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Chapter 16

Financial System Reform in China: Lessons from Japan's Main Bank System

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China's economic reform is at a crucial moment. On the one hand, 14 years of economic reform have achieved considerable success. China's GNP grew at an average annual rate of 8.6 per cent between 1979 and 1991 and reached 12.8 per cent in 1992; exports grew even faster so that the export-GNP ratio increased from 4.7 per cent in 1978 to 19.3 per cent in 1991 and foreign reserves increased from US\$1.6 billion to US\$21.71 billion correspondingly (Table 16.1). Accompanying high growth, the living standards of the Chinese people have improved greatly. On the other hand, several key institutional aspects of a market system, including the fiscal system, the financial system, and the ownership and governance of enterprises, still wait for a major breakthrough before the benefits of the market can be fully realized. In October 1992 the Chinese government officially designated its reform goal as a 'socialist market economy,' which opened ways for an all-round transition towards the market system. This could be an important new start.

Table 16.1

This chapter studies financial system reforms in China with a focus on institutional restructuring. The achievements of the reforms in the financial sector in the past 14 years have been mixed: household bank

deposits have risen to nearly 50 per cent of GNP; investment financing has gradually shifted from the government budget to bank loans; financial intermediaries have flourished; a nascent security market made a quick start; and financial assets have multiplied to include choices of government, financial and enterprise bonds, as well as equity shares. However, old problems with the planning system remain and new problems have arisen: allocation of financial resources has been inefficient because credit was allocated largely by quotas and interest rates played little role; 'soft budget constraint' problems have worsened, resulting in mounting bad loans and inter-enterprise arrears; and more seriously, inflationary pressure has threatened macroeconomic stability from time to time. Even worse, the government has no monetary instruments to deal with these problems, as the old method of credit control is becoming less effective.

The objective of financial reform is to establish a market for the mobilization and efficient allocation of financial resources, and to maintain macroeconomic stability. Fundamental institutional restructuring and change of control mechanisms are necessary to achieve this goal. In this regard, China faces a broad range of choices, and can learn from the experience of many other countries, in particular, from the experience of Japan.

Although China, Eastern Europe and the former Soviet Union are all making transitions from centrally planned to market economies, they face different types of economic, institutional and political constraints. Today's Chinese economy has already been decentralized in many ways. By the end of 1991, about 47 per cent of industrial output was already produced by the market-oriented non-state sector (including private businesses, joint ventures, cooperatives and collective enterprises), with the private sector accounting for about 10 per cent of the total (Qian and Xu, 1993). However, a dramatic departure from the past is very difficult, with the continuity of the current political system, as the government has a bias towards the status quo. For example, unlike Eastern Europe and Russia where mass privatization is imperative, centrally directed mass privatization of state-owned enterprises — let alone privatization of banks — is out of the question in China at the present time. This poses a special challenge to financial reform. Furthermore, most of the reforms in China so far have proceeded in an incremental, 'bottom-up' and decentralized fashion. More coherent action from the top is

necessary for restructuring the financial system as a whole (as well as the fiscal system), which seems particularly difficult for China given its already decentralized structure and political constraints.

Discussion of the transformation of the Chinese financial sector and the lessons and relevance of the Japanese financial system is conducted bearing these facts in mind. The chapter is organized as follows. The first section reviews major changes in China's financial sector since 1979. The second discusses the main institutional problems with the financial sector to the end of 1992. The third section analyses the relevance and limits of the Japanese financial system to Chinese reforms from both evolutionary and comparative perspectives. The fourth section suggests some essential aspects in the next stage of financial reforms, focusing on institutional restructuring.

1 Major Changes in the Chinese Financial Sector Since 1979

Before economic reform started in 1979, Soviet-type central planning was dominant in China, like all other Central and Eastern European countries, where the financial sector (that is, the banking sector) played only a subordinate role in the economy. The planned economy was 'semi-monetized' (Kornai, 1992). Under central planning, the State Planning Commission made all the important decisions on investment, production and finance. There was only one bank, the People's Bank of China (PBC), which served both as the central bank and as a commercial bank; we can define this as a mono-bank system. The role of the PBC was very limited, as most long-term investment financing was not channelled to enterprises through the banking system, but through the state budget: all investment projects were financed with budgetary grants. The state bank was only responsible for providing working capital to enterprises. Therefore, it is not surprising that household savings were small relative to government savings — total household bank deposits were less than 6 per cent of GNP

in 1978. The PBC followed cash and credit plans from the State Planning Commission, and its branches provided financial resources to enterprises according to the plan.

As in the other sectors in the Chinese economy, the financial sector has also undergone substantial changes since 1978. Generally speaking, more progress has been made on the deposit than on the lending side: the latter requiring not just policy adjustments, but also institutional changes, which is a more difficult task to achieve. A brief description of the major changes are given in this section, further analysis and evaluation of those changes follow in the next section. Detailed descriptions of the Chinese financial system can be found in Xie (1992) and World Bank (1988, 1991).

1.1 The Banking Sector

In 1978, the People's Bank of China (PBC) was separated from the Ministry of Finance and granted ministerial rank. Five years later, in 1983, the State Council granted the PBC the authority of a central bank and the PBC subsequently transferred its commercial operations to four specialized banks: the Agricultural Bank of China (ABC) for the rural sector; the Industrial and Commercial Bank of China (ICBC) for the industrial sector, the People's Construction Bank of China (PCBC) for long-term investment, and the Bank of China (BOC) for foreign exchange. In addition, the China Investment Bank (CIB) was established in 1981 to channel World Bank loans to China. Affiliated with the ABC are rural credit cooperatives whose main lending is to rural households' farming and township-village enterprises. Two additional universal banks were established in 1988: the Bank of Communications (BOCOM) and CITIC Industrial Bank. By 1990, the six banks had vast national networks, with more than 120,000 branches and more than 1.3 million employees. In addition, rural and urban credit cooperatives had 60,000 branches and more than half a million employees (State Statistical Bureau, 1992).

Since 1984, the four specialized banks have been allowed to compete for deposits and loans in each other's previously monopolized markets, and enterprises are allowed to open accounts with more than one bank (Zhou and Zhu, 1987). For example, the ABC is able to set up branches in cities and the ICBC is allowed to undertake foreign exchange business. However, all four banks have remained highly specialized in their operations. Unlike the industrial sector, by the end of 1992, the banking sector was characterized by the monopoly of state ownership dominated by the four big state banks.

The old way of financing projects with budgetary grants was phased out, and financing of fixed investment gradually shifted to bank loans and extra-budgetary funds of local governments and ministries (80 per cent of which are retained profits of enterprises). In 1978, fixed investment by state-owned enterprises, financed by the government, accounted for 12.7 per cent of GNP; this declined to only 3.6 per cent in 1991. Nevertheless, many investment projects still need to be approved by the central and local Planning Commissions (known as 'project registration' (lixiang)), although they are financed in a decentralized way. The share of bank financing of both fixed and working capital increased from 30 per cent in 1980 to 73 per cent in 1990 (Xie, 1992, table 3-11). Compared to the pre-reform era, the role of the banking sector in financing increased significantly.

1.2 Interest Rates Determination

Interest rates were fixed and adjusted periodically by the central bank. A positive real interest rate (that is, household one-year time deposit rate minus national retail price index) has been maintained for most years except 1988 and 1989 when the real rate turned very negative (Table 16.2). However, starting from the fourth quarter of 1988, indexation for time deposits with more than three years' maturity has been introduced. For example, for a three-year deposit, the annual rate was 9.72 per cent in the fourth quarter of 1988 and the annual rate of the cost of living allowance was 7.28 per cent, so the effective rate was 17.00 per cent (Table 16.3). Hence, for an indexed three-year time deposit, the real interest rate in 1989 was well above zero (the inflation

rates from 1989 to 1991 were 17.8 per cent, 2.1 per cent and 2.9 per cent). The cost of living allowance was dropped to zero after June 1990, and the indexation scheme was eliminated in December 1991 (Almanac of China's Finance and Banking, 1992).

Table 16.2

Table 16.3

Floating rates in a narrow range based on rate standards provided by the central bank have been allowed by specialized banks and branches since 1984. For example, branches below the county level may increase deposit rates by 10 to 30 per cent and rural credit cooperatives by 70 per cent; the lending rate of banks may be adjusted upwards by 30 per cent and that of rural credit cooperatives by 100 per cent (Almanac of China's Finance and Banking, 1990).

1.3 Non-Bank Financial Intermediaries and Informal Financial Institutions

Before the reform, the only non-bank financial intermediary in China was the People's Insurance Company of China (PICC). Since 1979, numerous non-bank financial intermediaries were established. There are at least three major types of non-bank intermediaries other than the insurance companies: trust investment corporations established by the central and regional governments (China International Trust Investment Corporation, or CITIC, is the largest); trust investment corporations established by specialized banks and their branches; and finance companies of enterprise groups. In contrast to the six national banks under tight central control, these 'outside-the-plan' financial intermediaries are much less regulated.¹

By the end of 1992, there were more than 1,000 trust investment corporations run by bank branches and government at all levels. The main reason for the rapid expansion of non-financial intermediaries is their ability

¹The phrase 'outside-the-plan' is used here for lack of a better term. Readers are cautioned that many financial institutions in this category are not entirely outside the plan, unlike outside-the-plan industrial firms.

to circumvent credit quotas imposed by the central bank on specialized banks and their access to a wide range of business alternatives. At a time the central bank still uses direct credit quotas as the main control instrument, the local branches of specialized banks, local governments and enterprises make use of loopholes and non-financial intermediaries to extend loans to meet the demand for fast growth.

Informal financial institutions in China are widespread, especially in the rural areas, but documentation of their transactions is not always available. In the rural areas, a major form of informal financial institution are 'rural cooperative funds' (nongcun hezuo jijinhui) (RCFs). According to Chen (1993) by 1991, there were 18,000 township-level RCFs (about one-third of all townships) and 120,000 village-level RCFs (about one-sixth of all villages). The initial funds of RCFs came mainly from receipts of sales of grain and the collective assets of townships and villages. Chen gives several reasons for the rise of independent rural cooperative funds outside the state-controlled rural credit cooperatives (RCCs). First, there is generally inadequate credit provided for rural activities, and the formal banking system including the RCCs has the binding constraint of a credit limit; second, the operation of the Agricultural Bank of China and the RCCs is still too rigid and can not meet the demands of rapid market development; and third, RCCs are in fact de facto branches of the Agricultural Bank of China, and are not really cooperatives.

1.4 Capital Markets

With the issue of government bonds in 1981, capital market development in China has been relatively fast compared to the reform of the banking institutions. Capital market instruments now include not only government securities, but also financial bonds (bonds issued by financial intermediaries), enterprise bonds, and equities. The total volume of all instruments issued was estimated to be approximately 400 billion yuan from 1981 to 1991, with government securities amounting to 150 billion yuan and other instruments amounting to approximately 250 billion yuan (Almanac of China's Finance and Banking, 1992). The total volume of

secondary market trading increased from about 100 million yuan in 1987 to over 40 billion yuan in 1991. The share of trading in treasury issues decreased from 92 per cent of total trading in 1988 to 80 per cent in 1991, and the share of trading in equities increased from less than 0.4 per cent in 1988 to 10 per cent in 1991. There are two stock exchanges, one in Shenzhen, the other in Shanghai. By the end of 1992, more than 70 publicly traded equity issues were available. In addition, with the introduction of the Securities Trading Automated Quotation System (STAQS), a computerized quotation and trading system links nine cities on-line through a central computer in Beijing. OTC trading started in December 1990, with both treasury bonds and shares trading in Shanghai and Shenzhen.

Capital market development got a big push from the emergence of a secondary market for government bonds. During most of the 1980s, the government ran a budget deficit, part of which was financed by issuing bonds. At the beginning, allocation of bonds was through mandatory planning and with very low interest rates: enterprises and households were forced to buy them. In the mid-1980s, some arbitrageurs found a profitable business in buying government bonds in rural areas at a discount and selling them to residents in urban areas. (One of Shanghai's security companies, Shanghai International, started by doing this type of trading.) A liquid government bond market then emerged. With the liquid secondary market, the government no longer allocated bonds by command; instead, bonds were offered at a slightly higher interest rate (about 1 per cent) than similar bank deposits. Starting from the late 1980s, shares and commercial bonds were also traded.

1.5 Household Financial Savings and Movements of Monetary Aggregates

China's national savings increased from 30 per cent of GNP in 1980 to around 35 per cent in 1991.² More significantly, major saving sources have been shifted from the government to households and enterprises. A remarkable phenomenon of the 14 years of economic reform is the sustained and rapid increase of household financial savings. Total household bank deposits reached 911 billion yuan in 1991, or about 46 per cent of GNP, from merely 6 per cent in 1978 (Table 16.4). This translates into per capita household bank deposits increasing by more than 16 times in real terms. In 1979, household savings accounted for only 23 per cent, enterprises for 34 per cent and the government for 43 per cent of total saving. In 1991, household savings increased to 71 per cent, enterprise savings decreased to 26 per cent and the government savings fell to a mere 4 per cent of the total (Xie, 1992, table 3-13). Total household financial assets increased correspondingly from 87 billion yuan in 1980, or about 19 per cent of GNP, to 1,365 billion yuan in 1991, or about 70 per cent of GNP (Xie, 1992, table 3-8).

Table 16.4

The sharp rise in household savings after the reforms has provoked a debate about whether or not it is forced saving. Two hypotheses were proposed in Qian (1988). One is the reflection of increasing disequilibrium or monetary overhang, which was the prevailing view at the time (see Feltenstein and others, 1986). An alternative hypothesis, which I favour, is increased monetization due to economic reforms. As more evidence accumulates, it becomes clear that savings continue to rise because of the rapid increase in personal income and monetization of the economy, especially the rapid entry and expansion of private and non-state businesses. Additional evidence supporting the voluntary savings hypothesis is the abundance of consumer goods on the market, and the fast increase in savings after interest rate indexing starting in the fourth quarter of 1988. Blejer and others (1991) conclude that monetary holdings of households is largely voluntary. However, the high degree of liquidity reflects the lack of less liquid assets for household portfolios, especially

²Since China's GNP figures may be underestimated, the savings-GNP ratio (and for that matter, all ratios using GNP as the denominator, for example, the M2-GNP ratio) may be upward biased.

real assets such as housing. One policy implication is to increase the availability of less liquid assets like sales of government-owned housing (Qian, 1988).

China's financial sector became deeper and more liquid at a fast pace during the reform period (Table 16.5). The currency to GNP ratio rose from 6 per cent in 1978 to 16 per cent in 1991. M2 (broad money) increased from 61 per cent of GNP in 1985 to 72 per cent in 1988, and to 98 per cent in 1991. Monetary development in recent years has shown a faster increase in M1 and M2 than in loan credits from banks. In 1991, M2 increased by 27 per cent over the previous year, while loan credit increased by 20 per cent. In the first eight months of 1992, credit increased by 23 per cent over the same period of the previous year, but currency increased by 30 per cent, M1 by 36 per cent and M2 by 30 per cent (Table 16.6).

Table 16.5

Table 16.6

2 Financial Sector Problems

2.1 Concerns for Inflation

With fast monetary expansion, inflation became a serious concern for the government. Fortunately, except for 1988 and 1989, China was able to control annual price increases within the single-digit range (Table 16.1). There are two institutional reasons that make controlling inflation in China difficult (and therefore costly), and both have to do with incomplete reforms. First, the central bank does not yet have monetary instruments that are more discriminating than credit quotas to manage aggregate demand, the second has to do with the fiscal reforms carried out in the 1980s.

With the introduction of the fiscal revenue-sharing scheme between the central and provincial–local governments in 1980, (consolidated) budget revenue declined steadily from about 35 per cent of GNP in 1978

to 18 per cent of GNP in 1991, and from 44 per cent to 33 per cent if extra-budgetary revenue is included (Sicular, 1992). At the same time, the official government budget deficit continued to rise and amounted to about 2-3 per cent of GNP. About half of the deficit was financed by government bond issues or by foreign loans and the other half by borrowing from the central bank (Table 16.7). Monetization of the budget deficit is clearly one possible source of inflation. Furthermore, under the current fiscal revenue-sharing system, the central government lost much of its ability to regulate aggregate demand through fiscal instruments. Even worse, since the fixed remittance by a local government is not indexed, the fiscal scheme tends to be pro-cyclical: in times of expansion, revenue remitted to the central government in real terms is reduced; in times of recession, it is increased. The fiscal sharing schemes also provide regional governments with strong incentives for fast expansion; the central bank is often unable to resist the pressure from local governments, and this may lead to a loose monetary policy.

Table 16.7

Three distinct periods can be identified as far as inflation is concerned. In the first half of the 1980s, the rapid increase in money supply did not lead to inflation and the price level was kept quite stable. Most Chinese economists agree that agricultural reforms and monetization of the rural sector played important roles in keeping the price level low. More specifically, McKinnon (1992a) argued that because rural households did not have access to credit, they had to build up their cash balance with the bank (or rural credit cooperatives) when they converted into production units. The government was then able to borrow from the banking system to capture the seigniorage without much inflationary effect.

This mechanism could not and in fact did not last long. In the second half of the 1980s, the price level started to rise; inflation grew out of control in 1988 and reached more than 50 per cent at an annual rate for several months in that year. Inflation, together with widespread corruption, led to a serious political crisis and caused a major disruption of economic development and reversal of economic reforms in 1989.

During 1990-92, the government deficit continued to climb and monetary expansion grew even faster, the price level nevertheless remained stable. During this period, rural income stagnated (showing an average 0.7 per cent annual increase between 1989 and 1991, and 4 per cent in 1992) and urban income soared. But the consumer goods markets were depressed, as were the producer goods markets because of the government's retrenchment programme. The clue to this puzzle probably lies in the change of expectations in urban areas. Unlike rural households, urban households do not own their houses and rely heavily on government for retirement, education, health and many other benefits. Therefore, the urban household savings propensity was much lower than that of the rural households (Qian, 1988). Following the political crisis in 1989 — first concerning the uncertainty of the economy, and then anticipating the reforms in housing, health, and education — urban households had to increase their monetary balance in the absence of a credit market. A new wave of private businesses started in 1992 and this increased the demand for money. The fact that the rate of increase of urban household savings exceeds that of rural households since 1985 partially indicates a shift of monetization from rural areas to urban areas during this period (Table 16.4).³ It is clear that this monetization process will not last forever. Whether and when the inflation crisis of 1988-89 will return is a question of a great importance.

2.2 The Control Mechanism of the Central Bank

Three phases of control mechanism evolved between 1979 and 1992. Prior to 1983 when the specialized banks separated from the People's Bank of China, the control mechanism was essentially the same as in the pre-reform period. There were two separate plans for credit and cash each year, and cash was used only for wage payments and payments to rural households through the procurement of agricultural products; therefore, it was

³Rural household savings deposits are deposits in rural credit cooperatives. Some farmers may deposit their savings in banks located in urban areas or in informal financial institutions like RCFs.

the cash plan that determined household demand. Because there was only one bank, no other financial intermediaries and no financial instruments other than credit, cash and credit controls were effective. From 1983 to the fourth quarter of 1988, while the old credit and cash plans were still in place, there was a gradual shift towards the use of indirect instruments such as reserve requirements (13 per cent, with an additional 5-7 per cent for excess reserve) and the deposit-lending ratio to achieve financial control. However, no capital requirement was imposed. During this period, specialized banks and their branches were allowed to float deposit and loan rates in a range 20-30 per cent wide around the rate set by the central bank.

Inflation in 1988 disrupted these experiments, and starting from the fourth quarter of 1988, strict credit quota controls were again imposed, except for credit cooperatives which were still under the deposit-lending ratio regulation. Interest rates were generally no longer allowed to float except in few special areas. This mechanism was maintained till the end of 1992.

The credit quotas plan is the centre piece in the central bank's control mechanisms. Each year the PBC disaggregates credit quotas to each of the specialized banks, which in turn disaggregate to their branches. When strictly enforced, credit quotas are a binding constraint on specialized banks. (A branch director of the PBC in Sichuan province committed suicide in 1988 when facing the dilemma of extending the additional credit demanded by the local government while strict credit quotas were being imposed by the central government.) The second most important tool of the central bank is its credit to specialized banks. The central bank's claims on specialized banks account for more than two-thirds of its total assets (IMF, 1993). Indirect instruments of interest rates and reserve requirements do not yet play very important roles; there may be good reasons for this given the large size of the state sector. The last point is taken up in the fourth section.

Universal direct credit rationing results in misallocation of resources: some profitable projects may not be able to get finance, but less profitable ones may. Moreover, unlike indirect instruments such as interest rates, it is hard to achieve better macroeconomic demand management with credit quotas. The result of this situation is often the familiar 'stop-go' cycle with extreme swings in output: when the brakes are applied to slow down

an overheated economy, there is a period of retrenchment before credit expands and the cycle continues. Even worse, evidence shows that it is mainly the non-state-owned enterprises like the township-village enterprises that get hurt most during a credit crunch, and these appear to be the more efficient and dynamic enterprises in China now (Qian and Xu, 1993).

Two new problems arose during the reform period. First, the boundary between the two monetary circuits, cash and credit, became increasingly blurred; because of the rise of non-state enterprises, business transactions used more cash than cheques. Even in the state sector, cash is used in order to avoid monitoring by the government (in particular for bonus payments and other benefits for employees). It is estimated that about 15 per cent of household savings is actually deposited by individual businesses and about 10 per cent by enterprises and institutions. Unlike enterprise deposit accounts, depositors with household accounts may withdraw cash with no questions asked. (Therefore enterprise and institutional deposits in household accounts will eventually end up in the hands of the individuals.) Second, with the faster pace of reform in other sectors due to the regional demand for high growth, using credit quotas imposed by the central bank becomes a less effective method of controlling the money supply. Local governments and bank branches found many ways to circumvent the limits (see below).

For several reasons, both the central bank and the central government were very reluctant to increase lending rates to cool off the economy. In 1992, interest rates on black market loans had soared to between 25 per cent and 30 per cent, more than 16 percentage points higher than the official rates. Some argue that the state sector, with its soft budget constraint problem, will not respond to increases in interest rates anyway. With the amount of decentralization and the rise of the non-state sector, the interest rate is not totally ineffective as it was in the past. Second, the government worries that the increased cost of capital as a result of interest rate hikes will make more state-owned firms lose money, which will require more subsidies from an already shrinking budget. The low interest rate for loans is in fact a subsidy through the banking system (rather than the government budget) for loss-making firms.

In recent years, the central government has restricted the banking sector from making major reforms assuming that this is perhaps the only leverage still at its disposal. During the 1990 retrenchment, the central government tried to revoke fiscal revenue-sharing schemes and to re-centralize investment decisions, but it failed after encountering strong opposition from the governors of the provinces. The only institutional reversal achieved during that period was the re-centralization of the banking system, moving back to credit quotas control, eliminating much of the floating interest rate, and re-centralizing personnel appointment and supervision from local government to the central bank. However, sticking to the old credit quotas system will not help in an already largely decentralized economy. Better financial control and a stable economy cannot be achieved unless the financial system is reformed and the control mechanism is changed.

2.3 Behaviour of State Banks

Chinese economists consider one of the most serious problems with state banks is the mixing of policy-oriented loans and profit-oriented loans in specialized banks. This is, by far, one of the most important institutional reasons for pervasive moral hazard problems in Chinese banking. Reform has set a clear objective for enterprises: to maximize profits (whether it is achieved is another matter), and incentives are offered to meet that goal. This is not the case in the banking sector. As the rest of the economy is focusing on how to make enterprises more profitable, the banks are debating whether they should maximize profits.⁴

Partly due to distorted prices and partly because of the importance of structural adjustment and priority industries, the government insists that loans should be granted not for reasons of profitability but as 'policy

⁴The governor of the PBC stated plainly in 1991 that: 'Banks are not only commercial entities conducting banking business but are also units empowered by the state to undertake policy lending — specialized banks are not supposed to operate for profit only or, rather, they are required to take on certain functions of macroeconomic regulation and control.' As late as in December 1992 when another new wave of economic reform was under way, the Chinese Premier still insisted that specialized banks should be responsible for structural adjustment and policy loans in the near future (People's Daily, 26 December 1992).

loans' (zhengcexing daikuan). The government is also concerned that it will suffer a loss of control if specialized banks become autonomous, profit-seeking commercial banks. This concern has increased given the already decentralized fiscal system mentioned above.

However, this practice appears to be responsible for the moral hazard problem and the loss of effective control in several ways. First, it becomes difficult to monitor diversion of funds from a less to a more profitable use if the same bank is responsible for both policy lending and commercial lending. This undermines the intention of structural adjustment and investments in priority industries because badly needed policy loans are not necessarily channelled to intended users. Instead, they are often diverted to other more profitable projects by banks. For example, agricultural credit is diverted for industrial use or for real estate, so that the government has to pay an IOU to farmers for grain procurement. This became a serious national problem in 1992.

Second, all levels of government constantly intervene in the operation of banks in the name of policy lending. The relationship between banks and the government is complicated due to the multi-layer multi-regional organization of China's economy — the deep 'M-form' hierarchy (Qian and Xu, 1993). Local bank branches are under so-called 'dual leadership' (shuangchong lingdao): they are subordinated to the banking hierarchy (to the higher level of the specialized bank and to the same level of the PBC branch), they are also under the leadership of the same level of local government. The influence of the local government can be seen at two points in time: ex ante, local governments are directly involved in credit plan formulation, in some cases, local governments are inclined to impose loans on specialized banks. Ex post, the local government can decide whether to let the enterprise pay back the loan or not; conflicts between the local finance department and bank branches may arise over this issue. The power of local governments comes from their power to make appointments as well as to allocate housing and other benefits.⁵

⁵In a survey of 10 cities experimenting with financial reforms, the ICBC found that local government officials imposed policy loans on local bank branches for 73 per cent of the category of technical renovation loans in 1986

Third, an objective measurement of performance is difficult to achieve (if not impossible) when banks are obliged to extend loans to both money-losing and money-making projects, and their decisions are under constant government intervention. In such cases, if bank managers make loans to risky or bad projects, their incompetence can be easily disguised and their losses will most likely be excused. For this reason, bank managers often object to taking policy lending away from their banks, a seemingly paradoxical phenomenon. During 1985-90, specialized banks received credits from the PBC at a below-market rate which accounted for about a quarter to a third of their total assets (IMF, 1993). Heavy central bank lending is perhaps normal in a high growth period. But given the moral hazard problems described above, a high level of soft credit from the central bank may become an important source of soft budget problems at banks, which in turn become a source of soft budget problems at enterprises.

One of the alarming signals of the banking system is fast decapitalization, as both bad loans and the cost of capital increase, a result of imbalanced reform in favour of the deposit side together with the high remittance rate of bank profit to the Ministry of Finance (bank profits are taxed at 62 per cent). In only six years between 1985 and 1991, the capital to asset ratio of the specialized banks fell from 9.6 per cent to 6.1 per cent. Because Chinese banks are not allowed to write off bad loans easily, the net value of the state banks is questionable. Privately, Chinese economists estimated that bad loans account for more than 20 per cent of the total outstanding bank loans. If that is true and if all bad loans are written off, the net worth of every specialized bank would be negative. This may be less serious than it sounds because the banks are owned by the government anyway. Nevertheless, it poses a serious problem for the government's already troubled budget.

2.4 The Rise of 'Outside-the-Plan' Intermediaries

(Wu, 1990). The Party branch affiliations of bank officials are with the local Party Committee, in which the organization department controls appointments. This system was changed after re-centralization in 1988.

The rise of the outside-the-plan financial intermediaries has been a major event in financial institutional development in the past few years and could have profound consequences on the economy. Most of them are different from the state banks not so much because of ownership but because of control: they are generally subject to less regulation than state banks. Therefore, they are flexible in their financial activities, and have expanded quickly in recent years, especially in 1992.

Rural and urban credit cooperatives contribute to financing the non-state sector. The reserves-deposit ratio of rural credit cooperatives with the Agricultural Bank of China declined gradually from about 78 per cent in 1979 to about 34 per cent in 1991, and more loans are extended to township-village enterprises than to households (Table 16.8). Recently, foreign banks have been allowed to establish branches in some areas in China, but domestic non-state banks are not yet seen.

Table 16.8

Most trust investment corporations are fully controlled subsidiaries of bank branches. Such a practice features what the Chinese call 'one factory, two systems,' that is, one part is under a planned system and the other is under a market system.⁶ Although both banks and their affiliates remain state owned, the affiliated trust corporations are much less controlled by the government and are flexible in providing badly needed financing; they are, to a large extent, market led.

Qian and Stiglitz (1993) found several interesting financial practices in the Pearl River delta of Guangdong province in their field studies in December 1992. For example, bank deposits were often diverted to the banks' affiliated trust investment corporations and loans were renamed 'trust investments'; bank branches or their trust investment corporations sometimes channelled funds directly between enterprises to avoid credit limits, so they

⁶This practice started, and became quite common, in the industrial sector. State-owned enterprises set up fully controlled subsidiaries but register them as having collective ownership, or they establish joint ventures with another state or non-state-owned enterprise. These collectives and joint ventures are not under the control of the government. Similar practices in Hungary are called 'partial transformation,' which is considered to have a tendency toward spontaneous privatization (Frydman and others, 1993).

provided a brokerage service; and banks helped firms by arranging bond financing, also to avoid credit quotas. Lou (1993) reported several other practices in China. In one incident, a bank-industry joint venture was formed in which the industrial enterprise deposited 50 million yuan and borrowed 80 million from the bank, but the amount borrowed was treated as an investment not as a bank loan. In another case, a bank affiliated trust investment corporation imposed fixed payments in a specific time period so that it was an investment in name, but a loan in practice. In fact, about 50 per cent of the financial sources of banks' affiliated trust investment corporations came from banks and other financial intermediaries and only 45 per cent came from direct trust deposits. The widespread practice of disguised credit expansion in the presence of credit quotas is reflected in the consolidated balance sheet of the banks in a curious way: a negative 150 billion yuan was registered on the liability side at the end of August 1992, which makes the amount of total assets look smaller.

From the microeconomic point of view, the rise of outside-the-plan financial intermediaries is an institutional innovation in response both to economic development and the constraints of the old system. At the same time, the moral hazard problems of bank managers are also pervasive: it is easy to divert state funds to private pockets to enable a spontaneous privatization. From the macroeconomic perspective, it may become a factor that destabilizes the economy if the central bank fails to react accordingly.

2.5 The Relationship Between Banks and State-Owned Enterprises

Financial system reforms cannot be separated from enterprise reforms. The failure of state-owned enterprises is partly a failure of the state banking system and vice versa. The greatest problem concerning state-owned enterprises is known as the problem of soft budget constraint (Kornai, 1992). The situation is a familiar one: when a state-owned enterprise is in financial trouble, the government, very often a state bank, steps in to rescue it by refinancing the investment or by rescheduling the overdue loans. Therefore, few bankruptcies of state-owned enterprises occur despite the passage of the Law on Bankruptcy by the Chinese Parliament in December

1986. Managers in state-owned enterprises react to the soft budget constraint problem opportunistically: they undertake every possible investment project regardless of its profitability, which leads to 'investment hunger.' As a consequence of the soft budget constraint, investment is inefficient and completion of a project is slow.

Therefore, loss making and soft budget constraints are mutually supporting equilibrium phenomena: because of the soft budget constraint, there are more projects generating a loss; because of projects making a loss, subsidies are provided and the budget is soft. Most losses occur in the state sector. On paper, loss-making state-owned enterprises accounted for one-third of all state-owned firms; but the number may be underestimated, as there are many ways to disguise loss making simply by playing accounting tricks. (For more information on China's loss-making firms, see Sicular, 1992.)

Table 16.9

Table 16.10

There are basically two channels for an enterprise to finance losses (or two sources for the soft budget constraint of enterprises): either through the state budgetary process (subsidies or reduction of taxes), or through the banking system. The annual subsidies to enterprises from the state budget account for more than 15 per cent of budgetary revenue each year since 1986, peaking at 20 per cent in 1989 (Table 16.9). As government budgetary revenue declined, the government increasingly pressed the banking system to take responsibility. Soft credit has become a main source of the soft budget constraint. A recent survey reveals that between 1986 and 1988, 229 of 403 (56.8 per cent) large and medium state-owned enterprises investigated had experienced difficulty in repaying loans. Furthermore, 203 enterprises had received assistance from their superiors, of which 48 per cent was loan repayment before taxes, 30 per cent was on extension of the repayment period, and 12 per cent was a roll over of loans. (Table 16.10).⁷

⁷The survey was conducted jointly by the Institute of Economics of the Chinese Academy of Social Sciences, Oxford University, University of Michigan and University of California (San Diego) under the sponsorship of the Ford Foundation.

In a separate study, Bowles and White (1989) identified numerous cases from the official newspapers and

It is not surprising that overdue (yuqi) and non-performing loans (daizhang) grew rapidly. However, there is no published information; even worse, there is no clear definition of bad debts in the Chinese accounting system in the first place. The situation became much worse between 1989 and 1991. The increase of loss-making enterprises and weak market demand in 1989-91 also created a national problem of inter-enterprise arrears amounting to about 200 billion yuan: the government has injected 35 billion yuan into the economy to help settle this problem. Jump-starting the troubled enterprises is only a temporary solution, it also intensifies the problem of the soft budget constraint.

Unlike many financial rescue cases reported in Japan, no restructuring of state-owned firms (for example, replacement of management) has ever happened after financial assistance has been given in China — and the same symptoms are repeated. It is now widely recognized that the problem of soft budget constraint is a major obstacle to reform in virtually all socialist countries in transition, not just China. At the centre of the problem is the fact that the state bank is unable to make a credible commitment not to rescue enterprises in financial trouble. Although there are external reasons for the increase of loss-making — for example, the austerity programme in 1989-91 in China — the fundamental reason is an institutional one, concerning the problems of ownership, control, and the governance structure of enterprises and banks, as is discussed later.

3 Financial Reform from Evolutionary and Comparative Perspectives

Despite considerable progress made in financial reforms during the past 14 years, the financial system in China as a whole has not yet been transformed into a market-oriented system. Major institutional restructuring is

journal articles published in China in recent years about the soft credit relationship between state banks and state firms. They concluded that 'if the intention of the banking reforms has been to harden enterprise credit constraints by increasing the autonomy and commercial orientation of the banks, the evidence to date, after eight years of reform, suggests that this has not been realized. In fact, the credit constraint may have become softer.'

necessary now before it is too late. Compared to Eastern Europe and the former Soviet Union, China enjoys several advantages, but it also faces its own economic and political constraints. It is likely that institutional restructuring in the next five years must be carried out in an environment where most banks and large-scale enterprises remain state owned. The choice of the model financial system and the transitional path may affect not only the short-run cost but also the long-run performance of the economy. Careful evaluation and analysis of alternatives and their feasibility for China is important.

3.1 Development of Security Markets

For the past few years, China has experienced several waves of 'stock fever.' The enthusiasm (perhaps over-enthusiasm) for stocks and bonds in China has several reasons which are mainly related to incompleteness of the reform. First, issuing undervalued stocks and bonds is a method of 'spontaneous privatization,' and hence the stock market serves as a channel to transfer assets from the state to individuals and to capitalize the gains obtained from privatization. In such a process, employees are usually given the privilege of buying their own shares at a price discounted from face value (par), which is already much undervalued. Managers gain even more: turning a firm into a joint stock company and listing it on the stock market is more than fund raising, it is a way to avoid government interference in business and to get control rights to the company. As capital market discipline is unlikely in the near future, managers will get effective control and handsome rents if shareholding is widespread. Investors are also eager to buy shares in initial public offerings (but much less so in the secondary market) because, typically, stock is sold to the public at 5 to 6 times its face value, and its price rises to more than 10 times immediately after trading begins. At the initial experiment stage, all stock issues were carefully selected and they were the best projects available. Partly because these are experiments, the government feels obliged to back up the new institution.

Second, from the point of view of local governments and enterprises, direct financing from employees or the public is a practical way to meet the pressing need for raising funds for rapid development in the presence of an unreformed and inefficient state banking system. As an official from the Guangdong Provincial Government said 'Given the current institutional constraints, it is better to raise funds directly from investors than to rely on inefficient state banks.' This argument is reinforced by the fact that the central bank in China still relies on credit quotas as the main control mechanism. Hence direct financing through bonds and stocks is a way to circumvent credit limits imposed by the central government. Given the delay of reforms to the banking system, which needs the central government's initiative (local governments are not allowed to establish their own banks), direct financing through stocks and bonds is a natural response. Some economists are in favour of developing the stock market as a first priority for similar reasons: it is relatively easier to develop new institutions than to reform old ones (like banks) because the former do not require the central government's initiative and can be established in isolation from the rest of the system.

There is no doubt that China should develop security markets for both equities and bonds. However, it is unlikely that the stock market will play a major role in allocating financial resources in the next 10 years, because China is still at a low stage of development and a stock market takes a long time to become established. There are also special problems associated with transition, which makes it difficult for a stock market to work efficiently in the initial stage. First, the purpose of a stock market is to facilitate risk sharing and supply information that helps discipline management and increase profit opportunities. A key feature of transition from a planned to a market economy is the unusual degree of uncertainty. The absence of trained analysts and reliable accounting data deprives stock prices of most of their informational content in the noisy environment, and price fluctuations are unlikely to reflect the fundamental value of the company or measure managerial performance accurately. This disables the stock market's capacity to monitor and discipline managers. Garbled stock market prices may also give the wrong signals for restructuring (Tirole, 1991).

Second, the volatile nature of a stock market, plus the lack of regulation in the initial phase of transition, will attract scarce and talented people away from productive activities. Instead, they will be drawn to speculative and rent-seeking activities in security exchanges by using inside information, or by manipulating the market, or both. There is little social gain from such speculative trading in a noisy environment.

Third, many state-owned enterprises have accumulated a large amount of bad debts and it will be difficult to attract investors because, as residual claimants, they have low priority in claims. Therefore, for a majority of state-owned enterprises, going to the stock market is perhaps not a realistic option.

Nevertheless, market financing for those cream of the crop enterprises makes more sense. The recent successful initial public offerings by two Chinese state-owned enterprises on the New York Stock Exchange and the Hong Kong Stock Exchange demonstrated this potential. However, it should be noted that both enterprises are in the automobile industry, which is perceived to have great potential in China. Brilliance, Inc., which owns a company making mini-buses in Shenyang, was the first Chinese company listing on the New York Stock Exchange (October 1992). Denway Investment, which owns a car-manufacturing company in Guangzhou, was oversubscribed by 657 times on its initial public offering on the Hong Kong Stock Exchange in February 1993.

3.2 The Case for a Bank-Oriented Financial System in China

While development of a stock market is clearly important, the highest priority should be placed on the reform and adaptation of the commercial banking system (Corrigan, 1992). But reshaping the banking system is a more difficult task, and in this aspect, China can learn a lot from the Japanese experience. The Japanese development experience has been carefully studied by Chinese economists and government officials. Attention so far has been confined mainly to the roles of the Ministry of International Trade and Industry (MITI) for industrial policies, of the Economic Planning Agency (EPA) for indicative planning, and of the industrial

grouping and interlocking shareholding inside a keiretsu. The experience of the Japanese financial system (including the main bank system) has yet to receive much attention.

It is important to realize that the Japanese main bank system has evolved in a market environment and was not imposed by the government (as in South Korea). Nevertheless, the Japanese government did play an important role in designing the institutional framework during the initial stage, such as setting up development banks and creating an environment that enabled commercial banks gradually to take over development bank loans. From both evolutionary and comparative perspectives, the Japanese experience is relevant for China's financial system reforms in several important aspects.

First, restructuring China's banking system by studying the Japanese experience can better utilize existing organizational capital, the transition can be made more gradually, and institutional transformation less costly. China's 14 years of reform have shown that a gradual and evolutionary approach in institutional transformation has the benefit of reduced risks and better use of existing organizational capital. The four specialized banks already have a vast number of branches throughout the country, and their personnel are learning market economics by practising economic reform. Even before the economic reforms, each PBC branch with whom an enterprise had a designated account had a responsibility to monitor enterprises on transactions, levels of inventory, wage and bonus bills, and the like, to ensure they were within the scope of the plan. This monitoring was very close before the reform. For example, bank branches had to make sure that every transaction over 50 yuan was conducted through a bank transfer, and that enterprises in areas where a bank branch was located did not hold more than three days' cash requirements. Of course, this monitoring was more gathering information than exercising control. Transforming the four specialized banks into commercial banks on the Japanese city bank model will be less costly and faster than destroying the existing system and building everything anew.

Second, scarcity of expertise and human capital in the financial sector is one of the major constraints in China. The Japanese financial system concentrates scarce expertise in the banking sector and uses it in an

effective way. Integrated monitoring by the main bank uses scarce monitoring resources to better advantage (see Chapter 4 by Aoki). It also serves to reduce information asymmetry and to achieve better coordination in an environment where other institutional supports are lacking. In addition, repeated interactions between monitors and the monitored will help to develop reputations which are extremely valuable in the noisy environment of transition where enforcement of law and contracts needs time to develop.

Third, China demands a high growth rate, close to 10 per cent per year, for the next 5 to 10 years. This is not unrealistic, given that the average growth rate has been close to 9 per cent for the past 14 years and the continued high savings rate of more than 35 per cent of GNP. The Japanese financial system successfully supported double-digit growth from the 1950s to the mid-70s, and the Japanese government, mainly the Ministry of Finance and the Bank of Japan, played an important role in this. The Japanese development banks and long-term credit banks were instrumental in financing priority industries to avoid coordination failures of the market and to escape the under-development trap. The Japanese government also maintained a business-like relationship with banks; they tended to collaborate and cooperate with, rather than being hostile to, the banks. The government's involvement is particularly valuable and less costly at the initial stage of development, because this is the time when the market is less developed, when the task of catching up is relatively simple, and the technology used is not at the frontier. As the economy becomes more mature, the relative advantage of government intervention may recede.

Fourth, firms in China need to acquire new technology, to streamline the work force, and to develop new corporate governance structures. Given the current political constraint, a Chinese-style ownership reform will mainly include: corporatization (reorganization of state-owned enterprises into limited liability or joint stock companies); joint ventures (between state-owned and foreign firms); mergers and acquisition (by non-state firms like township and village enterprises); and sales and repackaging of some small and medium firms into private, cooperative, or worker-controlled firms. A bank-oriented financial system is compatible with a variety of property ownership arrangements, and this flexibility is valuable in the transition period.

One feature of the Japanese main bank system is the bank's role in corporate governance. Banks use their expertise, resources, and information to help corporations in restructuring and investment decisions, particularly at critical times. In this context, the Japanese banking system, as opposed to arm's-length banking systems, is a useful model in two ways. One is for the bank to play a role in the transformation process itself; banks may contribute to evaluation of assets, settlement of bad loans, provision of ideas for new organizational forms, and the like. The other is the banks' role in corporate governance through taking equity positions.

Finally, historically, the current Japanese financial system evolved during and after the war-time economy, which shares several features with the contemporary Chinese economy: considerable concentration of the banking system; allocation of funds by government authorities; massive debts of firms; enormous demands for restructuring; and the critical situation of the government budget. Banks started to play an active role in corporate governance as a tight fiscal policy was imposed and the bad debts of corporations were removed in the post-war reconstruction period. The historical similarities suggest that China may benefit more from adopting features of the Japanese financial model than from other models in achieving its objective of restructuring the corporate sector while stabilizing its economy.⁸

Of course differences exist between Japan and China, which tend either to limit the scope of applicability of the Japanese experience to China, or to require China to take additional steps in order for the assumed benefits to be realized. First of all, banks in Japan, except for the development banks, are all privately owned, including the long-term credit banks and city banks. Government agencies like the Ministry of Finance and Bank of Japan concentrate on regulatory issues; they do not have to worry about the profit motives of bank owners. Because all banks in China are state owned, bank managers' concern about profitability cannot be

⁸In a different opinion, Scott (1992) recommended that the transitional objectives of restructuring enterprises be pursued by non-bank financial institutions (like mutual funds and trust companies), in order to ensure that the banking system achieved its fundamental objectives of maintaining the integrity of the payments system and the safety of depositors' savings. Maintaining the soundness of the banking system is indeed a primary concern for reforming the financial system. On the other hand, if banks lack managerial capacity and supervision skills for restructuring, as argued by Scott, it is even less clear how the newly established non-bank financial institutions acquire such capacity and skills in the short run other than by hiring foreign managers.

taken for granted. Governance structures must be created so that control will reside in those who benefit most from the banks' profits.

Second, the Japanese financial system has worked well in an environment of a sound fiscal system together with government budget surplus (up to 1975). In contrast, China's fiscal system still needs major reforms before the trend of declining government revenue can be halted and the government budget deficit comes under control. As mentioned earlier, the government's budget revenue has continued to decline and the deficit to rise in recent years. However, this is just part of the story. More frequently, governments at all levels tend to force the banks to make 'policy loans' for items that are supposed to be taken care of by the budget. Bad loans are less transparent than a budget deficit: this essentially has the effect of depleting bank capital, and will eventually show up in the government budget. Without a sound fiscal system and prudent fiscal policy, the functioning of the main bank system might be seriously undermined. Therefore, financial reform requires complementary reforms in the fiscal sector and a prudent fiscal policy to reduce pressure on the banking system.

Third, China is much larger than Japan and regional variations are much greater. Therefore, China needs more decentralization.

Finally, China's firms tend to be small scale and Chinese industries are not very concentrated. Also Chinese people are more family oriented and less organization oriented than the Japanese. For this reason, informal financial institutions may play a greater role in China.

4 Restructuring China's Financial System: The Next Stage

Banks differ from ordinary manufacturing firms in that most of their claimholders, that is, depositors, are highly dispersed, which makes monitoring of bank behaviour extremely difficult. With private ownership, the

owners of the bank (its capital account) care about returns to their assets, and therefore its profitability. Even in this case, government regulation and monitoring are required because owners may pursue investments contrary to depositors' interests, or if depositors are insured by the government, contrary to the public's interest. When the banks are owned by the state, the government itself may become a serious problem because it often has multiple objectives like macroeconomic stability, industrial policies, and employment, along with concerns for profitability. Hence, institutional re-arrangement is needed to mitigate agency costs and reduce the risks inherent in the financial system.

In this section, I make suggestions for institutional changes in the next stage of China's financial restructuring, to be completed, say, within three years from 1994 to 1996. This includes dividing responsibility for the fiscal sector and the financial sector; reorganizing the central bank and restructuring its control mechanism; and establishing decentralized multi-tier financial intermediaries. The last consists of development banks; commercialized national banks; second-tier regional banks and credit cooperatives; non-bank financial intermediaries; and informal financial institutions. (Other financial institutions, such as security companies and investment banks, are beyond the scope of this chapter.) The proposed institutional changes are intended to be realistic, practical, and implementable. At the same time, they also represent a pivotal and significant step in the transition to a market-oriented financial system.

4.1 Division of Responsibility between the Fiscal and Financial Sectors

In Japan, the Ministry of Finance, the Bank of Japan, and other regulatory agencies are all active in financial regulation but each has different responsibilities. With a sound fiscal system, the Ministry of Finance was able to maintain a budget surplus for a long period of time and therefore the government had no need to borrow from the central bank. Differing from many other countries, the Ministry of Finance played an important role in regulating banks and, in that context, it often exercised some rights of control as well, such as replacement of

bank managers or granting more branch operations as a reward. But the Bank of Japan, like other central banks, operates through the market with the main objective of maintaining stability — stability in the purchasing power of the currency and stability of the workings of the financial system. The Bank of Japan did rediscount loans from commercial banks in support of some activities like exports, in particular in the high growth period when demand for money increased rapidly. Nevertheless, it was the responsibility of the commercial banks to make independent lending decisions.

In the current framework, the PBC combines the functions of a central bank, the government financial regulatory agency, and the supervising agency of the specialized banks exercising control rights on behalf of the state. The central bank's mission has at least two facets: it is responsible for macroeconomic management as well as for policy lending for structural adjustment (Lou, 1993). The central bank and its branches allocate the task of policy lending to specialized banks, and make policy loans directly in some cases as well. Recently, the central bank has even operated its own security companies. In the past 14 years China has moved from one extreme to the other: from the situation in which most finance comes from the state budget to one where most finance is bank loans.

In China, a clear division of responsibility between the fiscal and financial sectors should be a priority. A pre-condition for a good financial system is a sound fiscal system, and hence a reformed fiscal system is a prerequisite for financial reforms. First, the banking system should not assume fiscal responsibility. If there is no particular reason for policy lending (such as an important ongoing relationship), then subsidies should be channelled through the budget. The fiscal channel is much more transparent and therefore may be subject to better discipline. Nevertheless, such a change may mean an increase in the budget deficit in the short run, but that is no more than a transformation of implicit into explicit deficit. Second, tax reform is needed to ensure a sound base for government revenue. Third, in the case of a budget deficit, to avoid inflation, bond financing should be preferred to direct borrowing from the central bank.

It should be emphasized that the current definition of 'policy loans' in China is too broad. It essentially has two distinct categories: subsidies and loans for development purposes. The former includes subsidies to agricultural products through procurement and subsidies to state-owned enterprises due to price distortions or inefficient operation. Funds for the latter category should be used for infrastructure or priority industrial investment. The conceptual distinction between the two categories has important practical implications: a subsidy is a fiscal matter and should be financed from the budget and administered by an agency under the Ministry of Finance. Subsidies should not be treated as loans. Only loans for development purposes can be labelled 'policy loans,' to be managed by development banks, as discussed below.

Finally, because China is much larger than Japan, more independent regulatory agencies might be needed to reduce the work load of the Ministry of Finance. In October 1992, regulation of security markets was transferred to a newly established agency, the State Security Exchange Commission, but regulation of security companies is still under the central bank. In fact, most security companies are subsidiaries of specialized banks or their branches. Furthermore, the People's Bank of China is also the supervising agency of the banks, which gives it the authority to exercise rights of control and to engage in micro intervention. This may undermine the central bank's ability to maintain stability. Therefore, ownership and control of the state banks should be shifted to an agency with strong profit motives, for example, the State Assets Commission (SAC).

4.2 The Central Bank's Control Mechanisms in Transition

Eventually, the central bank will apply indirect monetary instruments to achieve macroeconomic management by adjustment of the discount rate and reserve requirements, and through open market operations. But it would be unwise to jump into that position in one step. There are two special problems in the case of China that Japan and many other developing countries do not have.

One problem has to do with the still large state-sector. Although using credit quotas is a crude and indiscriminate mechanism, it is perhaps more effective in dealing with the state sector than any other instrument when the demand for investment is hard to curtail. It might well be the case that imposing credit quotas is the only effective way to constrain the state sector from expanding, because many state-owned firms are not sensitive to interest rates if they face a soft budget constraint. Enforcing strict credit quotas is one way to harden the budget constraint. Both Lau (1992) and McKinnon (1992a) are in favour of putting quota limits on state-owned firms' borrowing. The Bank of Japan for a long time used credit quotas, but as a supplementary, not as a main, control means.

Another unique situation in China is its fast process of monetization and financial deepening as the economy moves away from central planning to a decentralized market (Tables 14.5 and 14.6). As the velocity of money slows rapidly, setting a monetary target may be difficult, if not impossible. In this event, targeting a real interest rate is a better alternative (Lau, 1992). For example, the nominal interest rate can be indexed to the consumer price index, and targeted at say, 2 to 3 per cent above the inflation rate. Even in the United States, recent experience shows that adopting a monetary target may be less useful.

Another control instrument used by the central bank is lending to specialized banks (about a third of their total liabilities). During the high growth period, the central bank has to supply credit to meet increased demand for money. If the Japanese experience is relevant, the central bank should not be directly involved in policy lending or the direct supply of credit to specialized banks, instead, it should rediscount loans already made by the specialized banks.

Underlying the control mechanism is the institutional issue of the reorganization of the central bank. At the moment, the People's Bank of China has more than 160,000 employees and has branches down to the county level, the largest network in the world. The system is also very localized in the way the credit plan is balanced by regions through provincial branches of the PBC. Provincial branches of specialized banks hold reserves with provincial branches of the central bank; the reserve requirement and reallocation of credit are

segmented across regions. This is rooted in the 'deep M-form' (the multi-layer-multi-regional form) of hierarchical organization in China (Qian and Xu, 1993). As a result, provincial branches of the central bank often form an alliance with provincial governments, and ignore instructions from Beijing.

To prevent localization of the central bank system by the provinces, a cross-province regionally based central banking system like the US Federal Reserve System could be a better choice for China. This means that the central bank establishes headquarters in seven or eight large regions (daqu, or districts) consisting of three or four neighbouring provinces. With such a scheme, a dramatic reduction in the number of employees and branches of the PBC is required. It seems appropriate to eliminate branches of the PBC at the county and municipality levels, and to consolidate provincial branches into large regional headquarters and their local offices.

4.3 Separation of Policy Lending from Commercial Lending: Establishment of Development Banks and Commercialization of Specialized Banks

One of the first priorities on the reform agenda is to remove policy lending from the portfolio of specialized banks and assign that task exclusively to newly established development banks. This is particularly important for China precisely because all other banks are also state owned. As analysed in the second section, pervasive moral hazard problems when policy and commercial lending are combined are the prime reasons for the inefficiency of the banking system at the current time. Because up to 40 per cent of loans are policy loans, it is impossible to impose a hard budget constraint on the specialized banks which, in turn, have no incentives to harden the budget constraints of firms.

Externalities and spill-over effects are strong at a low stage of economic development when the market is incomplete and selective policy lending (development loan) may become a catalyst for take-off. In Japan, development banks played an important role in transforming an economy with limited resources by setting

priorities and performing indicative planning. An important point of the Japanese experience is that development bank loans were gradually taken over by commercial banks and there was an exchange of information between the Japan Development Bank and commercial banks (see Chapter 4 by Aoki).

The fact that the Chinese economy is still in the process of reform provides additional reasons for policy lending. Not only are some prices still distorted, but more significantly, there is a great demand for experimenting, for learning, and for building up the institutional infrastructure of the market system. To achieve this, there is an urgent need to establish one or several development banks with the explicit mission of lending for development and not for profit maximization. However, the amount of policy lending should be dramatically reduced from the current level of 40 per cent, given the moral hazard problems analysed above. At the present stage of economic development, the activities of development banks in China may include projects in transportation, communications, energy, and high risk, high tech industries, as well as for restructuring and building market institutions.⁹

China can learn from the Japanese experience in setting up development banks. The JDB was founded in 1951 with some employees transferred from the IBJ. It obtained trust funds from the government, which in turn obtained funds, in part, from the postal savings system. The average holding period of postal saving certificates was long, about 3.84 years in 1965, as opposed to 0.85 of a year for bank savings (Yasuda, 1992). China's new development bank could be built on the same basis as the People's Construction Bank of China and the six investment corporations under the State Planning Commission. Because China has already established a nationwide postal savings network, it is also possible to channel some of those funds to development banks. However, to the extent that loans of development banks are long term, they should be matched by long-term deposits.

⁹The combined share of outstanding equipment loans by JDB and IBJ reached a peak at about 50 per cent in 1955, and were respectively 21.7 per cent and 18.1 per cent in 1960. The combined share declined to 22.4 per cent at the end of 1970. JDB loans were concentrated in transport, energy, and key industries like steel and chemicals (see Chapter 4 by Aoki).

With all policy lending removed, the four specialized banks should be made ordinary profit-seeking commercial banks. There are three aspects associated with this change. First, the central bank, as well as other central and local government agencies, should stop interfering with the detailed business activities of banks. In particular, the government and the central bank should not direct credit allocation and decisions. Banks can be incorporated into limited liability or joint-stock companies; the board of directors could be chosen from public institutions concerned with the profit and stability of banks, such as officials from the State Assets Commission, as well as academic financial experts. Incorporation can to some degree shield the management of banks from frequent government intervention and also make the future transfer or sale of partial shares of the banks easy.

Second, banks should be held accountable for their actions, and a hard budget constraint should be placed on them. After having provided the initial capital, the government should not provide additional funds. Because of the expected fast growth in the next 5 to 10 years, credit from the central bank to commercial banks will continue, but that credit should be provided at the market interest rate and preferably in the form of rediscounting commercial loans. This is to ensure that no soft credit is given to the commercial banks by the central bank. There is an implicit deposit insurance under traditional state ownership of banks. However, an explicit deposit insurance programme is needed to safeguard depositors' funds after specialized banks are commercialized.

Third, in order to judge the managerial performance of banks, the state banks should be allowed to operate in overlapping business areas so that idiosyncratic uncertainty can be identified. Profitability should reflect good performance rather than random events, and reward or punishment can provide the correct incentives. This reflects the informational role of competition discussed in Holmstrom (1982). Overlapping business is also desirable for a bank's risk diversification as well as for mitigating the soft budget constraint problem of exclusive relational banking.

4.4 Decentralization of the Banking System:

Establishment of Second-Tier Banking

Although commercialized national banks will be the core of the commercial banking system in China, there is plenty of room for regional banks and further expansion of urban and rural credit cooperatives. At present, only some coastal provinces have regional banks; provincial branches of the Bank of Communication are joint stock banks with local governments holding significant interests and they are to a large extent regional banks. Several reasons support the proposition that regional banks are important for regional development: the huge size of the country; great regional variations; local aspirations for regional development. Regional banks in Japan provided 14 per cent of short-term loans to listed firms in manufacturing and they play an even more important role in serving medium and small firms.

It is often heard that the state banking system in China is already over-decentralized, referring to the fact local governments usually have effective control over local branches of both the central bank and specialized banks. However, this should be more precisely referred to as fragmentation. China clearly needs a centralized central banking system and centralized control within each of the four specialized banks (the future national banks), but at the same time, China also needs truly decentralized regional banks.

The role of this second-tier banking, regional banks together with urban and rural credit cooperatives, is not just limited to the contribution of funds. It is important for the sake of the decentralization of the banking system, now dominated by the four specialized national banks. Decentralization not only creates a competitive environment, it also provides an alternative device for mitigating soft budget problems.

When soft budgeting is seen as an agency problem, the central issue becomes the lack of commitment by banks to stop bad projects when they are discovered. The problem arises in situations where sunk costs make it more efficient to refinance a project ex post even though it is not efficient to do so ex ante. Dewatripont and Maskin (1990) argue that a decentralized competitive banking system can be used as a commitment device

against the soft budget constraint. The reason is that when a bank is relatively small and is constrained by a lack of available funds (that is, the bank does not have a deep pocket), then additional financing must come from another bank. Inefficient ex post renegotiation between the new and old banks (due to asymmetric information) reduce the returns the new bank may receive, thereby reducing its incentive to refinance.

Qian and Xu (1991) suggest that even if banks are large, renegotiating projects financed by several banks is more difficult than renegotiating projects financed by a single bank, which makes additional financing less likely and the budget constraint harder. It is interesting to note that in Japan, although main banks' monitoring is exclusive, there is no exclusive financing. There may be other reasons for this, such as firms being afraid of being held up by the bank ex post under exclusive financing. From this perspective, a more important benefit of allowing foreign banks to operate in China would be the achievement of credible commitment and the imposition of harsh discipline on managers, rather than bringing in capital.

One practical method for achieving fast decentralization of the banking system is to establish regional commercial banks using the employees and facilities of branches of the People's Bank of China at the county and municipality levels. As discussed previously, after the recommended reorganization of the central bank, those lower level branches will be abolished and the personnel will be released. There are two possible options. One is to set up province-based regional commercial banks with the current facilities of the PBC as the initial investment by the central government. The provincial government then injects additional funds to maintain its controlling interest in the bank. Or, regional commercial banks could be established (serving, say, three to four provinces), with no single province having a controlling share. This has the advantage of facilitating capital flows across provinces and preventing regional banks from investing in projects that are only of provincial interest. Either way, the proposed method could make the best use of existing institutions, it could reduce the cost of re-employment by engaging the redundant central bank employees, and could create a competitive banking environment relatively quickly.

4.5 Banks' Roles in Corporate Governance

One of the benefits of the Japanese main bank system is the monitoring and information-collecting roles of main banks (city banks and regional banks alike). At present, most Chinese firms have only one designated bank branch for settlement of accounts and loans. For a more active role by the banks in corporate governance, institutional changes are needed; the newly commercialized banks may be allowed to hold some equity in newly incorporated state firms. This can be done through debt-equity swaps, as there are so many non-performing loans.

The presumed role of banks in corporate control is clearly dependent on the establishment of a new corporate governance structure, known as corporatization. The discussion on new governance structures of state-owned enterprises dates back to 1985 (World Bank, 1985, chapter 10). The main idea is to mimic corporations in capitalist economies with shares held by many financial intermediaries like pension funds, mutual funds, insurance companies and holding companies. (To a large extent, the first stage of Lipton-Sachs' proposal (1990) of privatization for Poland (corporatization or commercialization) has similar ideas.) Although individuals are also allowed to hold shares in these financial intermediaries, the majority of shares are expected to be held by the State Assets Commission (SAC), to which the public delegates the rights of ownership. A major enterprise reform plan on these lines is under study in Shanghai with assistance from the World Bank.

The problems with this kind of plan are twofold: first, it is not clear how the soft budget constraint problem can be solved or mitigated, and second, the role of the banks is missing. There is little evidence in the market economy, at least to date, that mutual funds, pension funds and other institutional investors closely monitor or actively participate in the control of corporations in which they have large shareholdings, although there are some indications of growing activism by some public pension funds in the United States. Under the current Chinese plan, holding companies and other institutional investors (equity holders) are supposed to have

the responsibility of monitoring, but their effectiveness is doubtful. Furthermore, all these institutions need to be built from scratch, which is both costly and time consuming.

However, there already are banking institutions, and it would be economic to make the best use of them. In fact, banks are uniquely positioned to play a monitoring role, and together with other institutional investors are able to provide better discipline. As large debt holders, banks are more likely to be tough on managers than equity holders would be. In addition, banks can access information on the flow of funds in and out of a firm and may threaten to withhold or cut off credit at any moment (Scharfstein, 1992). By comparison, a holding company cannot engage in close monitoring on a routine basis and does not have the tools to discipline unless things are really getting out of hand. Of course, the holding company, as an owner, can take many steps that banks cannot. The point is that, in restructuring the governance structure of state-owned enterprises, balancing power between banks and other large institutional investors is useful.

4.6 Development and Regulation of

Non-Bank Financial Intermediaries and Informal Financial Institutions

As emphasized earlier, non-bank financial institutions in China rose rapidly in recent years as a response to strict credit quotas imposed by the central bank. The financial activities of trust investment corporations and enterprise finance companies alike played an important role in supporting fast regional growth, and most of their activities were perfectly legal. In order to maintain macroeconomic stability in China, there is an urgent need for regulation to ensure a proper balance between the two sectors. In particular, non-bank institutions should not be de facto banks; that is, their liabilities should not be deposits in disguise.

The non-state sector is producing nearly one half of China's national industrial output and even more in terms of GNP, and the township-village-private enterprises in rural areas already contribute to about a quarter to a third of total industrial output and export. Nevertheless, total lending from all banks and rural credit

cooperatives to the non-state sector (including agriculture) was rather small, only about 20 per cent of total loans outstanding in 1989 (Table 16.11). Formal financial institutions can seldom satisfy demand from small firms in any country at a low development stage. At present, about 70 per cent of industrial output in China is contributed by medium and small businesses. To the extent they are a dominant force of China's emerging non-state sector, informal financial institutions should not be prohibited, but should be supported by the government.

Table 16.11

Taiwan's case may be relevant in this context. In Taiwan, up to half of the domestic financing of the private sector came from the informal financial system in its early period of development, with an average of more than a third between 1964 and 1989 (Shea and Yen, 1991, table 4). One of the old problems with informal contracts, as opposed to formal ones, is enforcement. Family bonds have been an important enforcement mechanism in Chinese society. What is particularly interesting in Taiwan is the use of post-dated cheques and the government's willingness to punish the bouncing of checks by imprisonment. The Taiwanese experience shows that informal financial institutions have been helpful in mobilizing savings and financing the needs of those enterprises discriminated against by formal financial institutions. The government should set rules and create an environment for streamlining the operations of informal financial institutions to improve their efficiency in allocating loans in the curb market. It should also be pointed out that in Japan too local credit banks for small businesses, which grew out of the pre-war local credit cooperatives, have played a very important role in the regional development of small businesses.

McKinnon (1992) is in favour of China's adoption of a type of dual financial system following the establishment of a proper tax system. He argues that the extensive use of informal non-bank financial institutions has an additional advantage for maintaining confidence and stability of the monetary payment system, if the formal banking system finances only low-risk projects while the high-risk projects will be financed by the non-bank informal institutions. However, the informal system tends to divert funds away from

the formal sector, which undermines the government's ability to borrow from the banking system and consequently endangers the financial stability of the economy if a proper tax system is not in place.

On the one hand, the market-oriented non-state firms (and reformed state firms) would not be allowed to borrow from the state banks and could only raise funds from retained earnings and from non-bank and informal institutions; on the other hand, un-reformed state-firms would still have access to bank credits, but their activities would be strictly limited and monitored. It is hoped that the 'within-the-plan' system (the state banks and unreformed state-owned firms) and the 'outside-the-plan' system (non-bank financial institutions and non-state firms) would be insulated from each other, and the former would be phased out eventually. As discussed above, it is important to limit the credit available to unreformed state firms. The main difficulty with this arrangement, however, is how the intended insulation between the two systems is implemented. In fact, many township enterprises (perhaps not village or private enterprises) relied heavily on bank credits to grow (Zhou and Hu, 1987), and cutting off their access to bank credits might lead to undesirable consequences.

5 Concluding Comments

This chapter makes a case for China to adopt several institutional elements of the Japanese financial system in its next stage of financial system reforms. But the Japanese model cannot be, and should not be, applied in its entirety because of the differences between the two countries. Perhaps the most important lesson China can learn from Japan is Japan's willingness and ability to adapt, rather than simply copy, institutions found in other countries which are useful to its own particular situation. Institutional changes are complex and it is impossible to have complete knowledge of the true benefits and costs of institutional alternatives in advance. Learning by experimenting is an effective way to reduce uncertainty and costs. In this regard, maintaining the flexibility of institutions and adopting pragmatic attitudes provide an option for corrections and changes at a later stage.

Given the vast size of China, a more diverse and decentralized system than the Japanese one is not just necessary, it is also beneficial.

Table 16.1

China: Selected Macroeconomic Indicators (1978-1991)

	Growth of GNP	National Retail Price Index	Urban Cost of Living Index	Export/GNP	Foreign Reserves* (billion \$)
1978				4.67%	
1979	7.6%	2.0%	1.9%	5.31%	0.84
1980	7.9%	6.0%	7.5%	6.07%	-1.30
1981	4.4%	2.4%	2.5%	7.70%	2.71
1982	8.8%	1.9%	2.0%	7.97%	6.99
1983	10.4%	1.5%	2.0%	7.55%	8.90
1984	14.7%	2.8%	2.7%	8.34%	8.22
1985	12.8%	8.8%	11.9%	9.45%	2.64
1986	8.1%	6.0%	7.0%	11.16%	2.07
1987	10.9%	7.3%	8.8%	13.01%	2.92
1988	11.0%	18.5%	20.7%	12.60%	3.37
1989	4.0%	17.8%	16.3%	12.29%	5.55
1990	5.2%	2.1%	1.3%	16.88%	11.09
1991	7.7%	2.9%	5.1%	19.30%	21.71

Source: *Statistical Yearbook of China, 1992*.

Remark: *) With the Central Bank only.

Table 16.2

China: Selected Real Interest Rates (1980-1991)

	National Retail Price Index	Household 1- year Time Deposit (nominal)	Household 3-year Time Deposit (nominal)	Household 1- year Time Deposit (real)	Household 3-year Time Deposit (real)
1980	6.0%	5.4%	6.12%	-0.60%	0.12%
1981	2.4%	5.4%	6.12%	3.00%	3.72%
1982	1.9%	5.76%	6.84%	3.86%	4.94%
1983	1.5%	5.76%	6.84%	4.26%	5.34%
1984	2.8%	5.76%	6.84%	2.96%	4.04%
1985	8.8%	7.2%	8.28%	-1.60%	-0.52%
1986	6.0%	7.7%	8.28%	1.70%	2.28%
1987	7.3%	7.2%	8.28%	-0.10%	0.98%
1988	18.5%	8.64%	9.72%*	-9.86%	-8.78%*
1989	17.8%	11.34%	13.14%*	-6.46%	-4.66%*
1990	2.1%	8.64%	10.08%	6.54%	7.98%
1991	2.9%	7.56%	8.28%	4.66%	5.38%

Source: *Statistical Yearbook of China, 1992* and *Almanac of China's Finance and Banking, 1990, 1992*.

Remark: Year-end figures.

*) cost of living adjustment allowance not included (see Table 3).

Table 16.3

China: Interest Rates with Cost of Living Adjustments (1988:IV-1990:IV)

	Household 3-year Time Deposit (nominal)	Annual Rate of Cost of Living Adjustment Allowance	Effective Household 3-year Time Deposit (nominal)
1988:IV	9.72%	7.28%	17.00%
1989:I	13.14%	12.71%	25.85%
1989:II	13.14%	12.59%	25.73%
1989:III	13.14%	13.64%	26.78%
1989:IV	13.14%	8.36%	21.50%
1990:1	13.14%	0.89%	14.03%
1990:2	13.14%	1.46%	14.60%
1990:3	13.14%	0%	13.14%
1990:4	13.14%	1.42%	14.56%
1990:5	13.14%	1.38%	14.52%
1990:6	13.14%	0%	13.14%
1990:III	10.08%	0%	10.08%
1990:IV	10.08%	0%	10.08%

Source: *Almanac of China's Finance and Banking, 1990, 1991.*

Table 16.4

China: Household Bank Deposits (billion yuan, 1978-91)

	Total Household Deposits	Increase Over Previous Year	Urban Household Deposits	Increase Over Previous Year	Rural Household Deposit	Increase Over Previous Year	Total Household Deposit/GNP
1978	21.06		15.49		5.57		5.87%
1979	28.10	33.43%	20.26	30.79%	7.84	40.75%	7.05%
1980	39.95	42.17%	28.25	39.44%	11.70	49.23%	8.94%
1981	52.37	31.09%	35.41	25.35%	16.96	44.96%	10.97%
1982	67.54	28.97%	44.73	26.32%	22.81	34.49%	13.01%
1983	89.25	32.14%	57.26	28.01%	31.99	40.25%	15.36%
1984	121.47	36.10%	77.66	35.63%	43.81	36.95%	17.45%
1985	162.26	33.58%	105.78	36.21%	56.48	28.92%	18.96%
1986	223.76	37.90%	147.15	39.11%	76.61	35.64%	23.08%
1987	307.33	37.35%	206.76	40.51%	100.57	31.28%	27.19%
1988	380.15	23.69%	265.92	28.61%	114.23	13.58%	27.12%
1989	514.69	35.39%	373.48	40.45%	141.21	23.62%	32.34%
1990	703.42	36.67%	519.26	39.03%	184.16	30.42%	39.77%
1991	911.03	29.51%	679.09	30.78%	231.94	25.94%	45.88%

Source: *Statistical Yearbook of China, 1992*.

Table 16.5

China: Monetary Aggregates As Share of GNP

	Currency/GNP	M1/GNP	M2/GNP
1978	5.91%		
1985	11.5%	39.0%	60.8%
1986	12.6%	43.6%	69.3%
1987	12.9%	43.8%	73.7%
1988	15.2%	42.5%	71.8%
1989	14.7%	39.9%	74.7%
1990	14.9%	43.0%	86.4%
1991	16.0%	47.5%	97.5%

Source: *Almanac of China's Finance and Banking, 1992*.

Remark: (1) M1 = currency + enterprise and institution demand deposit

(2) M2 = M1 + household bank savings deposit (demand and time) + enterprise and institution time deposit

In China, household demand deposit is not checkable, but enterprise and institution demand deposit is.

Table 16.6

China: Annual Monetary Expansion (1986-1992)

	Credit	Currency	M1	M2
1986	29.4%	23.3%	26.7%	29.3%
1987	20.3%	19.4%	16.9%	24.0%
1988	17.0%	46.7%	21.0%	21.2%
1989	17.9%	9.8%	6.6%	18.3%
1990	22.8%	12.8%	19.2%	28.0%
1991	19.8%	20.2%	23.0%	26.5%
1992*	23.0%	30.0%	36.0%	30.0%

Source: *Almanac of China's Finance and Banking, 1992*.

Remark: *) first 8 months, preliminary, Lou (1993).

Table 16.7

China: The Government Budgetary Deficit and Its Financing (percent)

	Deficit/GNP	Financing of the Deficit		
		Foreign Loans	Domestic Non-Bank Borrowing	Borrowing from the Central Bank
1978	(0.28)			
1979	5.15	17.5	0.0	82.5
1980	3.40	15.1	0.0	84.9
1981	1.21	55.2	84.5	-39.7
1982	1.48	-2.8	62.0	40.8
1983	1.64	11.5	43.8	44.8
1984	1.48	17.1	40.0	42.9
1985	0.50	2.4	148.8	-51.2
1986	1.82	28.3	3.7	67.9
1987	1.71	29.4	40.7	29.9
1988	2.17	31.8	36.5	31.8
1989	2.06	44.0	81.9	-25.9
1990	2.25			

Source: Tables 3 and 9 in Sicular (1992).

Remark: Adjusted figures.

Table 16.8

China: Rural Credit Cooperative Activities (billion yuan)

	Total Deposit	Loan to Households	Loan to TVEs	Loan to Collective Agriculture	Total Loan/Total Deposits
1979	21.59	1.09	1.42	2.24	22.00%
1980	27.23	1.60	3.11	3.45	29.97%
1981	31.96	2.52	3.55	3.57	30.16%
1982	38.99	4.41	4.23	3.48	31.08%
1983	48.74	7.54	6.01	2.82	33.59%
1984	62.49	18.11	13.5	3.84	56.73%
1985	72.49	19.42	16.44	4.14	55.18%
1986	96.23	25.80	26.59	4.46	59.08%
1987	122.52	34.76	35.93	6.45	62.96%
1988	139.98	37.24	45.61	8.01	64.91%
1989	166.95	41.57	57.19	10.73	65.58%
1990	214.49	51.82	76.07	13.41	65.88%
1991	270.93	63.14	100.73	16.99	66.76%

Source: *Statistical Yearbook of China, 1992*.

Table 16.9

China: Subsidies to Money-Losing Enterprises from the State Budget

	1986	1987	1988	1989	1990	1991
Subsidies (billion yuan)	32.48	37.64	44.65	59.89	57.89	50.64
As percent of Budgetary Revenue	14.37%	15.89%	16.99%	20.32%	17.48%	14.02%

Source: *Statistical Yearbook of China, 1992*.

Table 16.10

China: Methods of Bailing-Out Loss-Making Firms

	Loan repayment before taxes*	Extending repayment period	Rollover of the loans	Reducing the amount owed	other methods
Number of Bailed- Out Firms (of 229)	98	60	24	3	18
Percent	48.3%	29.6%	11.8%	1.5%	8.9%

Source: Survey sponsored by the Ford Foundation, 1990.

Remark: According to the Chinese tax law, there is no interest deduction, that is, loans should be repaid out of profit after tax.

Table 16.11

China: Lending to the Non-State Sector
As Percentage of Total Outstanding Loans

	Urban Collectives	Urban Individuals	TVEs	Agriculture	Total
1985	4.95%	0.17%	5.63%	6.85%	17.60%
1986	5.11%	0.13%	6.82%	6.68%	18.74%
1987	5.47%	0.16%	7.25%	7.28%	20.16%
1988	5.58%	0.17%	7.59%	7.19%	20.53%
1989	5.15%	0.11%	7.39%	7.12%	19.77%
1990	4.93%	0.09%	7.42%	7.17%	19.61%
1991	4.74%	0.08%	7.63%	7.39%	19.84%

Source: *Almanac of China's Finance and Banking, 1992*.

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