in many other areas---financial liberalization, price deregulation, trade reform and so on---can work only in a stable fiscal situation.[39] The Chinese government's deficit---excess of its spending over its revenue---has resulted from many problems in China's fiscal reform and even economic reform. An examination of the inherent problem in the Chinese government's deficit will help to understand the borrowing requirements of the Chinese government, and also to understand the borrowing methods which are mostly dominated by administrative ways.

3.5.1 Trends in Fiscal Revenue and Expenditure

The Chinese government's fiscal deficit stems from the fact that the growth in fiscal revenue has declined faster than expenditure, which is a general trend in recent years. Therefore, the question is why the government failed to collect sufficient revenue, or why the government could not cut down their expenditure. These questions will be answered through investigating each side of the budget balance in turn.

1 Trends in Fiscal Revenue

Since the fiscal reform, fiscal revenue in proportion to national income has declined. In 1979, the fiscal revenue was 38.03% of the total national income, while it was only 22.2% in 1989. (See Table 3-1). The decline in fiscal revenue is sometimes attributed to be one of the main causes of the imbalance in the macro-economy. Some Chinese economists have believed that the

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39. McKinnon, (1982), *op. cit.*

appropriate share of the state budget in the national income should be 33%.[40] It was suggested that the share of the central government should be no less than 50% of the total state budget income.[41] Some Chinese economists have pointed out that the raising of these "two ratios" is a necessary condition for macro-economic management.[42] The most desirable ratios for the Chinese government are still under discussion among Chinese economists.

The relative decline of fiscal revenue in the national income is a result of the program of the decentralization in the allocation of financial resources.[43] When some financial resources are devolved to the productive units, one natural consequence is the decline of the state fiscal revenue. Hence, such a decline in fiscal revenue can be concluded as an intended and desirable outcome of the decentralization program. [44]

The fiscal reform has, however, a number of unintended consequences that have contributed to the relative decline in fiscal revenue. An obvious one is the government's tax policy. By 1986, almost all enterprises' profits were taxed instead of being remitted to the government. Hence, the design and implementation of the tax policy are the crucial factors in determining

40. Here, the "share" is the consolidated revenue of both the central and local governments, excluding extra-budgetary revenue. See, Wu Aimin (1984), "On the Share of the State Budget in National Income," Cai Zheng (The Public Finance), Vol.8.

41. The official data gives only the figures of the revenue collected by the central government and the local government. Hence, the real distributed revenues between the central government and the local government in recent years are not available in this study.

42. See, Yuan Zhenyu (1990), "Reflections on the Increase of'Two Ratios'," Ciamao Jingji (Finance and Trade Economies) Vol.3, pp.29-34.

43. It should be noted here that the decline of fiscal revenue is not absolute terms. It means the share of the state budget was declined in national income.

44. Blejer and Szapary (1989), *op. cit.*, p.8.

government revenue and the government's ability to carry out macro-economic policy and stabilization programs. The problem is that the Chinese government has not been successful in expanding its tax bases. The low elasticity of tax bases is a main failure in generating the revenue.[45]

The low revenue elasticity of the tax bases stemmed from the tax contracting system, which is characterized by a contractual agreement between the enterprises and the central/local government. Usually the contract is valid for five years. During this period, the contract stipulates a fixed tax rate on realized profits to be paid to the government by the enterprises. The profits above the contract amount are usually entirely retained by the enterprises or taxed at a low rate. The tax contracting system was introduced in 1984 and had extended to about 90% of the large and medium-sized state enterprises by 1987. Due to the policy that the below-quota profits are subject to a flat tax and the above-quota profits are taxed at a low or zero marginal rate, enterprises can therefore retain an increasingly large portion of their total profits as profits grow. The tax contracting system, therefore, has made the tax bases narrow and inflexible for the government revenue.

Another serious problem in the enterprises tax system is that some loan principal payments of state enterprises are deducted from the pre-tax profits. For instance, technical renovation loans allow for such deduction. Hence, many state enterprises have tried to lean more on bank loans to undertake their technical innovations in China. As shown at Table 3-6, the profits before tax used for debt service have increased in recent years. It was 19.27 billion yuan in 1988, 101.42 times that in 1978. Therefore, the state budget lost a certain

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45. A detailed discussion of China's tax reform is provided by the World Bank (1989,b), *op. cit.*; Blejer (et, al) (1991), *op. cit.*

amount of tax income. Moreover, repaying bank loans before tax repayment also reduces the effective cost of borrowing and makes an excessive demand for bank credits.

The fact that the price reform has not run its full course is another problem causing the decline in fiscal revenue. As a remedy to the problems caused by the distorted price system, the government has subsidized some enterprises for their loss-making and urban citizens for their food prices. Before 1986, the government treated their subsidies spending as a write-off to fiscal revenue. After 1986, spending on food subsidies is recorded as a part of the expenditure. However, subsidies for loss-making enterprises are still recorded as a negative income of the revenue. The amount, which accounted for about 15%-27% of total fiscal revenue from 1985-1989, can be seen from Table 3-11.

It should be noted that the share of the central government's budget in the consolidated state budget revenue has also been reduced, due to the "revenue sharing" system. To encourage the local government to collect taxes, revenue-sharing arrangements between the central and local government were established in 1980.[46] Under these arrangements, local governments agree to remit to the central government a fixed amount of revenue and retain all, or a major part, of the rest. The revenue to be transferred to the central government is set for several years with a fixed annual increment over the base year. The problem created by the revenue-sharing system is similar to the contract system between the state enterprises and government. The fixed quotas imply that the revenue transferred to the central government is not subject to the rate

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46. See, Caishui Gaige Shinian (Ten Years of Fiscal and Taxation Reform), *op. cit.*, p.196.

of growth of the economy.[47] However, comprehensive data in this aspect is not available.[48]

Apart from the result of decentralization program, the decline in revenue mobilization in China, therefore, has been largely caused by the failure of the tax system reform and by the sustained distortions in the price system.

2 Trends in Fiscal Expenditure

Along with the relative decline in the revenue of the government's budget, the Chinese government's fiscal expenditure has also declined as a percentage of national income, but at a slower rate than the revenue. The main changes in expenditure can be clearly seen from Table 3-11. Most reductions took place in capital construction. Compared with 1979, there was an almost 50% decline in 1989. This was caused by the decentralization of the decision-making process, and also because that the large profits were retained by the enterprises, which meant a reduction of the government's role in financing investments. Another reduction can be seen in the levels of defence spending, resulting from the Chinese government's disarmament of about one million servicemen.

Table 3-11 also presents the items with an increasing trend. The persistent high level of price subsidies is an obstacle to the reduction of the state budget expenditure. Since 1986, the price subsidies for food (including

47. For a detailed discussion see, Blejer and Szapary (1990,a), *op. cit.*, pp.33.

48. The figures given by the official statistics were the amounts of revenue allocated by the central government and local government. But the real amounts of revenue after distribution between the central government and local government are not available. See, China Finance Statistics (1950-1988), pp.58.

subsidies for citizens' food and subsidies for agricultural inputs) have been recorded into the expenditure of the budget rather than being written off from the fiscal revenue. The food subsidies were, on average, 11.78% of the total expenditure for 1986-88. Hence, it was a considerable part of the expenditure.

Administrative costs can be seen to be a fast-growing expenditure, despite a blanket curb on the spending of government offices almost every year. Table 3-11 shows that the ratio of administrative spending to the total fiscal expenditure increased from 4.5% in 1979 to 9.6% in 1989. On the average, it grew at 17.09% each year during 1981-88, exceeding the average growth rate of national income (15.48%) in the same period (see Table 3-12). The growth in administrative expenditure is considered to be one of the main causes of the imbalance between the total social supply and demand.[49]

In view of the above problems, three types of public finance reform measures recommended by the World Bank seem to be appropriate for the Chinese government: redirecting spending toward activities in which government participation is most critical, increasing the reliance on use and other benefit-related changes to finance such spending, and decentralizing some public responsibilities to those in closer touch with local needs and conditions.[50]

The discussion of the problem existing in both revenue and expenditure indicates that the deficits have emerged because of some fundamental problems in the distorted economic structure in China. The main issue is that: when the centrally planned economic system has broken down and before a

49. Yang Peixin (1988), "An Issue on the Financial Situation," Jingji Ribao (Economic Daily), 10 August, p.3.

50. World Bank (1988,a), *op. cit.*, p.8.

Table 3-11

The Composition of Chinese Consolidated State Fiscal Budget Revenue and Expenditure (In Percent)

Items	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989**
Revenue											
Taxation	48.7	52.7	57.8	62.3	62.1	63.1	109.3	92.5	90.4	91.0	93.5
Receipts from Enterprises	44.7	40.1	32.5	26.4	19.3	18.4	2.3	1.9	1.8	1.9	2.0
Public Debt	3.2	4.0	6.7	7.4	6.3	5.1	4.8	6.1	7.2	10.3	9.4
Collection Funds for Key Projects of Transportation and Energy					7.4	8.2	7.9	6.9	7.6	7.1	6.8
Others	3.4	3.2	3.0	3.9	4.9	5.2	2.8	6.9	9.0	6.7	6.3
Subsidize for Enterprises Losses							-27.1	-14.3	-16.0	-17.0	-20.6
Expenditure											
Basic Construction	40.4	34.6	29.7	26.8	29.6	31.6	31.6	28.8	25.7	23.4	20.3
Working Capital	4.1	3.0	2.0	2.0	1.0	0.6	0.8	0.4	0.5	0.3	0.3
Renovation & New-Product Experiment	5.6	6.6	5.8	6.0	6.5	7.2	5.6	5.6	5.1	5.6	5.0
Support of Agriculture	7.1	6.8	6.6	6.9	6.7	6.2	6.5	5.3	5.5	5.9	6.6
Culture, Education & Health	10.4	12.9	15.4	17.1	17.3	17.0	17.2	16.3	16.4	18.0	18.5
Administration	4.5	5.5	6.4	7.1	7.9	8.1	7.1	7.2	7.3	8.2	9.6
Debt Repayment		2.3	5.6	4.8	3.3	1.9	2.1	2.2	3.2	2.9	2.4
Subsides on Price								11.1	12.0	11.7	12.3
Defence	17.5	16.0	15.1	15.3	13.7	11.7	10.4	8.6	8.6	8.1	8.3
Others*	10.4	12.3	17.2	14.8	14.0	15.8	18.7	14.5	15.7	15.9	16.7

Source: China Finance Statistics 1950-1988, p.19, p.74, p.75.

* The others include geological prospecting, pension, social welfare relief, etc.

** Statistics Yearbook of China 1990, p.224-234.

Table 3-12

<u>A Comparison of the Growth Ratios of Administrative Expenditure and National Income</u>

Year	(1) Administrative Expenditure (Billion yuan)	(2) Annual Growth Rate (%)	(3) National Income (Billion yuan)	(4) Annual Growth Rate (%)
1980	6.67		369.80	
1981	7.06	5.85	394.00	6.77
1982	8.16	15.58	426.10	8.12
1983	10.22	25.24	473.00	11.03
1984	12.52	22.50	563.00	19.02
1985	13.05	4.23	703.10	24.42
1986	16.08	28.73	789.70	12.23
1987	17.93	11.50	936.10	18.63
1988	22.08	23.15	1153.30	23.18

Source: Col.(1)- <u>China Finance Statistics</u> (1950-1988), p.71.
Col.(2)- calculations from Col.(1).
Col.(3)- <u>China Finance Statistics</u> (1950-1988), p.173.
Col.(4)- calculations from Col.(3).

market mechanism functions well, including the tax system and price system, the government can and should still play its role in many areas to facilitate the market. This point of view can be further seen from the later discussion.

3.5.2 The Scope of Government Deficits and Borrowing

The Chinese government does not measure its budgetary deficit in term of international conventions. The purpose of measuring the public deficit is to measure the net claim on resources by government. A common conventional definition of the deficit, for example, is the public sector borrowing requirement (PSBR), which measures government's use of new financial resources, net of repayment of previously incurred debts. It is also called the "consolidated public sector deficits."[51]

The fiscal deficit, which is conventionally defined on a cash basis, measures the difference between total government cash outlays, including interest outlays but excluding amortization payments on the outstanding stock of public debt, and total cash receipts, including tax and nontax revenue and grants but excluding borrowing proceeds. In this sense, fiscal deficits reflect the gap to be covered by net government borrowing, including direct borrowing from the central bank.[52] As regards the Chinese government's deficit on a cash basis, there are several points of difference. One is that the Chinese government treats its debt income (both domestic and external) as revenue. As a consequence, the public revenue was enlarged, but the deficit is

51. See, World Bank (1988, a), *op. cit.*, p.56.

52. V. Tanzi (et al), (1988), "The effects of Inflation on the Measurement of Fiscal Deficits," in M. I. Blejer and A. K. Y. Chu Measurement of Fiscal Impact: Methodological Issues, (Washington, D.C.: International Monetary Fund), pp.4-19.

nominally reduced. Hence, in such a case, it is important to note that the Chinese government's officially-declared deficits can only be covered by net government borrowing from the central bank. Another point is that the Chinese government includes both interest outlays and amortization payments into its expenditure.

The concept of current deficit is a kind of special-purpose deficit measures.[53] The conventional deficit measures the difference between public investment and public saving. In order to isolate public (dis)saving, the current deficit calculation omits such investment outlays and capital revenues as assets sales; i.e., the current deficit is the difference between non-capital revenues and expenditures. "If we maintained a separate and conceptually correct current and capital account system, the deficit on current account would be the true deficit, (...because) for capital items, any excess of expenditures over receipts on capital account does not change the net asset position of the government, since the new debt is matched by a new government assets."[54]

It is generally accepted that the current expenditure should be fully

53. The special-purpose deficit measure is that policy makers have, from time to time, calculated alternative measures of the deficit, with the aim of highlighting the differential impact of various budgetary transactions on important macro-economic variables. The main types of special-purpose deficits include: the current deficit; the deficit measuring the contribution of different transactions to aggregate demand; the domestic deficit; structural and cyclically adjusted deficits; the primary deficit; and the operational deficit. See, M. I. Blejer and A. Cheasty (1991) "The Measurement of Fiscal Deficits: Analytical and Methodological Issues," Journal of Economic Literature, Vol.XXIX, December, pp.1650. For another relevant discussion of different measurements of fiscal deficit, see, World Bank (1988), *op. cit.*, p.56..

54. M. J. Boskin (et al), (1982), "Federal Government Deficits: Some Myths and Realities," American Economic Review, December, 72(2), pp.296-303.

financed by taxes, whereas, like a private firm, the government can legitimately finance its socially profitable investment by debt.[55] In view of this statement, the Chinese government's deficit financing is very complicated. As there is no division between the current account and capital account in the fiscal budgetary system, the causes of deficits are not clear from the current expenditure or capital expenditure. In such a condition, the uses of both government debt income and borrowing from the central bank cannot be clearly identified. Consequently, the Chinese government cannot carry out a management program prudently in both the fiscal budget and debt repayment.[56]

The composition of the public sector determines the scope and coverage of the public sector that is relevant to economic analysis. The World Bank suggests that PSBR should "consolidate the net borrowing needs of all public sector entities, including public enterprises and the central bank."[57]

55. Blejer and Cheasty (1991), *op. cit.*, pp.1651.

56. It needs to be pointed out here that the Chinese government has decided to separate the current account and capital construction account in the budgetary system. The principle is that the current account has to be kept in balance or with a little surplus to support the capital construction account each year. The capital construction account is principally not allowed to exceed the state plan. If deficits happen, they will be financed by issuing government securities and borrowing from the banking system. But the overdraft from the state bank is prohibited. Such a reform is intended to clearly identify the sources of deficit creation. See, Wan Xinyi (1991), "New State Budgetary System Will Be Carried out in China: Total State Budget to be Divided into Current Account and Capital Construction Account," Renmin Ribao (People's Daily), November, 13, P.1.

57. World Bank, (1989, a), *op. cit.*, p.61. Moreover, there are often unexplained differences between different publications, by different international agencies. This is because each agency has its own interest rates, the Bank of International Settlements (BIS) looks after the central bank, the OECD monitors resource flows from its members, the World Bank takes responsibility for development strategy, and the IMF for problems arising from the balance of payments. The conceptual underpining of each system for data collection is different so the data sets do not dovetail neatly to provide a detailed and timely picture of most analysis. See, World Bank (1984), World Debt

Unfortunately, the data on the size, pattern, cost of the government debt in different countries are not standardized and are not easily compared. The difficulties stem from the question of what debt is "public".[58] The borrowing requirements of the all public sectors are taken into consideration in such countries as Japan, the United Kingdom and Belgium, whereas for Germany and Italy, only those of general government (i.e. excluding public corporation). The PSBR is defined to be that of the central government in the United States, France, Canada and Australia (including central government borrowing on behalf of local governments, which is important , in Canada and Australia).[59] Many countries often exclude some entities due to lack of data.[60]

Actually, the scope of the Chinese government's deficits covers the deficits of the central government, local governments and state enterprises. As noted in Chapter 1, local governments in surplus for most years. As the government still takes responsibility for the state enterprises, the funding of the losses of the state enterprises has been transferred to the state budget. Hence, the scope of the Chinese government's deficit covers the central government itself and the state enterprises.

What is more, as the distinction between the responsibilities of the fiscal and financial/banking system remains blurred in China, the central bank's quasi-fiscal activities are a very significant part of the government's deficits. Generally speaking, the quasi-fiscal activities include the following: the

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Tables: External Debt of Developing Countries, (Washington, D.C.),

58. See, A. A. Tait (1986), "Public Debt Statistics: Some Problems of Definition and Management," In B. P. Herber (ed), Public Finance and Public Debt, pp.60.

59. See, OECD, (1982), Budget Financing and Monetary Control, OECD, Monetary Studies Series.

60. World Bank, (1989, a), *op. cit.*, pp.61.

management of explicit subsidies, debt service and transfers, the provision of preferential credit, the bailout of ailing industrial enterprises, etc. The problem is that great difficulties arise in separating the central bank's monetary activities from its quasi-fiscal activities.[61]

The two most important activities should be considered as the quasi-fiscal activities of the central bank. One prominent quasi-fiscal activity which entails a change in the composition of the central bank's balance sheet is its lending for public policy purposes. An important example is the preferential sector lending, financed by high-power money. This type of loan is very similar to budgetary loans.[62] The second deviation is the losses of the central bank. Some significant central bank deficits are common in LDCs, such as the requirements on central banks to lend without interest or at very low interest rates for policy purposes. Operational losses also arise from the administration of a multiple exchange rate system (which may include an implicit subsidy to preferred buyers) and from currency devaluations when central banks have net foreign exchange liabilities vis-a-vis the domestic sector.[63] Therefore, to prevent measurement biases, central banks' losses should be included in the public sector balance to increase the recorded fiscal deficit.

As will be discussed later, similar quasi-fiscal activities to those outlined above can be mostly found in China's central bank operation. And those quasi-

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61. See, Blejer and Cheasty (1991), *op. cit.*, pp.1661. Notes (35): "Michiel de Kock lists monetary activities, which include currency issues, banking regulation and supervision, the aggregate control of credit, the clearance of balances between banks, and custody of governments reserves. However, clear distinctions may be difficult. For example, bond rediscounting, generally considered a monetary activity, will take on a quasi-fiscal dimension if performed at subsidized rates."

62. See, Blerjer and Cheasty (1991), *op. cit.*, pp.1662, notes (38).

63. Blejer and Cheasty, (1991), *op. cit.*, pp.1663.

fiscal activities also have some effects on China's financial reform through their influence on the monetary policy. It should be noted that the specialized banks in China also perform some fiscal activities. Conventionally, public financial institutions are excluded from the coverage of the public sector and consolidate with the private banking system. However, these institutions often engage in a variety of activities (such as preferential credit allocation, subsidized interest rates, etc.) with a clear fiscal content.[64] Therefore, the same considerations that apply to direct budgetary net lending by the government and to quasi-fiscal lending by the central bank seem to be applicable in China.

The concept of PSBR has not been introduced in China up to now. This means the significance of PSBR has not been recognized by the Chinese government. Therefore, systematic and consistent data are not available. The World Bank has outlined the main data problems of the Chinese government's deficits [see Table 3-13 (1)]. The real size of the Chinese government deficits (consolidated) has been re-estimated by the World Bank, as shown at Table 3-13 (2). The adjusted data indicates that the Chinese government's deficits were about 0.5-5.2% of GNP from 1978-1988. Compared with the official figures (which are also shown in the same table), the adjusted data was far larger (see diagram by Figure 3-3). However, the adjusted figures are still relatively modest if compared with other LDCs, as shown at Table 3-13 (3). China's quasi-fiscal deficits as estimated by the World Bank, together with the fiscal deficits, amounted to 5-6% of GNP during 1978-1988.[65]

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64. Blejer and Cheasty (1991), *op. cit.*, pp.1664.

65. Here, the quasi-fiscal deficits in China are defined by the World Bank as bad loans in the portfolios of state-owned banks and of subsidies to enterprises in the form of low interest rate loans. More widely, the concept of quasi-fiscal deficits means that the state banks are partly used as fiscal agencies, and that fiscal expenditure is underestimated in the published budget to the extent that loans are extended to support ailing enterprises. See, World Bank, (1989, b), *op. cit.*, p.11.

Table 3-13 (1)

Procedure for Adjusting Official Chinese Budget Data

Total Revenue: Chinese Definition

Less: - foreign loan receipts
- domestic loan receipts
- Treasury bonds receipts
- cash from sale of state assets

Plus: - subsidies for living necessities and agricultural inputs
- operating losses of state-owned industrial enterprises

Equals: Total revenue

Total Expenditure: Chinese Definition

less: - foreign loan repayments
- domestic loan repayments
- treasury bonds repayments

Plus: - Subsidies for living necessities and agricultural inputs
- operating losses of state-owned industrial enterprises
- extrabudgetary capital construction
- past surpluses

Equals: Total expenditure

Overall deficit (-): Chinese definition

less: - foreign loans received
- Treasury bonds
- "Key construction bonds" issued
- draw down of past surpluses
- receipts from sale of state assets

plus: - loan repayments (foreign)
- loan repayments (domestic)
- loan repayments (treasury bond)

Adjusted overall deficit (-)

Source: World Bank (1989,a), China's Revenue Mobilization and Tax Policy Issues and Options, (Washington, D.C: the World Bank), Box Table 1-1, p.12.

Table 3-13(2)

China: The Budget and Its Finance

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
					(In billion yuan)						
Revenue	123.3	126.3	131.6	138.6	141.2	159.4	183.5	228.3	244.3	255.7	281.4
Expenditure	122.5	146.9	146.2	144.4	148.3	169.0	193.9	232.4	262.2	281.4	315.6
Deficit	0.8	-20.6	-14.6	-5.8	-7.1	-9.6	-10.5	-4.1	-17.9	-25.7	-34.2
(Official figures)*	1.2	-17.1	-12.8	-2.6	-2.9	-4.4	-4.5	+2.2	-7.1	-8.0	-7.9
					(As % of Total Deficit)**						
Financing:											
Domestic:	125.0	82.5	84.9	44.8	102.8	88.5	82.9	97.6	70.4	75.5	72.9
(PBC)	125.0	82.5	84.9	-39.7	40.8	44.8	42.9	51.2	39.7	37.0	26.1
(Bank/nonbank)	-	--	--	84.5	62.0	43.8	40.0	148.8	30.7	38.5	46.7
Foreign	-25.0	17.5	15.1	55.2	-2.8	4.3	4.5	--	7.0	9.6	7.8

Source: World Bank (1989,a), China's Revenue Mobilization and Tax Policy Issues and Options, (Washington, D.C: the World Bank), Table 1-6, p.9

* China Finance Statistics (1950-1988), p.149.
** Totals may not add up to sum of components because of rounding.

Table 3-13 (3)

International Comparisons of Government Deficits

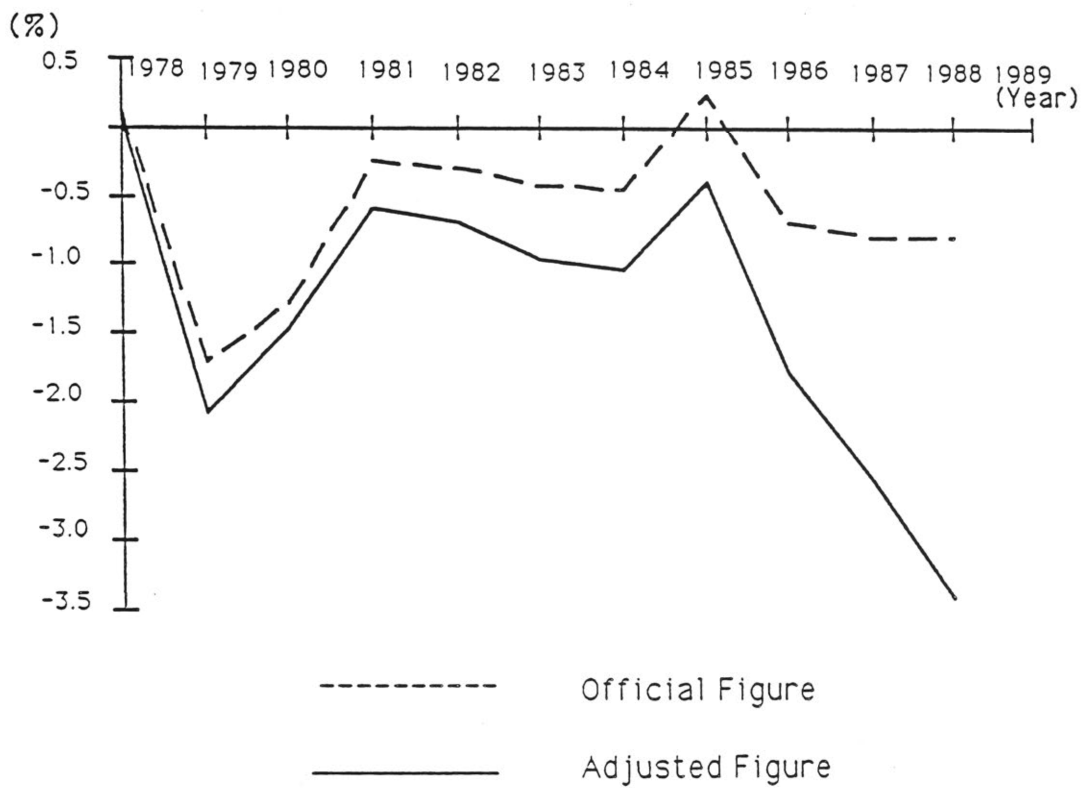
Country Group	Per Capita Income ($)	Expenditure/ GNP (%)	Revenue/ GNP (%)	Deficit/ GNP (%)
China (1978)	230	34.0	34.0	+0.2
China (1988)	320	22.0	19.8	-2.2
Low income countries	270	20.8	15.4	-5.1
Middle income countries	1,510	27.5	24.0	-5.8
Industrial countries	10,760	28.6	24.1	-5.1
Other socialist countries	2,000	65.0	62.0	-3.0

Note: For all country groups listed, data refer to central government revenue and expenditure only; for China: Consolidated central and provincial revenue and expenditure on a GFS basis. Figures for socialist countries are unweighted averages and not strictly comparable.

Source: World Bank (1989,a), China's Revenue Mobilization and Tax Policy Issues and Options, (Washington, D.C: the World Bank), Table 1-2, p.6.

Figure 3-3

Comparison Between the Chinese Official Figures and the World Bank Adjusted Figures of the Chinese Governemt Budget Deficit from 1978 to 1988



Source: Table 3-13 (2)

The impact of the government's deficit and government borrowing on the macro-economy depends, among many factors, on how the deficit is financed. Although the relative size of the Chinese government's official or re-estimated deficit is not so large, it has a major effect on the country's financial reform in the context of the development of financial institutions, financial instruments and financial market. The major effect is mainly from the fact that the Chinese government has adopted some inappropriate methods in financing the deficit, which will be discussed in the following chapters.

3.6 Conclusions

This chapter has examined three questions: the significance of the China's financial/banking system reform; the importance of separation of the function of fiscal and bank in financial reform; and the potential problems of the government deficit on the financial reform.

The significance of financial reform in China has been discussed in the context of the economic reform. The conclusion is that decentralized decision-making and the process of marketization require the financial/banking system to play a more effective role in financial resource allocation and macro-economic management. The discussion also indicates that the state enterprises reform, which is the core of the urban reform, has not been so successful. Low efficiency and "eating from the big rice bowl" in raw material and fund supply are still characteristics of state enterprises. Hence, the incomplete economic reform poses some obstacles to the efficient implementation of the financial reform.

A review of the system of centralized financial resource allocation in the pre-reform period provides a basis for understanding why separating the functions of the state budget from the state bank is a main task in the financial reform. It can be seen that the system of fiscal domination in financial resource allocation complies with the centrally planned economy, to support the government's economic development strategy which focused on heavy industries. The state bank acted as a fiscal agent rather than a financial intermediary. Therefore, there was no real distinction between the financial flows from the state budget and the state bank.

The role of the financial/banking system is promoted through restructuring the banking system, increasing the investment share in national income, and expanding the scope of financial business. However, although the process of decentralization has begun with the economic reform and central planning has been weakened, the conditions for ensuring an effective financial reform and avoiding government intervention have not been fully established. Absence of a capital market leads to the banking system has to undertake all financing responsibilities of the central government, state enterprises and even the local governments.

Among many obstacles, government borrowing has become a key factor determining the effectiveness of Chine's financial reform. The emerging pattern in the trends of fiscal revenue and expenditure has some implications for China's financial reform. Firstly, the failure to raise revenue is caused by an unsuccessful tax system. The "contract system" between the government and enterprises has narrowed the tax base. Hence, the government has to make some efforts to widen the tax base to generate more revenue. However, the Chinese government believes that raising the tax rate of enterprises will cause too many negative results for the economic reform, so that raising sufficient fiscal revenue is not an easy task in a short time unless personal income tax and indirect taxes are introduced. Second, direct budgetary subsidies to loss-making enterprises have substantially contributed to the central government's deficits. Reducing this part of spending depends on the price reform which is processing gradually. Third, the expanding share of administrative spending has also contributed to the great expenditure of the state budget. Hence, to eliminate the fiscal deficit is also not an easy task for the Chinese government in a short period. Beset by the above problems, the government still has to rely on its intervention in the banking system's operation to support the distorted economic activities.

Chapter 4

The Chinese Government Market Borrowing Activities

4.1 Introduction

The significance of the development of financial market in meeting the objective of both financial and economic reforms has been increasingly recognized by the Chinese decision-makers and economists. Some steps have been taken to develop financial markets to assist the banking system to allocate financial resources efficiently. For this purpose, a variety of financial instruments have been introduced. The terms and maturities of those instruments should in theory be in accordance with the different needs of individuals, financial institutions and enterprises. A short-term interbank money market was established to enhance the liquidity of the banking system. It is expected by PBC that the development of secondary markets in government securities and other financial instruments will enable it to use indirect monetary policy instruments.

In the initial stage of the financial market development, Chinese government securities, especially Treasury Bonds, have accounted for a large proportion in both the first issue market and the secondary market. This was because of a great increase in the government's borrowing requirements, and also because the Chinese government adopted some administrative methods in its "market" borrowing. The Chinese government has also issued other financial instruments to raise funds, including quasi-bonds and government agent bonds. The issue of government financial securities has continued for the last ten years, however, a well-functioning government securities market has still not been established.

As discussed in theoretical studies, government's deficits financed by market borrowing may create some positive impacts on financial reform, by promoting capital market development through encouraging people to hold and trade government securities, and establishing a base for central banks' open market operations. However, if inappropriate borrowing methods are employed, a segmented capital market will be created and financial reform will be retarded. In other circumstances, the "crowding out" effect may also occur and deter private investment. The quantity and quality of saving and investment will be reduced on a national scale.

In the light of above-mentioned issues, the Chinese government's main "market" borrowing activities are investigated in the following discussion. A well-functioning capital market should consist of a primary market for new debt issues, and a secondary market for trading in the debt instruments. The prices in the two markets should be determined by the interaction of supply and demand. Based on this principle, the discussion of the Chinese government market borrowing activities will focus on three aspects: market supply, market demand and market price. The black market in Treasury bonds is also discussed as a case study to illustrate inappropriate government polices in market borrowing activities.

4.2 Primary Market for Treasury Bonds

The primary market, or the issue market, is the market for mobilizing fresh capital. The traditional way of issuing government securities to the public in Western countries, is that the bonds are usually sold through the discount houses or underwritten by banks and/or investment banks. The issuing amounts, or the price, will be determined by those institutions in response to a competitive market situation. Therefore, the price of government securities is in fact determined by both supply and demand in market. The activities of Chinese government market borrowing in the primary market will be examined, in light of this principle.

4.2.1 Supply and Demand in the Primary Market

As a result of the build-up of large budget deficits since 1979, the Chinese government began to issue Treasury bonds to finance its deficit in 1981. No government securities had been issued in China for about two decades. Hence, Treasury bonds were the first financial market instrument to be issued after the economic reform. This meant that a financial market was non-existent when the Treasury bonds were issued. To ensure its efficient borrowing from the market, the Chinese government should have established an organized government securities market within a short time. The problem is that having chosen the market-oriented option to finance its deficits, in practice, the Chinese government does not stop using administrative methods to determine the market's supply, demand, and price.

1. Supply of Treasury Bonds

In China, the issue amount of Treasury bonds is determined by the Ministry of Finance (MOF). With the MOF, a special agency called the Department of State Debt Management, is set up to manage the issuing of

Treasury bonds. Each year, a plan is made by the MOF to determine the issue amount and the price of the bonds according to the needs arising from balancing state budget and the estimated financial capacity of bond holders.[1] The plan is subject to further examination and approval by the State Council. The actual issuing of Treasury bonds is carried out by the banking system. The Beijing headquarters of the PBC prints the bonds and distributes them to it's provincial headquarters. In each province, PBC distributes bonds to the specialized banks which act as selling and distribution agents.

Table 4-1 illustrates the issuing of government Treasury bonds in broad terms, including issue amount, the term, the interest rate, and the type of holders of Treasury bonds. In terms of the issued amount of Treasury bonds in each year, between 4 and 5 billion yuan's worth of Treasury bonds were issued each year during 1981-84. The volume rose from 6 billion yuan in the three years from 1985 to 1987 and 9.0 billion in 1988. The issued amount decreased to 5.5 billion in 1989 and 1990. The decline in the issue amount of Treasury bonds did not mean a decline in the financing requirements of the Chinese government. It was simply the result of an increase in the issuing of other government securities (which will be discussed in Section 4.4).

The Chinese government, as noted in Chapter 3, has included debt income from the sale of Treasury bonds as a part of fiscal revenues. Column (3) of Table 4-2 presents the ratios of newly issued Chinese government Treasury bonds to the total of consolidated budget revenues, it can be seen the ratios were about 1.86-4.22% during 1981-89. The ratios cannot be considered to be high. Therefore, the Chinese government still has great potential to raise

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1. "Regulations on Treasury Bonds of 1981 of the People's Republic of China," in Zhang Xie (eds), Collection of Law and Regulation of Securities, (Beijing: China's Financial Publishing House, 1989).

Table 4-1

General Situation of the Primary Market of China's Treasury Bonds

(Billion Yuan)

Year	(1) Planned Issue	(2) Actual Issued	(3) Term (Years)	(4) Interest Rates (%)		(5) Amount Subscribed		(6) Composition of Holders (%)		(7) Net Outstanding Balance
				(A)[a]	(B)[b]	(A)	(B)	(A)	(B)	
1981	4.0	4.87	10	4	4	4.86	0.10	99.8	0.20	4.87
1982	4.0	4.38	10	4	8	2.41	1.97	55.0	45.0	9.25
1983	4.0	4.16	10	4	8	2.10	2.06	50.5	49.5	13.41
1984	4.0	4.22	10	4	8	2.05	2.21	48.1	51.9	17.60
1985[c]	6.0	6.06	5	5	9	2.18	3.88	36.0	64.0	23.72
1986	6.0	6.17	5	6	10	2.29	3.96	36.0	63.4	29.00
1987	6.0	6.31	5	6	10	2.26	4.03	39.5	64.1	34.22
1988[d]	9.0	9.22	3	6	10	3.49	5.72	37.8	62.2	41.24
1989	5.0	5.61	3	0	14	0.00	5.61	0.0	100.0	45.54
1990[e]	5.5	N	3	0	14	0.00	5.50	0.0	100.0	48.49

Sources: China's Finance Statistics 1950-1988, p.192-194.
Almanac of China's Finance and Banking 1990.
"Reference of Economic Research" 1987, Vol.193.

a. Units buyer, including enterprises, public institutions, army, local government;
b. Individual buyer, including workers, staff, farmers and individual business;
c. In 1985, the government announced that the bonds bought by the enterprises could be used as collateral for applying bank loans.
d. In 1988, bonds issued in 1985 and 1986 were allowed to be traded at the secondary market in some cities.
e. The figure of 1990, see, "Regulation on Treasury Bonds and Special Treasury Bonds 1990," Jinrong Shibao (Financial News), 9 June, 1990, p.1.

Table 4-2

<u>The Size of Annual Treasury Bond Issue in China</u>

(Billion Yuan)

Year	(1) Consolidated Budgetary Revenue	(2) Treasury Bonds Issued	(3) (2) as % of (1)	(4) Consolidated Budgetary Tax Income	(5) (2) as % of (4)
1981	108.95	4.87	4.47	62.99	7.73
1982	112.40	4.38	3.90	70.00	6.26
1983	124.90	4.16	3.33	77.56	5.36
1984	150.19	4.22	2.81	94.74	4.45
1985	186.64	6.06	3.25	204.08	2.97
1986	226.03	6.17	2.73	209.07	2.95
1987	236.89	6.31	2.66	214.04	5.89
1988	262.80	9.22	3.51	239.05	3.86
1989	291.92	5.00	1.71	273.06	1.83
1990	331.26	5.50	1.66	282.18	1.95

Sources: Col.(1)-from <u>Statistical Yearbook of China 1991</u>, p.209-212
Col.(2)-Table 4-1
Col.(3)-computed from Col.(1) and Col.(2)
Col.(4)-from <u>Statistical Yearbook of China 1990</u>, p.232
Col.(5)-computed from Col.(2) and Col.(4)

the ratio of market borrowing. Table 4-2 also compares the annual Treasury bond income and the annual tax revenue income. It is clear that the income from Treasury bonds only accounted for 3-7% of the total taxation revenues. It may also suggest that if the government had made greater efforts in its tax system reform, the revenues from issuing of Treasury bond might not have been necessary.

The government's market borrowing has already exerted some influence on the shape of China's financial reform and financial market development. The issuing of Treasury bonds has brought new investment instruments in China where previously bank deposits was the only option for more than two decades. The issuing of long-term Treasury bonds marks the beginning of the development of a long-term capital market. Lack of short-term bonds, however, fails to provide the precondition for the central bank to conduct open market operations. This reflects the fact that when the government started to issue Treasury bonds, the aim and purpose of the government was to finance its deficits and spending. The government did not bother to introduce open market operations as an indirect monetary policy instruments in its initial progress Hence, to assist the financial reform, the issuing of short-term Treasury bonds (less than one year) is necessary in China. So far, short-term treasury bonds have not been issued in China. One reason was that the work of issuing Treasury bonds is still carried out by the banking system, hence, it may be a greater burden to banking system operations when short-term bonds are issued.

2. Demand for Treasury Bonds

In LDCs, one of the common problems in the development of securities markets is the lack of market demand due to the low income of investors. As discussed in Chapter 3, the decentralized allocation of financial resources has created new patterns of saving and investment in China. The state enterprises, public organizations, financial institutions and individuals have, in varying degrees, acquired financial autonomy and self-determined resources. Hence, investment classes have come into being, which paves the way for the development of capital market in China. China's key question is how to mobilize those funds more efficiently.

Like the supply of Treasury bonds, the demand for Treasury bonds was also administered by the government in the primary market. Buyers of Treasury bonds are under two categories: one is "units (Dan Wei)" including enterprises, public organizations, local governments, army and universities. Another is "the individuals (Ge Ren)" which consists of the staff members, workers, farmers and private entrepreneurs. Due to the fact that the issue amount and issuing price were both determined by supply considerations, the government adopted a system of allocating compulsory quotas to each buyer. In the first year (1981), all Treasury Bonds were allocated to public institutions, enterprises and local governments.[2] The quota given to each enterprise was supposedly based on after-tax profits of the enterprises. To each public organization, army unit and university, the quota was allocated according to their budget. The same principle was adhered to in these units in the years that followed.

From in 1982, individuals were 'encouraged' to subscribe Treasury bonds. The quotas, which were firstly allocated to each enterprise, organization and university varied with the total amount of wages of each unit. These quotas were sub-divided to each person. The "purchase " of bonds was sometimes made by directly docking a person's wages. It should be noted that

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2. Actually, about 1% Treasury bonds was bought by individuals in the first year. The reason is not clear.

the fulfillment of quota subscription was treated as a political task. The campaign for bond subscription was repeated almost every year despite the growing resentment of buyers. In consequence, buyers were fed up with compulsory purchase of government bonds year after year.

The annual amounts subscribed by the two categories of bond buyers are also shown at Table 4-1. The total cumulative amounts sold to the units were 21.64 billion yuan during 1981-88, which was about 38.18% of the total issue in that period. The shares of individuals accounted for about 61.82%. In 1989 and 1990, the new issues of Treasury bonds were all allocated to individual buyers. The trends between the two categories of buyers are shown in Figure 4-1. However, such an investment structure of the Treasury bonds was artificially created by government allocation. It fails to indicate the real trends of the public's desire in financial investment in China.

How much of the holders' income went to the purchase of the bonds? Data in Table 4-3 indicates that the investment shares in Treasury bonds were very low in the total income of the individuals and state enterprises. Further, considering the growth rates of saving deposits of individuals, the growth rate of buying Treasury bonds was rather low. It was reported that there was about 54-billion-yuan cash held in individuals' hands, which had not any particular purpose to spend in 1988.[3] (The total amount of Treasury bonds issued in 1988 was 6 billion yuan). Hence, it was possible for the Chinese government to raise further the market borrowing amount to finance its deficits.

Apart from raising funds to finance the fiscal spending, the issuing of

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3. Yang Qiguang (1989), "Correspondence on Circulation of Huge Amount of Money Outside Banks," Jinrong Shibao (Financial News), 22 February, p.1.

Table 4-3

The Share of Treasury Bonds Purchase in the Investors' Income In China (%)

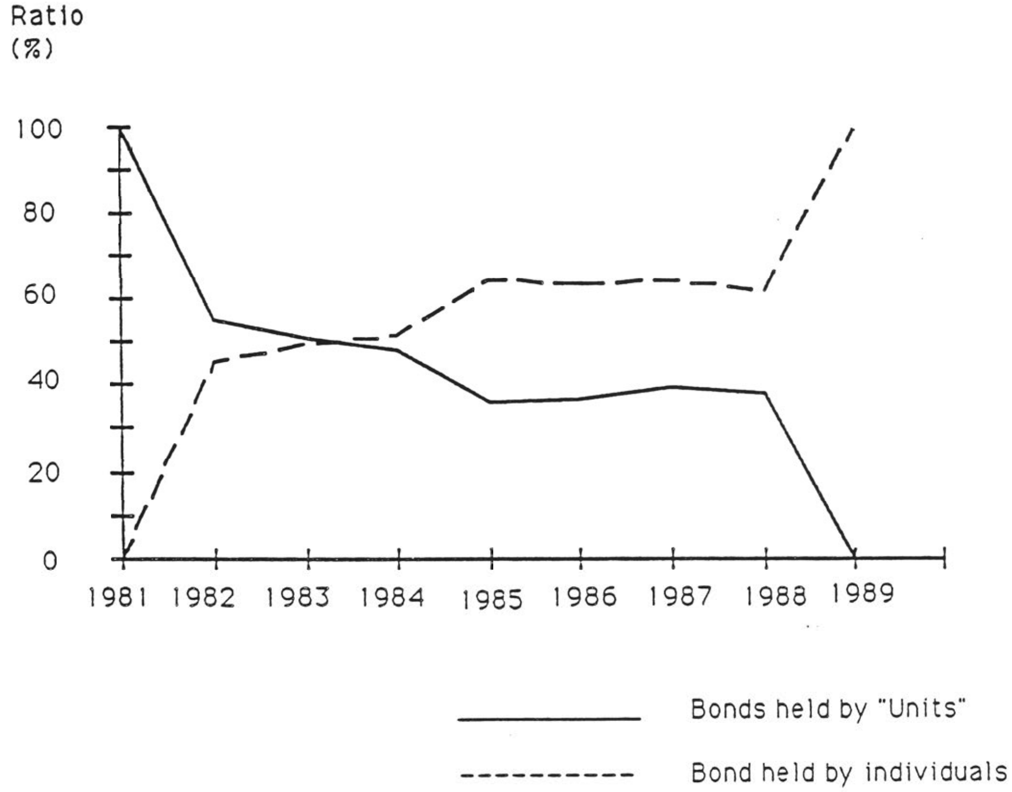
Year	Annual Issue Amount of Bonds (Billion yuan)	Bonds Bought by Staff & Workers as % of Their Total Annual Income (%)	Bonds Bought by Farmers as % of Their Annual Total Income (%)	Bonds Bought by Enterprises as % of Their Annual Total Retaining Profits (%)	Bonds Bought by Staff, Workers and Farmers/Net Growth of Saving Deposts*
1981-85	4	1.20	1.00	2.90	N
1988	6	1.85	1.00	1.50	9.00/100

Source: Zhao lihua (1990) "The Situation of Treasury Bonds of Repayment Peak and Some Related Measures," Caijing Wenti Yanjiu, (Financial and Economic Problem Research), No.1; Almanac of China's Finance and Banking, p.210.

* See, Col.(5) of Table 4-1; Almanac of China's Finance and Banking 1990, pp.53.

Figure 4-1

Composition of Holders of Treasury Bonds in the Primary Issue Market



Source: Table 4-1

Treasury bonds by the government had another implied objective, i.e. to reduce the expansion of social aggregate demand. The bonds sold to state enterprises and public organizations had the potential of reducing those units' discretionary purchasing power in the form of extra-budgetary funds so that the central government can concentrate investment funds on the planned key projects and state enterprises. The mandatory allocation of Treasury bonds has helped the government obtain the financial resources. However, whether the secondary objective was achieved needs to be examined further.

According to Chinese government regulations, all enterprises have to use their retained profits to purchase bonds. In reality, there were two kinds of funds that could be used by state enterprises to buy Treasury bonds. One was state enterprises' retained profits. Another was working capital. Working capital includes both the enterprises' own funds and working capital loaned by state banks. As discussed in Chapter 3, the retained profits of state enterprises were generally channelled to basic construction and workers bonuses. In reality, many enterprises used their working capital to buy bonds. No matter which part of working capital funds was used by state enterprises to buy bonds, the result was that the working capital available for production was reduced. Consequently, the government could not achieve the secondary objective as extra-budgetary funds of state enterprises were not used to buy Treasury bonds. Moreover, the reduced working capital of state enterprises had caused the state bank to expand loan to enterprises. Otherwise, the state enterprises could not have kept up their development and production targets with the reduced working capital. There are neither precise data to indicate how much working capital loans or working capital of state enterprises were used to buy Treasury bonds, nor how much bank loans were thus expanded. The influence caused by such enterprise activities on banking system operations will be further discussed in Chapter 5.

By the compulsory methods, the Chinese government has also raised funds from the individuals. However, it is unclear whether buying bonds has reduced the individuals' social aggregate demand. In reality, two kinds of funds could be used by individuals: one was the bank deposits, another was the cash in hand. The problem is that the saving function and money (cash) demand function of Chinese households could not be told. The term-deposit, to some extend, can be withdrawn before maturity. Hence, there may be no difference between the bank deposits and cash. Due to the fact that the bonds were bought by deducting from the person's wages, it may be assumed that buying Treasury bonds has reduced the aggregate demand of the individuals in this period. The purchasing amount of individuals was relative small compared with their incomes (see Table 4-3), hence, the amount of individual investment in Treasury bonds was not very significantly in reducing the total social aggregate demand

4.2.2 Interest Rate in the Primary Market

The situation of the supply and demand for Treasury bonds discussed above has indicated that interest rates of Treasury bonds could not be determined from the interaction between supply and demand in the primary market. The interest rates of Treasury bonds were in fact set administratively by the Chinese government. Based on the data of Table 4-4, the characteristics of interest rate in the primary Treasury bonds market can be summarized as follows:

1) Bonds sold to the enterprises were at lower interest rates than those sold to the individuals.

2) The interest rates of the bonds bought by the individuals were lower

Table 4-4

Chinese Treasury Bonds: Interest Rate Structure

Year		1981	1982	1983	1984	1985	1986	1987	1988	1989
Term (Year)		6-8	6-10	6-10	6-10	5	5	5	3	3
The Nominal Interest Rate of Bonds (%)	(A)	4	4	4	4	5	6	6	6	0
	(B)	4	8	8	8	9	10	10	10	14
The Nominal Interest Rates of Term Deposits* (Same Term as Bonds)		9	9	9	9	9.36	9.36	9.36	9.36	13.14
Annual Growth Rate of Consume Price Index		2.4	1.9	1.5	2.8	8.8	6.0	7.3	18.5	17.8
The Real Interest Rates of Bonds (%)	(A)	1.6	2.1	2.5	1.2	3.8	0.0	-1.3	-12.5	0.0
	(B)	1.6	6.1	6.5	5.2	0.2	4.0	2.7	-8.5	-3.8

Sources: Almanac of China's Finance and Banking, 1987, 1988, 1989, 1990; Statistical Yearbook of China 1990, p.249.

* the nominal interest rates of term deposits are based on annual interest rate of deposits of four specialized banks.

(A). Units
(B). Individuals.

than the interest rates of the banks' term deposit for the same period during 1981-86.

3) There has been an upward trend in the nominal interest rates of Treasury bonds. However, the trend for real interest rates has in fact come down, because the growth rate of interest rates of Treasury bonds was still lower than that of inflation.

4) The interest rates did not correspond to the term risk. The longer the terms of bonds, the lower the interest rates of bonds.

5) Bonds interest rates were calculated by using the simple interest method, which made the effective interest yield at maturity lower than the quoted interest rate. For example, 100 yuan bond at a simple interest rate of 10% for 5 years will yield a total interest payment of 50 yuan at the end of five years, corresponding only to a compound interest rate of 8.45%.

Therefore, it can be said that the interest rate of Treasury bonds was highly distorted in the primary market in China. Without money illusion, the distorted price cannot attract investors to buy the Treasury bonds. As a result, the effectiveness and efficiency in raising funds from that market were affected adversely. Furthermore, a market price was not created to generate a well-functioning capital market in China.

The problems of mandatory allocation and artificial interest rates in the primary market were gradually recognized by the Chinese government. To make Treasury bonds more appealing, the Chinese government has, since 1985, adopted the following remedial policies:

1) reducing the holding period of treasury bonds from 10 years to 5 years, and then to 3 years in 1988 (See Table 4-1);

2) raising the interest rates of Treasury bonds to be higher than the rate of term deposits from 1987 (see Table 4-4);

Table 4-5

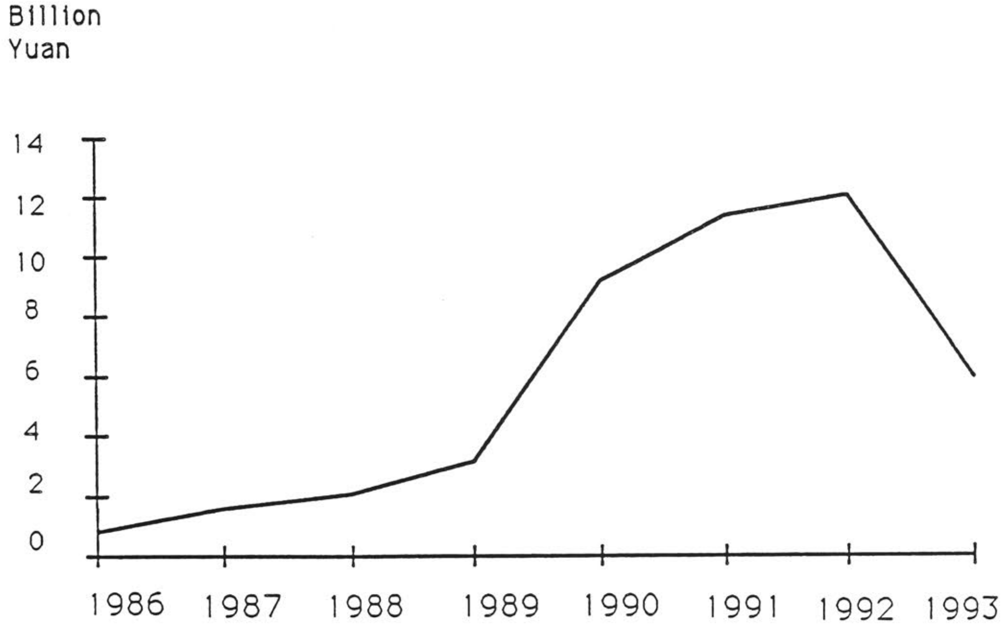
1986-93' Debt Repayment Situation of Treasury Bonds

(1) Redemption Method	(2) Date of Issue	(3) Term (Years)	(4) Issue Amount (Billion yuan)	(5) The Time of Repayment of Each Bonds	(6) Repay Amounts of Each Years (Billion yuan)
Redemption Starts at the Sixth of the ten year, 20% principle with interest will be paid	1981	10	4	1986,87,88,89,90	
	1982	10	4	1987,88,89,90,91	
	1983	10	4	1988,89,90,91,92	
	1984	10	4	1989,90,91,92,93	
The sixth year redemption, all with interest.	1985	5	6	1990	
	1986	5	6	1991	0.80
	1987	5	6	1992	1.60
The third year redemption, all with interest	1988	3	9	1991	2.04
Redemption all in the third Year	1989	3	5.0	1992	3.20
	1990	3	5.5	1993	9.20
	1991				11.40
	1992				12.06
	1993				6.03

Sources: Table 4-1, and various issues.

Figure 4-2

Treasury Bond Repayment in China
(Principal and Interest) During 1986-1993



Source: Table 4-5.

3) making bonds eligible as collateral securities for enterprises to apply for bank loans. The individuals could also discount their bonds at banks.[4]

4) Indexed-bonds were issued in September 1989. The interest rates of indexed bonds was offered at a 1% point premium over the rates of three-year term deposits offered by the specialized banks at similar maturity.[5]

Unfortunately, the above measures have not brought about significant changes in the issuing of government bonds. The main reason was that the remedial policies were still totally subject to supply considerations. The demand side had no say in the determination of the issued amounts and the prices of Treasury bonds. As the government had no clear policy to guide its borrowing activities, the new measures also created some problems. The gradual shortening of maturities of bonds created a repayment peak for the government during 1990-93 as shown at Table 4-5 and in Figure 4-2. Such a result should plunge the government into a financial plight. In 1990, the Chinese government rolled over redemption on all bonds held by enterprises, which totalled up to around 12.5 billion yuan. The government has not declared when the bonds will be refunded.[6] The bonds held by individuals, as the government promised, were all redeemed. Hence, the debt repayment has become one crucial problem faced by the Chinese government in economic reform in recent years.

It should be mentioned that a significant reform measure in Treasury

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4. "Regulations of PBC for Treasury Bonds in 1985,", in Zhang Xie (eds), (1989), *op. cit.*, p.15.

5. See, "Circulation for the Issuing of Value-guarantee Bond of 1989," Almanac of China's Finance and Banking 1990, p.450.

6. Tai Ming Cheung (1991), "Coy Capitalists: Peking Inches Closer to Reform of Financial System," Far Eastern Economic Review, 9 May. pp.42-43.

bonds issue was announced in late April 1991. The MOF is, for the first time, allowing a financial syndicate to underwrite a part of the bonds issued. A syndicate consisting of 58 financial institutions has contracted with the MOF to underwrite one-third of Treasury bonds issued in 1991. The amount underwritten was 2.5 billion yuan.[7] A team of 58 underwriters is being led by the Trust & Investment Company of Industrial and Commercial Bank of China, including members such as China International and Investment Cooperation and China Everbright International Trust and Investment Cooperation.[8] This experimental reform will exert considerable impacts on the government's market borrowing and financial reform. It seems that the mandatory allocation is planned to be gradually replaced by market-oriented approach. However, whether the underwriting method can be developed, and whether market prices can be created from the underwriting method, depends mainly on how much the government is willing to reduce its intervention in market development. Appropriate government policy here is very important. For instance, the government can help the market establish necessary law and legal framework, so as to ensure the stability of macro-economy.

4.3 Secondary Market for Treasury Bonds

The secondary market is where securities are traded after they are issued in the primary market. "The main social purpose of the secondary market is to make new issues easier, by providing liquidity for the new shares, by providing information on the appropriate prices, and by reducing

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7. Yan Jianjun (1991), " The First Experiment in Underwriting Treasury Bonds", Renmin Ribao (People's Daily), 21 April, p.2.

8. The Asian Wall Street Journal (1991), "Beijing to Issue 55% More Bonds in 1991: Premium Rate to Be Paid", June 28-29.

transaction costs."[9] It is widely accepted that raising long-term funds through stock and bond issues is likely to be constrained by the absence of a secondary market in many LDCs.[10] The same situation can be found in China.

4.3.1 Trading Activities, Prices and Related Problems

The issuing of Chinese government bonds started again in 1981. However, the secondary market was only officially allowed to operate in 1988. Hence, there was a long time lag between establishing the primary market and the secondary market in China. As a result, the liquidity of Treasury bonds was quite limited during this period of time. Only one-fifth of the bonds issued in 1981 were redeemable from the bank in 1985. After 1985, the government announced that bonds bought by the enterprises could be used as a collateral to apply for bank loans from state banks. Other trading activities were not allowed.

1. Developing Trade Activities

In April 1988, the State Council declared a new policy that permitted Treasury bonds held by individuals to be traded in the secondary market. Trading was initially permitted in seven cities as an experiment and only bonds issued in 1985 and 1986 could be traded.[11] The trading activities were soon extended to 63 cities in June 1988. A certain amount of bonds issued in other

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9. Wai & Patrick, (1973), *op. cit.*, p.284.

10. See the discussion in this areas, for example, Wai and Patrick (1973), *op. cit.;* Drake (1977), *op. cit.;* Drake, (1986), *op. cit.;* Calamanti (1983), *op. cit.;* Kitchen (1986), *op. cit.*

11. The seven cities were Shanghai, Shenyang, Wuhan, Chongqing, Guangzhou, Shenzhen and Harbin.

years were also traded in those cities, though officially discouraged. Therefore, the secondary Treasury bond market has begun to develop in China.

Bond trading has gradually boomed in Shanghai, Shenyang and Shenzhen after April 1988. Among them, Shanghai's market is especially active.[12] The sum total of transactions in Shanghai reached 0.76 billion yuan in 1989. It accounted for 36.4% of the total trading volume in the whole country.[13] Seven securities companies post bid and offer prices on the bonds issued in 1985 and 1986. 16 urban credit cooperatives in Shanghai are involved as brokers. The prices in Shanghai trading markets gradually came to act as a guide to the other cities.[14]

By the middle of 1991, about 300 cities had established secondary Treasury bonds markets in China.[15] Thirty four securities companies and 800 agents functioned as trading intermediaries.[16] All trading intermediaries have to be approved by the PBC and PBC's branch in the local cities. The approved trading intermediaries are issued a Licence for Operation in Financial Business.[17] Among those agents, more than 300 belong to the four specialized banks. So far, the NBFIs, such as financial companies and insurance companies, have been denied a role in the secondary market in China. Hence,

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12. Xu Zhihe and Xu Jianzhong (1988), "On Form and Development of Shanghai Financial Market", ShiJie Jingji Daobao (World Economic Herald) 10 October; Wang Shihao (1989), "A leading Shanghai Treasury Bond Market," Jinrong Shichang (Financial Market), Vol.1, pp.13.

13. Wang Shihao (1990), "From Infant to Maturity: Shanghai Securities Market Activities", Zhongguo Jinrong (China's Finance), Vol.10

14. Elizabeth Chang (1990), "Counters' Revolution: Chinese Capital Markets Back on Track," Far Eastern Economic Review, 26 July.

15. Until 1990, there were about 500 cities in China. See, China's Statistics Yearbook 1990.

16. Li Jianxin (1991), *op. cit.*, P.1.

17. Wang Guangqian (1991), *op. cit.*, pp.205.

Table 4-6

Trading of Treasury Bonds in the First Thirteen Days in Seven Cities (1988, April)

(In Billion Yuan)

Days	The Total amounts Bought by Trading Intermediaries	The Total amounts Sold by Trading Intermediaries as Percent of Buying
First	23.03	5.2%
Tenth	57.23	12.3%
Twentieth	96.21	24.0%
Thirtieth	1550.00	29.0%

Source: Lian Weidong (1988), "Summary of Situation of Treasury Bonds Market in Its Beginning," Jinrong Shichang (Financial Market), Vol.1, No.1, pp.28.

Table 4-7

The Situation of Securities Trading at the End of 1988 (31 Dec.)

(Million Yuan)

	(1) Treasury Bonds		(2) Basic Construction Bonds		(3) Bank Bonds		(4) Enterprises Bonds	
	Sales	Stock	Sales	Stock	Sales	Stock	Sales	Stock
Whole Country	767.37	717.05	8.75	13.75	22.43	22.25	37.95	27.34
Haerbin	36.70	47.14	Zero	Zero	Zero	Zero	1.07	0.61
Shenyang	141.38	83.43	1.65	1.89	1.54	3.46	8.07	1.58
Wuhan	30.83	37.71	Zero	Zero	0.23	0.01	0.84	0.03

Source: Almanac of China's Finance and Banking 1989, p.48.

Sales: the total amount of bonds sold by intermediaries at 31, December.

Stock: balance of stock held at 31, December by intermediaries.

market entry is still quite limited in China's financial market.

2. Price in the Secondary Market

An active secondary market depends on whether a) the bonds are issued at market prices or below market prices; b) the government redeems the bonds at any time; and c) interest rates are allowed to fluctuate, thus affecting bond prices.[18] The price of the secondary market features prominently in all these questions.

Initially, the trading prices in China, as well as the trading volumes and marketplace, were determined administratively in the secondary Treasury bonds market. As a result, an unbalanced market situation occurred. The trading situation of the Treasury bonds in the first thirty days in seven cities is shown in Table 4-6. It demonstrates that intended selling of the bonds was much larger than buying in the secondary market at the beginning. The same situation is also found in the other 54 cities.[19] At the end of 1988, about half of the Treasury bonds were held by those trading intermediaries as shown at Table 4-7. Hence, some trading intermediaries sometimes had to stop buy any bonds due to a large amount of unsold bonds.

The above mentioned situation results partly from the compulsory allocation of Treasury bonds in the primary market. However, the administratively-determined price was the main cause. In the secondary market, the basic prices were decided by consultations between the PBC and

18. Agtamel (1984), *op. cit.*, p.51.

19. Zhang Huangyu and Li Qin (1988), "What Has Been Indicated by 'Sellers More than Buyers' in the Secondary Treasury Bonds Markets in the First Experiment Month," Jinrong Shibao (Financial News), 27 May, p.1.

MOF based on the policy that none of the trading prices could be lower than that of the par value.[20] This policy was made for preventing the trade price from dropping by a large degree at the beginning. However, with such a policy, the selling of Treasury bonds boomed while buying slumped. Hence, some Treasury Bonds were held by the trade intermediaries. It can be seen from Table 4-8 that the amount of bonds held by the individuals and enterprises in the secondary markets become smaller than that in the primary market. Because the individuals and enterprises sold rather than bought their bonds in the secondary markets. As pointed out above, the government intended to redistribute financial resources by requiring the state enterprises and individuals to buy Treasury bonds. However, this attempt has been weakened by the changed pattern of debt holder in the secondary markets. The main debt holders were shifted to the trading intermediaries in the secondary markets.[21]

According to <u>The Interim Regulations of Bank Control</u>, the PBC is the supervisory authority of the country's securities markets. The PBC plans and regulates the issuing and trading of securities. Currently, the prices of Treasury bonds at the secondary markets are determined by the PBC. The PBC gave reference base prices and set limitations to intermediaries on the difference between buying and selling prices. The difference is usually 1.5-2.0%. As shown in Table 4-9, the prices in 14 cities are quite close and the difference between selling and buying prices is 2.0% in all of them.

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20. Lian Weidong (1988), "Summary of the Situation of Treasury Bonds Market in Its Beginning,", <u>Jinrong Shichang</u> (Financial Market), Vol.1.

21. Some trade intermediaries are sub-branches of the four specialized banks. When these intermediaries hold a large amount of Treasury bonds in hand, it may bring some effects on the banks' credit funds. However, there is not any information to relevant to this subject.

Table 4-8

The Structure of Holders in Primary and Secondary Market In 1988

(In Percent)

Holders	Treasury Bonds		Total Securities	
	Primary	Secondary	Primary	Secondary
Individuals	52.6	50.96	81.9	50.5
Units	47.4		18.1	
Securities Trade Intermediaries		47.6		47.1
Total	100.0	98.56*	100.0	97.6*

Source:

Study Group of Research Institute of Finance, the People's Bank of China, Wuhan Branch, (1991) "Relative Study on Some Major Issues on China's Domestic Bonds," Caimao Jingji (Financial and Trade Economies), pp.21.

* Over-the-counter transaction not included.

Table 4-9

Prices in the Secondary Treasury Bonds Market
In Easter China On 25 June, 1991 (Yuan)

Cities	Year of Bonds Issue							
	1986		1987		1988		1989	
	B	S	B	S	B	S	B	S
Shanghai	131.0	133.0	113.5	115.5	113.4	115.4		
Shuzhou	128.0	130.0	110.0	112.0	111.0	113.0		
Wuxi	129.5	131.0	111.0	113.0	112.0	114.2	105.0	107.0
Nanjin	127.5	129.5	109.5	111.5	110.5	112.5	103.5	105.5
Nanzhang	125.0	127.0	107.0	109.0	108.0	110.0		
Shanyrao	126.0	128.0	108.0	110.0	108.0	110.5	100.0	102.0
Fuzhou	129.2	131.0	112.5	114.0	111.5	113.5	104.0	106.0
Xiamen	127.8	129.8	109.5	111.5	110.5	112.5	102.8	104.8
Jinan	125.0	127.0	107.0	109.0	108.0	110.0	101.0	103.0
Qindao	127.6	129.6	110.0	112.0	110.3	112.3		
Hefei	126.2	128.2	108.2	110.2	109.0	110.0	101.0	103.0
Hangzhou	127.0	129.0	108.0	110.0	110.0	112.0	103.0	105.0
Ninbo	128.2	130.2	110.6	112.6	110.8	112.8	100.0	102.0
Shaoxin	128.0	130.0	110.0	112.0	110.8	112.8	104.0	106.0

Source: In Wang Guangqian (ed) China's Securities Market, p.209.

B---Buying prices
S---Selling prices

3. Some Related Problems

To develop a successful secondary market, there are some general requirements. For instance, financial intermediaries, legal environment, market information, and technical details are some crucial ones.

Lack of a unified law and legal system to regulate trading activities in the secondary market is a big problem. Hence, many cities have to draft *ad hoc* local regulations to manage market transaction. For instance, "Shanghai Securities Trading Regulations" was implemented in Shanghai. [22] "The Management Regulations of Wuhan Securities Trading Intermediaries" was formulated in Wuhan city.[23] Similar regulations were also formulated in Shenzhen, Shenyang and some other cities. However, the different regulations in different cities cannot generate an integrated nation-wide Treasury bonds market.

Lack of financial intermediaries participation in the secondary market has reduced the demand for government securities. The financial intermediaries hold the government securities as a portfolio necessity. Such institutions may include pension funds, mutual funds, investment banks and underwriters. However, the entry to the secondary market is at present rather restricted. Most trading intermediaries in the secondary treasury bond market are the trust and investment subsidiaries of ICBC and Urban Credit Cooperatives. Rural credit cooperatives are not permitted to enter the market. The insurance companies are also isolated from the treasury bonds market. Other NBFIs have not been allowed to operate in the treasury bonds market.

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22. Fu Tianmin (1990), "A Report of the Preparatory Work for Shanghai" Jinrong Shibao (Financial News), 18 October, p.1.

23. Pong Xujun (1990), "Wuhan Treasury Bond Trade on Market Activities", Jinrong shibao (Financial News), 18 October, p.3.

Hence, competition among different financial intermediaries in the secondary market is rather limited.

Lack of professional dealers and accountants is also a main obstacle to the current secondary market development in China. If trading is to be clean and efficient in the secondary market, honest and capable brokers are necessary.[24] With the increasing volume in transactions , training the dealers with the financial knowledge and skills becomes very important. In recent years, some training courses for professional brokers, dealers, and accountants have been held in many cities. In addition, some people who had experience in securities trading 40 years ago are still alive. These people have contributed their knowledge to market operation and training courses.

Backwardness in techniques is also a problem. For instance, trading by computers has not been introduced in the secondary market. Lack of other modern official equipment also limits the information for the market operation.

4.3.2 Black Market Trading in Treasury Bonds

As noted above, the secondary treasury bond market was restricted for a long period before being allowed to open. Initially, only seven cities were allowed to trade Treasury bonds. Then the number was extended to 62 big cities for some time. Meanwhile, trading was limited to those bonds issued in 1985 and 1986. Such a restricted trading market was far from satisfying the demands of a fully-functioning trading market. Consequently, black market trading emerged to fill the void of a formal secondary market. The rapid

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24. Drake, (1977), *op. cit.*, p.89.

growth rates in inflation was also a factor contributing to the emergence of black market trading. Spiraling inflation reduces the real value of the principal and interest of Treasury bonds. This is well understood by bond holders and dramatically shown by a peasant's remark," I could use ten yuan to buy almost five kilos of meat in 1982. However, I bought a ten-yuan government bond instead; now five years later the principal plus interest I earned accounted to more than 14 yuan. Unfortunately, the money can only buy two and a half kilos of meat." [25] The devaluation in investment in treasury bonds, therefore, reduced people's interest and confidence in holding government bonds. This acted as a catalyst to the expanding of the black market trading in Treasury bonds and it soon spread to the whole country. Soon after, the black market trading activities were rampant not only in big cities where the official secondary market was operating, but also in small towns and minority areas.[26]

The suppliers of Treasury bonds in the black market are normally workers, farmers, administrative staffs, teachers, and even some state and collective enterprises. For the sellers, the amounts traded are usually small, and therefore the prices are not a real concern to those suppliers. Therefore buying and selling bonds through private negotiations is a profitable business. The intermediate buyers are usually unemployed persons and individual businessmen. In those cities where secondary treasury bond market is not operating, black market dealers buy the bonds at 50-70% of their official prices. They then go to the big cities to sell bonds to the official trading agents at the official prices. [27] It is reported that when the Shanghai's secondary Treasury

25. Liu Minhua (1989), "Finding an Efficient Way for Treasury Bond Trading", Jinrong Shibao (Financial News), 4 February, p.3.

26. Fong Jiangang and Tian Nianshong (1990), "The Black Dealers Run Wild in Miao Minority Area of Hunan Province", Jinrong Shibao (Financial News), 31 January, p.2.

27. Wang Shihao, (1989), *op. cit.*, pp.12.

bonds market on April 1988, about 40% of the trading in bonds came from black market brokers in nearby cities. That was also one of the reasons why the secondary treasury bond market quickly boomed in Shanghai. It was not until the opening of securities market in another 62 big cities' in June, 1988, that the trading of Treasury bonds that came from other cities gradually declined in Shanghai.

In those cities where secondary treasury bond markets have already been established, black market trading activities also exist. The high profits even prompt some smart brokers to wait at the entrances to the official securities companies to intercept those people who have difficulty in calculating the true value of discounting offered by black market dealers, who go inside to gain exorbitant profits by discounting from securities companies.[28] Such activities are detected in Shanghai and Beijing. Black market trading activities are multifarious. Black market trading is usually conducted at the entrance to a cinema, theater, railway station and vegetables market. A sign-board advertising "Exchange treasury bonds for goods" in shops owned by individual business is a common in some cities.[29] The prices in these trading are usually only 50-70% of the officially fixed prices in the secondary market.

Systematic data on the amount of government bonds traded in black markets is not available. However, the evidence from the above discussion suggests that the black market trading has become an important element in government borrowing activities. It can be said that it is an example of government failure in its policy in developing financial markets in China.

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28. Chinese Youth Editor (1990), "The Black Dealers Run Wild in Treasury Bond Trading in Chuchen City ", 12, June.

29. Fong Jiangang (1990), "Rampant Black Trading in Treasury Bonds in Ma Yang Minority Area, Hunan Province," Jinrong Shibao (Financial News), 31 January, p.3.

However, a vigorous black market trading may force the government to speed up the establishment of the secondary market.[30] However, more efforts are needed for the establishment of a healthy government securities market.

4.4 Quasi-Fiscal Bonds and Government Agency Bonds

In recent years, the Chinese government has also issued two new government debt instruments: "quasi-fiscal bonds" and "government agency bonds". Table 4-10 gives the amounts and terms of the two new government securities.

Quasi-fiscal bonds are also issued by the MOF. However, the difference from the Treasury bonds is that the debt incomes from quasi-fiscal bonds were not recorded into the fiscal revenue. Based on this dividing line, quasi-fiscal bonds are defined as the bonds are issued for raising funds to increase the investment funds in key state projects and enterprises. In fact' the funds are indirectly used for financing government fiscal deficits. The repayment of quasi-bonds rests with the government fiscal budget in later years.

"Government Agency Bonds" are issued by various ministries and some state-owned specialized investment companies. Their issuing plans are subject to the approval of the State Planning Commission (SPC) and the PBC. The funds raised by government agents' bonds are entirely devoted to investments in special projects and state enterprises. For instance, the "Basic Construction Bond" was issued in 1988 by several state-owned specialized investment

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30. Zhao Qiang (1991), "Rampant Black Trading in Treasury Bonds: Financers' Appeal to Open Secondary Market" Jinrong Shibao (Financial News), 6 June, p.1.

Table 4-10

The Issued Amount of Chinese Government Quasi-Fiscal Bonds and Government Agency Bonds During 1987-89

(In Billion Yuan)

	1987	1988	1989
Quasi-Fiscal Bonds			
State Key Construction Bonds	5.50(3)*		
Fiscal Bonds		6.60(2)	
State Construction Bonds		3.65(2)	
Indexed Bonds			12.50(3)
Special Fiscal Bonds			4.37(3)
Government Agency Bonds			
Key Construction Bonds	3.00(5)	10.00(5)	7.94(5)
Basic Construction Bonds		8.00(5)	1.46(3)
Total	8.50	28.25	26.17

Source: Almanac of China Finance and Banking 1990, pp.71.

* the figures in brackets are the term of the bonds in years.

companies (State Energy Investment Company, State Railway Investment Company and State Transportation Investment Company) and Ministry of Petrol and Ministry of Railways. The funds raised were used in projects related to the petroleum and railway industries. The issuers are principally responsible for the repayment of government agency bonds. However, the issuing of government agents' bonds has the effect (and objective) of reducing the government's fiscal expenditure in those key state projects and enterprises, which are funded by the government budget. From this point of view, the issuing of government agents' bonds represented indirect borrowing by the government. Therefore, the government, which expects to get fiscal revenues from these projects and enterprises, may be required to take part of financial responsibility for the servicing of these debt instruments when repayments are due.

There are several problems related to the two new government debt instruments. First, as shown at table 4-11, the amount of government market borrowing has been enlarged since 1987, as most quasi-bonds and government agents' bonds will mature when the repayment peak comes to Treasury bonds. Hence, the repayment cycle of government securities is being worsened by the issuing of government quasi-bonds and government agents' bonds. Debt repayment is already a grave problem to the Chinese government's fiscal budget.

Second, the two new debt instruments are also sold mainly through mandatory methods. A buyer profile of the two government debt instruments is contained in Table 4-12. The buyers include state enterprises, urban and rural individuals and financial institutions. The question raised here is why the Chinese government raises funds from state enterprises and then uses them for state enterprises as well. The answer is that the government wants to

Table 4-11

The Situation of Chinese Government Domestic Market Borrowing

(In Billion Yuan)

Year	Name	Amount Issued	Term (Year) A	Term (Year) B	Purchasers	Net Outstanding Balance
1981-1984	Treasury Bonds	17.66	6-10	6-10	*State enterprises Collective enterprises Department of enterprises management local government, Public Institutions Army, Commune and brigade, Urban and rural individuals.	
1985	Treasury Bonds	6.00	6	6		
1986	Treasury Bonds	6.25	5	5		29.34
1987	Treasury Bonds	6.29	5	5	(As above *)	
	Key Construction Bonds	5.50	3	3	Local government, Public institutions, Ministries of the central government, Armies-policy, Enterprises and public institutions, Rural and urban individuals.	
	Key Enterprises Bonds	3.00	5		State and collective enterprises, public institutions.	42.72
1988	Treasury Bonds	9.22	3	3	(As above *)	
	Fiscal Bonds	6.61	2-5		Four specialized banks, two comprehensive banks, and other NBFIs.	
	Basic Construction Bonds	3.07	2	2	four specialized banks.	
	State Construction Bonds	8.00	5		Rural and urban individuals, foundations, financial institutions, enterprises and public institutions.	
	Key Enterprises Bonds	10.00	5		(As above *)	60.92
	Basic Construction Bonds	1.46		3	Rural and urban individuals.	
	Special Treasury Bonds	4.37		3	State and collective enterprises, state enterprises' Pension Foundations state enterprises' Employment Insurance Foundations.	
	Indexed Bonds	12.52	3	3	Urban individuals, private businesses, foundations, insurance companies, and other business companies.	
	Key Enterprises Bonds	7.49	5		(As above *)	84.35

Source: "Issue of Domestic Bonds and Stocks, Repayments of Bonds 1981-89," Almanac of China's Finance and Banking 1990, pp.71.
Wang Guangqian (1991), China's Securities Market.

concentrate financial resources on designated key state projects and enterprises. However, it should be noted that the lack of investment in those key state projects and enterprises is partly caused by the distorted price system. Hence, such government borrowing activities are intended to keep the distorted price system working. They may create other distortions and problems.

The purpose of government borrowing from the banks is not officially announced. In 1988, the financial institutions bought three kinds of quasi-bonds and government agents' bonds. The problem is that lack of autonomy in credit activities renders the specialized bank unable to absorb the government securities through adjusting their assets. Hence, a possibility for the specialized bank is that they rely on the central bank for loans to buy bonds. Therefore, the bonds are, in a sense, indirectly bought by the central bank. Therefore, contrary to conventional expectation, buying government securities is one important reason for the excessive issuing of currency in 1988. This will be further discussed in Chapter 5.

Third, quasi-bonds and government agents' bonds are issued partly through market activities, that is, bonds are sold by the banks to willing buyers. The issue amount and prices are still determined by the government. To attract more buyers, the government has adopted a more flexible interest-rate policy in issuing quasi-bonds and government agents' bonds. Figures on the interest rates of quasi-bonds and the interest rates of bank deposits for comparable terms are given at Table 4-12. It is clear that the interest rates of most quasi-bonds are higher than those of the bank deposits. In 1989, when "Construction Bonds" were issued in Shanghai, 30 million yuan bonds were subscribed within three days by anxious investors who queued overnight

Table 4-12

The Interest Rates of the Quasi-Bonds and the Bank Term Deposits at Equivalent Term

(per annual in %)

	1987	1988	1989
State Key Construction Bonds	10.05 **(8.28)***		
State Constru-tion Bonds		9.50 **(9.18)**	
Fiscal Bonds		8.00 **(9.18)**	
Indexed Bonds			**1%** Higher than the Indexed Bank Deposits

Source: Almanac of China's Finance and Banking (1990), pp.188.

* Figures in brackets are the interest rates of the bank deposits or equivalent term

outside banks.[31] This was because the interest rate of Construction Bonds was 1% higher than that of bank deposits.[32] The high interest rates of new government debt instruments indeed help the government raise funds to support the government's fiscal budget. However, the fact is that about 50% of individuals' funds invested in new bonds came from withdrawal of bank deposits. The withdrawing of the bank deposits to buy the bonds reached a peak when "Construction bonds" were issued in 1989. In Beijing, in 1989, about 30% of funds came from bank saving deposits in the buying of the various government quasi-bonds and government agents' bonds.[33] As a consequence, bank credit funds were reduced. The impact on the banking system operation will be further analyzed in Chapter 5 where the government's "protected" borrowing is discussed. It should be noted that, among the quasi-bonds and Government agents' bonds, Fiscal Bonds have lower interest rates. However, the 8 billion yuan's Fiscal Bonds was all allocated to the four specialized banks and the two comprehensive banks in 1988. Therefore, the Chinese government wanted to borrow from the specialized banks at low cost, making it difficulty to achieve the banking reform's objective of self-management and self-responsibility.

4.5 Conclusions:

As mentioned before, to the middle of 1991, Treasury bonds and other government securities accounted for 60% of trading in the primary securities

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31. Louise do Rosario (1989), "Borrowing Boom: Financial Markets Enable Enterprises to Beat Squeeze", Far Eastern Economic Review, 14 September, p.63.

32. "Interest Rates on Domestic Issued Bonds (1987-1989)," Almanac of China's Finance and Banking 1990, pp.118.

33. Qi Xin (1989), "The Impression of 'Construction Bonds' Issues", Jinrong Shibao (Financial News), 19 August, p.3.

market, and about 90% of the trading volume in the secondary securities.[34] Hence, an important feature of securities market development in China is that it is still dominated by the government's market borrowing activities.

The characteristics of the Chinese government's market borrowing activities has been examined in the discussion of the market structure (the primary market, the secondary market), market elements (supply, demand, and price), and market instruments (treasury bonds, quasi-bonds, and government agents bonds). The analysis indicates that an organized government securities market has not been created since the government securities were issued ten years ago.

An organized government securities market has not been created due to the fact that the supply of government bonds dominates the market in term of the issue amount, the maturity term, and the price of the bonds. However, the demand side is in such a passive position that it is not free to take advantage of difference in price, terms and flexibility. As a result demand and supply cannot interact with each other effectively to create a market price. Hence, the administered price has to be continually used in the market.

A fragmented government securities market has been created because the government adopts some inappropriate policies in marketing. For instance, there was a long gap in establishing the primary and the secondary markets. As a consequence, issuing in the primary market became difficult due to the absence of an active securities market. Even when the secondary market is established, the liquidity of the government bonds is still quite limited, because the government still determined the trading volume, the trading price and

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34. Li Jianxin, (1991), *op. cit.*, P.1.

marketplace. Black market trading came into being as a response to fill the void. In light of the above situation, the impact of the government borrowing on China's financial reform can be summed up as follows:

As noted in the theoretical review in Chapter 2, the development of a government borrowing market will offer some benefits for the development of a capital market. The benefits stem mainly from the fact that a market price will be generated to ensure a capital market efficient operation. Creating a market price is very significant to the reform of China's financial and economic system. However, the government in using administrative methods for the domination of the market has missed the chance to establish a well-functioning market.

Another benefit from establishing a government borrowing market is that the market can provide a basis for the central bank in implementing its monetary policies, e.g. open market operation. Facilitating the use of indirect monetary policy instruments to replace direct monetary policy instruments is one of the objectives of China's financial reform. However, the fixed long term maturity (at least three years) of government securities has not provided the possibility to conduct open market operations in China. The main reason, as noted above, is that the Chinese government does not have a unified blueprint in its reform program. As to the open market operation, the Chinese government should start to sell Treasury bills of negotiable short-term market rates, which will establish a basis for the PBC's open market operation.

The Chinese government's market borrowing has given rise to new financial instruments in China. This has changed the situation when the bank deposits were the only financial instrument. Theoretically, the new financial instruments can stimulate competition with bank deposits. However, the

Treasury bonds are characterized by mandatory allocation, artificial interest rate and limited transactions, thus, the investors lose their interest and confidence in the investment of Treasury bonds. Competition in different financial instruments is likewise weakened.

One piece of evidence is that a certain amount of bank deposits are withdrawn by individuals to buy the government agents' bonds because the interest rate of the government bonds is higher. These activities seem to indicate that the competition is getting fierce between the bank deposits and government bonds. But it should be noted that the interest rate of both the government bonds and bank deposits are also fixed by administrative methods. Whether such a competition in different financial instruments can lead to efficient financial resource mobilization and allocation or not is still to be ascertained because of the absence of guidance by market prices.

Through buying and selling of Government bonds, the banking system can increase their assets' liquidity through multiplying their assets' portfolio. At present, apart from being instructed by the government to buy the government quasi-bonds, the specialized banks are not really playing an active role in the government borrowing market. The specialized banks have two reasons in their limited participation in the market. One is that the lack of independent position of banking system has not created incentive to banking system to get involved in the securities market operation. And also the liquidity of China's bank assets is not so important as that of the bank in Western countries, because they never worry about solvency or bankruptcy since they are all state-owned banks. Another reason is that entry into the financial market is still limited in China. Whether the specialized banks and other financial institutions can enter the securities market or not depends on approval by the PBC, which acts as a government agent.

When government deficits are financed by the sale of government securities, it is generally believed to be an non-inflationary way, which is distinct from debt financing by money creation. One fact of the Chinese government borrowing is that the specialized banks are obliged to buy government quasi-bonds and government agents' bonds. Such activities may contribute to the increase of money supply in China because ultimately the debts are financed by new funds supplied indirectly from the PBC. As to the activities of state enterprises using working capital loans to buy bonds, more financial pressure is shifted onto the PBC through the specialized banks. Hence, a certain amount of the Chinese government market borrowing is in reality transferred to the PBC to contribute directly to the increase of money supply.

There is also another factor to affect the state bank operation, namely, a substantial amount of unsold Treasury bonds are held in stock by trading intermediaries. If the funds penned up in those financial institutions are large and the holding time is long, the government's "market" borrowing activities are not very different from the direct and compulsory borrowing from the financial system by the government. It will also cause other problems which will be discussed in detail in Chapter 5.

The problems in the government borrowing market also indicate that the government must provide some framework, including a set of laws and legal system for the market development. The government is also obliged to provide effective supervision in these areas: prevention of fraud; supply of information; and development of capital market techniques and institutions; training of brokers and specialists; listing requirements, transaction costs, and limitations on speculation.

Chapter 5

Government Borrowing from Banks and Nonbank Financial Institutions (NBFIs)

5.1 Introduction

The aim of this chapter is to investigate various forms of Chinese government borrowing from the banking system and NBFIs, so as to gauge the impacts of such "protected" borrowing on the country's financial reform.

The financial system in China is still characterized as bank-dominated. Hence, the study of the patterns and key issues in the government borrowing from the banking system is important in uncovering the main characteristics, problems and scope of China's financial reform. The limited development in NBFIs partly results from the government's "protected" borrowing, which ensures the protection of the monopolized position of state banks.

The officially-declared amount of the annual government budget deficit is routinely financed by borrowing from the PBC. Borrowing from the central bank, for any government, is a dangerous financing method because it may easily raise inflationary pressure. Persistent inflation will impede economic and financial reforms, result in an unstable macroeconomic environment and diminish the value of financial assets. Therefore, the relevant questions on government borrowing from the PBC are: why does the government have to borrow from the PBC? Why should the PBC have to lend to the government? What are the alternatives for the PBC?

The main purpose of the Chinese government borrowing from specialized banks is to obtain funds for various projects and enterprises for which budget expenditures could have been required, so that the official budget deficit could be nominally reduced. With this intention in view, the methods used to tap the specialized bank funds vary, and may directly or indirectly increase fiscal revenue and decrease fiscal expenditure. The main methods of the government borrowing from the specialized banks include requiring the specialized banks to hold government debts instruments at below market yields, and requiring them to place part of their deposits in the central bank. Characteristically, the Chinese government's borrowing from specialized banks is carried out through administrative pressure on specialized banks to extend directed loans with subsidized interest rates; and through continually placing interest rate ceilings.

In China, the amount of government bonds bought by NBFIs is small. As in other LDCs, the NBFIs, especially rural credit cooperatives (RCCs) and urban credit cooperatives (UCCs), are required by the government to place a high proportion of their deposits in the central bank or their supervising specialized banks to pool credit funds within the banking system. Currently, the Chinese government still limits the scope of operation of NBFIs and the entry of NBFIs is restricted, too. Trust and Investment Companies (TICs) are the main part of NBFIs in China, however, more than 60% of TICs are affiliated with the specialized banks. As a result, the NBFIs find it difficult to compete with the state banks.

Compared with the market borrowing activities of the Chinese government, the examination of government borrowing from the banking system and financial institutions is made more difficult by a shroud of secrecy surrounding such activities. The mechanism and procedures of Chinese government borrowing from the banking system cannot be clearly identified. As state-owned banks in China still act as the "organs of the state planning mechanism" serving the government's growth-oriented economic policy, the distinction between directed (policy) loans and commercial loans is very ambiguous for the Chinese bank and the two types of loans are not separately reported. Systematic and consistent data on the amount of direct and indirect government borrowing from the banking system is non-existent. This may be the reason why hitherto no serious study on this subject has ever been attempted. This chapter attempts to shed some lights on this issue by analyzing a large amount of scattered information and aggregate data on various aspects of government borrowing activities, gathered from official reports and papers.

Based on the current structure of financial/banking system in China, government borrowing from the central bank will be firstly discussed in Section 5.2. Section 5.3 examines how the government borrowed from the commercial (specialized) banks. Government borrowing from the NBFIs will be addressed in Section 5.4. Some conclusions will be drawn in Section 5.5.

5.2 Government Borrowing from the People's Bank of China (PBC)

Borrowing from the PBC has been a regular means of financing the budget by the Chinese government since 1979, when the fiscal budget was in deficit for the first time since the beginning of the economic reform.[1] At the end of the 1970s, the PBC, which functioned as both the central bank and the

1. See, "Sources and Uses of Credit Funds of State Banks (1952-1989), Almanac of China's Finance and Banking 1990, p.48-53.

commercial bank, was the only domestic bank in China. Capital markets did not exist. Hence, the PBC was obliged to take responsibilities for financing the government deficits in 1979 and 1980.

As discussed in Chapter 4, with the persistent budget deficits since 1979, the Chinese government has started to borrow from the public through the issue of the Treasury bonds since 1981. However, the underdeveloped capital market could not satisfy the borrowing requirements of the government. Moreover, for any government, borrowing from the market is relatively expensive way compared with borrowing from a captive funding source or central bank. Hence, a large amount of government borrowing is still in the form of loans from the central bank in China. Such a situation can be seen from the data given in Table 5-1. The data indicate that borrowing from the PBC was much larger than that from market activities.

Since 1984, the PBC has acted as the central monetary authority to conduct monetary policy. Its commercial functions were transferred to the newly established specialized banks (mainly to Industrial and Commercial Bank of China). In such a situation, government borrowing from the PBC has more profound implications and effects. When the government borrows heavily and continually from the PBC, PBC may have to engage in excessive money creation to finance the government's deficits, creating inflation pressure. As pointed out in Chapter 2, the Chinese government attempts to carry out its economic and financial reform in a stable situation. With the stabilization as an objective, the government should gradually reduce borrowing from the PBC and replace such financing with market borrowing.

The Chinese government's direct and indirect borrowings from the central bank were conducted through three channels: annual loans for deficit

Table 5-1

Comparison Between Government Borrowing from the Market and from the PBC in China

(In Billion Yuan)

Year	(1) Borrowing from the PBC (Outstanding Balance at the end of the Year)	(2) Annual Borrowing by Issuing Treasury Bonds
1979	9.02	0.00
1980	17.02	0.00
1981	17.02	4.87
1982	17.02	4.38
1983	19.96	4.16
1984	26.08	4.22
1985	27.51	6.06
1986	37.01	6.17
1987	51.05	6.31
1988	57.65	9.22
1989	68.46	5.61

Source: Col.(1)-from Col.(2) of Table 4-1.
Col.(2)-Almanac of China's Finance and Banking 1990, p.71.

financing, direct lending to government-determined priority sectors, and the central bank paid low interest rates to commercial banks' reserve deposits for issuing subsidized bank loans.

5.2.1 PBC's Annual Loans to the Government for Deficit Financing

Since 1979, the government has borrowed annually from the PBC to finance its deficits. Such loans accounted for 11.57% of the PBC's total assets of the 319.85 billion yuan 1986,[2] and 16% in 1987.[3] The amount of government borrowing was about 4.42-7.05% of the total loan assets of all the state banks, and 4.17-6.49% of total assets of all state banks during 1979-89, as shown in Table 5-2.[4] This ratio remained relatively stable. However, this trend tells only part of the story of government borrowing from the PBC. It should also be noted that the amount of government borrowing given in Table 5-2 is the outstanding balance at the end of the year. This means that the total volume of the flow of government borrowing during these years has certainly been larger than that shown in Table 5-2. Unfortunately, data on such flows are not available from official sources.

It has been pointed out by some Chinese economists that the government also financed its fiscal budget by using overdrafts from the PBC.[5]

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2. See, "Balance Sheets of People's Bank of China, 1986", Almanac of Finance and Banking 1987, pp.II-9.

3. See, Wan Jianhua and Wang Xiaoyan, (1987), *op. cit.*, pp.14.

4. Only the figures of PBC total assets in 1986 and 1987 are available. The other years are not available from official source. Hence, the figures of state-owned banks are used here. The state-owned banks include PBC, four specialized banks and two comprehensive banks (after 1981). See, Almanac of China's Finance and Banking, 1986, 1987, 1988, 1989, 1990.

5. Wang Guomin (1987), *op. cit.*, Xu Yaping (1987), *op. cit.*, Rong

Table 5-2

Government Borrowing from the People's Bank of China

(In Billion Yuan)

Year	(1) Governemnt Borrowing from PBC (Dec 31)	(2) Total Loan Assets of State Banks (Dec 31)	(3) (1) as % of (2)	(4) Total assets* of State Banks (Dec.31)	(5) (1) as % of (4)
1979	9.02	203.96	4.42	216.26	4.17
1980	17.02	241.43	7.05	262.43	6.49
1981	17.02	286.02	5.95	317.08	5.37
1982	17.02	321.06	5.35	361.84	4.74
1983	19.96	358.99	5.56	412.49	4.84
1984	26.08	476.61	5.47	537.03	4.86
1985	27.51	590.56	4.66	637.45	4.32
1986	37.01	759.08	4.88	811.14	4.56
1987	51.05	903.25	5.65	987.04	5.17
1988	57.65	1055.13	5.46	1148.53	5.02
1989	68.46	1240.93	5.52	1356.20	5.05

Source:
Col.(1) (2)- Almanac of China's finance and Banking 1990, p.53.
Col.(3)- computed from Col(1) and Col(2)

* The difference between (2) and (4) is that the total assets of the state banks (4)is equivalent to the total loan assets plus the item of gold, foreign exchange, international uses and fiscal borrowing.

Overdrawing from the central bank by the MOF is officially prohibited by the declaration of the State Council in the Interim Regulation of the People's Republic of China for Banking Control (1986).[6] Despite the regulations, the Chinese government continues to use overdrafts as a means of financing its deficits. Neither the Chinese government nor the PBC have ever published data on how much the government has overdrawn from the central bank. One way to show the Chinese government's overdraft from PBC is by examining the government's accounts in the PBC. Table 5-3 shows that after 1986 the amount of government borrowing was larger than those of fiscal budget deposits in the consolidated balance sheets of all state banks (including the PBC and the four specialized banks). Overdraft should normally be repaid. However, how much of the overdrafts has ever been repaid by the government remains unknown.

It has been accepted by both Chinese economists and Western scholars that government borrowing and overdrafts caused a significant increase of money supply in China after the economic reform. The Chinese economists estimated that, before 1987, about 50% of the newly issued money for each year was caused by the government's fiscal budget borrowing and overdraft.[7] The World Bank has on the other hand pointed out that until 1986 the government's borrowing from the PBC to finance the deficit was not a major contributor to monetary expansion. However, 37% of the government deficit was financed by the PBC in 1987 [See Table 3-13(2)], which accounted for about 40% of

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Fenge, Zheng Qirui and Xiao Gang (1988), "Remarkable Achievements Have Been Made in the Macro-control of Finance and Banking, Management System for Funds Have Been Further Improved", Almanac of China's Finance and Banking 1988, pp.137-139.

6. See, Almanac of China's Finance and Banking, 1987, pp.IX-2.

7. Wang Jianhua and Wang Xiaoyan, (1987), *op. cit.*

Table 5-3

The Central Government Fiscal Position with the PBC During 1978-89

(In Billion Yuan)

Year	(1) Fiscal Loans from the PBC (December 31)	(2) Fiscal Deposits in the PBC (December 31)	(3) (1)-(2)
1979	9.02	14.87	-5.85
1980	17.02	16.45	0.57
1981	17.02	23.76	-6.74
1982	17.02	21.92	-4.86
1983	19.96	24.34	-4.38
1984	26.08	22.97	3.11
1985	27.51	36.84	-9.33
1986	37.01	31.15	5.86
1987	51.05	30.70	20.35
1988	57.65	27.09	30.56
1989	68.46	43.80	24.66

Source:

Col.(1)- from Col.(1) of Table 5-(1)
Col.(2)- from Almanac of China's Finance and Banking 1990, pp.52-53
Col.(3)- calculated from Col.(1) and Col.(2).

reserve money growth.[8] There are no hard data to substantiate the above two figures. However, both indicate that government borrowing did contribute to the increase of money supply in China.

It should be stressed that the annual borrowing of the government from the PBC was only one of the significant factors that may have caused the loss of control over money creation. There were some other factors which contributed to excessive monetary expansion in China. These factors also pose fundamental issues concerning the role of the central bank and the progress of the process of financial reform.

5.2.2 PBC's Policy Loans: Indirect Government Borrowing

With the decentralization program and the raising of fiscal revenue is a hard nut to crack, the government frequently directs the financial/banking system to extend policy loans to help reduce its fiscal expenditure. Most policy loans are issued to state-designed priority projects and enterprises in China. Policy loans are also issued to loss-making enterprises to resolve the difficulties created by the still regulated price system. The successful experience of South Korea and Japan in using directed credit has indicated that the benefits of such a policy could only result from supporting "sunrise" industries in a certain period, rather than from compensating for price rigidity.[9] In principle, when lending to special sectors is considered as a national priority, the government budget should bear the cost rather than burdening the banks with such cost.

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8. World Bank, (1989, b), *op. cit.*

9. See, World Bank, (1989, a), *op. cit.*, p.128.

The PBC also issued some directed loans under the government's direction in recent years. After the PBC was transformed into China's central bank, its commercial functions were shifted to the newly established Industrial and Commercial Bank of China. Such a change was intended to enable the PBC to carry on its exclusive role of implementing monetary policy and supervising the financial system. Thus, the issuing of directed loans further compromised the PBC's central bank function.

For instance, in 1989, the PBC was required by the State Planning Commission (SPC) to issue a total of 24.4 billion yuan of directed loans, called "Revival Funding" (Qi Dong Zi Jin), to those large and medium-sized state enterprises, which were on the verge of collapse due to shortage of working capital funds. [10] It was reported that the share of state enterprises' own working capital in their total assets declined from 39.5% in 1983 to 18% in 1988.[11] Hence, more working capital was needed by those state enterprises to continue their production, The problem related to working capital of state enterprises will be further discussed in Section 5.3.3.

Some directed loans of the PBC are in fact issued to the specialized banks, which then lend those loans to certain projects as instructed by the government. In this case, the specialized banks are acting as an agent for the PBC, and their functions as financial intermediaries are weakened. In early 1986, the State Council decided that the PBC should issue a total of 4.00 billion yuan of "Special Loans" with interest subsidies during 1986-1990 to those

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10. Shang Fuli (1990), "Credit Policy" Almanac of China's Finance and Banking 1990, *op. cit.*, p.205

11. Financial Time Commentator (1990), "Why Do Enterprises Feel a Pinch with Banks Releasing More Loans?" Jinrong Shibao (Financial News), 25 June, 1990, p.1.

underdeveloped areas. The funds of special loans were from the PBC, and the loans were issued and managed by the Agriculture Bank of China. The interest rates were subsidized mainly by the central fiscal budget and partly by the PBC. The interest rate of special loans was 6.1% p.a. in 1986. The borrower would pay only 2.1% p.a., and the central fiscal budget would pay 4.0% p.a.(in 1986, the general interest rate of the PBC's loan was 6.6%). The terms of these special loans were 1-3 years, and the longest ones were 5 years.[12]

An interesting observation which reflects the extent of directed loans issued by the PBC is that in 1989 there were 14 items in PBC's interest rate schedule, set at different levels.[13] For instance, the interest rate for industries in poor counties was 7.02%, the subsidized interest rate for agriculture in the less developed areas was 3.6%. They were both lower than the general interest rate of 10.44%.

Directed loans of the PBC also played the role as the "last resort" of financial resources to the fiscal budget. In 1989, the MOF planned to issue 5.5 billion yuan "Key Construction Bonds", and 3.5 billion yuan "Key Enterprises Bonds". However, the planned amount was not fully attained. To support key state projects and enterprises, PBC lent 7 billion yuan as advance payment to MOF.[14] The repayment date and the interest rate of this borrowing are not known. How the PBC could lend to the MOF, through money creation or

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12. See, "Provisional Regulations of the People's Bank of China and the Agricultural Bank of China for Interest-Subsidy Loans Supporting Underdeveloped Areas." Almanac of China's Finance and Banking 1987, pp.IX-35.

13. Almanac of China's Finance and Banking 1990, *op. cit.*, p.169-170

14. Shang Fuli, *op. cit.*, p.206.

reduction of re-lending to the specialized banks, is not indicated by the official information.

Judging from the role of the PBC, there are two alternative sources used by the PBC to finance the government borrowing. One is the "planned credit funds" of the PBC.[15] Another is new money creation. The two alternatives used by the PBC have produced different effects on the economy.

Since 1987, the planned credit funds of PBC have been classified into "annual quota loan" (Nian Du Dai Kuan) and "short-term loan" (Duan Qi Dai Kuan).[16] The former is issued to specialized banks to meet the demand in credit funds required by "reasonable and rational economic growth". The latter is to meet temporary needs of production, such as seasonal needs. Hence, if the planned credit funds are used by the PBC for other non-planned projects, such as directed loans asked by some ministries, the PBC should reduce the lending scope of those specialized banks. In turn, the specialized banks need to reduce their loans to enterprises and other producers. In China, such a reallocation seems to affect mostly small and medium-sized enterprises.

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15. Theoretically, the planned credit funds of the PBC are used for adjusting the financial capability of the four specialized banks and two comprehensive banks. The scope of planned credit is determined by the credit plan. As stipulated by the State Council, the source of PBC's planned credit funds comes from: (1) deposits of state treasury; (2) deposits of public institutions whose funds are from the fiscal budget grants; (3) certain deposits redeposited by the four specialized banks and the two comprehensive banks (excluding reserve deposit); and (4) current year's new money issued for economic growth. See, Liu Hongru (1983) " Some Problems Concerning the Function of the PBC as the Central Bank," Zhongguo Jinrong (China's Finance), Vol.11, pp.12-14.

16. Before 1987, the PBC re-lending was classified into "Planned loan" (Ji Hu Nei Dai Kuan) and "Temporary loan" (Ling Shi Dai Kuan). The funds were used in the way their terms indicated. Since 1987, the PBC loan has changed into "Annual quota loan" (Nian Du Dai Kuan) and Short-term loan (Duan Qi Dai Kuan). See, Rong Fenge, Zheng Qirui and Xiao Gang, (1988), *op. cit.*, pp.138.

Hence, directed loans increase the cost to those small and medium-sized enterprises of obtaining credit funds from specialized banks. Most importantly, those small and medium-sized enterprises may function more efficiently than those enterprises supported by directed credits. Therefore, directed loans fail to make state banks allocate financial resources efficiently.

What is worse, when the PBC has used up its target quota of the credit plan, the PBC has resorted to increase of money supply to finance any financing requirements of government. Government borrowing from the PBC through directed loans becomes a factor which contributes to the increase of money supply. Therefore, as the PBC continues to conduct some commercial bank business, its central bank functions are weakened.

5.2.3 Government Borrowing and Required Reserve Deposits

As discussed in theoretical studies, in many LDCs, a high reserve requirement is often used for the implicit objective of collecting revenue for the government. The reason is that high required reserve and liquidity ratios ensure a ready demand for government securities that can help finance the government deficits at given ceiling interest rates. [17] However, a high reserve requirement has the effect of reducing the loanable funds and profitability of commercial banks.

A system of reserve requirements intended to function as an instrument of monetary policy has been in place in China since 1984. In the years before credit ceilings (in 1988) were imposed on specialized banks, monetary policy relied mainly on the control of bank liquidity through reserve requirements

17. Dooley and Mathieson, (1987), *op. cit.*, pp.31.

and the PBC re-lending system. At present, although credit ceilings are the major instrument of monetary policy, reserve requirement and PBC re-lending still retain their importance in China. [18]

Currently, reserve requirements are imposed on all banks and NBFIs. The rate of reserve requirement is uniform for all types of domestic currency deposits. The rate, in October 1987, was 12%,[19] and has been raised to the current rate of 13% since September 1, 1988.[20] The level of the reserve requirement in China cannot be considered high in comparison with other LDCs.

However, there was an "implicit tax" element in the reserve requirement system in China. Implicit taxes on the specialized banks arise because the PBC paid low interest rates on the reserve deposits of the specialized banks. Table 5-4 presents data on the interest rates of reserve deposits, the interest rates of one year's term-deposits and one year fixed assets loan of specialized banks. It can be seen that the interest rates of reserve deposit were significantly lower than those of the other two. Obviously, such low interest rates of reserve deposits have imposed a cost on the banks in mobilizing term-deposits.

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18. For detailed discussion of monetary policy of the PBC, see, de Wulf and Goldsbrough (1986) *op. cit.*; World Bank (1988, b), *op. cit.*; Blejer (et al), (1991), op. cit.; A. Feltenstein and Z. Farhadian (1987), "Fiscal Policy, Monetary Targets, and the Price Level in a Centrally Planned Economy: An Application to the Case of China," Journal of Money, Credit and Banking, Vol.19, No.2, May, pp.137-156; Lang Yu and Zhang Jianhai (1991), "On Macro-control over Finance," Caimao Jingji (Finance and Trade Economies), Vol.3, pp.32-38.

19. Liu Hongru, Vice Governor of PBC, (1988,a), "Adhering to the Policy of Seeking Flexibility in the Tight Money Environment, Promoting the Reform and Sustained Steady Development of National Economy", Almanac of China's Finance and Banking 1988, p.133.

20. Liu Hongru, Vice Governor of PBC, (1989), "Financial Situation and Working in 1988", Almanac of China's Finance and Banking 1989, pp.181.

Table 5-4

Interest Rates of Reserve Requirements and Interest Rates of Bank One-year Term Deposits (p.a)

	1986	1987	1988	1989
Interest rates paid by the PBC on reserve deposits	4.32%	4.32%	5.04%	7.20%
Interest rates paid by the ICBC on one-year savings deposits	4.32%	7.20%	8.64%	11.31%
Interest rates charged by ICBC on one-year fixed assets loans		7.92%	9.00%	11.34%

Source: Almanac of China's Finance and Banking, 1987, 1988, 1989, 1990.

(Currently, about 80% of the individual deposits are high-interest-bearing term deposits in China.[21]) The implicit taxes on reserve deposits were used by the PBC to subsidize selective directed credits to state enterprises with lower interest rates.[22] It should be stressed that the reserve deposits were not "frozen" in the PBC and they were in effect used by the PBC to hand out various loans. Hence, the effectiveness of the reserve requirement as a monetary policy instrument was reduced and compromised in China.

5.2.4 The Independence of PBC and Government Investment Plan

As a central bank, the PBC functions mainly to implement monetary policy. The PBC should, as those central banks in market economies, have a high degree of independence in formulating and implementing monetary policy. The PBC should not automatically monetize the government's deficits. Since the PBC was established as a central bank in 1984, there have been controversies over whether the monetary policy of a socialist country should have the single objective of attaining monetary stability or the dual objectives of "money stability and economic development".[23] This question remains

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21. After 1990, the term-deposit is defined as the deposits whose terms are longer than three months. See, Almanac of China's Finance and Banking 1990.

22. Yuan Dejun (1989), "The Position, Deficiency and Rectification of China's Reserve Requirement System", Jingji Luntan (Economic Forum), Vol.12.

23. Well before the central bank was established, discussion of the operational objective of the central bank had already started. The main issue was which of the two objectives of the central bank was more important: money stability or economic development. Government borrowing from the central bank was also one of the main arguments. See, Ma Yukang (1983), "Issues on Dual Objectives of Monetary Policy: Unity of Money Stability and Economic Development," Zhongguo Jinrong (China's Finance), Vol.8, pp.44-46; Yang Zheshen (1984), "Balance Between the state Budget and the State Bank," Zhongguo Jinrong (China's Finance), Vol.6, pp.13-15; Wang Guanqian (1986), "The

unresolved in China.

Some strong evidence indicates that the PBC has submitted its monetary policy to the government's growth-oriented economic policy. The PBC is therefore not in a position to formulate its monetary policy independently. The PBC's credit plan is currently the main monetary policy instrument which sets quantitative restrictions on the activities of the four specialized banks and the two comprehensive banks. It establishes ceilings on their total lending and sub-ceilings on certain type of loans. With credit ceilings, each bank's credit expansion is not to excess the targets. The credit plan is formulated through a process of consultation between the state banks and government economic agents at various levels. The formulation of the credit plan remains essentially a "bottom up" process that focuses on the credit needs of borrowers. Firstly, bank branches at local levels negotiate with production units and state enterprises in all sectors. The bank branches then submit their plans to PBC's provincial branches and their own head office. At the provincial level, the PBC branches consult with the local financial, and industrial bureaus. The figures produced by the consultation process are submitted to the PBC's head office. The four specialized banks' head offices also present their global and provincial credit plans to the PBC. When a draft of the credit plan is proposed by the PBC's head office, the credit plans are reconciled in further consultations involving the PBC, SPC, MOF and other ministries. Among them, the SPC also formulates its own credit plan independently as part of its formulation of investment plan. In this context, the SPC in effect determines the investment plan which will be financed by the state budget and the state banks.

As discussed in Chapter 3, the reform of the fiscal system has not paid

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Single Objective of Monetary Policy," Jinrong Yanjiu (Financial Studies), Vol.4, pp.15-17.

off so far as balancing revenue and expenditure are concerned. In this climate, the responsibility of meeting financial gaps of the fiscal budget are directly or indirectly shifted on to the state banks in the course of the consultation. The financial capacity of the state banks is theoretically limited by their liabilities. However, under the dominance of the government's growth-oriented policy requirements, the potential for state banks to create money was great and has not changed. To the PBC, "serving the Chinese government's economic growth policy has priority over maintaining monetary stability."[24] Hence, with such a central bank monetary policy, the banking system can and will continue to satisfy various demands of the government's investment plans.

Lack of autonomy for the PBC in monetary policy making and implementation has affected the economic reform in China. China's monetary policy in recent years can generally be characterized as expansionary and fluctuating. Soon after the PBC was established, a rapid expansion of credit occurred in 1984 and 1985. In consequence, the PBC adopted a restrictive monetary policy in response to the pressure of emerging inflation and balance of payments. However, concern about a slowdown in economic growth led to an easing-up of monetary policy in mid-1986. As expected, output growth picked up, but the inflation pressure also manifested itself as the economy began to overheat. There were four alternating cycles of easing and tightening of monetary policy during 1984-90. The restrictive cycle was usually short-lived as each was terminated by the government which was worried about slow growth in output. Therefore, China's monetary policy is not determined by the market demand and supply, but by the needs of the government's growth-oriented economic policy. The goal of monetary stability policy has

24. Tam, On Kit (1991), "Prospects For Reforming China's Financial System," Paper presented at Conference on China's Reform and Economic Growth, Australian National University, November.

become only a secondary consideration in the PBC's operations.[25]

It is obvious that China's central bank is still in an early stage of market-oriented development. The PBC accommodates all the spending-decisions approved by the authorities. As the functions between the fiscal budget and state bank are still blurred, the PBC cannot be efficient in the macro-control. As a consequence, the economic reform and financial reform cannot be implemented in a stable environment.

5.3 Government Borrowing from Specialized Banks

In a market economy, government borrowing from commercial banks has generally two approaches: 1) minimum deposits which commercial banks must place with the central bank; 2) legal or moral pressure on commercial banks to hold government bonds.[26] These activities also exist in China. It should be noted that when the government borrows from commercial banks, the commercial banks in a market economy will adjust their assets portfolios in response to government borrowings. In China, however, the structure of liabilities and assets of specialized banks are in effect determined by the credit plan which is formulated in the early months of the year. When the specialized banks are obliged to hold government bonds, they may do not need to adjust their credit activities to absorb the government debt, because their loanable assets are determined by the credit plan rather than their deposit

25. Cheng Yonghong (1990), "The Deficiency of Financial System in Macro-adjustment and the Current Countermeasures", Chengshi Jinrong (City Finance), Vol.10, pp.9-12.

26. Kitchen, (1986), *op. cit.*, p.108-111.

liabilities. The specialized banks can also rely on the PBC for new credit liquidity, based on the system of "eating from the same big rice bowl" (Da Guo Fan) between the central bank and specialized banks. In this respect, the Chinese government's borrowing from the specialized banks is quite different from that in a market economy.

The Chinese banking system still operates in a financially repressed environment: administered interest rates, planned investment, and the system of priority lending. This environment enables the Chinese government to obtain funds from the specialized banks for various projects and state enterprises without increasing its expenditure. Hence, the specialized banks in China face a complicated situation arising from the complexity and potential conflict of objectives inherent in their assigned role. While efficiency and a sound loan portfolio are the overriding objectives, state-owned banks usually respond to the economic and social imperatives of the government. Often, the government's requirements conflict with the institutional viability. The banks' interest rate reform, assets and liabilities management, market competition are all made difficult and impossible. Hence, the effectiveness of the financial reform will be reduced. The above-mentioned issues will be dealt with in the following.

5.3.1 Government Borrowing through Special Deposit Requirements

The four specialized banks are required to re-deposit a certain proportion of their deposits with the PBC, on top of the reserve requirements. The system of redeposit was implemented as one of the PBC's monetary policy instruments to balance credit funds in different branches because the interbank market remained shallow.[27] In 1984, when the redeposits system was introduced, the ratio was set at 20% of the total enterprise deposits, 25% of rural household deposits (including the rural credit cooperatives redeposited with the ABC), and 40% of urban household deposits.[28] In 1985, the rate of redeposits was reduced to a uniform 10% for all deposits.[29] A minimum rate of 5% to 7% of deposits was imposed in 1989. As discussed in Section 5.2.3, part of the redeposits of specialized banks was used by the PBC to extend policy loans under government directives. Using redeposited funds to issue directed credits has reduced the effectiveness of the redeposit requirements as a monetary policy instrument. The loanable funds of the specialized banks were also reduced. The special deposits accounted for 2.65% in the total assets of ICBC in 1989, and 6.70% in ABC, and 3.66% in PCBC [see, Table 5-5 (a) (b) (c) (d)].

5.3.2 Borrowing through Means of Bond-Holding

Like other governments in LDCs, the Chinese government also borrows from specialized banks by forcing them to hold government bonds. There are mainly two kinds of government bonds imposed on the specialized banks. One is the Treasury bonds issued by the MOF to finance fiscal deficits. Another is the government Quasi-fiscal Bonds and government Agencies Bonds issued for key state enterprises.

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27. The interbank market, which was started in 1986, develops very slowly because parochialism has worked against the market integration. In practice, the banks prefer to borrow in rather than lend out.

28. See. "People's Bank of China's Provisional Regulations on Some Questions Concerning its Exclusive Function as a Central Bank", Zhongguo Jinrong (China's Finance), Vol.4, pp.12-14.

29. Kong Xiangyi, (1986), An Introduction to the Central Bank, (China's Financial Publishing House)

Table 5-5 (a)

The Balance Sheet of the Industrial and Commercial Bank of China (ICBC), 31 December, 1989. (In Billion Yuan)

Use of Funds			Source of Funds		
Item	**Amount**	**As Percent of Total Assets**	**Item**	**Amount**	**As Percent of Total Liabilities**
Loans	575.19	87.53	Deposits	413.11	62.86
Industrial Working Capital	341.17	51.92	Enterprises Deposits	148.01	22.52
Commercial Working Capital	159.13	24.21	Household Savings	230.00	35.00
Fixed Capital	63.69	9.69	Sight	35.91	5.47
Trust Loans*	2.21	0.34	Term	194.08	29.53
Discount Loans**	1.90	0.29	Trust Deposits	1.08	0.16
Other Loans	3.36	0.51	Other Deposits	34.03	5.18
Cash in Vault	4.71	0.72	Bank Bonds	2.46	0.37
Required Reserve Deposits	52.48	7.99	Credit Funds	18.45	2.81
Deposits with PBC***	17.42	2.65	Self-owned Funds	16.89	2.57
Other Assets	7.36	1.12	Liabilities to PBC	173.65	26.43
			Other Liabilities	32.59	4.96
Total Assets	**657.16**	**100.00**	**Total Liabilities**	**657.16**	**100.00**

Sources: Almanac of China's Finance and Banking 1990, p.73.

* ICBC also receives some trust deposits and entrust deposits, but the share is very small in total assets portfolio.

** The official publications offer no explanation.

*** The four specialized banks are required to re-deposit a certain ratio of their deposits with the PBC, in additional to the amount of the reserve deposits. As to the detailed discussion of this subject, see, Section 5.3.1.

Table 5-5 (b)

The Balance Sheet of Agricultural Bank of China (ABC), 31 December 1989 (In Billion Yuan)

Use of Funds			Source of Funds		
Item	**Amount**	**As Percent of Total Assets**	**Item**	**Amount**	**As Percent of Total Liabilities**
Loans	305.80	81.96	Deposits	205.55	55.05
Industrial	18.92	5.04	Industrial	2.84	0.76
Commercial	187.34	50.21	Commercial	26.62	7.14
Fixed Assets	6.56	1.76	Township Enterprises	5.63	1.51
Township Enterprises	42.06	11.27	State Enterprises	9.43	2.53
State Enterprises	16.45	4.41	Collective Agriculture	1.67	0.45
Collective Agriculture	9.58	2.57	Rural Credit Cooperative	32.09	8.06
Individual Agriculture	9.06	2.43	Town Individual Deposits	84.85	22.74
Rural Credit Cooperative	3.40	0.91	Reserve Deposits from RCCs	29.07	7.79
Development Loans	3.13	0.84	Other Deposits	13.35	3.58
Special Loans*	2.60	0.70			
Other Loans	2.94	1.80	Liabilities with PBC	118.29	31.70
Reserve Requirements	25.86	6.93	Due to Other Banks	15.98	4.28
Deposits in PBC	25.00	6.70	Credit Funds	25.70	6.89
Due from Banks	10.50	2.81	Net Earning	1.23	0.33
Cash in Vault	5.96	1.60	Other Liabilities	6.38	1.71
Total Assets	**373.13**	**100.00**	**Total Liabilities**	**373.12**	**100.00**

Source: Almanac of China's Finance and Banking 1990, p.77.

* Special Loans were mainly issued to support poor areas' production at subsidized interest rates. See, Ma Yongwei (1990) "The Agricultural Bank of China: A Banking Business Review". Almanac of China's Finance and Banking, p.233.

Table 5-5 (c)

The Balance Sheet of the Bank of China (BOC), 31 December 1989 (In Billion Yuan)

Use of Funds			Source of Funds		
Item	Amount	As Percent of Total Assets	Item	Amount	As Percent of Total Liabilities
Cash	2.01	0.30	Due to Other Banks	102.18	15.08
Due from Banks	150.16	22.17	Deposits	276.35	40.79
Discounting and Buying Foreign Exchange	12.29	1.81	Transaction Services	11.86	17.51
Loans and Overdrafts	247.55	36.54	Accrued Liabilities	37.00	5.46
Securities and Investment	27.45	4.05	Bank Bonds	11.70	1.73
Real Estate and Equipment	2.21	0.33	Other Liabilities	12.21	1.80
Accrued Assets	39.63	5.85	Received Funds on Others' Behalf	43.71	6.45
Other Assets	6.28	0.93	Guarantee Funds	132.89	19.62
Accrued Assets on Other Banks' Behalf.	43.71	6.45	Trust Liabilities	13.23	1.95
Accrued Security Assets	132.98	19.62	Capital	15.00	2.21
Trust Funds	13.22	1.95	Accumulation Fund	8.39	1.24
			Reserve Funds	7.83	1.16
			Net Earnings	5.06	0.75
Total Assets	677.41	100.00	Total Liabilities	677.41	100.00

Source: Almanac of China's Finance and Banking 1990, p.79.

Table 5-5 (d)

The Balance Sheet of People's Construction Bank of China (PCBC), 31 December of 1989 (In Billion Yuan)

Use of Funds			Source of Funds		
Item	**Amount**	**As Percent of Total Assets**	**Item**	**Amount**	**As Percent of Total Liabilities**
Cash	1.44	0.35	Deposits	115.16	28.26
Deposits in PBC	14.89	3.66	Due to Other Banks	13.70	3.36
Reserve Requirements	14.51	3.56	Borrowing from PBC	25.27	6.20
Due from Banks	13.63	3.34	Bank Bonds	1.93	0.47
Securities	0.79	0.19	Liabilities with Government	128.16	31.45
Loans	149.95	36.89	Trust Funds	67.54	16.57
Accrued Receivables	4.82	1.18	Security Funds	2.56	0.63
Government Investment Loans	31.40	127.97	Accrued Payable Items	12.20	2.99
Trust Investment	65.29	16.02	Other Assets	11.13	2.73
Loan to Subsidized Enterprises	3.33	0.82	Capital	27.90	6.85
Fixed Investment	2.31	0.57	Allowance for Doubtful Accounts	0.20	0.05
Other Assets	8.56	2.10	Net Earning	1.74	0.43
Total Assets	**407.49**	**100.00**	**Total Liabilities**	**407.49**	**100.00**

Source: Almanac of China's Finance and Banking 1990, p.82.

1. Indirect Borrowing through Bank Loans against Treasury Bond as Collateral

The specialized banks do not purchase Treasury bonds from the primary market where the bonds are issued. Since 1985, the government has forced the specialized banks (mainly ICBC) to hold Treasury bonds. To encourage the enterprises to purchase more bonds, a new policy was implemented by MOF in 1985, allowing Treasury bonds subscribed by the state enterprises to be used as collateral security to apply for loans from the specialized banks (see the notes of Table 4-1). Such a policy allowed enterprises to purchase Treasury bonds, and then obtain loans from a specialized bank to offset their investments in Treasury bonds. Hence, such discounting activities are not voluntarily undertaken by the specialized banks.

So far, there has been no official data to indicate how much of Treasury bonds has been transferred into the banking system in that way. The " PBC and MOF Circular on Firmly Stopping the Mortgage, Mortgage Loan on Illegal Trade of Treasury Bonds" published in 1987 disclosed that some enterprises (including individuals enterprises) took advantage of the government policy to collect Treasury bonds at low prices from individuals, and then used them as collateral security to apply for bank loans or as repayment for bank loans.[30] Rooted in parochialism, some branches of local banks and RCCs' agencies accommodated such activities by accepting Treasury bonds at a discount rate as collateral security and lending credit funds to those enterprises. The circular stipulated that the activities of collecting Treasury bonds from individuals, and using them to repay bank loans should be prohibited, except for those enterprises being declared bankrupt. Despite the ban, such illegal activities still run unchecked from time to time.[31] Hence, it can be estimated

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30. See, Almanac of Finance and Banking 1988, pp.451.

that a certain amount of Treasury bonds has been transferred into the banks' assets (although no data can be obtained from official publications).

In a market economy, it is common for commercial banks to hold government bills. It is treated as a primary reserve for the liquidity of bank assets. In principle, China's specialized banks should hold a certain amount of government securities for liquidity and diversity of assets. However, the problem is that the term of China's government bonds is fixed for a period of at least three years and cannot be redeemed by banks before maturity. In addition, the fledging secondary market for Treasury bonds has not opened to the banking system. Hence, Treasury bonds held by the specialized banks do not have any liquidity.

Holding the Treasury bonds has increased security assets in the specialized banks' assets portfolio. Thus, the specialized banks need to adjust its planned credit activities, such as reducing credit loans to enterprises. Under the current banking system, a most likely possibility of specialized banks is to rely on additional credit funds to finance their mandatory bonds holdings.[32] In this case, there is no difference between government borrowing from the specialized banks and that from the PBC.

The interesting evidence is that some banks' credit funds are channelled

31. Wang Hei and Xi Ru (1990), "The Use of Immature Treasury Bonds to Repay Bank Loans: A Cause of Malady", Jinrong Shibao (Financial News), 11 September, p.2; Fei Min (1990), "Many Problems Arising from Using the Treasury Bonds to Return Banks' Loans", Jinrong ShiBao (Financial News), 31 January, p.3; Wang Aihong (1990), "Treasury Bonds: Not Intended to Repay Banks' Loans", Jinrong Shibao (Financial News), 31 January, p.3.

32. Sun Yongjian (1987), "On the Overborrowing by China's Industrial and Commercial Bank," Jinrong Yanjiu (Financial Studies), Vol.6, pp.40-43.

into the government's fiscal budget through state enterprises. For instance, state enterprises use their working capital loans to buy Treasury Bonds. As early as 1983, state banks stipulated that enterprises were prohibited to use their own working capital and banks' working capital loans to buy Treasury Bonds.[33] In reality, this activity did not stop. It was reported that about 24 billion yuan of banks' credit funds was used to purchase Treasury bonds by state enterprises and some other institutions in 1988.[34]

2. Bank Holding of Quasi-Fiscal Bonds and Government Agency Bonds

The characteristics of quasi-fiscal bonds and government Agency bonds are discussed in Chapter 4. Currently, although part of the government bonds is nominally sold through the market, the part sold to the state banks is still conducted through administrative means.

On April 20, 1988, the State Council approved the issue of 8 billion yuan of "Fiscal Bonds" by MOF. (1 billion yuan for 2 years, and 7 billion yuan for 5 years.) The funds raised through sale of Fiscal Bonds were to support key state projects and to finance the fiscal budget deficit.[35] These 8 billion yuan bonds were allocated administratively through quotas to the four specialized banks, the two comprehensive banks and other non-bank financial institutions. A quota designates the amount which a bank has to buy. The interest rate was

33. Zhu Tansuan (1983), "Promoting the Role of the Bank in Working Capital Management," Zhinggua Jinrong (China's Finance), Vol.8, pp.9-13.

34. Wang Zhiqin (1991), "Issues on More Transparency of the Banking System Being Used to Finance Fiscal Investments," Jinrong Yanjiu, (Financial Studies), Vol.10, pp.32-35.

35. See, "Circular of PBC on Issue 1988 fiscal Bonds". in Zhang Xie (eds), 1989, *op. cit.*, p.31.

7.5% p.a. for the two-year's bonds, and 8.0% p.a. for the five-year bonds. Compared with the general interest rates of ICBC and ABC, which was 9.90% for two-year fixed capital loan and 10.8 for five-year fixed capital loan, the interest rates of government securities were relatively low.

In the same year, an additional 8 billion yuan of "Basic Construction Bonds" issued by the Ministry of Petroleum and the Ministry of Transportation were also allocated to the four specialized banks.[36] The issuing of Basic Construction Bonds was to raise extra funds for key state projects which had been previously funded by fiscal budget grants. Therefore, the bond issue reduced the burden on fiscal budget investments. The exact figures of the purchasing amount by each bank are not available.

Besides "Fiscal Bonds" and "Basic Construction Bonds", another 8 billion yuan of "State Construction Bonds" was issued by the MOF in 1988. The bonds were sold to the public, various foundations[37] and financial institutions.[38] However, in this case, it was not compulsory for the specialized banks to buy them. There is no information on whether any purchase was made by the specialized banks or how much was purchased.

It was reported by some Chinese economists that the total amount of government securities purchased by the four specialized banks and NBFIs was about 20 billion yuan in 1988.[39] It was believed that this was a major factor

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36. See. "Circular of PBC and SPC on Issuing of 1988 Basic Construction Bonds", in Zhang Xie (eds), *op. cit.*, p.29.

37. For instance, the Children's Foundation, the Foundation for the Disabled.

38. See, "Circular of PBC and MOF on Issuing of 1988 State Construction Bonds.", in Zhang Xie (eds), *op. cit*, pp.33.

39. Wang Zhiqin (1991), *op. cit.*

causing money supply (cash) to increase in 1988 by 46.7% over the previous year.[40] Moreover, before the buying of government bonds, there was already an estimated 20 billion yuan's credit funds gap between bank credit demand and supply.[41] In such a situation, the bank was still required to buy government bonds. Hence, the only way for specialized banks to buy the bonds was to rely on the PBC for new loan funds. The financial situation of 1988 was that, with rapid growth of money supply, the inflation rate rose to 18.5%.[42] In August and September 1988, panic buying occurred in many parts of the country to hedge against inflation. Such a situation was invariably bound up with the specialized banks' purchasing of government financial securities in that year.

Therefore, it can reasonably concluded that the funds used for buying quasi-bonds by the specialized banks come from the PBC. The same situation can also be found in the banking system in other socialist states. For instance, in Tanzania, most of the subsidies channeled through commercial bank's `lending' appear to have been financed by the central bank.[43] Hence, just as there is no commercial banking system in the true sense of the world, there is no central bank.[44] This applies to China as well.

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40. Duan Yinling (1989),"Situation of Currency Circulation in 1988", Almanac of Finance and Banking 1989, pp.184-85; Wang Shaofei (1989), "Checking Inflation at the Root Level," Jinrong Yanjiu (Financial Studies), Vol.6, pp.10-15.

41. Lue Bin and Lo Lanbo (1989), "Problems in the Development of Money Market and the Lesson We Should Drow from It," Jinrong Yanjiu (Financial Studies), Vol.4, pp.17-23.

42. See, Almanac of China's Finance and Banking 1989, p.46.

43. Paul Collier and Jan Willem Gunning (1991), "Money Creation and Financial Liberalization in a Socialist Banking System: Tanzania 1983-88." World Development, Vol.19. No.5., pp.534.

44. Ibid, pp.543.

5.3.3 Borrowing through Issuing Directed (Policy) Loans

It is estimated by a Chinese economist that currently about 40% of the loan assets of specialized banks are policy (directed) loans.[45] Directed loans are mainly used to finance working capital and technical innovation of state enterprises. As noted in Section 3.4.1, lack of investment in these two parts is caused by the fact that the state enterprises favour fixed capital investments. Direct loans are also used to write off losses of state enterprises created by unmarketable products, and to subsidize the losses created by the rigid price system and depreciations of domestic currency. It should be mentioned that some directed loans are also imposed by the local governments. The intervention of the local governments in the local branches of the specialized banks has become one of the main problems in China's banking system operation.[46] The intervention by the local governments is not a relevant issue in this study. The relevant issue is how the central government uses directed loans to increase its spending indirectly.

1. Directed Credit and Working Capital Loans

Most of the reasons that have prompted government intervention in the banking system operation come from the state enterprises, as stressed in Chapter 3. The supply of working capital for state enterprises is one of the main reasons. Hence, extending directed (policy) loans by the specialized banks is closely related with the supply of working capital of state enterprises.

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45. Gao Zhenguo (1990), "On the Environment for Interest Rate Reform", Caimao Jingji (Finance and Trade Economies), Vol.9, pp.39-41;

46. See, Tam (1987), *op. cit.*, Zhou and Zhu (1987), *op. cit.*

Working capital loans normally mature at one year or less. However, in reality, working capital loans are characterized by "revolving funds" used by enterprises in one production cycle after another with hardly any repayment. As a result, the specialized banks are confronted with a mismatch between the maturity of their assets and liabilities, which aggravates their dependence on the PBC for additional loan funds.

The working capital of state and collective enterprises in urban areas is mainly provided by the ICBC. In 1989, outstanding working capital loans accounted for 77.84% of the total assets of ICBC, and 88.93% of the total loans issued by ICBC [See Table 5-5 (a)]. The working capital needs of township enterprises and collective enterprises in rural areas are supplied by the ABC, as shown at Table 5-5 (b). Currently about 80% of the working capital of state enterprises comes from the state banks (according to official regulations, enterprises should own at least 30% of funds in working capital.) Hence, in China, the state enterprise depends heavily on borrowing rather than on equity capital. The high ratio of debt financing from state banks is considered to be the cause of difficulties in tightening monetary policy in China. When the PBC adopts a stringent credit policy, the production of enterprises will easily be affected by the reduced supply of working capital.

Over-heated investments in capital construction in China have also boosted the demand for working capital. It was estimated by ICBC that a 20 billion yuan gap existed between the supply and demand of the planned working capital each year.[47] Hence, to protect the key state enterprises and projects, the government often determines the direct granting of working

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47. Cheng Shiqian (1987), "Issues on the Problem of the State Budget Borrowing from the State Bank," Jinrong Yanjiu (Financial Studies), Vol.10; Lue Bin and Xia Lan, (1990), *op. cit.*

capital loan. The following examples will demonstrate how working capital loans of specialized banks are extended to comply with the government's requirements and directives.

1) The Ineffectual Enforcement of Regulations on Working Capital Lending. The supply of working capital has recently become a controversial issue among Chinese financiers. One major problem is that many state enterprises have a low level of self-owned working capital and the amount is generally lower than the 30% level required by state banks as a prerequisite for a working capital loan. The self-owned working capital of state enterprises comes from that part of their retained profits called "Production Development Funds". For newly-established enterprises, their initial self-owned working capital is covered by the investment plan of the government budget. In reality, the overall average ratio of state enterprises' own working capital declined from 30.95% in 1983 to 18% in 1990. For newly-launched key state projects, the ratio was far lower than the required 30%.[48] The former situation was due to the fact that enterprises prefer to invest their retained funds in fixed capital projects. The latter one, however, was that the planned budget working capital was often diverted to increase investments in fixed capital. These two situations occurred because the state enterprises knew that the shortage of working capital could ultimately be financed by state banks.

In reality, the state banks have to ignore the lending regulations on working capital in dealing with those enterprises whose own working capital ratio was lower than 30%. In 1988, many key state projects' own working capital was lower than 30%. The state banks were instructed by the government to help those key state projects by supplying extra working capital. In response, the specialized banks began to issue Bank Bonds as an alternative

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48. Jinrong Shibao Commentators (1990), "Why Funds are still in Shortage with More Bank Loans?", 25 January, p.1.

for extra funds to extend working capital loans.[49] In 1988, about 1 billion yuan was raised through bank bonds, which aimed at financing those new key projects whose own working capital ratio has been lower than 30% since 1986. These enterprises included: the Qilu Petroleum and Chemistry Company, Yizhen Chemical Fiber Factory, Baoshan Iron and Steel Complex and Yangzi Ethylene Chemical Factory.[50] According to Chinese bank regulations, the own working capital of these key state projects should be funded by grants from the fiscal budget. However, they were in fact financed by the banking system, which acted simply as the fiscal agent in such circumstances.

2) Issuing of Bank Bonds to Fund Working Capital Loans Bank Bonds have been issued since 1985. Table 5-6(1) gives the annual amount of Bank Bonds issued from 1985-1989. It can also be seen from Table 5-5(a) that the Bank Bonds represented about 0.7% of the total bank deposit liability of ICBC in 1989. The main purpose of issuing Bank Bonds was to mobilize funds to extend working capital loans to those planned priority projects whose own working capital was below the bank's 30% requirement. All Bank Bonds were issued to urban and rural individuals. Bank Bonds carried higher interest rates than bank deposits. Enterprise borrowers from such funds also paid a correspondingly higher interest rate than banks' nominal lending rate for equal-maturity loans. One problem raised by Bank Bonds was that the high interest rates attracted some people to withdraw their bank deposits to buy bonds. Therefore, some bank deposits were transferred into the form of Bank Bonds. Hence, as far as the state banks were concerned, credit funds were not increased. The main change might be that the banks' credit funds were once

49. "Regulations of PBC for Issuing of 1988 Financial Bonds and Provisions of Specialized Loans", Almanac of China's Finance and Banking 1989, p.521.

50. Liu Hongru (1988,b) Financial Market, (Beijing: Xieyuan Publishing House), p.347.

Table 5-6 (1)

Bank Bonds Issued by the Four Specialized Banks

Year	(1) Amounts (Billion)	(2) Term	(3) Interest Rates of Bank Bonds (p.a)	(4) Interest Rates of Comparable Bank Deposits (p.a)
1985	0.50	1 Year	9%	7.2%
1986	3.00	1 Year	9%	7.2%
1987	6.00	1 Year	9%	7.2%
1988	6.50	3 Year	9-13%	8.64%
1989	6.07	1 Year	13.34%	11.34%

Source: Almanac of China's Finance and Banking, 1986,1987,1988,1989,1990.

redistributed to the benefit of key state enterprises and projects.

3) Obligations of Specialized Banks to Help State Enterprises for any Problems with Working Capital. In China, the state banks, under the government pressure, become the last financial resort of state enterprises, especially in the supply of working capital.[51] In early 1989, the Chinese government focused its financial attempts on breaking the chain of "triangle debts" (Shao Jiao Zhai) among state enterprises. The government clarified the amount of the accumulated unpaid inter-enterprise bills and large overdue receivables of enterprises vis-a-vis the banking system.

The chain of "triangle debts" has resulted in non-repayment of many banks' loans. Several factors have spawned the debt chain in China and they also reveal some fundamental problems in the process of both the economic and financial reforms. The first factor is the unchecked continual expansion of capital construction by state enterprises. It was reported that the actual investments of fixed capital of state enterprises were 347.7 billion in yuan 1989. However, the planned fixed capital investment was only 296.5 yuan (planned amounts included fiscal budgetary grant, planned state bank loans, funds raised by enterprises, and foreign investment). The 51.2 billion yuan of excessive investments was partly "financed" by unpaid bills among state enterprises due to each other.[52] The second factor lending up to the chain of "triangle debts" is that a large number of state enterprises operated persistently with losses. Some of the losses were caused by the regulated price system. For

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51. For detailed discussion of the financial relationship between the state banks and state enterprises, see, Bowles and White (1989) *op. cit.*, Zhou and Zhu (1987), *op. cit.*

52. Shi Minshen (1991, b), "Breakthrough: Invigorating Large and Medium-sized State Enterprises," Renmin Ribao (People' Daily), 19 August, p.2.

those enterprises, their low repayment ability often resulted in delays in their repayments. The stockpiling of unmarketable products is the third factor that has caused rising overdue repayments. It was reported that about 80 billion yuan's worth of products was unmarketable and stockpiled in state-owned industrial enterprises at the county level in June 1991. Therefore, they could not pay off their debt to other enterprises and banks.[53]

One phenomenon is that many bills of large and medium-sized state enterprises have been default by small enterprises or capital construction enterprises, because the latter has more difficulties in getting funds from state banks than those large and medium-sized enterprises to expand their investments.[54] Hence, some small and construction enterprises have resorted to defaulting others' debts so as to continue to expand their production. As a consequence, to protect those large and medium-sized enterprises, the state banks sometimes may have to issue some extra loans to fill up their investment shortages.[55] Therefore, many problems arising from expansion of fixed and working capital investments, continuation of the regulated price system, incomplete reform of state enterprises, etc., are to be solved by the state bank currently in China.

To "invigorate" the state enterprises, the specialized banks are required to provide extra funds for enterprises so as to break up the debt chain. It was reported that the ICBC extended about 4 billion yuan's credit funds to revive enterprises in 1989.[56] On 30th November 1989, the PCBC issued a total of 6

53. Shi Minshen (1991,a), "Continual Increase of Debt Chains and Their Causes," Renmin Ribao (People's Daily), 8 August, p.2.

54. For those capital construction companies, their working capital investments are more controlled by the plan.

55. Shi Minshen (1991,a), *op. cit.*

billion yuan of loans to enable over 200 major state construction projects to make payments on defaulted loans. About 88% of the amount was channelled to projects in the fields of energy, transportation and raw materials industries. The new loans increased the scale of that year's loans for capital construction to over 30 billion yuan, a remarkable increase over the previous year.[57] From March 1989 to August 1990, 160 billion yuan unpaid debt was settled with the assistance from state banks,[58] which was about 12.89% of the total loan assets of state banks in 1989.

Two questions need to be addressed here. One is how specialized banks were able to expand their lending to break up inter-enterprises debts, e.g. where they got the funds for settling the debt-chain. According to a official Chinese report, a total of 30 billion yuan bank loans was issued in 1991 to break up debt chains.[59] It also indicated that the 30 billion yuan of loans came from the unplanned credit funds of the PBC, e.g., increase of money supply.[60] The second question is that if the fundamental problems which caused "triangle debt" chain are not solved, unpaid inter-enterprises bills and overdue receivables will not disappear. In practice, China is confronted with a situation where new debts are incurred shortly after the old debts are settled.[61] However, if the Chinese government continues to rely on the banking system

56. See, Almanac of China's Finance and Banking 1990, pp.212.

57. SWB, FE/W0158, (90), p.A/1. "Bank to Issue Loan to Settle Debts".

58. Shi Minshen (1991,b), *op. cit.*

59. A campaign was launched in China in 1991 to break up the debt chains among the enterprises, under the direct supervision of the State Council. See, Xu Kehong (1991), "Debt Chains Being Broken up in the Whole Country," Renmin Ribao (People's Daily), 21 September, p.1.

60. The PBC' spokesman, (1992), "Stable Financial Situation in China," Renmin Ribao (People's Daily), 12 March, P.1.

61. Shi Minshen (1991,a), *op. cit.;* Fu Xinyu (1991), "Over-Heated Economy to Be Controlled to Stave off Continual Increase in Triangle Debt Chains," 17 August, Renmin Ribao (People's Daily), p.2.

to untie debt chains, China's financial system will be in distress.[62] The key question is that the Chinese government should improve the repayment ability of the borrowers.

The shortage of working capital of state enterprises is also caused by the state enterprises diverting their working capital loans to other purposes. For instance, some state enterprises use working capital loans (or their own working capital) to pay their taxes to the government. Under the "contract responsibility system", paying taxes is a hard target for state enterprises who contracts with the government. Thus, state enterprises resort to every possible means to pay their taxes. Official discussion has revealed the evidence of using working capital loan to pay taxes.[63] However, there are no available data to show how much bank credit funds have actually been diverted. Enterprises can divert their working capital loans to other uses because they know that the government will always help them solve working capital problems through the state banks.

For any bank, there is a major risk that major losses will occur if low-yielding or unbankable investments become a large share of the banks' total loans. Table 5-6 (2) shows the efficiency of working capital loans of ICBC revealed by the survey of 248,653 state enterprises. It can be seen that more than 10% of working capital loans had problems in different forms. These problems cannot be said to have no relation with direct loans issued under administrative directives.

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62. For the discussion of the macro-consequence of financial distress, see, World Bank (1989,a), *op. cit.*, pp.72-83.

63. Wang Zhuhua (1989), "Ten Methods by Fiscal Budget to Squeeze Banks' Credit Funds," Jinrong Yanjiu (Financial Studies), Vol.4, pp.59-60; Xia Deren (1991) "On the Deformation of China's Credit Relationship," Vol 4, Caijing Wenti Yanjiu (Research on Financial and Economic Problems), Vol.4, pp.1-5.

Table 5-6 (2)

Survey of Working Capital Loans of ICBC
(148,653 State Enterprises), 1989

Types	Amounts (Billion Yuan)	As % of Total Loans in 1988 (%)	As % of Total Problem Loans
(1) The accumulative amount of working capital loans issued to 148,653 state enterprises	268.74		
(2) The total amount of problem loans	29.68	11.04	
(a) Loans used in excessive stockpile of materials	5.64	2.10	19.00
(b) Loans used for nonmarketable products	7.44	2.77	25.06
(c) Loans switched to other purposes	12.26	4.56	41.31
(d) Bad loans	4.34	1.61	14.63

Source: Almanac of China's Finance and Banking 1990, p.229.

2. Directed Credit and Fixed Capital Loans

As discussed in Chapter 3, the share of fiscal authorities in financing the capital investments of state enterprises has been gradually reduced since 1979. Correspondingly, the shares of state bank loans are increased (see Table 3-10). These changes enable the state banks to extend their loans in fixed capital investments. However, in fact, the government's role continues to be significant in fixed capital investments even for that portion of credits granted through the banking system.

It is reported that most of the fixed capital loans of the specialized banks (over one-year term) are directed by the government dictation.[64] For instance, 40 billion yuan's fixed capital loans were extended by the four specialized banks during 1981-86 under the direct instructions of the government.[65] It accounted for about 35% of the total fixed capital investment of state banks in this period.[66] Extending fixed capital loans by state banks is one of the key reform measures in the financial reform in China, aiming to improve the efficiency of fixed capital investments through the form of interest-bearing funds, as opposed to the state budget grants. However, these long-term loans provided under government directions may impose a higher risk on banks' operation.

Extending directed credits (policy loans) is a significant part of the

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64. Jia Kang, (1987), *op. cit.*, p.26; Wang Shaofei (1987), *op. cit.*; Zhang Xiaohui and Fei Changzhi (1990), "Some Thoughts on Rational Arrangement of State Banks' Working Capital and Fixed Capital Loans," Jinrong Shibao (Financial News), 4 September, p.2.

65. Wang Jiachun and Wang Xiaoyan, (1987), *op. cit.*, pp.28.

66. Calculated from data in "Sources of Credit Funds of State Banks (1952-1989)", Almanac of China's Finance and Banking, 1990, p.48.

operation of the PCBC. Apart from the budget-funded resources, [in 1989, budgetary grants contributed 31.45% of PCBC's total liabilities, as shown at Table 5-5 (d)][67]. The resources mobilized by ICPC itself were also directed by the government. It was reported that directed loans accounted for more than 70% of the total loans of PCBC in 1985.[68] However, the budgetary grants to the PCBC in 1985 accounted for only about 35% of the total liabilities.[69] In 1987, more than 60% of PCBC loans were used to finance key state projects.[70] Hence, to a certain extent, the PCBC still acts as a fiscal budget agent of MOF rather than a bank.

3. Policy (Directed) Loans for Other Purposes

With scarce budgetary resources, the Chinese government relies largely on directed loans to expand its investment. Hence, the state banks have to play a more fiscal and social role in their operations. Here are some examples.

1) Using Banks' Own Capital to Write off Bad Loans The banks' own capital has been used several times to write off bad loans under the government's directions. During 1978-83, 11.7 billion yuan was used to write

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67. Before the economic reform, PCBC functioned to distribute funds from state budgetary appropriations to enterprises to be used in capital construction (i.e. investment in new enterprises or major expansion of existing enterprises), and to supervise the use of the funds. Since 1979, investment grants previously made by the budget have been gradually replaced by loans. In addition to budget-financed loans, PCBC also extends loans by mobilizing funds by itself.

68. Jia Kang, (1987), *op. cit.*, pp.26.

69. World Bank (1988,b), *op. cit.*, p.256.

70. Zhou Daojiang, President of PCBC, "Forging Ahead in the Course of Reform and Development along the Way of Openning-up New Business Areas", Almanac of Finance and Banking 1988, pp.195.

off scrapped steel and electrical products.[71] It amounted to about 15% of the total own capital of the state banks in 1983 (The own capital of state banks was 72.07 billion yuan in 1983).[72] The banks' own capital was also used to write off the bad loans caused by "loans to less developed areas" (Fu Pin Kuan).[73] Such activities reduced the value of assets and own capital of the state banks. The downward trend of own capital in total liabilities of state banks is shown in Figure 5-1. The decline reflects the reduction in the degree of protection afforded to depositors. In Western countries, this decline is modified by the increase in the bank's size and the diversification of assets, the relatively large holding of liquidity government securities, the increasing efficiency of money and capital markets. The Chinese banking system has not experienced these developments. Currently, China's banking system resorts mostly to its monopolized position in financial operation. (Figure 5-1)

2) Filling Various Financial Gaps of Fiscal Budget Beset with difficulties in its fiscal budget, the Chinese government instructs the state bank to offer more financial help to the state budget in some investment areas. For example, 8.10 billion yuan of bank funds were used by MOF to make up for the deficits of foreign trade settlements during 1978-83.[74] In another instance, bank funds were also used to make up for the losses of some state enterprises, including foreign export sectors, coal industry and oil sectors, whose losses resulted normally from the continually regulated price system. Those enterprises should have received subsidies from budgetary grants from the

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71. Deng Yinlin and Geng Hong (1986), *op. cit.*, pp.24.

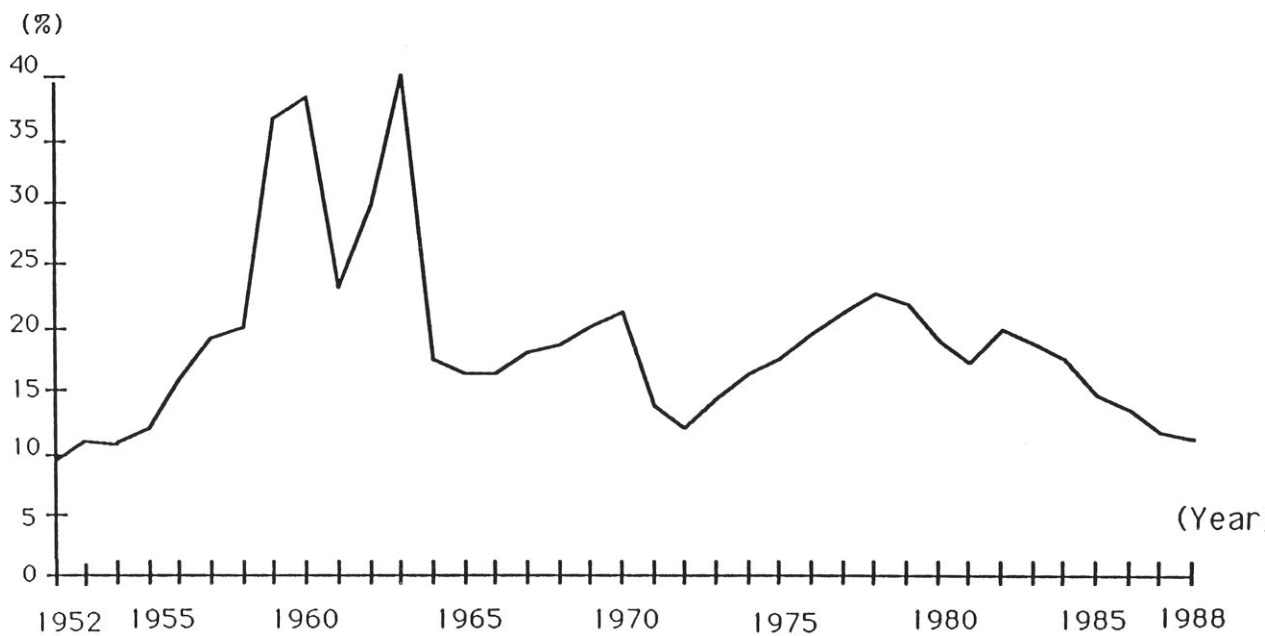
72. See, Almanac of China's finance and Banking 1989, p.53.

73. Xu Nuo (1989), "A Probe into the Problems Causing less Liquidity of Assets of State Banks," Jingji Tizhi Gaige (Reform in Economic Structure), Vol.3, pp.86-90.

74. Deng Yinlin and Geng Hong (1986), *op. cit.*

Figure 5-1

Own Capital of State Banks as Percent of the Total Liabilities of the State Banks During 1952-1988



Source: The Almanac of China's Finance and Banking 1989, p.52-57 government to cover their losses. In practice, the government often delays paying their subsidies or does not effectively pay at all. Hence, these enterprises have to rely on soliciting loans from the state banks so as to continue their production.

3) Loans For Political Purposes The specialized banks often extend some loans for political reasons in China. The purposes of these loans can be seen from their names. For instance, "Stability and Unity loan" (An Ding Tuan Jie Dai Kuan), "Relief Loans" (Jiu Zai Kuan), and "Loans for Less Developed Areas" (Fu Pin Kuan). Many borrowers of this category of loans have little ability to repay, but the banks have no choice but to make the loans.[75]

The above activities of the Chinese government using bank funds to finance its investment directly or indirectly reflect a common characteristic in CPEs, namely, bank lending is determined by the government rather than the market demands. With interventions from the government, the specialized banks have limited autonomy in decision-making. The assets and liabilities management are also made impossible. Such a situation reflects an ongoing confusion over the respective spheres of the fiscal and the financial systems in China. Hence, further fiscal reform is necessary to facilitate the reform in the banking system.

5.3.4 Borrowing through Administered Interest Rates

As the process of financial reform unfolded, the significance of interest

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75. For the discussion of some political loans, see, Zhou Dangjiang (1990), "Tentatively on the Nature of China's Specialized Banks," Caijing Wenti Yanjiu (Research in Financial and Economic Problems), Vol.85, No.12, pp.25-32.

rates in financial mobilization and allocation is gradually being recognized.[76] As shown at Column (2) and Column (4) of Table 5-7, both bank deposits and loan rates have been adjusted several times. But the interest rate continues to be set administratively by PBC, after consultation with and approval by the State Council. Since 1 February, 1987, the specialized banks have been given authority to set interest rates of working capital loans 20% higher than the level stipulated by PBC.[77] It rose to 30% in 1988, and the same discretionary power was extended to fixed capital loans.[78] Although nominal interest rates have been adjusted several time in China, compared with the changes in the retail price index (see Column 3 of Table 5-7), the real interest rate was still low and in some cases, registered negative (see the figure in 1987, 1988).

In China, the structure of the interest rates system reflects the government's preference with respect to distribution of subsidies to various productive activities, groups and regions. It also reflects the government's different policies for development of heavy industry, light industry, agriculture and individual businesses. Many characteristics reflected in the structure of interest rates in other countries---differential for risk, maturity (term structure), inflationary expectations and the opportunity cost of alternative investments---had not yet been fully reflected in the structure of the interest rates system in China. The reason is that the interest rate still plays only a limited role in allocating resources.

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76. Xia Deren (1989), "Mainline the Interest Rates, Continue the Financial Reform", Zhongguo Jinrong (China's Finance), Vol.1, pp.19-20.

77 "A Table of Interest Rates for Loans of the Specialized Banks in 1987", Almanac of Finance and Banking 1988, pp.119.

78. "Tables of Interest Rates for Bank Loan of ICBC in 1988", Almanac of China's Finance and Banking 1989, p.158.

Table 5-7

Nominal Bank Interest Rates and CPI During 1978-89

Year	(1) Price Index of Retails Sales of Consummer Goods (annual Growth rate)	(2) Interest Rates of One-Year Term-Deposits (% per year)	(3) (2)-(1)	(4) Interest Rates of One-Year Working Capital Loans (% per year)	(5) (4)-(1)
1979	2.00	3.96	1.96	5.04	3.04
1980	6.00	5.40	-1.60	5.04	-0.96
1981	2.40	5.40	3.00	2.52	0.12
1982	1.90	5.76	3.86	3.60	2.70
1983	1.50	5.76	4.26	7.20	5.70
1984	2.80	5.76	2.96	7.20	4.40
1985	8.80	6.84	-1.96	7.92	-0.88
1986	6.00	7.20	1.2	7.92	-1.92
1987	7.30	7.20	-0.10	7.92	-0.62
1988	18.50	8.64	-9.86	9.00	-9.50
1989	17.80	11.34	-6.46	11.34	-6.46

Source: Col.(1)- from Statistics Yearbook of China 1990, p.249.
Col.(2), (3), (4) (5)- from Almanac of China's Finance and Banking, 1986,1987, 1988, 1989, 1990.

In line with the government's economic policy, interest rates are currently set according to the categories of clients and types of loans. For instance, the rates vary in the case of budgetary-financed loans, working capital loans, technical transformation loans , capital construction loans, loans by RCCs and by NBFIs, bank bonds, etc. Such a system functions directly for the government's intended priorities. Therefore, there are many different types and categories of interest rates in the bank's interest rate schedule. For instance, there were 9 categories, and about 30 lending rates in ICBC published rate schedule in 1989.[79] The difference between the preferential interest rates and general interest rates is shown in Table 5-8. It can be seen that general working capital loans and general fixed capital loans were considerably higher than the preferential interest rates.

Raising nominal interest rates during the last twelves years in China has not in practice improved the efficiency of allocating financial resources. The effect of the interest rate reform has been largely counterbalanced by the existence of directed credits. Directed loans are often granted with interest subsidies financed by the banks and, sometimes by the government budget. As mentioned before, currently, more than 40% of bank loan assets are directed (policy) loans with interest subsidies.[80] Such a large proportion of loans with subsidized interest rates induced the following problems. First, existing subsidized interest rates had provided a chance for state enterprises to bargain with the state banks, so that they have had no incentive to raise funds from the financial markets. This may be one of the reasons for the delayed development of a capital market in China. Second, low interest rates supported by subsidies impose a burden on savers because the banking system have to keep the

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79. See, <u>Almanac of China's Finance and Banking 1989.</u> p.157

80. Wang Zhiqin (etc) (1991), *op. cit.;* Gao Zhenguo, (1991), *op. cit.*

Table 5-8

The General Interest Rates and Preferential Interest Rates of ICBC, Starting from 1 September, 1988.

Item	Interest Rates (% p. a.)
General working capital loans	9.00
(1) Working capital loans for factories run by ethnic minorities (production, trade & handcrafts)	6.00
(2) Working capital loans for welfare factories	7.20
General fixed capital loans (1-3 years)	9.90
(1) Fixed capital loans for industry of mine, electricity, petroleum, transportation, telecommunication, iron and steel, forestry, railway, etc. (1-5 years)	7.92
(2) Loan for 14 coastal cities and special economic zones (SEZs) (1-5 years)	5.88*
(3) 0.4 billions technical exploration loans (1-3 years)	7.02**

Source: Almanac of China's Fiance and Banking 1989. p.158.

* the borrowers paid an interest rate of 2.88% and the central fiscal budget paid 3.0%

** the PBC subsidized an interest rate of 2.88% to ICBC.

deposit rates at a low level. Third, the subsidized low interest rate system hinders price competition among the financial sectors. Hence, the equilibrium market interest rates cannot emerge due to the existence of nonprice competition. Fourth, the large proportion of interest rate subsidies renders interest rates inoperative in the field of indirect monetary policy. Moreover, the combination of directed credits and subsidized interest rates has created an excessive demand for bank funds, which ultimately becomes a pressure on the PBC to loosen its credit control.[81]

5.4 Government Borrowing from Non-Bank Financial Institutions (NBFIs)

The development of NBFIs can improve financial service and ensure a competitive environment for improving financial intermediaries' efficiency in mobilizing and allocating financial resources. Most NBFIs were established in China after the financial reform begun. As in other countries, the emergence of NBFIs caters to satisfy the unmet demands for financial services arising from the economic reform. The development of NBFIs indicates that the nonbank sector is more likely to operate in areas where market forces and financial discipline are stronger, and is linked more closely to the growing non-state economy and the use of rising extra-budgetary resources.[82]

Table 5-9 presents a summary of the functions, financial resources and operation areas of major NBFIs in China. The NBFIs include a number of investment and trust companies specializing in long-term financing, based largely on resources mobilized outside of China; leasing companies, often

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81. Sun Yongjian, (1987), *op. cit.*

82. See, Tam, (1991, b), p.14.

Table 5-9 (1)

General Characteristics of China's Nonbank Financial Institutions

Name & Time Established	Functions	Sources of Funds	Remarks
China International Trust and Investment Corporation (CITIC) (1979)	Introducing foreign investments, engaging in trust investments for foreigners, and handling the ordinary banking business of foreign currency within China.		as a ministry directly under the State Council; also an advisor to other investment and trust companies.
Trust and Investment Companies (TICs) (1986)	Raising foreign currency funding for projects in China; entrusting the deposits; leasing and equity investment; trading securities and issuing guarantees. It mainly serves state enterprises, and Chinese-foreign joint-venture projects.	Received trust deposits from the government and enterprises; borrowings from foreign banks, issuing bonds abroad, raising foreign exchange deposits from overseas Chinese.	They cannot accept deposits. They must be licensed by PBC. 291 owned by local governments, 454 owned by specialized banks, and supervised by the PBC and specialized banks.
China Investment Bank (1981)	As a development finance company. Financing import equipment for small and medium-sized industrial enterprises.	From foreign currency loans; from World Bank loans; from PCBC loans with low interest rates	Supervised by PCBC.
Rural Credit Cooperatives (RCCs) (Later of 1950s)	Extending credits to individual collective/rural enterprises and town and village enterprises.	Saving and term deposits from individuals, rural collectives and private businesses, township and village enterprises.	Subordinate to ABC. Redeposit certain percent of their total deposits with ABC. It was 30% in 1985, 20% in 1986.
Urban Credit Cooperatives (UCCs) (Most after 1987)	Providing loans and payment services mainly to small urban collectives and private enterprises.	Individual household deposits, private enterprise deposits, small and medium-sized SOEs deposits.	More than 60% supervised by ICBC.
Finance Companies (1986)	Recycling idle internal funds among enterprises. Channeling the long-term capital investments and short-term working capital loans to their shareholders. Providing other leading activities, e.g., leasing, acceptance, bill discounting and credit guarantees; and also providing other non-financial services, e.g., consulting and notary public functions.	Their own capital; time deposits from intergroups or affiliated companies and short-term bank credits.	According to PBC's regulations, finance companies can be formed only by industrial and commercial conglomerates to conduct intra-group financing.

Table 5-9 (2)

General Characteristics of China's Nonbank Financial Institutions

Name & Time Established	Functions	Sources of Funds	Remarks
Financial Leasing Companies (in early 1980s)	Financing import capital goods and machinery for export-oriented companies	Own capital; interbank loans and external loans.	Activities limited to finance-leasing, they cannot import capital goods directly, nor grant operating leases.
Security Companies (1986)	Trading in Treasury bonds, bank bonds, enterprises' stocks, securities, and underwriting issues of Treasury bonds.[1]	No available.	46 securities companies and 700 branches.[2]
People's Insurance Company of China (PICC) (1980)	Handling all insurance business. By the 1986, the company had offered some 120 types of domestic insurance coverage and 30 kinds of foreign insurance.	From income of various insurance services; mainly from pension, accidents, industrial and life insurance.	In 1988, PICC reserve could be placed in time deposits with the specialized banks. Purchase of straight bonds or real estate or loans of any type, including housing loans, are not allowed.

Source:
World Bank (1988,b), *op. cit.*
Almanac of China's Finance and Banking, 1986, 1987, 1988, 1989, 1990.

1.Yan Jianqan, (1991), "Underwriting in This Years Issuing of Treasury Bonds," Renmin Ribao (People's Daily), 21 April, p.2.
2." A Good beginning of the Secondary Securities Market," Renmin Ribao (People's Daily), 19 April, p.1.

associated with a bank or investment companies and also provide access to external funds; insurance companies which have a monopoly in providing the service for the whole country; and RCCs and UCCs which provide a wide range of services in rural and urban areas. Hence, the operation scope of individual NBFIs is rather limited in term of their functions and geographical areas in China.

Table 5-10 shows a comparison between the state banks and the NBFIs in 1989. So far as the number of branches are concerned, there was almost no difference between the two of them. However, that does not mean that China's financial reform is deepening. This is because among branches of NBFIs, about 64% of them (58,418 branches) belonged to RCCs, 3.76% to UCCs, and to 3.1% PICC.[83] A large number of RCCs is determined by China's geographical and population pattern in the rural areas. Many branches have a small staff of two or three people. The figures of employees in state banks and NBFIs further indicate the degree of financial reform in China, since the employees of NBFIs account for only about 50% of that of state banks. The indicator which could fully reflect the relative development of NBFIs in China is their assets. NBFIs assets were only 14.99% of the total assets of the state bank in 1989 (12.69% in 1986, 13.23% in 1987).[84] Hence, the NBFIs are still a small part of financial sector.

There is an ideological problem to hinder the development of NBFIs in China. The government fears that the development of NBFIs may snatch financial resources from the state banks so as to affect the funding of state enterprises and key state projects. The government is also nervous that fixed

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83. See, "Membership, Organization of the Whole Financial System," Almanac of China's Finance and Banking 1990, p.189.

84. See, Tam (1991, b), Table 7.

Table 5-10

<u>Comparison Between State Banks and NBFIs in 1989</u>

1989	(1) Branches	(2) Employees (Million)	(3) Assets (Billion)
State Banks*	94.530	1.34	2309.2
NBFIs**	90.721	0.63	346.20
NBFIs/State Banks	95.97%	47%	14.99%

Source: Col.(1)- see, "Membership, Organization of the Whole Financial System," <u>Almanac of China's Finance and Banking 1990</u>, p.189.
Col.(2)- as same as Col.(1)
Col.(3)- from Tam (1991, b).

* State Banks- include the PBC, ICBC, ABC, BOC, BOCOM and CITIC' Industrial Bank.
** NBFIs- include the RCCs, UCCs, PICC and TICs.

capital investment can get out of control because enterprises may be able to get funds from the less controlled channels. Hence, the government has given some protection to the state banks by restricting the development of NBFIs. Since March 1989, the credit activities of NBFIs have been brought in line with a broad credit plan. Such a move by the government is intended to address the loss of control over both the expansion and allocation of credit and to enhance its macro-control.[85] The fact is that the NBFIs have so far been a small part of financial sectors. Hence, the development of NBFIs may be a factor, but not a fundamental one to cause losses in macro-control. As in other LDCs, NBFIs are also used by the Chinese government as a channel to finance its expanded investment. How the Chinese government has intervened in NBFIs' operation can be shown in the following aspects.

1. Holding Government Bonds by NBFIs

It should be noted that direct borrowing from the NBFIs by the government is not substantial at present. The only evidence is that some NBFIs (including RCCs, UCCs, PICC, and Trust and Investment Companies) were required to purchase two kinds of quasi-bonds with the specialized banks in 1988. Data on the precise purchasing amounts are not available.

2. Borrowing through High Re-deposits Ratio

A typical way of the Chinese government in using NBFIs to finance its requirements is to impose upon them a high re-deposits ratio with the PBC or their supervising specialized banks (as RCCs redeposited in ABC). For instance, RCCs were obliged to redeposit 30% of their total deposits with ABC until 1985, but in 1986, this was reduced to 20% for RCCs in poor counties and 25-28% in other areas. In 1989, 40% of their total deposits was placed with ABC

85. Jia Xiaofeng (1990) "The Macro-Control of Credit Funds," Almanac of China's Finance and Banking 1990, p.204.

at interest rates below their marginal cost of funds.[86] The funds concentrated in state banks are mostly invested in key state projects. Therefore, through such protected borrowing, the Chinese government obtains funds at below the "market" rates, which greatly reduces the capacity and profitability of RCCs.

TICs are also required to place a high ratio of re-deposits. For instance, along with the government's tight fiscal policy and monetary policy in 1988, acting on the order of the State Council, the PBC adopted several measures to rectify the financial activities of TICs. The measures include: 1) all TICs were to stop extending loans starting from October, 1988; 2) all TICs had to place 30% of their net increase in deposits as "special deposits" with the PBC since June 30, 1988; TICs were also subject to lending quotas which, if exceeded, triggered the requirement that 50% of any loan extended over their ceilings must be deposited at PBC as a penalty (These special deposits were renewed in 1990); 3) stopping establishment of new TICs.[87] As noted earlier, in LDCs, government borrowing from the banking system or NBFIs is sometimes undertaken through a high deposit level which the specialized banks and NBFIs must place with the central bank. Hence, the above high percentage of deposits of TICs redeposited with the PBC could be regarded as a manifestation of the government's effort in redistributing funds from NBFIs to key state projects.

3. Borrowing through Administered Interest Rates

86. In June, 1989, the RCCs submitted 21.3 billion yuan reserve deposits, 4.8 billion yuan special deposits, 27.8 billion transformed deposits, and also purchased 2.68 billion yuan Fiscal Bonds. Lin Mode, Cen Zhaoxi and Zu Huaiqin (1990), "On Crisis and Reform of Rural Credit Cooperatives," Jinrong Yanjiu (Financial Studies), Vol. 4, pp.28-58.

87. See, "Rectifying Financial Cooperation", Almanac of China's Finance and Banking 1990, pp.213.

Of all of NBFIs, the government intervenes more heavily in the operation of RCCs. RCCs have the longest history in NBFIs and largest percentage of NBFIs' assets.[88] RCCs can accept sight, saving and time deposits from individuals, rural collective enterprises and township and village enterprises (TVEs). RCCs extend credits to individuals, collective/rural enterprises and TVEs. In recent years, RCCs are finding their operation more and more difficult. Nearly 14% of the RCCs' branches operated in a loss-making situation nationwide in 1989. Their losses amounted to 0.42 billion, about one-fourth of the total profits of RCCs in that year.[89]

The difficulties of the RCCs are also caused by the administered interest rate system. It was estimated that RCCs incurred about 3 billion yuan of losses in 1990 due to the current phenomenon of "Li Lu Dao Gua" which means that the interest rates of RCCs' deposits in the central bank or their supervising bank are lower than those paid by the RCCs to their customers.[90] The grave situation of "Li Lu Dao Gua" can be seen from the data given by Table 5-11.[91] It shows that the cost of RCCs in mobilizing deposits was higher than the incomes from interest of loans, reserve deposits, special deposits and Fiscal Bonds.

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88. RCCs were established in the late 1950s. In 1990, there were 2100 RCCs branches at county levels. The independent accounting branches were about 61,000. The total number of agencies at village levels was 0.34 million. The total staff were 700,000. In June 1989, the total deposits were 146.3 billion, and total loans were 109.2 billion, about 50% of total deposits liability of state banks. Lin Mode (et al), (1990), *op. cit.*

89. Tam, On Kit (1988), "Rural Finance in China," The China Quarterly, No.113, March, pp.60-76; Jin Weihong and Gan Yong (1989), "The Difficult Situation of Rural Credit Cooperatives," Jinrong Yanjiu (Financial Studies), Vol. 12., pp.50-52.

90. Lin Mode (et al), (1990), *op. cit.*

91. A recurring phenomenon in China's banking system. It refers to a bank's pratice of high interest rate deposits and low interest rate loans.

Table 5-11

The "Li Lu Dao Cua" Situation of RCCs in 1989*

(Per annual)

	(1)	(2)	(3) [(1)-(2)]
The average interest rate of deposits mobilized by RCCs (including indexed value-proof deposits)	16.00%		
The average interest rate** of loans made by RCCs		12.00%	-4.00%
Interest rate of reserve deposits with the PBC		7.20%	-8.40%
Interest rate of re-deposits with the ABC		9.44%	-6.50%
Interest rate of special deposits with the ABC		12.60%	-3.40%
Interest rate of Fiscal Bonds held by RCCs		8.00%	-8.00%

Source: Jin Weihong and Gai Yong (1989), *op.cit.*

* A recurring phenomenon in China's banking system. It refers to a bank's practice of high interest rate deposits and low interest rate loans. The detailed discussion of this issue, see, Section 5.4.

** estimates from Almanac of China's Finance and Banking 1990, and Lin Mode, (1990), *op. cit.*

The loss-making situation is worsened by RCCs having to offer value-proof indexed deposits which further increased the cost of interest. Under the administered interest rate system, RCCs can not raise their loan rates when the interest rates of deposits are raised. Hence, the increased cost of raising funds, which has to be borne by RCCs, reduces RCCs profits. In June 1989, 39.5 billion yuan's indexed deposits were mobilized by RCCs (the interest rate for indexed deposits for 3 years was 12.5%, interest rate for ordinary deposits was 11.34%), therefore, RCCs had to pay about 4 billion yuan's extra interest for indexed deposits. The undertaking of indexed deposits business caused more than 120,000 RCCs' branches to be in loss-making status in 1989.[92]

NBFIs emerge as a response to the demand for new financial institutions and services. But they are developing at a slow pace in China. The evidence as shown above helps to explain why NBFIs in China, as in most LDCs, are a relatively small part of financial sector, and why the four large specialized banks continue to be a dominant part of China's financial system.

5.6 Conclusion:

From the above discussion of government borrowing activities from financial sectors, it can be concluded that additional fundamental reforms are needed for China's financial system. In particular, it is necessary to further reform the state banks so as that they can become true intermediaries rather

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92. Lin Mode (et al), (1990), *op. cit.*

than a channel of funds to meet the government's requirements. It is also necessary to establish a financial system on a broader basis, which can provide alternative financing sources for the government, enterprises, households and financial institutions.

The efficiency of the financial reform has been affected in term of its macro-control by the government's borrowing activities. The preceding discussion indicates that monetary policy has played a reactive and accommodating role to the government's demands rather than to changes in market circumstances. As a consequence, the resultant fluctuating and expansionary monetary policy has contributed to the loss of control in the macro-economy. The discussion also suggests that the PBC should acquire more independence and experience in monetary policy, such as in the control of reserve money, currency issues and PBC lending. The lack of success in monetary policy formulation and implementation has further affected the government borrowing adversely in term of macro-control.

The purpose of restructuring the banking system is to make the specialized bank operate efficiently in mobilizing and allocating financial resources. To achieve this objective, the specialized banks have to change their functions as administrative organs. However, the above evidence indicates that the reform objective of specialized banks has been weakened by the government's different borrowing activities. The operations of specialized banks, in varying degrees, respond to the government's strategy of economic development and certain social imperatives which sometimes conflict with the profitability of the financial institutions. The large volume of directed credit loans with subsidized interest rate has imposed distortion and losses in specialized banks' operation. Moreover, filling all gaps of working capital of state enterprises has limited the specialized banks' ability to diversify their assets portfolios. Therefore, the management of bank assets and liabilities has become less important and more impossible. As a result, the specialized banks have to continue to rely on the central bank for credit liquidity and continue to eat from "a big rice bowl" with the central bank. Therefore, the specialized banks need a further reform to place them in a better position so as to operate independently.

The discussion also shows the sluggish and limited progress in restructuring China's financial system. The state banks have not yet developed their comparative advantages into full play in a completing stance as financial intermediaries. The four specialized banks still dominate the lion's share of financial resources. The small share of NBFIs in financial resource allocation indicates a limited degree of financial liberalization. To enhance the effectiveness of its financial reform, China should further develop NBFIs to promote competition in the financial system.

The analysis of the Chinese government's borrowing activities also reveals that the government's continuing intervention in credit allocation has its roots in the price system and the system of state enterprises subsidies. Due to the continual regulated price system and protected state enterprises, the interest rate reform is weakened. The discussion indicates that interest rates still cannot allocate financial resources appropriately and be a key instrument of monetary policy. Therefore, reforms in the system of finance, enterprise, and price must be tackled together in China. In the long run, a successful financial reform cannot be visualized without corresponding changes in the controlled price system and low efficient state enterprises. Moreover, the Chinese government's continuation of the administered price system and subsidization of state enterprises will not only retard the financial reform, but also delay the process of marketization in China.

Chapter 6

Conclusion

Based on analysis of the experience of the Chinese government's borrowing activities, this study has examined China's financial reform in the context of the restructuring of the new financial institutions, the introduction of new financial instruments and the establishment of financial markets. It has shown that the twelve-year financial reform has contributed to the emergence of a broader financial market which provides alternative financing sources for the government, enterprises, households and financial institutions. However, the twelve-year financial reform in China is still quite repressed and financial resource allocation in China is far from optimal efficiency. The reform has been less successful in changing the bank-dominated structure of the financial system, in fostering price competition between financial institutions, and in allocating a meaningful role to the financial sector---distinct from that of the budget---in allocating funds. Hence, China has to further deepen its financial reform to enable banks to become true financial intermediaries rather than channel of funds financing government priorities, and to achieve a more complete separation of fiscal and monetary function.

The thesis has shown that, as hypothesized in Chapter 1, the Chinese government borrowing activities directly affect the process of financial reform through their borrowing methods. To control funds to ensure government investment, the government has used protected borrowing methods to ensure the monopoly position of the state banks. As a result, development of NBFIs are repressed. Due to the fact that administrative guidance still direct government market borrowing activities, development of capital market in China is still relatively slow. This thesis also reveals that the characteristics of the Chinese government borrowing activities are heavily determined by the economic structure which is in a transitional period from a CPE to a market economy. As state enterprises are still the major sector of economy, and the price system is still rigid, government borrowing is often required and the borrowing may be routinely financed through administrative way. Hence, the separation of the function of the state budget and state bank is necessary but difficult. Further, the relatively incomplete financial system reform also increased negative impacts of government borrowing activities, such as, lack of effectiveness of monetary policy in macro-control, less attention on financial and risk management, nonprice competition. Therefore, to reduce the negative results of government borrowing, it is also necessary to deepen the financial reform in China.

Based on the finds of this thesis, some major conclusions from this study can be outlined as follows.

1. It is found that China's present form of administrative intervention is inconsistent with the objective of country's financial reform. The basic objective of the financial reform in China is to establish a more efficient and competitive financial system to mobilize and allocate financial resources and to separate the functions of the state budget and the state bank. In practice, many credit activities and reform measures run counter to this objective. The development of China's financial system is still limited by the bank-dominated system, which operates fairly closely under government orders. The administrative controls on bank operations fail to concern the banks with their credit structure. The imposed administrative "guidance" was inconsistent with the aim of making banks autonomous, and the obligation to extend priority loans at low interest rates conflicted with the objective of making banks accountable for profits. Moreover, the approach of subsidizing interest rates to priority sectors has a negative impact on developing capital market because all enterprises strive to seek access to subsidized credit rather than to raise funds from the market. This impedes capital market development in China.

The objective of the financial reform has been affected by the fact that the Chinese government has not a clear policy-guidance for marketization process. For instance, although the Chinese government intends to introduce the market mechanism into its borrowing activities, it has only absorbed some market elements in the vain hope of creating a market. And some other key market elements are still being replaced by the government administrative methods. As a result, the government's wishful thinking is in fact frustrated by an explosion of problems. For instance, a fragmental and incomplete capital market has emerged. Therefore, a market-oriented financial reform in China must have a clear and consistent set of objectives in its process.

2 The lack of independence of the central bank has harmed macro-economic control through use of the administrative monetary policy instruments in China. Three factors have affected the PBC's capability in mcaro-control: a) the PBC still does not have real autonomy in the formulation of the monetary policy; b) the PBC also lacks independence in its operation. It has to accommodate submissively the government's inadequate borrowing activities by monetizing the budget deficits; also it has to continue to extend directed loans according to government dictation; c) The PBC has relied mainly on target-based credit plans and cash plans as monetary policy instruments, so that it has little room for implementing discretionary monetary policy. Hence, the PBC fails to act in line with the objective of monetary stabilization. As a result, excessive growth of money supply has contributed to the loss of macro-control.

A central bank that can independently implement monetary policy provides a firm basis for efficient macro-control. Therefore, to ensure macro-economic stability, the roles of monetary policy and the central bank in macro-economic control should be strengthened. Between the "assigned twin objectives of "monetary stabilization and economic development", the PBC has to focus on stabilizing money as its operational objective. Therefore, it is important for the PBC to stop undertake any commercial bank businesses, including that of directed credits.

Efficiency in macro-control calls for a gradual use of indirect monetary policy instruments. The discussion in this study indicates that the deepening in financial reform has gradually established a favorable situation for the PBC to use market-oriented monetary policy instruments. For instance, the PBC can try to start open market operation based on government securities. Currently, it may be possible for the PBC Head Office to begin occasional small-scale operation to buy and sell government securities from enterprises as a means of injecting or reducing liquidity at times of seasonal demand for currency by enterprises. Through these activities, it will reduce the burden on the specialized banks of credit funds supply, and also the PBC can redesign its re-lending facility to enhance the effects of reserve requirements.

For stable macro-control, the PBC needs to place more emphasis on bank supervision. It is necessary to change the deformed credit relationship between state budget and state banks, between banks, between banks and enterprises, and between enterprises. The correct credit relationship between the state budget and the state banks should be that the state budget must totally stop overdraft from the PBC. The short-term borrowing requirements of the state budget can be financed by applying loans from the PBC or sales of short-term securities, but they should be repaid in a limited period of time. As to the relationship between the central bank and the specialized banks, the discount system should be gradually introduced so as to replace the re-lending loan facilities. In this way, the ability of self-management and self-development of the specialized banks can be promoted. Considering the relationship between the specialized banks and state enterprises, the means of discounting commercial paper, issuing bank acceptance and mortgage loans should be gradually brought into the bank loans. The financial relationship among the state enterprises should be regulated by law to prevent enterprises defaulting on payments to each other. Only when such credit relations are clearly defined, can macro-economic instability be prevented in China.

3 **The specialized banks in China still act as state organizations in close compliance with the government financial requirements.** The characteristics of the specialized banks can be summed up as follows. First, the plan-determined asset portfolio affects directly the operation results of the state banks. And the system of priority lending and specific direction has imposed a significant cost on bank operation due to the fact that repayment of directed loans are often hard to collect and not very profitable. Second, the directed credit loans have encouraged the specialized banks to depend largely on the central bank as a lender of the last resort. With the help of the central bank, the specialized banks need only to make limited efforts to mobilize deposits. Third, the continuing limited autonomy in setting interest rates makes the specialized banks' interest rates irresponsible to the bank's average funding cost, recipient of credits, the riskiness of loans. Fourth, the low efficiency of specialized banks is also caused by the replacement of prudential regulation by administrative regulation in China's banking operation. The administrative regulation is designed to ensure that bank lending is in line with the state-defined economic goals. However, prudential regulation in such fields as the safety, profits, liquidity is all neglected. China's banking system has run too many risks, and their profits has deteriorated. If no drastic measures are to be

taken, China's financial sector will suffer a financial distress in the long run.[1]

As commercial banks, the specialized banks must focus on improving their techniques in asset and liabilities management in the next step. Obviously, to change the deformed credit relation between the state banks and state enterprises is an important prerequisite to promote the efficiency of specialized banks' operation. The specialized banks should not be held responsible for the financing of all financial requirements of state enterprises. In view of this point, specialized banks should, and can, obtain more leeway to choose borrowers according to criteria of credit worthiness and profitability. The specialized banks should also have a certain degree of autonomy in charging different interest rates to different enterprises. Moreover, as the specialized banks can gradually diversify their business activities, through using interbank money markets, gaining flexibility in setting loans and deposits rates, and introducing new financial instruments. A supervisory system aimed at assets quality and measures of liquidity and solvency must be established to improve the internal management of the financial system.

4 The heavy reliance on the banking system to satisfy the government' financing requirement is the main reason why the government continues to limit the development of the NBFIs in China. In recent years, NBFIs have developed but they are still a small part of the financial system. Under the current policy guidance of the Chinese government, the state banks have to "mop-up" most financial resources to finance those sectors designed by the planning authorities. To accomplish this task, the specialized banks have high market share directly through their large number of branches, and indirectly through the system that channels a large share of RCCs and UCCs deposits to the PBC, ICBC and ABC. The limited development on NBFIs has

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1. For the detailed discussion on the effects of financial distress on resources mobilization and allocation, see, P. Callier, (1991). pp.25.

reflected the difficulty in competing against highly protected state bank monopoly, therefore, the small size of NBFIs indicates to some extent the "illiberal" nature of the financial system reform in China.

The establishment of new NBFIs and enhancing competition is beneficial to deepen the financial reform in China. Currently, a favorable condition for developing of NBFIs has been provided by a deepening reform in state enterprises. To enable state enterprises to operate more independently and efficiently, the government has decided to separate the social welfare functions from the state enterprises and try to establish a state-run social insurance scheme.[2] Social security is to be financed primarily by compulsory wage-related contributions from workers and employers, which can provide old-age pensions, unemployment benefits, sickness and maternity benefits, and so on, to those who have contributed to them.[3] This can offers a good opportunity for China to enable NBFIs to run pension funds, unemployments insurance, life insurance.

The speeding-up of a housing reform in the Eighth Five-Year Plan (1990-1995) also provides a chance for developing NBFIs in China.[4] The housing reform, which began four years ago, is now again high on the Chinese government's reform agenda. In 1992, the 450 cities in the country are required by the State Council to work out specific housing reform programs.[5] The government hopes that the state, collectives and individuals will have joint

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2. Premier Li Peng (1992), "Emphasis on the Reform Operational System of State Enterprises: Enterprises Take Real responsibility for its Profits and Losses," Renmin Ribao (People's Daily), January 13, p.1.

4. Xin Hua News Agency (1991), "China Begins to Establish the Unemployment System," Renmin Ribao (People's Daily, Overseas Edition), January 11, p.2., Han Guojian (1991), Life Insurance in China Developing," Beijing Review, July 29-Auguest 4, p.20.

4. Xin Hua News Agency (1992) "China Starts A Sweeping Housing Reform," Renmin Ribao (People's Daily, Overseas Edition), February 2, p.1.

5. Beijing Review, "Housing Reform High on Agenda," July 1-7, pp.5.

involvement in raising housing funds. Hence, the housing reform offers another opportunity to develop banking operation as well as NBFIs in China; such as building society.

5 So far capital market in China has not provided a real alternative for the majority of savers and borrowers/issuers. The main supply of securities in capital market is Treasury bonds which are administratively allocated to the investors. Issuing enterprises' securities in the market are quite limited by various government regulations. The interest rates of government securities are "administrative" rates which are lower than market rates. Hence, the market interest rates cannot emerge and market development cannot be stimulated, either. Further, under the narrowly developed financial market, both the government and state enterprises have to continue their reliance mostly on the bank credits. The state banks alone have to carry alone the burden of over-investment. Some small and private businesses are crowded out from the state banks' credit supply. The benefits of establishing government borrowing market are also reduced because the fragmented market does not provide a base for open market operation. As a result, administratively directed monetary policy instrument is still the main method of macro-control in China.

The Chinese government has announced that in the Eighth Five-Year Plan (1990-1995), China will speed up the process of financial market development. In light of the existing problems in the development of securities market, the key issue is that the government should have a blueprint to guide the market development. Financial theories suggest that the development of securities market usually starts with trading in a short-term money market instruments, often government securities. As the discussion in Chapter 4 shows, short-term government securities have not been issued so far. Hence, in the next step of development of the financial market, the Chinese government should consider issuing negotiable short-term and market-rate Treasury bills on a voluntary basis to financial institutions. In time, this will establish a basis for the PBC's open market operation.

Moreover, developing new types of financial instruments, such as banker's acceptance, certificates of deposits and commercial papers, has significant importance for both the banking system reform and the capital market development. Through discounting negotiable bills, the source of short-term financing will be provided. Furthermore, the development of these new financial instruments will in addition, provide the central bank with new tools for the monetary policy, and also ease the potential conflict between monetary stability and satisfaction of the borrowing needs of the government and state enterprises. The increasing of new investment instruments is also a main task in that in will enlarge the medium-term and long-term capital markets in China. Meanwhile, the terms of various bonds and securities must be diversified, and what is more, all securities must be standardized. Hence, an appropriate legal, regulatory and tax framework it to be established in China as soon as possible. To those enterprises that raise funds from the market, the government should give some tax incentive so as to encourage them to go to the market. The government also needs to establish some market infrastructures and frameworks to train underwriters, brokers and dealers, and establish a modern information transmission system, etc.

This study has examined China's financial reform from the perspective of government borrowing activities. The findings of this study are consistent with the latest arguments by McKinnon based on the common problems of financial reforms in the former Soviet Union, Eastern Europe, China and many smaller socialist economies of Asia.[6] McKinnon points out that the main reason of financial control in the transition from a classical socialism to a

6. McKinnon, (1991), *op. cit.*, pp.111

market economy is "a sharp decline in the revenue of the consolidated government as liberalization proceeds."[7] This sharp decline in the revenue has caused fiscal deficits in those countries. Thus, liberalizing socialist governments typically cover their revenue shortfalls by borrowing from the (state) banking system. Hence, McKinnon stresses that the re-intervention in financial resources allocation in transition period is generally caused by the fact that "a government is fiscally straitened and must grab economic surplus whenever they become visible."[8] The analysis of Chinese government borrowing in this study has demonstrated that, despite decentralized financial resource allocation, the government still intervenes in state bank operation. The Chinese government has tried to do too much by using the financing system to finance the government deficits, concentrating funds and directing credit activities. As a result, the financial system in China remained rather repressed in the last twelve years. Therefore, reducing the government deficits, and more exactly, reducing government intervention, is a key factor in the process of China's financial reform.

The financial reform is a key element in the transition from a CPE to a market-oriented economy. However, a market-oriented financial reform requires many prerequisites. Most important of all, the financial reform needs a stable macro-economic situation. The current situation of government budget imbalance situation remains serious in China and is a main factor in the unstable macro-economy.[9] As discussed in Chapter 3, the problems causing the imbalance in the state budget are very complex. Hence, to improve the situation of state budget, it needs to restructure the economic system, including the reforms of state enterprises, market circulation, price system, labour, wage

7. *Ibid*, pp.112.

8. *Ibid*, pp.113.

9. Beijing Review, (1991), "Budget Situation Remains Serious," August 5-11, pp.10.

system, social security, and housing.

It can be seen that many government borrowing activities are related to the financing requirements of state enterprises. Hence, the successful reform of the state enterprises is the key to reducing excessive demand and government intervention in the financial system operation. The practice of subsidizing on inefficient state enterprises is a main cause of difficulties in the state budget. Faced with this problem, the Chinese government in 1991 once again shifted their priority to promote changes in the internal management system of enterprises and invigorate large and medium-sized state enterprises for better efficiency.[10]

It should be noted here that the attitude of the Chinese government to ownership reform indicated in the Eighth Five-Year Plan (1991-1995) is to establish a ownership structure with socialist state ownership as the mainstay simultaneously with the development of multiple ownerships.[11] Hence, the Chinese government will not abandon the state ownership of enterprises in China. It is reported that by the end of March 1991, 95% of the enterprises in the first-round of contracts had switched into their second-round of contracts.[12] At the same time, with the approval of the State Council, the share-holding system is continually being experimented and has rapidly boomed in Shanghai and Shenzhen where supportive measures and regulations has been installed.[13] However, many contentious issues remain, concerning

10. See, Premier Li Peng's speech in National Working Conference in 1991, "On the Issues of the Current Economic Situation and Further Invigorating of Large and Medium-sized State Enterprises ," Renmin Ribao, (People's Daily), October 11, p.1.

11. "Reform and the Open Policy in the 1990s", Beijing Review, Sep. 9-11, 1991.

12. Niu Genying (1991), "Progress in China's Economic Reform," Beijing Review, NOV.11-17, pp.12.

13. *Ibid*, p.12.

the development of the two systems. Hence, how to improve and promote the efficiency of about 10,000 large- and medium-sized state enterprises is still a hard task for the Chinese government.

The Chinese economy suffers from a heavily distorted price system. Subsidizing on state enterprises often results from the continually regulated price system. Hence, to reduce the burden of subsides for the state budget depends largely on reforming the distorted price system. The fact is that it may take some year for prices to response fully to the market forces in China. At present, the degree of market development is at present not sufficient to generate an appropriate price level. Hence, the practice of fully liberalizing prices to create a market competition may bring a high cost in short-term for the economic and financial reform, which will suffer from price hikes. The attitude of the Chinese government on the price reform in the Eight Five-Year Plan (1991-95) is that the price reform it to be introduced steadily.[14] This means a fully liberalized price system cannot be established and operate in China in the immediate future.

Without the reform of the main elements of state enterprises and the price system, the state budget reform involves an inconsistency by itself in its objectives of promoting efficiency. As it takes time to reform the state enterprises and the price system, it is not possible in reduce to the government deficits significantly is not possible in China in a short time. In such a situation, the Chinese government should strive to finance its deficits mostly on market borrowing rather than on the banking system. Hence, the pressure of the excessive growth of money supply will be diminished and the financial reform in China can be carried out in a more favorable situation.

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14. See, Premier Li Peng's speech in National Working Conference in 1991, *op. cit.*

Finally, it should be stressed that the Chinese government needs to gradually change its role in financial resources allocation. The gradual removal of administrative controls will lead to a more healthy, dynamic, and efficient financial system. That does not mean the government has to totally abandon all legitimate interventions in financial resources allocation. On the contrary, interventions of many types are essential if the economy is to achieve its full potential.[15] The difference from administrative intervention is that the government's intervention is only to exert some influence over the flow of credit, interest rates and credit control. The purpose is to ensure the stability of financial system. This should also be the role of Chinese government in its economic reform and development.

To make significant contribution to sustaining China's economic reform and development, it is necessary to further reform the financial system in China. It can be seen that financial reform involves the resolution of fundamental economic issues and problems. Chinese government borrowing is only one of them. To achieve more effective process of financial reform, a comprehensive strategy of reform should be established. More market elements should be introduced into the reform to gradually replace administrative means. Strengthening the financial diversification, autonomy and self-responsibility of the financial system is a important task. Moreover, price competition should be allowed and continual administrative fixing of interest rates should be reformed. Together with the state enterprises and price system reform, the financial reform in China can achieve its objective to promote economic growth.

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15. See, World Bank, The World Development Report 1991, *op. cit.*, p.131.

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