Macroeconomic Reform in China

Laying the Foundation for a Socialist Market Economy

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Macroeconomic Reform in China

Laying the Foundation for a Socialist Market Economy

Edited by
Jiwei Lou

The World Bank
Washington, D.C.
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Jiwei Lou is the director of the System Restructuring Committee’s Department of Macroeconomic Regulation Studies.

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FOREWORD

World Bank

After a three-year struggle, the Chinese economy successfully achieved a "soft landing" in 1996. Few had predicted this successful outcome. The adjustment was wrenching from a political perspective. The high and rising inflation of 1993, 1994 and 1995 threatened to derail part of the reform process. The battle was won in 1996 and victory was consolidated in 1997. For the first time since the start of the reforms in 1978, China has succeeded in subduing an inflationary boom without killing the growth momentum. The critical difference, in our view, is made by the government's timely launching of a package of macroeconomic reforms that have resulted in tightening the "soft budget" constraint on state-owned enterprises and state commercial banks.

China's program of macroeconomic reform is far-ranging. It comprises monetary, financial, fiscal, exchange rate policy as well as institution building. It was embodied in "Decisions for Establishing a Socialist Market Economy for China," promulgated at the end of 1993. One of the most important institutions in China that has contributed to the formulation of this policy package is the State Economic Commission For Restructuring Economic System (SECRES).

This volume contains articles written by the staff of the Macroeconomic Department of SECRES in 1992-93. These articles deal with all aspects of macroeconomic reform and policies, most of which have been submitted to the State Council for consideration. Not all the views expressed in this volume have been adopted by the State Council. Some are still somewhat controversial. Nonetheless, the importance of these articles for the debate on reform policy formulation and institutional development in China justifies their wider circulation. Through publication of this volume we hope to contribute to a better understanding of macroeconomic policy formulation in China at a crucial time of China's overall reform.

Pieter Bottelier
Chief of Mission
Resident Mission in China
Beijing, China—1997
Government of China

Economic reform in our country began in the rural areas after the Third Plenary Session of the Eleventh Party Congress and achieved great breakthroughs. In 1984, the Third Plenary Session of the Twelfth Party Congress approved “The Decisions of the Central Committee of the Communist Party of China on Restructuring the Economic System.” With this, priority shifted from the rural areas to the urban areas due to the successful experience with the former. The main features were decentralizing responsibilities and profit-sharing from the old centralized planning system. Also, reforms combined a gradual approach and regional experiments to eliminate the traditional constraints and motivate local government and enterprise initiatives.

In just a few years, various reforms progressed greatly, promoting economic development. By the 1980s, the economy reached a new high level. However, we recognized that, as the reforms were entirely new, we needed continuous exploration and practice.

At present, the deep-rooted problems in the economic system have not yet been addressed, reforms have not been fully coordinated and the piecemeal approach has not yet achieved what was anticipated. These problems were particularly evident given the lag in efforts toward macroeconomic reform: The system was still in transition, mainly due to the lack of experience and insufficient coordination. Thus, we organized large-scale research and preparatory work.

In early 1992, Deng Xiaoping’s speeches during a southern tour pointed the way to deeper reform and a policy of opening. These talks brought an enthusiastic response from people all over the country. As a result, a new round of thought emerged: In the System Restructuring Commission (SRC), we intensified our study and organized research on concrete proposals and measures of macroeconomic reform—drawing lessons from the past. We believed macroeconomic reform was inevitable and could not be carried out piecemeal in some regions and sectors; rather, it would have to involve the national economy, and reforms in any one sector would have to be integrated with others.

Thus, SRC’s Department of Macroeconomic Regulation Studies (DMRS), cooperating with other government departments, began work on a new design for the macroeconomy. From mid-1992 onward, drafts were made for an integrated proposal of pricing, taxation, fiscal and financial reforms, and the plan was thoroughly discussed in SRC. In October 1992, at the Communist Party’s Fourteenth Party Congress, General Secretary Jiang Zemin noted that “the goal of our economic reform is to establish a socialist market economy to further liberate and develop productive forces. Establishing such an economy will involve many areas of the economic foundation and superstructure. A series of systematic restructuring and policy adjustments are required. We must make the overall plan and implement it in a scheduled and step-by-step way as soon as possible.”
In the spirit of the Fourteenth Party Congress, SRC, together with other government departments, began planning the overall reforms, focusing on the macroeconomy. The "Proposal for Establishing a New Macroeconomic Regulation Mechanism in a Socialist Market Economy," drafted by DMRS, was submitted to the National Conference on Economic System Reform in early 1993. The plan was to be discussed by local governments and others to complete and improve it, and make it more operationally feasible.

In the first half of 1993, some serious problems occurred due to rapid economic growth. By late June, a document with 16 measures to strengthen and improve macroregulations was approved by the Central Committee of the Party and the State Council. Thus, macroeconomic reforms were introduced.

Following the State Council's instructions, our Commission (specifically DMRS) took an active part in designing the fiscal, financial and foreign exchange reforms. DMRS staff have cooperated closely with various government departments and academic institutions, completed a number of research projects with practical feasibility in the field of macroneconomic reform, and proposed many valuable policy recommendations. It also suggested some measures that were imposed this year, based on previous research. Due to limited theory and practice, there may be some inappropriate and incomplete views, or even mistakes—which can be improved or corrected.

Various macroeconomic reforms introduced this year are moving the process forward, with notable effects. We hope DMRS staff will work harder and never be unworthy of the great mission asked of them by history and the people.

He Guanghui  
Deputy Chairman, SRC  
September 1994
ABSTRACT

This book contains papers produced from 1992 to 1994 by the Department of Macroeconomic Regulation Studies (DMRS), under the direction of the System Restructuring Commission (SRC) of the People's Republic of China. These include reports and essays on Chinese macroeconomic policy and reforms carried out or led by DMRS. More than merely a record of the Department's work, the book reflects the issues and debates during this period. Also, it provides information about the history, corrects some misunderstandings and constitutes a record of the experiences that may be useful for future studies on economic reform and policy initiatives.
PREFACE

This book contains papers produced from 1992 to 1994 by the Department of Macroeconomic Regulation Studies (DMRS), under the direction of the System Restructuring Commission (SRC) of the People's Republic of China. These include reports and essays on Chinese macroeconomic policy and reforms carried out or led by DMRS. More than merely a record of the Department's work, the book reflects the issues and debates during this period. Also, it provide information about the history, corrects some misunderstandings and constitutes a record of the experiences that may be useful for future studies on economic reform and policy initiatives.

As the book focuses on the practical design of economic reforms, proposals and policies, it is not merely a collection of theoretical papers. While theory is a useful guide, it must translate into practice. Thus, although many experts and scholars have contributed to theories of economic reform, and theoretical progress has been the foundation on which the ongoing economic reform has advanced, we believe (through our work experience) that we are not sufficiently prepared to cope with the challenges related to operational techniques such as system design, policy-making and implementation. These elements are still critical to the reform, even after the objectives and models are devised.

This book is organized in line with the working areas of DMRS, which cover almost every aspect of the macroeconomy. The reform proposals and policies reflect the teamwork of experts and scholars. The papers were completed by DMRS staff; however, they also reflect the input of many others in government departments and academic institutions to whom we are heavily indebted. We believe that much more work is needed, and for quite a long period, in this time of economic transformation.

The papers were completed in the process of preparing for the new round of major economic reforms introduced in 1994. It was the favorable climate for reform created by Deng Xiaoping's southern China tour in the spring of 1992 that motivated our research on new proposals for macroeconomic reform; the work was guided by the leadership of SRC.

Our studies began with an integrated proposal of reforms for pricing, taxation, fiscal and financial systems. In October 1992, the Communist Party of China held its Fourteenth Party Congress, on which Jiang Zemin, the General Secretary, pointed out that, "the goal of our economic system reform is to establish a socialist market economy to further liberate and develop productive forces." Also, that "It is a long process and a complicated social systematic project to establish and complete the socialist market
economy.” This requires both a long-lasting endeavor, sense of urgency, and consideration of the real situation. “Establishing the socialist market economy will involve many areas of the economic foundation and superstructure, as well as systematic restructuring and policy adjustments. We must make the overall plan and implement it in a scheduled and step-by-step way as early as possible.”

The report of the Fourteenth Party Congress motivated us and pointed the direction. Also, it assured us that our effort was consistent with the direction of the country’s economic reform.

Then, in the first half of 1993, given the country’s rapid growth and overheated economy, some problems occurred with the financial order and scale of investment, such as overheated business activities in real estate, development zones, securities and fundraising. In this context, we paid more attention to analyzing the economy and its dynamics, and put forth the report, with policy recommendations.

At the same time, we felt the economic system was the fundamental source of periodic fluctuations and policy change. Reform of the financial system already lagged far behind, defects in the fiscal system had intensified, and neither flexible indirect instruments nor effective institutional backup in macroeconomic regulation were available. And, although it was agreed that some macroeconomic regulations had to be introduced immediately to cope with the overheated economy, it was also clear that major economic reforms were needed.

In June 1993, an international conference on macroeconomic management, organized by SRC, the Ministry of Finance (MOF) and the World Bank, was held in Dalian, and suggestions were made with respect to short-term policies and systemic reform. The State Council considered these recommendations, and, along with the Central Committee of the Party, it imposed various macroeconomic regulations. Meanwhile, it was officially decided that macroeconomic reform would begin. Based on its research, DMRS proposed various measures. Together with other government departments, we discussed and designed fiscal, financial, foreign exchange and investment reforms for each sector.

It has been noted in “The Decisions of the Central Committee of Community Party of China on Issues in the Creation of the Socialist Market Economy” (the “Decisions”), approved by the Third Plenary Session of the Fourteenth Party Congress, that “the socialist market economy is consistent with the basic socialist system. Market forces will play a fundamental role in allocating resources under the State’s macroeconomic regulations.”

The Decisions also confirmed that “the Government’s function in managing the economy is principally to design and implement macroeconomic policies, improve infrastructure and provide a good environment for economic development. In addition, it is responsible for developing a market system, overseeing market operations, safeguarding fair competition, adjusting social distribution, organizing social security
systems, controlling population growth, protecting natural resources and the environment, managing state-owned assets and overseeing their operations, and realizing national economic and social objectives. The government should manage the national economy by economic, legal and administrative measures; it should not interfere with enterprises' management of production." Further, "the tasks of macroeconomic regulation are to maintain a basic equilibrium of economic aggregates, upgrade the economic structure, guide the economy to a sustained, rapid and healthy growth, and promote overall social progress."

The Decisions’ proposals on the function of macroeconomic regulation illustrate the basic objectives of reform. These include:

- The socialist market economy cannot be developed in a lassez-faire environment. Instead, the government must play an active role in the transition to and introduction of the market economy because international competition is intense and there is not enough time to allow market mechanisms to simply evolve. Because of China’s enormous size (with a population of 1.2 billion), it is difficult to estimate the cost of this approach.

Worldwide, over 100 market-oriented economies exist, but only a few are well developed. Thus, merely stating the objectives is quite different from establishing such a system. Indeed, successful models vary; however, the common features can be summarized as economic order, fair competition, flexible and effective macroeconomic regulations, and distribution mechanisms that emphasize efficiency while addressing the concerns of equity and social welfare. These factors are the elements of a successful market economy, and must be introduced with the State’s participation and guidance.

- The major tasks of macroeconomic reform are to create an institutional framework through which the government can manage the macroeconomy, ensure economic order, safeguard the rule of fair competition, provide indirect instruments of regulation, and build effective mechanisms with which to carry out policies.

- Macroeconomic regulation is one of the important government functions in a market economy. However, interventions into major economic activities are not necessarily appropriate; rather, the government should adjust the aggregates through economic policy. Therefore, the government should determine the regulations’ contents and methods so as to maintain stability, increase the efficiency of the national economy, and unify rules, markets and the nation.

- Macroeconomic regulation should be carried out primarily through monetary and fiscal policy. In this respect, the use of direct or indirect instruments is not a question of government preference; rather, it is determined by the economic system and the operational features of the national economy, whether indirect instruments and an institutional foundation exist. To fundamentally change the way the government
regulates economic activities, it must introduce a new economic system that would be a mechanism for flexible and effective macroeconomic regulation, and the matching microeconomic institutional foundation.

- The main objectives of macroeconomic regulation are to adjust aggregate demand to guarantee stable economic growth and balance of payments; also, to remedy market failures by providing public goods and services, regulate income distributions, ensure social justice, promote balanced regional development, implement appropriate industrial policy to optimize industrial structures, and increase the aggregate supply. Of the major macroeconomic tools, monetary policy should regulate aggregate demand, fiscal policy should promote structural adjustment, industrial policy should be functional and unbiased so as to transform and upgrade economic structures, and the fiscal system should be neutral.

- Efficiency and equity must be considered when systems are designed and policies applied. While the market plays a major role in allocating resources, the government should, by means of income distribution, ensure a reasonably balanced regional development, provide basic public services and necessities, and ensure the gains of economic development are shared by all.

Various ideas and arguments were presented when discussing Chinese economic reform. The following are our views on major issues.

**The relation between anti-inflation policy and reforms.** Macroeconomic stability and economic reform must work hand in hand. First, policies must be introduced to curb inflation and fluctuations, because inflation misallocates resources, exacerbates disparities in income distribution and causes social unrest. Rapid price hikes are usually accompanied by short-term high rates of economic growth and investments in inappropriate sectors. After this, recessions occur, and products and services (that grew beyond the level of real demand) become redundant. As a result, enterprises and society must bear the costs of the recession and adjustment—since resources were applied to the redundant sectors—and reforms must bear the double challenge of systemwide transformation and structural adjustment. Thus, an anti-inflation policy is required in the process of macroeconomic reform. At the same time, reforms should promote economic stability and efficiency.

**The relation between piecemeal and integrated reform.** Gradualism and regional reform are features in the Chinese process that have succeeded in many areas. Although the outcome of the reform is not yet clear, and most public opinion is constrained by the traditional system, the gradual decontrol of industries and agriculture, commerce, trade and banking, and some regions has scored considerable achievements. Moreover, as the reforms liberated the productive forces, the level of public understanding improved. However, the gradual model has its limitations and costs, since it does not meet the needs of some sectors that require a national plan and overall balance: For example, in a unified country, resources should be mobile, nationwide.
Thus, it is inefficient to apply a new tax system or make the currency convertible in just one region. Rather, reforms must be integrated, with priority breakthroughs in some sectors.

The necessity and feasibility of such an approach are fully explained in the documents of the Third Plenary Session of the Fourteenth Party Congress. Mr. Li Tieying, the State Councillor and Chairman of SRC also noted that “Today’s reform is deeper than before, progressing from piecemeal actions to a comprehensive approach, from a focus on relatively individual measures to overall economic relations. Thus, strategies must be integrated, with a comprehensive design and measures. Since the reform has entered the final stage, we must achieve a major breakthrough in the key sectors while implementing a comprehensive, integrated reform strategy” (from the speech at the 1993 National Conference of Economic System Reform).

However, an integrated approach should not translate into resistance to the reforms. Rather, the public should understand the need for them and accept the risks. In such a context, fiscal reform begins with the system of tax revenues and then extends to expenditures. In the foreign exchange sector, the proposal that the Yuan should make current accounts convertible first, and capital accounts next, is an aggressive but safe resolution.

The relation between the Chinese reality and foreign experiences. The Chinese reality is the starting point of our reform, which must consider both potential and present factors such as population, resources, culture and history. However, this does not mean that current conditions must be preserved. Even with systems that have already experienced reform, further changes are required.

The problem is that during the transition, a new pattern of vested interests has developed and the “Chinese reality” is often used as an excuse to protect them, consolidating transitional systems and measures. These interests insist that establishing a standard system is idealist and out of touch with reality. However, we should learn from the principles, common practices and successful experiences that have been effective in many countries (such as tax-sharing systems, neutral tax systems, central bank independence, basic instruments of monetary policy and international models of foreign exchange regulations). After 14 years of economic reform, deepening it will require standardizing the transitional system in the direction of the socialist market economy.

The relation of the new macroeconomic system to centralization. This issue can be misunderstood. Generally, our economy is still overcentralized. The direction of the reform is to allow the market to play a fundamental role in allocating resources along with further decentralization. Nevertheless, not all decision-making can be decentralized, even in a market economy, and reforms cannot be judged conservative, regressive or progressive simply on the basis of whether systems are centralized or decentralized. Of the macroeconomic reforms adopted in 1994, both processes are involved; and the degree to which each is applied should be adjusted according to the needs of the socialist market
economy. For example, the government must retain control over macroeconomic regulation in order to create conditions for fair competition and further decentralize a wide range of economic activities. However, in the current system, fiscal revenues are far too decentralized, which neither helps local governments nor promotes autonomous enterprises. The central government is not able to guarantee it will carry out its basic functions and its role in the market economy is distorted. Thus, it must centralize an appropriate degree of power. This is not conservatism or the restoration of the old system, but rather the necessary condition for the government to play a reasonable role. At the same time, with respect to constructing infrastructure and providing public services to households, government functions and funds should be further decentralized. With respect to microeconomic activities, enterprises should be autonomous.

The relation between feasible plans and various groups' interests. A key factor in the reform is the feasibility of the plans. In the 1994 proposals, many problems surfaced despite the efforts of government departments to work out the implementation details. The problems stemmed from two sources. First, various instruments of the market economy were not fully understood and the techniques with which they could be made operational were not mastered. For example, with tax reform, the unification of tax rates necessarily caused the price of some goods to fluctuate. Those involved needed to understand this and design tax categories and rates of some final, less processed goods in a way that would prevent the price of consumption goods from rising too rapidly. Second, existing work styles and departmental interests were difficult to change: Operational plans were often devised to protect departmental interests and diverged from the reform principles.

Nevertheless, after more than a decade of reform and opening of the economy, as well as the development of various operational techniques, it appears techniques have been learned and operations have improved. Thus, the main hurdle now is vested interests. To solve this, the plans' problems must be addressed and new operational methods proposed. Further, decisionmakers will need to reach agreements that will reflect overall interests.

We have tried to introduce the macroeconomic reforms in a way that reflects the level of awareness and work attitudes. The papers are listed in the order in which they were written, to help readers understand how the process evolved. Undoubtedly, the work has its limitations, and we would be pleased to receive comments to improve our understanding and move the reforms forward.

The book contains a collection of conference summaries. At the closing session of the Dalian conference, Mr. S. J. Burki, then director of the Bank's China and Mongolia Department, summarized the meeting's conclusions. This report was included as Appendix.

I wish to express my sincere thanks to all DMRS staff; it is owing to their wisdom and pragmatic spirit that this book was produced. In particular, I wish to thank the
following for their contributions: Li Keping, who was the leading researcher for studies on integrated reforms; Li Keping, Wang Xiaozhuo and You Xiang, who drafted the reports on fiscal reform; Feng Ailing, Liu Ying, Gao Jianhong who wrote on financial systems, foreign exchange and government bonds; Zong Kaiyuan and Guo Xiangjun, who were in charge of economic analyses and completed the reports on macroeconomic conditions; and Wang Manling, who proofread the material. As I helped organize and select parts of the book, I would like to view myself as their megaphone.

Lou Jiwei
Director, DMRS, SRC
April, 8, 1994
# ABBREVIATIONS AND ACRONYMS

<table>
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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>ABC</td>
<td>Agricultural Bank of China</td>
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<td>AD</td>
<td>Aggregate Demand</td>
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<td>Aggregate Supply</td>
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<td>BOC</td>
<td>Bank of China</td>
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<td>BOCOM</td>
<td>Bank of Communications</td>
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<td>China’s Foreign Exchange Trade Center</td>
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<td>China International Trust and Investment Company</td>
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<td>Department of Macroeconomic Regulation System</td>
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<td>FDI</td>
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<td>FEC</td>
<td>Foreign Exchange Certificate</td>
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<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
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<td>Gross Domestic Product</td>
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<td>GNP</td>
<td>Gross National Product</td>
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<td>ICBC</td>
<td>Industrial and Commercial Bank of China</td>
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<td>M1</td>
<td>Payable Cash and Deposits</td>
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<td>M2</td>
<td>All Types of Deposits</td>
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<tr>
<td>MOF</td>
<td>Ministry of Finance</td>
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<tr>
<td>PBC</td>
<td>People’s Bank of China</td>
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<td>PCBC</td>
<td>People’s Construction Bank of China</td>
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<td>RP</td>
<td>Repurchase Agreement</td>
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<td>SAMB</td>
<td>State Assets Management Bureau</td>
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<tr>
<td>SETC</td>
<td>State Economic and Trade Commission</td>
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<td>SFEAB</td>
<td>State Foreign Exchange Administration Bureau</td>
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<td>SOE</td>
<td>State-Owned Enterprise</td>
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<td>SPC</td>
<td>State Planning Commission</td>
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<td>SRC</td>
<td>System Restructuring Commission [abbreviation for State Commission for Restructuring Economic Systems (SCRES)]</td>
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<tr>
<td>STAQ</td>
<td>Securities Trading Automated Quotation System</td>
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<tr>
<td>STB</td>
<td>State Taxation Bureau</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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PART I: REFORM OF THE MACROECONOMIC SYSTEM

ABSTRACT

Economic development and reform in China have faced two long-standing and interrelated problems. While growth rates have been high and products and services diversified, there has also been no efficient stabilizing mechanism for the national economy. Second, while microeconomic activities have been reformed very rapidly, macroeconomic reform has been left far behind. As a result, the economy moves periodically through business cycles and policy fluctuations.

The problems are rooted in our procyclical fiscal and monetary policies. The tax base is narrow and further weakened by the fiscal contract system (a fiscal contract in brief is a contract between the central government and a local government on the amount of taxes the latter needs to submit to the former) and the overreliance of the government on the tax revenues of local governments, which cannot raise enough resources to ensure the work can be completed.

For its part, the fiscal contract system is not compatible with the fiscal system of a modern nation. The central bank’s direct lending to the economy compensates for fiscal depressions, but increases the money supply. Its organizational structure and accounting regime contain the driving forces for monetary expansion. Thus, the economy has always been subject to business cycles and policy fluctuations. Further, excluding banks, the foreign exchange market, which is subject to fluctuations, is basically between the exchange earners and users. Once the economy is overheated, traditional controls would certainly have to be employed when flexible, indirect regulatory instruments are not available. For these reasons, the macroeconomic system must be restructured, which involves changing the fiscal, financial and investment systems, and creating a basic institutional framework of macroeconomic regulations.

Based on this understanding and following research on the restructuring of the macroeconomic system, in late 1992 we proposed the report entitled “Suggestions for Integrated Reforms of Pricing, Taxation, Fiscal and Financial Systems.” At the 1993 Dalian conference, we also proposed macroeconomic regulations and hastening the system’s reform.
SUGGESTIONS FOR INTEGRATED REFORMS OF PRICING, TAXATION, FISCAL AND FINANCIAL SYSTEMS

The State Council decided that the reform of energy, transport, infrastructure and agricultural prices would begin next year and be completed in about three years. Fiscal and financial reforms, embodied in next year's price reform, will provide the framework for a new national macroregulatory mechanism based on a market allocation of resources. At the same time, they will be significant steps toward constructing a socialist market economy. Thus, the reforms are of practical importance.

Comprehensive Price, Tax, Fiscal and Financial Reforms

The reforms, opening-up and modernization process are entering a new era, and the general situation is good. However, various deep-rooted problems still remain. First, social aggregate demand grew rapidly after the tight macroregulations were relaxed, because internal inflation was not yet eliminated. Second, expanded demand, inflation and structural imbalance all coexist. The current irrational structure of products, industries and enterprises has improved very little, and the aggregate balance has been adversely affected. Third, given its rapid growth rate, overall economic efficiency remains low: state-owned enterprise (SOE) losses are very large, and the debt problem is serious. Fourth, fiscal and financial conditions are experiencing severe difficulties, and the Government's ability to manage the macroeconomy is limited: its fiscal deficits are growing, and only about 38 billion yuan of capital construction funds could be allocated to the priority projects; but the pressure of structural adjustment is transmitted to the banks, hastening the use of credit funds to support the budget. Thus, it is difficult for the central bank to control the money supply and inflationary pressures increase.

The main reasons for these problems are that current macroregulations cannot meet the needs of a market economy, and the transformation of government functions and macro reform have lagged far behind.

To begin with, the tax regime is not rational: The tax base is too narrow and biased with respect to the manufacturing sector, and it cannot adapt to changing tax sources. Thus, revenues are unstable. A second problem is that the tax system is used to shape the industrial structure and enterprises with different types of ownership are taxed differently. Fiscal policy is excessively biased, and results in too many categories, rate levels that are too complex, and uneven tax burdens. Third, the tax policy not only fails

1 DMRS began researching the comprehensive reform proposals in late 1992 under the leadership of SRC. This report was submitted to the national conference on the reform of economic system in January 1993. Some relevant ministries and state departments commented on it after the conference. On this basis, DMRS completed the "Proposals for Establishing New Macroeconomic Regulations in a Socialist Market Economy" in May 1993. (It is not included in this book, as it has the same contents as this paper.)
to achieve its goal, but also makes it more difficult to unify the tax norms, opens the system to tax evasion and makes tax administration more difficult.

Further, neither the existing fiscal contract system nor tax-sharing contract system, which is to be introduced, can standardize the distribution of revenues between the central and local governments. First, the distribution of fiscal revenue does not eliminate the administrative hierarchy, a situation that is not conducive to separating the government from enterprises. Second, with respect to local government revenues, the share of turnover tax (which affects the economy more than other taxes is too high; thus, construction projects are duplicated, accelerating the growth rate and intensifying economic fluctuations and regional segmentation. Third, bargaining and fixed-base figures in the fiscal contract system negatively affect government revenues. As a result, the Government’s ability to use fiscal means to adjust the economic structure is weakened. Fourth, fiscal revenue grows slowly, although the overall economic rate is high. This year (1993), from January-October, taxes on land use and income dropped, product taxes grew at only 5.2 percent, while real estate profits grew by 20 percent, and fiscal expenditures mounted. This led to an expansionary fiscal policy.

In addition, the functions of the financial system are not clearly defined. The central bank bears too many structural functions which often conflict with its task of regulating aggregate demand. At the same time, it relies primarily on administrative means to regulate the money supply, which does not give it flexibility to regulate aggregate demand. Also, specialized banks operate as administrative bodies with a lack of vigor, the amount of the banks’ bad debt reached hundreds of billions, and the quality of their assets deteriorated further.

Finally, the system of planning and investment is biased toward regulations (over microeconomic activities) and planning is static; it focuses on determining indicators, allocating funds and foreign exchange, and approving projects. Macroeconomic policy coordination remains weak.

The current plan is to accelerate price reform, which will provide the best opportunity to comprehensively reform macroregulations. The State Council has decided that price reform is to be intensified in 1993 and completed in about three years, by which time a market-oriented mechanism to determine prices will be established. With prices liberalized, market reform of the real sector and enterprise management in particular, will move more rapidly. Without macroeconomic reform, conflicts between existing regulations and the enterprises and market, will be more severe, negatively affecting steady economic growth.

Reform of macroeconomic management must be comprehensive. First, it should involve a major adjustment of the responsibilities and interests of many government
departments and regions, which is difficult. Thus, the reforms must be implemented carefully.

Second, many departments have or are ready to present major reform plans: For example, the State Taxation Bureau (STB) and Ministry of Finance (MOF) have put their plans on the agenda, and the State Planning Commission (SPC) and People's Bank of China (PBC) are ready to shape theirs. However, progress will be hard to achieve if the approach remains piecemeal, and comprehensive reforms are not considered and accelerated. Thus, a comprehensive approach is needed that will help standardize the new system, make the reforms more efficient, coordinate the process and hasten individual reforms and the progress, in general, as well as reduce the difficulty and cost of the system's overall restructuring.

Third, reform of the macromanagement system should be carried out as follows:

- It should be achieved along with economic development and the general political, economic and social situation, and be done in a timely fashion;
- The basic functions of the new system and division of labor among government departments must be designed in a comprehensive manner;
- Reforms of various departments must be implemented correspondingly;
- The preparation, design, discussion, and organization of reforms must be comprehensive.

The objective of the Fourteenth Party Congress was to allow market mechanisms to play a fundamental role in allocating resources under the State's macroregulations. Thus, the reforms must be accelerated and achieved comprehensively, and a new framework created for macroregulation of a market economy within three to five years.

The New System of Macroregulation and the Goal of Systemwide Reform

The major goals of macroregulation are to regulate aggregate demand so as to guarantee the stability and growth of the economy and balance international payments; remedy the failure of the market to provide society with public goods and services; regulate income distribution; guarantee social equity and promote balanced regional development; and adopt appropriate industrial policies.

Monetary policy should be used to regulate aggregate demand and fiscal means should be applied to adjust certain economic structures. Taxation regimes should be neutral. Such a policy would:
Part I: Reform of the Macroeconomic System

- Liberalize prices to create a market-pricing mechanism. While aggregate demand will be responsible for general price levels, the government will support prices for basic agricultural products, while price controls and other measures will be used to counter natural monopolies;

- Make fiscal policy neutral and play a limited role in allocating resources. The main function of the regime would be to provide a stable revenue base for government and a level playing field for market competition. Also, taxes would be responsible for regulating income distribution. Hence, in a relatively long period, indirect taxes, of which the value added tax (VAT) would play a major role, would account for a larger share in the tax system. Also, among direct taxes, land and resource taxes would be important, the share of corporate income tax would decrease, and individual income tax would gradually increase until it is one of the major categories. Direct taxes would gradually replace indirect taxes as the most important sources.

  For now, the indirect tax (with the VAT as the major tax) is needed to guarantee a wide tax base and stable revenue, and at the same time avoid the defects of turnover taxes (such as repeating taxes and distorting the structure of industries). By its nature, VAT is levied on factors and differs from turnover taxes (such as product taxes).

- The major function of the fiscal system would be to promote balanced regional development by redistributing fiscal revenue, provide public infrastructure and social services to support long-term stable and balanced economic growth, and, in conjunction with monetary policy, regulate aggregate demand.

  For these functions to succeed, it is necessary to establish a tax-sharing system, create a transfer payment regimen from central to local governments, and a fiscal financing mechanism to attract long-term funds backed by the State to finance investments in infrastructure.

- The central bank must occupy a key position in the financial system. Its monetary policy should be deflationary and stabilize the currency. Also, it will need to supervise general banking operations and keep financial activities in order, while it refrains from directly adjusting the economic structures. Thus, a capable and efficient institution must be developed, along with national and local commercial banks and sector-oriented banks.

  Under such a system of macroregulation and reforms, it should be possible to achieve an efficient market economy, guarantee economic stability and improve the industrial structure so as to support sustained, rapid and stable growth. In this regard, as departments prepare next year’s price reforms, they should coordinate their efforts so as to develop a comprehensive system of price, tax, fiscal, financial, planning and investment reforms.
The Relations, Tasks and Measures to Introduce Price, Tax, Fiscal and Financial Reforms

**Fiscal, financial and price reforms must be coordinated.** The current fiscal regime is based on the old principle of “taxes for prices;” however, the irrationality of the tax rates and categories was exposed when the prices changed. Also, the change in prices and taxes affected fiscal revenues, as well as income distribution. Thus, price reform should be accomplished gradually, say, in three years, as this would give the fiscal system time to take measures and ease possible pressure on public finances by a one-time price reform. Finally, it is extremely important to apply financial reforms in an integrated fashion when there is strong inflationary pressure.

In view of the linkages, price and fiscal reforms should be adopted at roughly the same pace, and reform of the tax-sharing system should begin with revenues—namely, the relation between central and local governments. Financial reform should first focus on the central bank and regulatory mechanisms, along with long-term fiscal reform that will promote stability. Then, as fiscal and price reforms deepen, the second stage of tax-sharing reform would focus on expenditures—that is, adjusting their structure and establishing a transfer payment system from central to local governments. Financial reform will transform most specialized banks into genuine commercial banks.

Reform of foreign exchange and custom regimes is somewhat independent. But, in line with price and tax reforms, the present structure of tariff and exchange rates should be reviewed with regard to international standards and restructured in a timely fashion.

**Steps to implement price reform.** A mechanism to formulate market prices must be created and the price of energy and production goods rationalized, particularly for coal, petroleum, electricity and steel. Adjusting transport and railway prices should be priority actions. Prices of agricultural and related products (mainly of grain and cotton) should be liberalized.

Price reform should involve liberalization, adjustment and creation of the mechanisms as soon as possible. To liberalize prices, the process will need to be completed in two or three stages and prices will finally be set either by the market or the State. The price of public utilities and services will be raised from existing low levels to allow for minimal operating profits. For utilities that generate profits, prices will be set at levels that allow them to finally repay their loans and interest. A policy of price supports will be exercised for major agricultural products such as grain and cotton, to ensure stable growth in the sector.

**Price reform will be gradually introduced in three years.** Grain prices will be among the first to be liberalized; low-grade coal prices will be freed first, and high-grade prices last; petroleum prices will be raised to a planned ceiling price and then to
international market prices; railway cargo prices will be raised by 1 cent/ton-km each year over two years; and the price of other raw materials will be liberalized accordingly.

The initial price increases will amount to about 120 billion yuan, raising the retail price index by 12 percent. Structural price hikes will be 3 to 4 percent each year, if they are done in three years. The target for the increases will be under 6 percent a year, considering the cost-push factor.

**The tasks and steps of tax reform.** A new taxation system must be created with a broad tax base, equitable tax burden and efficient administration. To achieve this, it will be necessary to restructure the current turnover tax, standardize and unify the enterprise tax of both domestic and foreign firms and personal income tax, and enlarge the land tax and resources tax. Such a fiscal structure would have a broad tax base, could guarantee stable revenues and would have little impact on the structure of industries. Also, it would leave more room for dividing the tax categories and creating a standard tax-sharing system between central and local governments. Moreover, both the standard VAT and unified income tax would create the conditions for taxes to be efficiently administered. The goal is to raise the share of fiscal revenue in national income by two percentage points.

The process of tax and price reform should proceed at the same pace. The first step would be to decrease product taxes, since this is the single most important step when raising or freeing the price of commodities, as the rates of product taxes for manufacturing industries would be either too low or too high. At the same time, these taxes should be retained for a few luxury items and then transformed into a consumption tax. One or two VAT rates would replace the tax on all other products. A VAT with a unified rate and standard collection would be levied comprehensively, calculated by a unified invoice that notes the tax to be paid. This method would create a new structure of indirect taxes, with a larger share in the total, as well as guarantee stable revenues.

With regard to the distribution between the State and SOEs, taxes would be deducted from profits, and the interest and principal on loans would be paid after taxes. Based on uniform accounting guidelines, corporate taxes for domestic and foreign enterprises would be unified. Also, personal income tax for Chinese citizens and foreigners would be unified.

The second step would be to restructure land, resource and business taxes, enlarge the range of land and resource taxes and adjust differential income from price liberalization of primary products. Price liberalization of primary products would begin from low-grade to high-grade resources.

Tariffs would be adjusted according to the speed of price reform and the requirement to join the General Agreement on Tariffs and Trade (GATT). Nominal tariff rates would be reduced and various exemptions would be controlled to basically eliminate
the irrationality of high nominal tariffs and low real rates. China’s average nominal tariff rates are 22.5 percent, but the average effective import rates are only 13 percent due to various exemptions and concessions. This rate is lower than the 14 percent average in developing countries.

Tax collection would be freed of government interference. Under the principle of centralization and efficiency, the government assumed the tax function but allowed some local governments to tax certain categories they could collect more efficiently. Two systems would be established for the central and local authorities, and exemptions and deductions would be strictly controlled. Also, any contract system on the turnover tax would be prohibited.

The tasks and steps of fiscal reform. The basic task of fiscal reform is to introduce a standardized tax-sharing system and set up a revenue transfer payment system and fiscal long-term financing system. For this purpose, government functions must be clearly defined as to which departments will assume them and the corresponding expenditures. The general principle is that central and local governments should not interfere with enterprise management. Instead, they should be concerned with ensuring social stability and order, as well as a unified national market. They should also be constructing transregional national infrastructure, and adjusting major economic (regional and industrial) structures. For their part, local governments would be responsible for local social and economic issues, including construction of infrastructure, environmental protection, education and medical care, income distribution and social security policy, development of commerce and other tertiary industries, and improving the investment climate.

To establish a tax-sharing system, revenues must be divided between the central and local governments. The present method of contract tax-sharing must be changed along with the changes in tax categories: Dividing the income taxes must go beyond the limit of administrative subordinate relations. The turnover tax should not be shared by the two levels of authorities.

Along with separating the revenues and expenditures for governments at various levels, a transfer payment regime must be established: Namely, the government should allocate a certain portion of revenues to some of the less developed regions, based on criteria such as population, location, and per capita gross national product (GNP).

The function of the new fiscal long-term financing system (a fund) would be to construct infrastructure and compensate for a shortage of investment capital. The fund would receive postal savings, pensions and government bonds, etc., as its major source of finance, and its costs would be covered by the central budget; in this way, lending terms would be improved. The system would focus on infrastructure projects with high risk,
long-term and low-profit rates, and long-term export credit. Also, the fund would provide interest-free finances to some public projects that cannot regain their investments.

Government fiscal institutions should no longer intervene directly in the SOEs' financial affairs. The national fiscal system currently has two parts: government finance and SOE finance. This bears some residual of the traditional planning system, where administrative and management functions were combined, along with taxes and profits, which prevents the SOEs from operating autonomously. Now, financial and accounting legislation closer to international standards has been published, which would strengthen independent accounting. Thus, the fiscal institutions' departments that deal with SOE finance must be abolished and the functions of public finance, taxation and management of state-owned assets functions must be rationalized.

Coordination of Fiscal and Price Reforms and Gradual Implementation of the Taxation and Tax-Sharing System

Subsidies for policy losses should be gradually abolished in line with price and tax reforms; at the same time, subsidies for the oil and coal industries should be limited to 10.4 billion yuan a year.

The standard tax-sharing system should be completed in two stages. As it will be difficult to divide responsibilities between the central and local government and create the transfer payment system, revenues will be the first target and expenditures the second. In the first stage, while the relation between central and local revenues will be restructured, along with the reform of indirect and income taxes, the expenditure base of all government bodies will remain unchanged. Considering the different impact of each tax on fiscal revenue and economic structure, and considering the ability to collect taxes, the pattern should be created with respect to the major categories: For example, the product tax (consumption), VAT, tariff and major resource taxes will accrue to the central government, while the business, real estate, and social security taxes (or collective funds tax) will accrue to local governments. Income taxes can be shared by both, after being standardized. Local budget deficits will be covered by the central budget. At the same time, two separate tax systems will be established through tax-sharing reforms.

In the second stage, the expenditure base and structure will be determined according to the division of government responsibilities at each level. Also, a standard revenue transfer payment system will be established through which the central government will balance each region's financial capacity and provide subsidies to those that are less developed.

With the tax-sharing reform underway, the dual budget system must be completed, the functions of financial and planning departments must be adjusted and simplified, and a fiscal long-term financing plan must be worked out. The institutions
conducting such financing will be policy banks such as the Import and Export Bank, and the Long-Term Credit Bank.

**Tasks and implementation steps of financial reform.** A highly efficient central banking system with a few regional branches should be established that would control the money supply indirectly and regulate aggregate demand.

The specialized banks' (SBs) policy and profit-oriented banking should be separated so they can become commercial banks. At the same time, policy lending should be reduced significantly and included in the fiscal long-term financing system. The policy banks should be introduced. The central bank's policy lending should be transferred to policy banks, postal savings to other related institutions, and the ratio of government bonds in the central bank’s assets should be increased.

It is the basic task of foreign exchange reforms to gradually achieve current account convertibility (including foreign trade, post, communications, transport and the profits of foreign direct investment). Administrative interference into foreign exchange utilization should be reduced.

Financial reforms should be carried out according to price reforms and macroregulation of the central bank, along with setting up more commercial banks for various business needs.

The central bank should reduce its present business scope, cease lending to nonbank financial institutions and remove all agencies smaller than the branch level. Surplus branches should be spun off into one or more national and regional commercial banks.

The central bank should gradually abandon its control over credit quotas and use indirect regulations, that is, adjust the money supply by buying or selling government bonds with its own funds, and by regulating interest rates.

The management of assets/liabilities and asset risks should be enforced in commercial banks according to international banking standards.

The foreign exchange rate must be altered; at first, the rate should be adjusted to the proper level and foreign exchange markets developed. Next, the foreign exchange retention system should be abolished, a floating rate introduced, and eventually, the currency made convertible in certain areas of current accounts.

Competition among commercial banks should be encouraged.
Banking and securities trading activities should be separated, and the securities commission and securities regulations committee must be merged into a regulatory commission that supervises and monitors the securities sector.

Tasks and steps of planning reforms. Planning reforms in other areas such as pricing, fiscal and financial systems should also be changed because of their comprehensive coverage. The function of planning is to realize an aggregate equilibrium and implement industrial policy. Macroe regulation reforms require that a high level equilibrium be achieved, along with a change in industrial policy. The old concepts used to design priority industrial policies and which took prices, tax rates and interest rates as the major instruments conflict with the needs of a market economy. Thus, these industrial policies should be abandoned when market signals and distortions are corrected by price, tax and fiscal reforms. Moreover, the market should not be interfered with frequently; instead, the new industrial policy should focus on expanding infrastructure, educating management and developing technologies, along with export-oriented trade policy, to integrate the domestic with the international economy. Fiscal long-term finance will be the important instrument of industrial policy and the following changes will be carried out.

To manage investments, planning authorities should no longer be responsible for approving ordinary investment programs, and an “application” system should gradually replace the “approval” system. Policy lending such as regional development loans and poverty loans should no longer be financed from the central bank but from the fiscal long-term financing system. Government planning departments along with fiscal departments should plan for this process.

The Government’s foreign exchange needs should not be allocated by planning quotas, but through a “purchasing regime.”

The various licensing regimes should be reduced and a trade policy should be promoted.

Vocational training should be an important item on the planning authorities’ agenda.

Risks of Integrated Reform and Strengthening Guidance

Integrated price, tax, fiscal and financial systems reforms are not risk-free. First, the public may not tolerate them because price changes in basic industries will cause prices to rise 3 to 4 percent a year and will affect price stability. However, the tolerance problem does not seem to be an overly large issue, judging from the experience of the past few years of price increases; and, price hikes could be softened if salaries also change.
Second, enterprises face some risks. These stem from reforms and market competition, both of which have been expected, with the introduction of the market economy; thus, they should not provoke dramatic responses.

Third, conflicts of interest arise among government departments whose functions will be changed. Also, many issues will be raised, such as: (a) dividing the functions and responsibilities of governments at various levels—which is the key issue with respect to changing government functions and standardizing relations between the central and local governments; (b) requiring that basic functions and divisions of various major government departments in the new system be studied, to prevent distortions in the new structure and new vested interest groups that hamper the reforms, in general. The essence of resolving these problems lies in a fundamental restructuring of major government department functions, and of governments at the central and local levels.

Faced with these risks, we must fight a difficult battle, or we will pay a terrible price. First, it would not be possible to create a unified and standard market economic system that suits China's reality. Second, high, steady and healthy economic growth could not be sustained, and we will be subject to the boom and bust syndrome. Third, a valuable chance would be missed to move toward sustainable high growth and long-term economic stability, and society would be threatened.

Nevertheless, there are positive factors that support integrated reform. The economic reforms and opening of the past 14 years have achieved a great deal and provided the basic conditions for the transition from the old to the new system. The foundation for further reform was also strengthened by the Fourteenth Party Congress. In addition, the present economic situation provides a good context for such a reform: People expect major reforms after the Fourteenth Party Congress and are ready for government functions to change, which is the important condition for successful reforms.

Thus, the important issues must be studied and discussed by a high-level group headed by senior leaders of the State Council, made up by relevant departments and organized by SRC. The group would be responsible for coordinating and introducing the plans, and completing the reforms in three or five years.

THE ROLE OF CENTRAL AND LOCAL GOVERNMENTS

Theory and practice in China's socialist market economy have made great progress, which is explained in a chapter in "The Decisions of the Central Committee of the Party on Establishing a Socialist Market Economy" (the Decisions) passed by the

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2 This article was written by Lou Jiwei and published in the Newspaper of Chinese Reform, March, 29, 1994.
Third Plenary Session of the Fourteenth Party Congress of the Communist Part of China. The following is my understanding of the Decisions.

**Macroeconomic management can only work in a market economy.** The major element of macroeconomic management is regulating aggregates of the national economy. In the planned economy, aggregates were fragmented by the administrative system. Management was divided into regulations over sectoral and regional production, even of each firm’s production and individual consumption. This type of decision-making was not macroeconomic management.

In a market economy, productive factors are allocated to production activities by market signals that include foreign exchange rates (because a market economy is open). For the government, control of monetary aggregates will enable it to control aggregates in the national economy. Monetary policy instruments consist of base interest rates, foreign exchange rates, the money supply, tax rates and adjustment of tax revenues. These instruments directly affect firms and individuals and are defined as macroeconomic management; regulations over firms’ and individuals’ activities are microeconomic measures. Thus, it is only in a market economy that genuine macroeconomic management can exist.

In general, government policies designed to protect fair market competition, redistribute income, oversee prices and infrastructure construction, and protect some industries, are elements of macroregulation. They can only be applied in a market economy because in the planned economy, they were combined with the direct allocation of resources at various levels.

**Responsibilities and instruments of macroeconomic management must be lodged at the central government.** According to the Decisions, the “responsibilities of macroregulation, including issuing money, determining base interest rates, adjusting tax rates and categories of major taxes, must be concentrated at the central government level. This would ensure the equilibrium of aggregates, optimize economic structures and unify the national market.” The argument is consistent with economic principles.

Local governments cannot be responsible for regulating aggregates at the national level or even locally because it is only at the national level that a unified money, foreign exchange system and customs regime can exist.

Unifying the national market and optimizing the economic structure are also responsibilities of macroregulation that must be centralized. To maintain national unity, rules of competition must be applied and supervised by the government nationwide. For example, if overseeing financial sector risks were not exercised at the central level, high risk capital would flow from regions with strict controls to those with loose controls; thus, the control needed would be lost and the financial sector would be run in a high-risk
environment. Similar results would occur with tax rates, which would lead to unfair competition.

Market mechanisms can only play a role in allocating resources optimally if the aggregates are in equilibrium and the national market is unified. On this basis, the government may need to reduce or remove some industries' protection because any regional or local industrial protection would create "free riders."

Local governments' responsibilities in a market economy. The Decisions state that "our country is large and has a big population. Thus, the government must give the provinces, autonomous regions and municipalities the right to legislate regional regulations, determine policies and programs under the guidance of state laws, regulations and macropolicy, and take advantage of regional resources to promote economic and social development." In a market economy, local governments have broad responsibility for social and economic management: For example, the construction of regional infrastructure, education and development of human resources at various levels, environmental protection, social security, public security and the spread of new technologies. Such measures, while not the regulation of aggregates, can compensate for market inefficiencies in allocating resources and play a positive role in optimizing the economic structure and unifying the national market.

Local fiscal policy is the basic instrument for local social and economic management, which includes levying local taxes, issuing local treasury bonds with limited amounts, allocating treasury funds, guaranteeing funding and interest payments for some infrastructure projects. Local rules and regulations, policies and plans play an important part in regulating local economic and social affairs and will be enhanced with fiscal policies.

The Decisions does not mention financial instruments in the context of local policy instruments. This is correct, because only the central government or central bank can apply financial instruments in a market economy; these involve monetary policy and oversight of the financial sector. Conversely, these instruments should not provide the right to distribute credit or select which enterprises qualify for credit. Rather, such decisions belong to the enterprises.

The market's allocation of resources should correct misunderstandings and enable the government to exercise its responsibilities.

During the past 10 years, economic reform in China has been market-oriented. And, while some transitional measures have played a positive role, they have also created misunderstandings. For example, the notion of "implementing macroregulation at various levels but with a focus at the central level" was popular and applied. It modified the traditional planning system, because it required that resource allocation conducted by local governments be segmented and isolated. Decentralization in the early stages was
just such an idea, but now is incompatible with market-oriented reforms. Thus, a new theoretical framework of management at various levels of governments must be established.

Another perception, based on the *Decisions*, is that “the Government makes policy decisions and local governments implement them.” However, this understanding is incomplete. Rather, the *Decisions* determines that macroregulation policies will be made and implemented by the government and its departments. In other areas of national economic management, some policies will be made by local governments guided by central policies, while others will be the sole responsibly of local governments.

Some people viewed the *Decisions* as enhancing the centralized system. However, this is not correct, because neither centralization nor decentralization is related to method of resource allocation. The *Decisions* clearly determines the direction of a market-oriented reform, which provides more decision-making to the economic participants, and decentralizes the economy to a large extent. Centralization will occur only in the area of macroregulation, and local governments will have power in the areas that require local administration and regulations.

Thus, it is important for government institutions, particularly central departments, to fundamentally change traditional ideas and practices in terms of macroeconomic management. It must be stressed that the centralization of macroregulation does not mean increasing the share of resources allocated directly by the government, which would replace market forces. Rather, the core of the new system is for the market to allocate resources.

**REGULATING IN A TIMELY FASHION, STABILIZING THE ECONOMY AND ACCELERATING THE REFORM**

The international conference of “Macroeconomic Management in China,” jointly sponsored by SRC, MOF and the World Bank, was held in Dalian on June 6-10, 1993. It focused on two issues: first, understanding the present economic situation and policy initiatives; second, creating measures for short- and medium-term macroeconomic reform.

**Understanding the Present Economic Situation and Policy Initiatives**

The discussion focused on what constitutes the economic situation. All participants agreed the economy was overheated, evidenced by a shortage of materials,
accelerating inflation rates, increased demand for imports and slow growth of exports, the widening gap between official and unofficial exchange rates, and the worsening of structural constraints in industries presenting bottlenecks. The immediate source of the overheating was the rapid growth of fixed investment, facilitated by an accommodating monetary policy, which led to excessive expansion of demand. These pressures would sooner or later lead to price increases in final goods, if the excessive growth of the money supply is not effectively controlled.

Thus, timely actions relying on indirect instruments must be taken to return the economy to a path of steady and sustainable growth.

Unlike the last overheating of the economy in 1988, supply and demand conditions are better. Hence, direct and indirect instruments should be combined, relying more on the latter, so that a "soft landing" could be reached without dampening growth and the "boom and bust" cycle could be avoided.

The focus of current initiatives is to control aggregate demand, through tight macroregulation of finance and the money supply.

A package of measures was recommended. First, real interest rates should be raised to 2 to 4 percent, or at least to at positive level. To achieve this, the one-year deposit rate would need to rise at least 3 to 5 percent from its present level of 9 percent, and other rates would also need to be adjusted, with an appropriate spread for different terms.

Second, the central bank should tighten its control over credit, assume the responsibility of relending (through its headquarters), and stop granting credit to nonbank financial institutions; earlier loans must be repaid in due course. Meanwhile, profit-making activities in the central bank system must be stopped and the profit-retention system in branches of the PBC must be abolished.

Third, the banking system’s required liquidity must be enforced, and measures must be adopted to limit and regulate the bank’s lending by using special deposits or reserve requirements. Further, the specialized banks must recall in a timely fashion the funds leaked from the interbank market to nonbank financial institutions.

Fourth, the banks’ assets (liquidity) and risks must be well managed. At the same time, their credit capacity should be controlled and regulated by increasing their special deposits or legal reserves in the central bank.

Fifth, a monetary policy committee, consisting of experts and leaders in an umbrella-type department, may need to be established to increase the effectiveness of macroregulation.
Another urgent problem is to ease fiscal pressures and cool down the "hot" real estate and stock markets. To this end, financial institutions should bid to be the underwriters of government bonds. This would solve the difficulties attached to issuing government bonds and set interest rates at a level related to the market, which would pave the way for quickly adjusting interest rates and developing a stock market.

Also, tariff exemptions should be thoroughly examined and provisional ones strictly controlled. In the near future, some exemptions should be reduced, while the general level of tariffs drops.

Further, the way that land leases are approved should be changed, and the practice of giving free land, except to public utilities, should be stopped. Also, governments should introduce public bidding and auctions for land lease or use.

Finally, the stock market should be slowed down. Authorities should consider allowing state shares of some standardized joint stock companies to be sold in the market, so some state-owned assets could be converted into monetary assets and the market cooled off.

**Short- and Medium-Term Measures for Macroeconomic Reform**

The overheated economy reflects both the underdeveloped instruments and institutions of indirect economic management, and the root defects of the economic system. Short-term measures could help ease the problems, but could not prevent them from recurring every few years in boom and bust cycles. Some foreign experts stressed that although China's economy is changing rapidly, the process of organizational and institutional reform generally move slowly, evidenced by the minimal change in the market order, legal framework and economic system, particularly institutional arrangements: Indeed, incentive mechanisms have only improved slightly. Thus, it is necessary to look beyond the short-term difficulties and focus on the medium term. To this end, the pace of some reforms must be hastened.

**Monetary policy and financial system reforms.** It is commonly accepted that financial reforms have lagged behind severely. The defects of the present system are a major source of the current expanded demand. After various short-term financial actions, monetary policy must be adjusted and the following measures introduced:

- The central bank's targets should be to stabilize the currency and supervise the banking system. In so doing, it would improve its control of the credit quota, establish a system to regulate credit based on the volume of money supply, and strengthen its regulation of aggregate demand.
To achieve these goals, PBC must be restructured, with regional branches. At the same time, branches at lower administrative levels (such as provinces, districts and counties) should be removed.

Policy banking should be distinguished from commercial business, and reduced; the business of policy banks, such as the Development Bank, should be built up. Specialized banks should be transformed into genuine commercial banks.

By setting and strictly monitoring quantitative targets for assets risks and liquidity, PBC should supervise the specialized banks and nonbank deposit-taking financial institutions to ensure the banking system's safety.

Reform of the foreign exchange system must be accelerated, immediately. First, it is the market rate, not the official rate that should become the basis for government to obtain export receipts. Moreover, the retention quota system should be abolished very early on, and the move made rapidly to unify the dual exchange rates. After this, current accounts should be made convertible. Second, restrictions on capital outflow must be maintained for a longer period; it may be premature to allow Yuan to be exported by individuals going overseas, as this is could encourage capital outflows and hoarding of foreign exchange.

**Fiscal and tax reform.** Fiscal and tax reform should be at the center of the reform agenda. A few major adjustments have been carried out in fiscal and taxation areas since the reform began; however, some problems remain, such as the system lacks instruments with less elastic revenues and rigid expenditures to solve short-term problems. An “adverse regulation effect” occurred in taxation policy.

An even deeper-rooted issue is that while the existing system spurred lower-level governments toward economic development, this led to incentives with serious defects, indicated by the SOEs’ poor efficiency and severe losses, trade barriers between regions, duplicated construction and investment expansion at lower levels, and government interference into financial and economic business.

The goal of tax reform is to create a new system with a wide base, along with fair and effective tax collections and management. First, taxes are needed to provide governments with a stable source of revenue (with the tax base adopting to the changed economy), to level the level playing field for competition, and to adjust income distribution.

Second, with regard to the tax structure, indirect taxes will be maintained as a lion’s share in the total for a long period. Still, the various categories and rates must be standardized, with VAT as the major tax. The product tax should be replaced with a consumer tax on some special commodities. The enterprise income tax should be unified, as well as the personal income tax, which initially should be raised a bit, so it can be effectively managed at low cost.
Third, during a period of economic change, a number of new taxes should be introduced. These include land, property, energy and VAT (on land transactions) taxes. Resource taxes should be broadened and redefined.

Finally, two separate taxation systems at the central and lower levels should be devised, and the heavy reliance of the central on lower tax agencies must be avoided. Further, tax exemptions and deductions must be examined and rationalized, at the same time as enforcement and transparency is increased.

Another area relates to the fiscal contract system and tax sharing system, which must be addressed soon. Government functions must be clearly defined and responsibilities divided appropriately at each level. The current irrational mix of functions and duties is a source of confusion and overlap. Clarifying these issues is a condition for implementing the tax-sharing system. The duties and responsibilities, once clearly divided, should become the basis for determining the structure of expenditures.

Next, the distribution of revenue between central and lower levels of government should be based on the categories, and the tax responsibilities should be clearly defined, with an associated reduction in “shared” taxes. A well-organized local taxation system should be strengthened and local tax rates should be decided locally.

Also, the government should gain a larger part of the revenue so as to equalize the fiscal capacity of lower-level governments, with a transfer payment regime from the central to the lower.

Fiscal activities should be more transparent, overdrafts and borrowing from the central bank should be prohibited. The deficit should be covered by government bonds.

Last, the budget should be improved so it can be a policy tool: All government expenditures should be managed by the budget and the function of budget expenditures as countercyclical stabilizers should increase. Finally, a dual budget system should be introduced.

**Income distribution policy.** Participants noted that household savings and expenditures are important variables in the economy, as household income grew rapidly (they played a limited role in macroeconomic decisions in the planned economy). Now, increased household savings are the main source of bank capital. For this reason, the response of households to economic policy must be addressed in macroeconomic decision-making.

The initial income distribution is aimed at achieving efficient competition, while redistribution will aim at fairness. The unfair aspect in the initial stage, as with real estate, must be corrected. In general, current high profits are a form of rent-seeking. Thus, it is necessary to improve and perfect the market and transaction rules, using
actions such as redistribution to adjust the gap of income differentials that occurs with fair market transactions. At the same time, hidden income should be discovered.

With respect to social security, some believe it is necessary to consider the impact of fundraising and the use of the social security fund on macroeconomic equilibrium. Various systems should be established, based on the specific type of social security: For those pertaining to the elderly or retired, such as pensions and medical care, the principle of "deposit first and withdraw later" should be stressed and the individual account is the most appropriate form. For unemployment insurance, a special type of salary tax is suitable.

Management of state-owned assets. This is one of the most complex elements of China's economic reform: The issues are how to restructure and clearly define the SOEs' property rights (their assets are valued at $2,000 billion), and how to develop an efficient arrangement for them in a market economy.

In general, the SOEs are far from meeting the requirement of market competition, as they enjoy indefinite property rights and nonconstraining mechanisms for losses: Indeed, salaries can even be raised at the same time as the SOEs register losses. With large amounts of their assets drained off in various ways, the SOEs need finances from both fiscal subsidies and bank loans, which is one of the causes of the unstable macroeconomy.

However, the SOEs' reform is not simply a matter of large-scale privatization. Some participants argued that a marketization and legal person should restructure the SOEs in the initial stage of the transition. Also, a shareholding company with a majority of state-owned shares could be introduced to transform the SOEs, provided other reforms are underway. At the same time, monopolies in industries and regions must be broken and the issues of debt, recapitalization of the SOEs and a change of state-owned banks must be addressed in an integrated way when the organization of the shareholding company is designed. At the conference, various forms of managing state-owned assets were discussed and compared.

In addition, the state shareholding company, as one of the forms to represent the State's property rights, should be tested first, along with other alternatives, and only introduced after the experiment has matured.

Macroeconomic reform. This reform touches all areas of the economy; thus, partial implementation is not appropriate. Instead, it must be coordinated, gradual and guided by a well-planned blueprint. If not, the arrangements between the central and local governments, and among the state departments, could be distorted.
PART II: REFORM OF FISCAL AND TAXATION SYSTEMS

ABSTRACT

The issue of how to manage the distribution of revenues between central and local governments has been the main concern of fiscal reform for many years. Before 1980, the system was characterized by centralized revenues and expenditures. Since 1980, a contract budget regime has operated at various levels.

In the early stages of economic reform, the new system dismantled the centralized system in a way that was compatible with the concept of decentralization; in turn, this stimulated initiatives by central and local governments. However, it also caused many new problems and a stable mechanism for distributing revenues between the levels has not yet been found. As the system is transitional, it needs to be changed further toward a standard tax-sharing regime. The purpose of such a regime is not to centralize power even more within the central government, nor is it a photocopy of systems elsewhere. Rather, it is the necessary alternative for standardizing fiscal relations between governments at various levels in a market economy.

The system involves three components: (a) dividing revenues by tax categories among governments at each level and broadening the local tax system; (b) defining the governments' responsibilities and the standard criteria of expenditures to determine their reasonable level and range; and (c) building a transfer payment system between the central and local governments. In 1994, this system progressed, but more needs to be done to standardize and improve it.

With the future tax-sharing regime, changes will be required to manage and unify the government budget, coordinate fiscal and monetary policies and the treasury's funding investment in order to establish a new fiscal system compatible with a socialist market economy.

Overhaul of the tax system will continue the reform begun in 1980. At that time, the funding function was strengthened, the economy was adjusted and a complex system was built that consisted of various tax categories, levying links and levels, with the turnover and income tax as the major categories. However, this system was formed under a regimen of state ownership and planned prices, and the profit rates of various sectors were not reasonable. It used taxes to correct the defects of price formation and introduced different tax policies in different sectors. Now it must be changed to meet the needs of a market economy. The change should involve standardizing the tax categories, integrating tax rates, broadening the tax base, levying fairly, and strengthening
institutions and the tax laws. This will provide a solid base for fiscal revenues, create fair competition for economic participants, and establish an institutional framework for a unified national market.

**ADJUST THE SEQUENCE OF CHANGES WITHIN THE TAX SYSTEM AND ACCELERATE REFORM OF THE VAT**

Comments on “The Basic Way of Thinking” of the State Taxation Bureau

The “basic way of thinking” proposed by the State Taxation Bureau (STB) summarizes the major tax issues, puts forward a comprehensive proposal with a concrete timetable and is a relatively complete and up-to-date plan. The following are our opinions on some of its recommendations.

Taxes can be divided into three major categories: turnover, income and local taxes. While STB suggests that firms’ income taxes be the first step of the reform, we believe it should be the turnover tax, if the reform of the tax system is to be coordinated and completed by 1993-94. In 1993, a unified VAT (which is not a turnover tax) should apply to all industrial sectors, including firms with foreign investments, and a consumption tax (simplified product tax) should apply to final goods only. In 1994, a unified VAT should include wholesale and retail sectors, and the consumption tax could be levied at the wholesale stage. The share of turnover tax with the VAT as the main category (in the total) should be increased to over 80 percent.

These moves are recommended for the following reasons.

- **The turnover tax is the main tax in China in the sense of fiscal revenue guarantees. Efforts to change the income tax can hardly ensure stable tax revenues during major economic restructuring and reform. Conversely, the turnover tax has a solid base, which, if modified, could be a reliable source of revenue and play an important role in easing the budget deficit that is becoming a significant threat to the economy.**

- **The turnover tax, designed to complement planned prices, somewhat hinders the rationalization of prices because the price structure has changed greatly, with 80 percent of consumer prices now determined by the market, control over many prices (of equipment) lifted, and less than 40 percent of raw materials still traded at planned prices. In total, 70 percent of product prices are already set by the market and more will be added in time. And, because such changes require neutral and unified turnover taxes, the existing structure of turnover taxes would negatively affect price formation.**

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- A change of the turnover tax can effectively reduce tax evasion. The purpose of modifying the turnover tax is to enlarge the application of a unified VAT; the latter requires that the tax to be paid be noted on the invoice and the amount due be calculated on the difference between the purchase and selling prices. This will create a more scientific and strict regimen, enhance the self-auditing mechanism, reduce tax evasion and reduce the irregularities of the tax collectors. At present, tax evasion is very pronounced and is accomplished in two ways. The first is by artificially increasing costs and reducing profits to lower the income tax; the other is by hiding the volume of the operation so as to evade the turnover tax. A third way to reduce the turnover tax involves unauthorized tax relief by lower-level authorities. Turnover taxes account for the largest volume of taxes evaded; and, while there is still no effective way to eliminate income tax evasion, collection of turnover taxes could be improved by the changes suggested.

- The procedure suggested will provide a scientific basis for an export tax rebate and reduce loopholes. The current rate of export tax rebate is calculated on the basis of accumulated taxes paid by firms. The work cannot be done scientifically because of multiple tax rates and means of levying. The rebate rates diversify according to the system of indirect taxes. This increases the complexity of managing the tax rebate and also provides the possibility for falsifying the tax rebate. However, a unified VAT levied on the last production stage or wholesale stage will simplify the rebate procedure and reduce the possibility of falsifying them.

- Increasing the share of indirect taxes and reforming the accounting regime will ease the difficulties involved in changing the income tax system and after-tax income distribution. Reforming the indirect taxes will help rationalize price structures by reducing the price of products that are highly taxed and raising the price of those with low taxes; also, this will improve the product and investment structures and will help create a mechanism to equalize profits. If the accounting regime is changed, this would better reflect real costs: For example, the cost of labor and capital must be included in the operating costs, along with bonuses, medical expenditures and capital depreciation. As a result, profits will drop, which will provide an ideal basis for reforming the income tax and distributing profits. The alternative of changing the income tax before the turnover tax would require a large functional change within the treasury, taxation and assets management departments. Thus, we propose reviewing the functions of MOF’s departments that are concerned with enterprise finances, and dividing enterprise profits into income tax and return to capital.

- Establishing a tax-sharing regime can be accelerated more than is proposed by the STB. It requires that tax categories that influence product structure be classified as central taxes. After indirect taxes are changed, the choices pertaining to classifying taxes as central or local will be increased. For example, when the product tax is turned into a consumption tax, it is obviously a central tax, while turnover taxes of...
retail goods may be classified as local taxes. The VAT can be shared by both levels, as can the corporate income tax, when it is significantly reduced in volume. By establishing a tax-sharing regime, local governments should be able to speed up the change of local taxes on land and real estate, so as to complete the reforms in the near future.

- In reviewing international experiences, it seems greater success was initially achieved by changing indirect taxes before income taxes; while there are no successful examples to date of the latter, many exist for the former, such as with Taiwan (China), Korea, Chile, Brazil, Mexico and Israel. Moreover, in a transition to a market economy, corporate profits and then income tax will decline, because a large part of corporate income goes to production factors instead of just profit, as occurred in the planned economy with fixed prices. In planned economies, profits generally accounted for 20 percent of GNP, which was passed on to the treasury. In market economies, profits only account for about 5 percent of GNP: For example, in the United States, these are just 5.4 percent, and corporate taxes account for 2.3 percent. In developed economies, where corporate tax rates are low, more taxes are levied on production factors such as fixed assets and individual income. However, in China, direct taxation of factors will be difficult. Thus, the VAT is a better choice in the transition because it is indirectly levied on capital and labor. Implementing the VAT is a simple and easier reform of the tax system that meets the needs of a market economy.

In summary, our suggestions are as follows:

- Adjustments to the indirect tax should be first on the reform agenda, with priority given to the VAT. The VAT should be unified and noted on invoices, the rates and grades of product taxes should be reduced, and only final goods should be taxed. Business taxes should be standardized and integrated with the VAT.

- The accounting regime should be reformed before corporate income taxes are changed, which may take longer to prepare and should occur in the second round of changes.

- Individual income, land and real estate taxes should be levied because the real estate sector is growing rapidly, land leases is increasing, and agricultural taxes must be replaced with a land tax, as the price reform of agricultural products accelerates.

- Some piecemeal and small taxes that are levied repeatedly can remain unchanged.

- With respect to reforming the taxation institutions, two points are worth noting. The first is about their organization. Some argue that a single institution would be more convenient for taxpayers. However, we believe that separate institutions for different categories of taxes would not represent a duplication, and taxpayers should be
educated about the concept of paying taxes. Separate institutions are needed, but this could occur later. The second point concerns an internal auditing agency that should be created in STB to supervise local taxes. This can be done before the organizational shift.

- STB proposed setting up a committee on tax reform to guide the process. The name of the institution is not important as long as there is a body to lead it, which may be called the “leading group for coordinating the reform.”

**BASIC VIEWS ON TAX REFORM**

The System’s Shortcomings

The current tax system has various problems. To begin with, the tax base is very narrow and relies disproportionately on manufacturing industries that cannot alone produce the revenues needed and are an unstable source.

The structure of tax categories is irrational, the classification of items and rates is complicated, the tax burden is unfair, and tax policy is fragmented, which does not provide a climate for fair competition within a unified national market.

The tax system and division of tax categories between governments at each level lead to economic discrepancies among sectors and regions.

Change of the Fiscal and Tax Systems

Because problems stem from both the fiscal and tax systems, they must be changed, together. To achieve this, initiatives of the central and local governments must be enhanced and a larger share of revenue must be ensured for the central level. The key to this will be introducing a tax-sharing system, which will require that government responsibilities at each level be clearly defined, and the structure of categories changed. Based on our calculation, the government should take two thirds of total revenues and assume one third of total expenditures, with local governments the remainder. This will strengthen the Government’s financial capacity and thus establish a transfer payment system that can improve the disparities in sectors and regions. At present, the government accounts for only 40 percent of total revenues and expenditures, and has little capacity to improve the structure. In order to provide the local governments with greater incentives, they must be allowed to apply a broader range of taxes, reduce their share of joint taxes, and increase their share of constant tax revenues out of the total (it should be 50 to 60 percent). To this end, laws and executive power must be developed.

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5 This report was submitted to higher authorities in April 1993.
The fiscal and tax systems are the basic institutional framework of a market economy which determine government behavior and interest at all levels and greatly affect firms' investments. They are also partly responsible for the boom and bust cycles of the economy (the other source is the enterprise system).

**Elements of the Tax System**

To create a unified, standardized, fair and effective tax system and stable revenue, the VAT will be of primary importance, along with restructured corporate and individual income taxes. Also, the turnover tax must be accelerated so as to increase the VAT share to about 60 percent of the total.

Land and resource taxes must also play important roles, as they will enlarge the tax base, increase revenues and reduce regional disparities between eastern and western China. Currently, these two taxes only account for 2 percent total revenues; this figure should be raised, along with revenues from land leases, to 20 percent. Thus, research must begin on designing the categories and levying the land tax.

Changing the tax system should increase the share of fiscal revenue in GNP by 3 to 5 percent. As mentioned above, this can be realized by extending and increasing land and resource taxes, introducing a unified VAT, strengthening tax regulations, reducing tax evasion, rationalizing off-budget items and funds and including the ones that should be represented, such as land lease income and some funds.

**Tax Regulations and Revenue Losses**

Two separate systems of tax collection must be created at the central and local levels. Responsibility for tax legislation and executive power, with respect to government taxes, must be located at that level. At the same time, the range of local taxes must be expanded, and local governments should have the right to change them. Legislation for local taxes could be set by either level, with local governments having the power to adjust rates.

**Tax Concessions**

These must be strictly controlled and the broad range of exemptions must be reduced. Relief from the turnover tax must be determined by the government. Thus, tax concessions must be thoroughly reviewed, and those that led to the growth of some enterprises, industries or regions, and not of others, must be gradually eliminated.

**Enforcement**

A court and policing authority must be established to guarantee that taxes are levied. Also, the supervision and auditing of taxes must be strengthened taxation.
SUGGESTIONS FOR ACCELERATING FISCAL AND TAX REFORMS

Various financial reforms were recently created by the State Council that are essential to controlling inflation, stabilizing the economy and enhancing the role of monetary policy in macroregulation. Along with financial reforms, work should begin on the fiscal and tax systems and be completed this year. The changes should be introduced next year, to establish a framework for macroeconomic regulation within three years.

Problems with the Fiscal and Tax Systems

As fiscal revenues are unstable and the tax base is narrow, they cannot meet the needs of the changing economy. Also, the economic structure cannot be adjusted nor regional disparities improved due to insufficient fiscal capability: Taxes are duplicated, rates are complicated and the tax burden falls unevenly, thereby preventing firms to compete fairly.

Tax regulations are ineffective. The government relies heavily on local tax agencies for revenues and lacks the ability to carry out macroregulations.

In the present fiscal system, a built-in mechanism leads to an expansionary fiscal policy, which intensifies economic fluctuations.

Although the fiscal contract system stimulates local initiatives, it makes it more difficult to separate administrative and management functions in enterprises and aggravates local protectionism; this ultimately results in a regional blockade and market segmentation. At the same time, the drive of local governments toward investments is the major source of overheating, aggregate demand expansion, duplicated construction and low efficiency. Local authorities pay more attention to local interests when democratic elections are implemented; but, given an incomplete fiscal system, this will intensify the expansionary fiscal policy.

Due to the imbalanced fiscal policies, regional disparities become even larger, which creates regional disputes.

The governments’ fiscal problems weaken their ability to fulfill social responsibilities and provide services. As a result, charges have been levied for social services such as compulsory education and free medical care, and rent-seeking occurs. Such corruption causes the public to be severely dissatisfied.

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6 This DMRS report was written in July 1993 and submitted to a meeting of the State Council in August 1993.
These problems indicate that the fiscal and tax systems must be reformed as soon as possible. First, as reforms in the financial system deepen, the conflict in the economy will shift from the financial sector to the fiscal and enterprise systems, as defects in these two are the main source of many economic problems. Thus, changes in the financial sector will not be effective and lasting without corresponding reforms in the fiscal and enterprise systems. Second, China is now making a great effort to rejoin GATT, but the existing fiscal and tax systems are far from meeting GATT’s requirements: The tax regime even differs across regions, and this is an obstacle to integrating with the international economy. Thus, reforms will support the effort to join GATT. Third, now is an ideal time to begin the reforms: A number of measures on consolidating the financial and fiscal order and strengthening macroregulation have had the anticipated effects and changed people’s expectations, which has provided a good economic and political atmosphere for moving on the major reforms.

**Short- and Medium-Term Objectives of the Reform**

A stable base should be established for fiscal revenues. By enlarging the tax base and strengthening administration, they should grow steadily with economic growth; the target is to increase their share of GNP by 5 to 7 percent. Based on 1992 volumes, this would be a growth of 120 billion yuan.

Also, the tax system should be restructured, rates simplified, categories delineated, duplicated taxes reduced, tax burdens equalized, and distortions eliminated. This should promote competition and allow market forces to play a fundamental role in allocating resources.

The fiscal system should be standardized by adjusting the relationship between central and local governments; revenues should be concentrated at the central level, while more responsibilities and expenditure power should be developed at the local level. For this purpose, the tax-sharing regime should be strengthened. With respect to fiscal revenues, the tax target quota should be abolished. Revenue shares between central and local governments must be divided by categories to ensure the government has a larger share (about two thirds). With respect to expenditures, based on a clear division of functions and responsibilities at each level, the local government share of expenditures should be raised from 50 percent to two thirds. At the same time, the transfer payment regime should be created through which the government allocates funds according to a standard formula and finances special projects to cover local budget deficits.

**Key Issues of the Reform**

An indirect tax system should be established with the VAT as the major category. At present, 64.8 percent of tax revenues are provided by the turnover tax, which includes product, business and value added taxes. The change would abolish the product tax, levy a consumption tax on some special goods and enlarge the VAT. There should only be
two VAT rates: a general one at 17 percent and a preferential one at 10 percent, for food and other necessities. It should be imposed with a unified invoice that notes the taxes paid. All goods should be covered by VAT, but levies on the purely agricultural and retail sectors should be suspended for a while, in the event that confusion occurs due to premature implementation. Given its attributes, the VAT should be the major source of fiscal revenue for a long period before it is replaced by an effective income tax.

Corporate and personal income taxes must be standardized. A unified corporate tax should be imposed first on domestic firms, then on those with foreign investment. The unified rate could be 30 percent, and the “two funds” should be abolished at the same time. SOEs would not be required to turn over their after-tax profits to the treasury, because the amount would be very small after the new accounting regime is imposed; and, given ambiguous property rights, it would be difficult to distribute the profits properly. Thus, the focus of modifying the personal income tax would be on regulation. Also, the base level for personal income tax should be raised to 600 yuan and the tax reporting regime completed.

The administration of tariffs must be standardized and rates reduced accordingly, while exemptions are strictly controlled. At present, there is a large gap between nominal and effective tariffs, with a quite small volume of tariff income and large exemptions and deductions. Thus, nominal tariff rates must be decreased in order to more closely comply with GATT requirements and tighten up tariff concessions. This would be based on more clearly defined categories of tariff deductions and relief. Also, tax regimes must be completed and laws strengthened.

The aim of fiscal and tax reform is to increase governments’ ability to carry out macroregulation by raising the share of fiscal revenue in GNP from 14.68 percent in 1992 to about 20 percent in the next couple years.

In addition, social security reforms must be addressed in fiscal and tax changes. It may be worth considering some sort of tax on salaries, equal parts of which could be paid by employers and employees and used for social security expenditures. At the same time, the individual income tax threshold should be raised to target a minority of high-income earners.

The tax-sharing system. Tax-sharing involves determining government revenues by tax categories. It also involves enlarging and completing the local tax system, determining expenditure criteria according to government duties and responsibilities at various levels, and arranging for transfer payments from the central to local governments.

Given the economic system is being transformed in a context of conflicting interests and regional disparities, a multitier regulation system must be established with
more centralization of fiscal revenues. Under this system, local governments will gain more autonomy in taxation and expenditures.

The principle behind dividing duties is that the government is responsible for stabilizing the economy, unifying the national market, optimizing the economic structure, sustaining economic growth, and distributing national income rationally and equitably. It is also responsible for constructing infrastructure for national and security, and for national and regional needs. Local governments are responsible for local social, economic and cultural development, particularly improving infrastructure and the environment, primary education, medical care, culture, public security and other social services, developing tertiary industries and increasing employment.

In this context, government expenditures concentrate on administrative items including defense, armed police and foreign affairs, basic scientific research, high-tech development, the national environment, infrastructure, basic industries, and the domestic and foreign debt. Financial allocations to local governments constitute a significant part of these expenditures. Conversely, local governments would concentrate on improving local investments and the quality of life, compulsory education, culture, medical care and social welfare, local social security and promoting employment. These expenditures will account for two thirds of total expenditures after the change.

In a reformed tax system, the VAT, consumption tax, goods tax, tariff, and business tax of financial firms would be the main elements. Other business taxes, individual income tax, simplified local tax, real estate tax, and corporate income tax should be local taxes. The resource tax could be shared, while taxes on large national mines should be paid to the government, and others to local governments. Corporate income tax may be classified as a shared tax if the Government's revenue is scarce and the rate can be set at 30 percent, with the government levying 15 percent. The tax-sharing system should allow the government to dispose of about two thirds of total revenues.

Transfer payments will include general and special financial allocations. General allocations will allow local governments to maintain the same standard of government services; special allocations for investment projects and programs can be used to adjust regional and industrial structures. The first are the most important and should be implemented by a formula that is a weighted calculation of combined factors (population, area, geological position, climate, per capita GNP, education and medical care, etc.).

A two-tier tax-sharing and payment transfer system should be established: one for central and provincial governments, another for provincial and lower levels, because the country is huge and populations differ. The government may allocate funds directly to city or county governments for important projects; tax sharing and transfer payments for
governments beneath the provincial level must be guided by government and differences across regions will be permitted as long as basic principles are followed.

The relationship between the central and local governments, with respect to the distribution of revenues, must be legalized and not changed arbitrarily.

As the tax-sharing system changes, budget management will need to improve. All revenue and expenditure activities must be covered, and the system must be more uniform and transparent; the countercyclical function of budget expenditures regulating the business cycle must be strengthened. Also, a dual budget system must be introduced by legislative means.

Moreover, the relationship between the treasury and banks must be standardized and legalized. From now on, budget deficits must be financed by government bonds, not by overdrafts in the central bank. During the transition, the treasury could make short-term loans to be repaid within the same year, but only for temporarily circulating capital, in times of scarcity.

**Implementing the Reforms**

To complete the new fiscal and tax systems, the following must be accomplished: (a) turnover taxes, with VAT as the major tax, must be completely restructured, and income taxes must be unified; (b) a tax-sharing structure must be devised, and new categories opened to expand local taxes and build a personal income distribution mechanism that combines a tax on wages and personal income (this would match the social security reforms); (c) tax-sharing systems must be established at various levels, with two separate tax institutions; and (d) the amount of government expenditures at each level must be determined through a standard formula, which would enable a transfer payment system to be created.

The four tasks should be completed in about two years, through different scenarios.

**Scenario 1:** The work of (a), (c) and (d) would be completed in 1994. Because it is difficult to determine expenditure formulas and amounts at each governmental level, 1993 expenditures could be used as base figures to determine the 1994 level. The government would help finance deficits at each level. Once the formulas are calculated, from the second half of 1994 onward, the central government could use the transfer payment system and the task of (d) would be completed. Task (b) should be finished in 1995 and further improved.

**Scenario 2:** The new system should be established within two years, in two stages. In stage one, (a) and (c) would be completed in 1994. Expenditure levels for
1994 could be determined by using 1993 figures as the base, with the government financing deficits. In stage two, (b) and (d) would be completed, by 1995.

We recommend Scenario 1, since Scenario 2 would postpone the difficulties and accumulate problems that could possibly ruin the reforms.

The leading group for fiscal and tax reforms should be responsible for their design, implementation and coordination.

It must be stressed that an anticorruption campaign must accompany the institutional changes; also, government agencies must be supervised and staff strengthened.

**TRANSITIONAL MEASURES AND IMPOSING THE VAT**

The following measures are recommended:

1. Draw up an implementing plan and prepare for the VAT legislation.

2. Conduct public education and technical training. Use the media to provide information about VAT, explain the method of collecting it, and publish a handbook of guidelines for the tax collector. Meanwhile, organize technical training of staff and mobilize experienced manpower in VAT methods.

3. Register the VAT number, name (and firm name), address, telephone number, industrial sector, and the date of registration and when the business opened.

4. Unify the VAT invoice. The invoice must bear the volume of purchase, name and address of the seller, VAT registration number, name and VAT registration number of customer, value of the purchase and amount of VAT payable. Each invoice should have four copies; the purchaser and seller should each get one that they send to their respective local tax agencies. The two agencies must send copies of the invoice to the data processing center to be checked. The invoice must be kept on record for five years.

5. Inventory must be taken and tax rebates given. In the process of substituting the VAT for product and business taxes, companies that already paid product and business taxes on their inventories should be eligible for tax rebates. Four methods are used internationally: (a) the full rebate is paid at once; (b) the rebate is paid in installments; (c) a partial rebate is made; (d) no rebate is given. In most cases, rebates are given. In China, it would be best to give a partial rebate, in installments. The rebate process could be completed, once the ratio is set, in three to five years, and one third or half of the tax may be paid in government securities.

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7 This paper was submitted to the State Council in July 1993.
THE TAX BASE, SYSTEM AND REVENUES

The objectives of the recent fiscal and tax reforms are to achieve a unified, fair, standard and effective tax system, consolidate and improve the financial base, adjust the fiscal relationship between the central and local governments and strengthen the Government's ability to carry out macroregulation. If the reforms achieve these objectives, they will also eliminate economic chaos, establish market order, reduce inequitable income distribution and increase public confidence in a socialist market economy.

However, a big gap exists between the current reform plan and objectives. The tax base is very narrow and regulations have many loopholes that lead to serious tax evasion. Unfortunately, as no specific resolution exists with which to solve these problems, it does not appear feasible that tax revenues will increase. According to our estimates, potential 1992 revenue was, at the least, over 100 billion, and 1994 revenue could increase by 50 billion, if an effort were made to collect the evaded tax.

If the revenue targets were achieved, it would not be difficult to guarantee the local expenditure quotas, increase the central financial capability and balance regional fiscal services. Thus, it is necessary to reconsider the proposal in terms of the ratio of shared tax, and the transfer-payment regime.

Some suggestions for changing the tax system include:

For the VAT

- Create a unified rate of 17 percent and a preferential rate of 10 percent.
- Unify the turnover tax of domestic firms and those with foreign investment and end the industrial and commercial tax.
- Unify invoices, with notification and deduction of payable taxes. This should be in effect by April, 1, 1994.
- Levy it on the retail sector.

Based on 1992 GNP, the VAT should total 177.5 billion yuan, which is 40 billion more than the current estimate of the reform plan. This amount is equal to a 5.6 percent turnover tax rate, which is not at all high. An increased VAT would be totally transferred into prices, which means revenues would be taken from investment and consumption and would not significantly increase the tax burden on firms.

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8 This paper on fiscal and tax reforms was written in August 1993.
For corporate income tax

- The unified rate is 27 percent and preferential rate is 18 percent, which applies to enterprises with incomes of 50,000 yuan or less.

- Current tax relief and deductions must be ended within three years, except for a small number of special zones, high-tech development areas, poor regions, special industries and firms (such as welfare firms run by the disabled). The range of tax relief and deductions must be decided solely by the government.

For individual income tax

- Estimated individual income tax was 20 to 50 billion yuan (based on a calculation of 5 to 10 million people with monthly incomes of over 2,000 yuan). However, in 1992, the amount collected was only 0.98 billion yuan. Next year, by standardizing the tax base and strictly regulating taxes, the target would be an increase of 5 billion yuan (this accounts for only 10 to 25 percent of the tax base). To accomplish this, it is suggested that real names be required in financial activities such as deposits and dealing securities; individuals be required to open personal accounts for payments as far as possible, and reduce cash payments; a computer network and personal tax registration number be established.

For land and resource taxes

- At present, the government may levy 1 to 10 cents from local governments per square meter on urban land use, depending on the quality and location of the land, and adjust the rate according to changes in the regional economy. Tax revenue on land transfers and related transactions would go to local governments.

- The scope of the resource tax should be enlarged and a new mines, forest and water tax should be created in the near future.

**Suggestions for the VAT rate**

The current tax reform should and can increase tax revenue. According to estimates based on 1992 data, the goal is a hike of 50 billion yuan. To achieve this, the general VAT rate should be set at 17 percent and the preferential rate at 10 percent. The reasons are as follows:

1. A 17 percent VAT would not go beyond the level of the legal turnover tax. According to a national survey, the average turnover tax burden of industrial enterprises in 1990 was 7.18 percent, which equals a 20.5 percent VAT rate calculated on a 0.35

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9 This paper presents the views of various departments in September 1993.
value-added coefficient of the industrial sector in 1992 provided by STB. The figure would be 26.3 percent if calculated on the basis of a 0.273 coefficient.

2. According to an MOF study of 70,000 enterprises in 1992, their average turnover tax (after deducting business taxes) rate was 8.59 percent, which equals 24.5 percent of VAT with a coefficient of 0.35, and 31.46 percent with a coefficient of 0.273.

3. Some argue that because VAT’s existing base rate is 14 percent, the new unified VAT should be the same, to maintain the current level of tax burden. However, as there are 12 rate grades in the current VAT system (8 percent, 12 percent, 14 percent, 16 percent, 18 percent, 20 percent, 21 percent, 23 percent, 26 percent, 30 percent, 43 percent and 45 percent), the 14 percent rate does not constitute an average. Also, from the structure of the current VAT, 66 items are taxed at 14 percent, which accounts for 46.8 percent of the total; 68 items are taxed at 16 to 45 percent and account for 47.2 percent; 9 are taxed at 12 percent, and 1 at 8 percent; the two, together, account for 6.9 percent of the total.

In addition, the sector rate structure shows that of the major sectors, only the chemical fiber, pharmaceutical and machinery (except agricultural and motor ship machinery, which qualify for the 12 percent rate) sectors are taxed at the 14 percent rate. Sectors with a real rate level of 15 to 17 percent include household electrical appliances and electronic products. Sectors with a real rate of 16 to 18 percent include textiles, clothing, household machinery, nonferrous metal, food and beverages, leather and fur goods, paper goods and other light industries. The household chemical goods sector has a real rate of about 20 percent. Only metal mines and billet are taxed at 12 and 8 percent, respectively.

It is obvious the current legal VAT rate is higher than 14 percent, roughly 16 to 18 percent. Thus, our suggested 17 percent base rate and 10 percent preferential rate are close to or slightly lower than the present level, while a 14 percent base rate and 11 percent preferential rate would significantly lower it.

4. Based on the calculations of (1) and (2) above, the VAT rate is higher than the average level of the 16 percent (with a base rate of 17 percent and a preferential rate of 10 percent) we suggested: With a unified VAT, some products would still qualify for a consumption tax, which would total about 30 to 40 billion yuan and equal 3 to 4 percent of the VAT.

5. As mentioned earlier, the tax burden of large- and medium-size SOEs will decrease with the new 17 percent and 10 percent rates. But, due to serious loopholes, irrational relief and deductions (which mainly involve taxpayers other than SOEs), uncollected tax revenue from the turnover tax in 1992 could be over 40 billion yuan, if calculated at VAT rates of 17 and 10 percent.
6. The 40 billion yuan potential increase in tax revenue will stem from improving regulations, but not raise the legal tax burden of firms nor significantly affect the level of prices. In general, the real tax burden of firms that have enjoyed irrational tax relief and deductions or evaded taxes, will be raised to the legal level—which is exactly what a new, unified tax system requires. With respect to prices, if the money supply is unchanged, the VAT hike means transferring purchasing power from firms and individuals to the public sectors, and the level of aggregate demand will not vary. In addition, if the money supply is relaxed somewhat, the tax increase will affect prices by as little as 1 percent, which is acceptable.

**FISCAL AND TAX REFORM PLANS**

Some added suggestions for the current reform plan include the following:

1. The government should assign some funds to implement the transfer payment system, at least in its embryonic form. This round of reform would not only increase government revenues but also establish a new, efficient and standardized fiscal and taxation system. Since September 1993, after the central and local governments exchanged opinions, the original plan was modified to ensure vested local interests that the base figure for revenues and expenditures would be set on the 1993 level, rather than 1992. Also, the government would allow some tax preferential policies approved by provincial governments to be maintained until 1995. These changes would make the reform easier to adopt, but would reduce the increase planned for the central level; thus, the government will find it harder to make transfer payments to the local levels.

As a result, the government could obtain funds for transfer payments by:
(a) allowing a budget deficit of a couple billion in the early stages; and (b) gradually reducing treasury funds controlled by ministries and government departments by constraining their growth and transforming the increment into funds for transfer payments.

2. Guidelines are urgently needed for a second-tier, tax-sharing regime between provincial governments and lower levels.

The current design focuses primarily on tax-sharing between the central and provincial governments. However, with the new tax categories and separate institutions, local revenue from the turnover tax will accrue to the government, which will undermine the base of the tax contract regime between provincial and lower level governments. Thus, the government must set guidelines, including those that pertain to general issues and those that divide the major tax categories between the two levels. Also, with

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10 This paper contains supplementary comments and suggestions submitted to the State Council in October 1993.
government guidance, the provinces should develop fiscal regulations for each level of government to ensure the national reforms are smoothly introduced.

3. Develop the VAT rate in a timely fashion.

It was decided that the VAT would be the major tax in the new system, shared by central and local governments, and levied by STB. The State Council must carefully study the rate; this should involve the relevant departments’ reaching consensus. However, we believe the base rate should not be below 16 percent, to guarantee a reasonable concentration of revenue at the central level.

An operational plan and technical preparations must be expedited. In designing the general plan, technical preparations at both the central and provincial levels will need to accelerate because until now, progress has not been satisfactory: Some departmental implementation plans are still not completed; coordination between departments is not satisfactory; provincial governments know little about the contents of the reform or have some misconceptions, and provincial plans thus cannot be devised; no requirements exist with respect to specific tasks or a timetable for departmental preparation; also, there is a lack of effective coordination and supervision. This situation must change, and the following should be priorities.

- Preparations must be made immediately to build the two separate tax institutions. To date, no proposal has been advanced on how to organize them. It will involve training staff, distributing equipment and establishing an information network as soon as possible.

- Preparations must begin for imposing transitional measures for the VAT. An implementation plan for the VAT must be designed that stipulates a law or conventional regulations. The public must be educated and technical staff trained. The unified invoice must be printed before the system is introduced. An early decision must be made on the policy for firms’ taking inventories and obtaining tax rebates (that will occur during the shift from the product and business taxes to the VAT), to prevent possible confusion.

- By the central departments and local governments entering into discussions, new principles and models governing relations between provincial and local governments will emerge. The new regime must address the need to further standardize the fiscal and tax system.

- Much preparation will need to made and laws passed to facilitate the change of transaction methods with respect to next year’s government debt; it will require new relations among the central treasury, central bank and financial institutions.
PART III: REFORM OF THE FINANCIAL SYSTEM

ABSTRACT

Because financial activities are crucial in economic development and stability, reform of the financial system is a top priority.

Since 1978, a number of restructuring experiments have dismantled the centralized, single banking system, changed credit regulations characterized by centralized deposits and loans, and built a financial system led by the central bank and consisting of the specialized banks as the main bodies along with other financial institutions. However, many of the problems are still not eliminated. For example, the central bank has not yet created a new mechanism that enables it to implement independent monetary policy, mainly with indirect instruments. In the specialized banks, administrative and management functions are still not separated, and the commercialization process is moving slowly. Further, the financial market does not run in an orderly fashion. In the government bond market, there is lack of support from the banks, and banks and fiscal institutions have not yet coordinated their actions.

It is particularly worrisome that given local economic autonomy, the banking system is inclined to restore the traditional centralized PBC system. Thus, PBC branches organized by administrative regions are involved in profit-making activities (given their control of capital and the profit retention system) and thereby lose the neutral position of a central bank; also, they regulate and control the capital of the specialized banks' branches, dismantling their uniformity. This has created bloated, inefficient institutions. Moreover, it leads to credit expansion which forces the central bank to increase the base money supply, makes the growth of supply excessive, and causes a new round of inflation. Thus, the centralized PBC and localization of banking operations are the key problems that threaten economic stability. Constrained in this way, the boom and bust cycle cannot be avoided and financial reforms cannot move forward significantly.

The key reform will involve continuing the restructuring of the central bank and developing a double-tier banking system. First, it must end the local governments' interference in financial activities, which affects macroeconomic stability. Thus, it should aim to: (a) build a system of macroregulation in which the central bank can exercise independent monetary policy under the State Council; (b) establish a financial system that separates policy banking from commercial banking, with state-owned commercial banks as the main bodies coexisting with various types of financial
Part III: Reform of the Financial System

institutions; (c) develop a financial market system that is open but uniform, competitive but orderly, and strictly regulated.

To achieve these objectives, the PBC’s functions must first be transformed to focus on the central bank’s regulation and oversight. Second, at the time the policy banks are created, the commercialization of state-owned specialized banks should be accelerated; they must be autonomous, bear their risks, be accountable and self-constrained. Further, financial markets should be completed (including money, bond, stock, and securities markets), and compete in an orderly and standardized fashion.

By accelerating and deepening the reforms, a completely new and efficient financial market system should be established by the end of the ninth five-year plan period, which, together with additional planning and investment, fiscal, pricing, enterprise, distribution and circulation reforms will provide the base for sustainable, rapid, and stable economic growth.

THE CENTRAL BANK’S USE OF FUNDS

Because it issues money and is the bank to the government and other banks, and as it is the source of credit, the central bank is different from any commercial bank.

As a medium in the credit business, a commercial bank (in China, it is specialized bank) receives deposits from firms, households or other sources (called original deposits), and then lends its capital. Because only part of the deposits are withdrawn in cash, and part of the loans it makes are transferred into deposits and not withdrawn, the bank needs to retain only a certain ratio of its deposits in cash, i.e., in deposit reserves, and lend the remaining part to make profit. Borrowers, after getting a small amount of cash from their loans, may deposit the money in the bank, which creates derived deposits. In this way, commercial banks create a kind of derived deposit that is much larger than the original deposit and make the money supply increase many times. In this sense, commercial banks can create money.

When the ratio of the deposit reserve is high, the quantity of money created by deposits is small. The central bank can influence and control the commercial bank’s credit and credit-making ability by adjusting the ratio of deposit reserves.

However, under a double-tier banking system of central and commercial banks, the former’s utilization of capital is an important source of the latter’s credit. The derived deposit is not only constrained by the ratio of deposit reserves, control over the scale of credit and withdrawal of cash, but also by the quantity of original deposits. As the only

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11 This paper was written by Zhu Li, former deputy director of the DMRS, in May 1992, and submitted to the State Council.
bank to issue money, the central bank creates all cash in circulation. When this cash is absorbed, commercial banks either must recall their loans or increase their borrowing from the central bank, if they need to increase their deposits. Recalling loans would reduce their capacity to make derived deposits because of the impact of the ratio of deposit reserves, and would not increase the income of credit funds. Thus, commercial banks can only increase their quantity of credit funds by increasing their borrowing from the central bank.

Capital in the central bank is called base money or high-power money because of its ability to increase or decrease the volume of the money supply and credit. In China, based on empirical studies, the expanding ratio of commercial banks' base money creation and credit expansion is around 1:5.

According to Chinese regulations, the source of capital and utilization of the central bank are indicated in the following table:

**Central Bank Assets and Debts**

<table>
<thead>
<tr>
<th>Debts</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Deposits</td>
<td>1. Special lending</td>
</tr>
<tr>
<td>Fiscal deposits</td>
<td>2. Lending to specialized banks</td>
</tr>
<tr>
<td>Institutional deposits</td>
<td>3. Lending to other financial institutions</td>
</tr>
<tr>
<td>2. Legal reserve</td>
<td>4. Gold and silver</td>
</tr>
<tr>
<td>3. Deposits from financial institutions(extra reserve)</td>
<td>5. Foreign exchange</td>
</tr>
<tr>
<td>4. Transfers of postal savings</td>
<td>6. Treasury overdraft</td>
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<tr>
<td>5. Circulating money</td>
<td>7. Treasury borrowing</td>
</tr>
<tr>
<td>6. Current year surplus (own capital)</td>
<td>8. Treasury taxes and profits</td>
</tr>
</tbody>
</table>

In systems where the central bank and commercial banks are separate, base money consists of cash in circulation and deposit reserves (the legal reserve and extra reserve). However, in China, base money includes the first five items of the central bank's debts (on the above table).

Due to the central bank's monopoly over issuing money, the use of capital determines its source in that bank. This is contrary to common practice in commercial banks, where deposits determine lending: That is, the central bank's creation of base money is the result of the utilization of its funds.

The central bank macroregulates through ratios of deposit reserves, relending and open market operations. Of these, the open market operation cannot be used widely (as exists in other developed economies) because the securities market is less developed.
The legal deposit reserve regime began in 1984, and the ratio for all specialized banks is now 13 percent, having been adjusted three times. While policy played a role in regulating the scale of credit and the money supply, this instrument cannot effectively control them, even if the ratio is raised, when the central bank increases its lending to commercial banks. Moreover, since specialized banks must do policy lending, they cannot bear a very high ratio of deposit reserves.

Thus, the central bank’s most effective instrument is its lending to specialized banks (called relending), which, according to a broad definition of money, is equal to issuing cash. Its relending combines lending to head offices of the specialized banks and their regional branches, through regional PBC branches: 80 percent goes through the former channel and 20 percent through the latter.

The central bank’s loans have time frames: Annual loans (long-term loans), which account for about 30 percent, and daily lending (short-term loans), which account for 70 percent.

From 1989 to 1991, the central bank’s average annual relending was as high as 80 billion yuan (including loans to repay PBC’s debts), which is excessive. PBC cannot be blamed solely for this, but these defects in the central bank’s lending were either caused by the system or its technical operations. These problems can only be solved by further financial reforms.

The problems with the central bank’s use of capital include:

- While PBC’s credit control focused on applying a ceiling, the relending channel was overlooked: The central bank paid attention to setting limits on the scale of credit of the specialized banks, but it did not strictly control its own lending to those banks, allowing too much to flow to them. The result was that the credit ceiling to the specialized banks was ineffective, because they could easily find other channels through which to lend their capital. Thus, the focus must be on controlling the central bank’s relending, which would control the aggregate credit scale.

- Few ways exist for the central bank to regulate and plan effectively for its short-term loans to specialized banks. It is difficult for these to be repaid in the first half of a year; even when they are, they are lent again in the second half and always over the limit planned. Thus, if the central bank’s relending is excessive, most is in short-term loans. While the credit-expanding aspects of fiscal overdrafts and loans are commonly recognized, relending has the same effect.

- Based on the central bank’s statistics on credit funds, both the specialized banks’ excess reserves and the central bank’s relending increased from 1989 to 1991: The average annual amount was 60 billion yuan and 80 billion yuan, respectively. This means the central bank supplied funds to the specialized banks while they had
surpluses themselves, which seems irrational. The reason for this phenomenon is the PBC’s profit retention regime.

The present interest rate on the specialized banks’ excess reserves is 6.12 percent and PBC’s relending rate is 7.2 percent. Since the gap is 1.08 percent, increased relending will provide extra profit for PBC. As a result, PBC branches have no motivation to constrain their relending volume when the more they relend, the more profit they retain. Further, it is not surprising that PBC’s asset bureau chooses to recall the relent loans at the same time as the accounting bureau gives instructions in profit-making. The branches are naturally reluctant to recall or reduce relending because it would mean less profit to fulfill the planned quota and less money to accommodate construction, bonuses and other bank staff benefits.

PBC’s profit-retention regime is the main reason for its loose control of relending. Thus, it must be abolished and replaced with more rational accounting that will prevent it from seeking only profit.

- The central bank issues direct loans such as for poverty assistance and regional development, which are not appropriate, given its control of the money supply. This type of business overlaps with the specialized banks and would affect the neutrality of PBC’s monetary policy, if such loans increase substantially. Moreover, the loans create base money and expand credit. Thus, those that are profitable could be made by the specialized banks, and others transferred to the budget.

**INTRODUCING A NEW SYSTEM FOR REGULATING AGGREGATE MARKET DEMAND**

The market cannot balance aggregate demand (AD) and aggregate supply (AS) spontaneously. Rather, rapid growth requires that AD be regulated to achieve stable and efficient growth. Thus, a new system must be established by restructuring and improving AD.

The move to the market is proceeding rapidly. At present, prices for 90 percent of consumer goods and 70 percent of materials have been deregulated. In another two or three years, prices on most goods will be decontrolled. Although this is not necessarily the same as the market setting prices, and obstacles to free entry to the market, state policies and other nonprice distortions are reflected by the prices which cannot completely correct the signals, the microeconomy will be regulated largely by market forces. Economic growth began to rise from last year and in the 1990s is expected to be 8 to 9 percent a year.

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12 This article was written by Lou Jiwei in October 1992 and was published in *Reform*, no. 1, 1993.
In the 1980s, the economy witnessed several boom and bust cycles, mainly due to weak macroeconomic management. While it appears that with the marketization of the microeconomy and weak macroeconomic regulations, the economy will grow at a reasonable pace, the growth rate should not be too high—or the macroregulatory reform would have to accelerate.

Regulating aggregate demand is the essential content of macroeconomic policy; reforming it requires that the departments involved be divided. In developed economies, AD regulation is usually carried out by monetary and fiscal policy; at present, monetary policy occupies a leading role, with fiscal policy often applied as a supplement. During recessions, when the economy shows no sign of recovering after the central bank lowers interest rates and increases the money supply, an expansionary fiscal policy is needed to increase effective demand.

As China moves to a market economy, it should learn from these experiences, but not simply copy them, because conditions are different. First, the demand for money is extremely high, as it is needed for land and real estate. Also, prices need to be adjusted to correct distortions, and nonmoney wages need to be transformed into money wages. This process will increase pressure on structural inflation and the supply of money, as well as change the speed at which money circulates. Second, the demand for infrastructure investment and structural adjustment will be high over a long period; this will be exaggerated by the growth of investments due to their being incorrectly assessed (because of SOEs' unclear property rights). Given these problems during the transition, the macroeconomy will not need an expansionary fiscal policy. Thus, China needs a cautious and conservative fiscal policy that relies on a deflationary monetary policy to regulate AD. Even with this arrangement, AD could still go out of control, which could lead to sharp fluctuations and inefficiencies. For this reason, reforms are essential and macroregulatory policy (particularly monetary policy) must improve.

The central bank is the major institution in charge of monetary policy, and its intermediate aims, instruments, regulatory mechanisms and organizational structure are decisive in implementing AD regulations. At present, the central bank has many problems with this task. Its policy goal has two targets: stabilizing the economy and directly supporting economic growth. Its intermediate target is the size of the annual credit quota. It relies on distributing its relending to the SBs and on controlling the SBs' management personnel. Its branches are located all over the country, which makes it the largest central bank in the world. Moreover, the branches are motivated to expand demand and lend more for profit because of the profit-retention system. As this organizational structure is the result of many factors, PBC should not be the only institution blamed for the weak AD regulations (although it is the major actor).

Monetary policy is by nature deflationary: Its aim is to stabilize the currency and help realize AS. In terms of economics, growth means significant structural change.
PBC's direct development lending has a growth objective; but if the loans come from the supply of base money, this will destabilize the currency, due to the high multiplier effect.

The intermediate goal of the regulation should be the volume of money, i.e., cash and deposits that can be paid for with cash, checks and transfer payments, not the scale of relending loans—because deposits constitute the only money with purchasing power (not the loans). In the traditional system, all credit was centralized in state banks and control of lending was the same as control of deposits. Now, sources of derived deposits are not necessarily the loans, when credit sources are diversified.

The instruments with which to regulate the volume of money should be the use of funds and the central bank's interest rates. Controlling the distribution of its relending scale cannot effectively control AD; further, it hinders the SBs' efficiency. A large number of directed loans would lead to many bad and dead accounts that could be a form of disguised inflation.

Along with credit controls and directed loans, the regulatory mechanism simply relies on direct administrative control over the SB branches at various levels. As a result, the PBC has an inefficient, bloated organization.

The defects of the banking system are generated in the traditional centralized planning system. This paper cannot cover all the defects; rather, it will analyze how the AD regulatory efficiency was affected by the intermediate objective and instruments.

What is social AD and the balance of AD and AS? Social AD refers to the purchasing power of money. AD can be classified as consumer, investment and export demand. In terms of money, it means payable cash and deposits (M1); if savings deposits can be transformed into payable deposits, it means all types of deposits (M2). AD is indicated as M1 or M2. AS is the production capacity in a year. To balance AD and AS means to control AD and money purchasing power, make it no bigger than AS and not allow it to lead to inflation, but no smaller than AS, which would result in idle production capacity. Controlling the growth of M1 or M2 is usually carried out through adjusting the use of central bank funds, interest rates and central bank lending scales. Because production capacity is more or less constant, and the purchasing power of money is adjustable, AD control is active money supply regulation.

Under the traditional planning system, the banking system was dominated by a single state bank, and the control of loans was the same as the control of deposits, i.e., control of the money supply. Now, a central bank and SBs, commercial credit institutions, nonbank financial institutions and capital market have been developed to some degree; thus, controlling loans is no longer the same as controlling the money supply. The lending scale is no longer the only one hard macroregulatory constraint. Credit outside the loan scale could be created when the central bank's control of AD is
weak, which would produce derived deposits and increase the money supply; such a situation can be clearly seen this year.

From January to August of this year, the state bank's lending grew at 23 percent compared to the same period last year, but M2 grew at 30 percent, M1 36 percent, and M0 nearly 30 percent (source: China Financial Information, June 1992). M2 and lending are major elements of the central bank's assets and debts. While growth of M2 is much higher than that of loans, the central bank has to balance its assets-debts sheets by a large negative value of "other items" in debts. At the end of June, PBC's aggregate debt was 100 billion yuan; by the end of August, the figure was 150 billion yuan. The key issue is whether this gap—the central bank's excessive deposits (i.e., increase of deposits is higher than of lending)—will be converted into real purchasing power, turning into expanded AD.

Usually, excessive deposits go into the central bank if they do not become purchasing power, which would increase other financial institutions' deposits in the central bank. However, in China, deposits of other financial institutions include two parts: legal deposit reserves and excess deposit reserves. Since 1988, the legal reserve ratio was set at 13 percent, while there was virtually no rule for the ratio of excess deposit reserves. The purpose of the two types of reserves is not the same as in other economies: Here, excess deposit reserves serve as legal reserves, while the latter is used to increase the central bank's disposable funds. Because of the limitations of the credit plan, SBs cannot allocate capital flexibly across regions, some SB branches have a credit quota but no cash to lend, and the central bank needs funds for policy lending. Thus, part of the funds must be concentrated at the central bank by means of legal reserves. In almost a year, excess deposit reserves have decreased, although legal reserves increased with the growth of M2. But the decrease of both ratios and the absolute volume of the former is bigger than the increase of the latter, which indicates that the financial institutions' excessive deposits did not go back to the central bank. This also explains that the decrease in excess deposit reserves was the important reason for many banks' payment difficulties.

A significant part of the 150 billion yuan in excessive deposits that was not returned to the central bank was lent by the SBs to nonbank financial institutions. These institutions relend or invest the borrowings. Their control over credit is looser than that of state banks, while the lending and investments of some small financial institutions (such as trust and investment companies, securities companies and municipal credit cooperatives) are not even included in the banks' lending statistics. Thus, many funds are not subject to the credit ceiling, are lent to firms and ultimately translate into purchasing power and expanded AD. Further, because nonbank institutions may not accept deposit accounts, their lending usually becomes a deposit in a recipient bank, which in turn, becomes a derived deposit and a large amount of the banks' excessive deposits. This enhances the nonbank financial institutions' capacity to create money. The figure quoted
above may support this argument and indicate the size of the process. That M1 grew six percentage points higher than M2 meant savings deposits increased less than the firms' deposits, which is also a sign of the speedy circulation of money, increased purchasing power and expanded AD.

The following are a few channels by which excessive deposits are transformed into purchasing power:

- **Interbank lending to nonbank financial institutions.** The economy contains a great number of nonbank financial institutions, including trust and investment companies run by specialized banks and local trust, investment, securities, and investment development companies, which can determine their distribution of funds; the interbank call market is an important source of their funds. For instance, at the end of July 1992, these institutions held 38.96 billion yuan, of which 48.4 percent was net borrowing from specialized banks and other nonbank financial institutions, and only 44.6 percent was from deposits. The institutions invest the funds from the interbank call market that are not under the credit quota control in real estate, bonds, shares, and direct investments.

- **Joint accounts of banks and enterprises.** Such accounts, opened by a bank and enterprise, are those into which the two place some funds. They then use the funds together in lending or other investments, thereby bypassing the credit quota control. For example, in a city in Henan province, an enterprise deposited 50 million yuan and a bank 80 million yuan to a joint account. The enterprise subsequently got a loan of 130 million yuan from that account.

- **Fiscal lending.** This term refers to lending with fiscal funds that benefits from the gap between the time the funds are received and disbursed. This can occur in two ways: One is direct lending by local fiscal authorities, often in the form of short-term circulating funds, while the other is trust lending through local trust and investment companies which either lend the funds or invest them in real estate, bonds, shares, etc. From January to September, fiscal revenues grew by 21.8 percent over the same period last year, with a net surplus of about 5 billion yuan, while deposits of fiscal authorities in the central bank dropped by 1.34 billion yuan, since the end of last year, and were 9.05 billion yuan less than the same period last year. It seems a large part of the funds were siphoned into fiscal lending.

- **Off-account lending.** To bypass the credit quota control, some financial institutions become involved in off-account lending. For example, the bank (or credit cooperative) which borrows the funds does not record the borrowing; rather, with the lender's cooperation, the funds are transferred directly into the account of the end borrower—the enterprise. The direct transfer of interbank borrowing to an enterprise
is beyond the scope of interbank call operations and escapes the credit quota control system. Overall, it disturbs the implementation of the state credit plan.

- **Interbank lending beyond the stipulated scope and period.** Interbank borrowings were designed to respond to the financial institutions’ shortage of reserves in the central bank, not to be used as credit funds. They are short-term by nature, normally on the basis of one day, three days, one week and so on. However, in the current situation, they can be used as credit funds, with periods as long as three months. They are often multilateral and successive, and often finance long-term loans by short-term interbank borrowing.

- **Disguised loans.** Some large nonbank financial institutions, mainly investment trust companies affiliated with banks, disguise their loans because of the strict limitations on them. For example, investment trust companies prefix the time and rate of return on their “investment” in the contract, which makes the investment like a loan. Some finance companies “lend” capital to nongroup firms for profit, which again, has the nature of a loan.

As most of the above channels are legal, the issue is whether they are supervised by macroregulations. These phenomena indicate that relying on the lending quota to control money demand is no longer effective.

Excessive deposits in the state banks are not related to the central bank itself, because before 1987, “other items” in the state banks’ aggregate debt were positive, although the amount was small.

During this period, both the credit quota and control of the money supply were used for financial macroregulation, with the latter the more popular of the two. From the fourth quarter of 1988, credit policy began to rely primarily on the credit quota, and in the same period, “other items” of the sheet moved into the red and grew increasingly. In September 1991, the figure was 66.6 billion yuan, and in August 1992, it was 150 billion yuan. Net interbank lending was about 30 billion yuan in the first half of 1991 and 44.6 billion yuan by the end of the year. By the end of April 1992, it was 63.9 billion yuan, and in August of that year, 70 billion yuan. In 1988, growth rates of lending, the M2 and base money were 16.8 percent, 22.4 percent, 22.68 percent, respectively; in 1989, they were 17.6 percent, 18.1 percent and 26.96 percent; in 1990, they were 22.2 percent, 27.9 percent, 26.93 percent; and in 1991, they were 19 percent, 26.8 percent, 29.12 percent.

Comparing the three rates, the growth of base money was the highest and lending the lowest. This indicates that control of the money supply was weakened while the focus was on credit control.

This year the situation is even worse. The share of very volatile M1 in M2 increased and threatened inflation. It is worrisome that under these conditions, financial
personnel still believe that single credit control can constrain the scale of credit, stabilizing the currency and preventing inflation (Economic Daily, October, 10, 1992).

Thus, single credit quota control may play less and less a part in AD regulation than in a traditional system. Further, it has other defects: Because the quota is issued through an administrative channel to the SBs, it affects the SBs’ autonomous rights, initiatives and efficiency.

- The SBs are not actively attracting deposits because more deposits do not mean a higher credit quota. This is “financial repression”.
- The SBs are less concerned about the quality of the lending, particularly when the banks must fill the quota in a limited time.
- SBs rely overwhelmingly on the central bank’s relending.
- Nonbank financial institutions develop in an abnormal response to market demand, but are not regulated properly.
- It seems that financial regulatory departments have great power over the credit quota, but not over the money supply. As has been said, water cannot be stopped from draining, if branch holes are blocked and the main gate is open.
- Local institutions resist macroregulations because the present methods are the traditional, administrative measures that conflict with market-oriented reform. Strengthening macroregulations is perceived as recentralization, while deepening reform is perceived as loosening macroregulation. Repetition of this kind of “recentralization or decentralization” will affect the goodwill the government enjoys.

As mentioned earlier, economic growth should be retained at a reasonable speed when AD regulation is weak. However, it seems a high growth rate is the only alternative, either due to the de facto present growth rate or the pressure of economic growth of the neighboring economies. Now, reform of AD regulation is more urgently needed.

Undoubtedly, some instruments of AD regulation in a market economy must be introduced. But, China is not ready to adopt the three tools of financial policy applied in developed economies, i.e., open market operations, rediscount and reserve ratios. Therefore, the credit quota cannot be relinquished, although it has many negative effects as discussed earlier. Meanwhile, some indirect instruments can be considered. They include:
• Enforcing control of the central bank’s relending to specialized banks. At present, the focus must be on recalling some of the excessive loans. More effective regulatory methods must be discussed.

• Government bonds may be considered as collateral for the SBs’ relending applications. In this way, the depressed bond market could be supported, while circulating money would be reduced and the central bank’s assets/debts structure improved. This would also force the SBs to attract deposits.

• The treasury is not allowed to borrow from the central bank to make up for its shortage of short-term circulating funds; instead, it issues short-term bonds.

• Interest rates, particularly lending rates, must be raised. Various phenomena are related to low interest rates, such as excessive bank deposits going through various channels to real estate and the stock market; the growth rate and ratio of households’ saving deposits declining; fiscal deposits decreasing; and, enterprises borrowing capital for long periods and paying no attention to using it efficiently.

• The central bank and head offices of specialized banks audit funding sources: For example, interbank call capital may be used for cash shortages, but not for credit lending, and nonfinancial institutions may not participate in the interbank call market. However, these requirements are not adequately followed. Thus, auditing must be enforced and the source of financial institutions’ funds examined.

• Direct lending by the central bank must be strictly controlled. This may involve an adjustment of functions by the banks, public financing, the central bank and specialized banks. It cannot be done immediately, but must be addressed in the next stage of reform.

• The SBs should be commercialized and not responsible for macroregulation. Since the central bank controls the “gate” of the money supply and raises interest rates to reflect supply of and demand for capital, commercialized SBs would pay more attention to attracting deposits, improving efficiency and the quality of their lending, which would support AD regulations.

Macroregulations should be based on the experiences of more than a decade. Moreover, financial reforms must be accompanied by reforms in other sectors, because they cannot move forward on their own. Economic reform needs to be carried out in an integrated fashion.
ACCELERATING FINANCIAL REFORMS

The financial system plays a significant role in economic growth and stability. This year’s high economic growth rate, overheated investments, inflation, abnormally rapid growth of the money supply and lack of order among financial activities indicate the financial system has become the bottleneck in the economy. The way to correct it is to accelerate the system’s reform.

Roots of the Problems and Their Effects

PBC’s objectives and functions. These are not clearly defined, its regulatory tools are outdated and its organizational structure and accounting regime are irrational.

For many years, PBC sought the dual monetary policy objectives of economic growth and a stable currency, focusing on the former, which often conflicts with the latter. This makes it difficult for decisionmakers to support economic growth by regulating the money supply, to avoid inflation and fluctuations, and to allocate resources optimally.

In general, PBC’s main function was to regulate the money supply and secure the financial system. Now, it is responsible for structural adjustment. However, it has not set any quantitative criteria nor examined asset risks and the liquidity of the specialized banks. Instead, it only proposed instructions and general policy requirements; as a result, the quality of bank assets deteriorated and operational risks increased.

Although the central bank developed some new indirect regulating instruments since the reforms began, these have not been effective because of loopholes caused by external pressure and internal conflicts of interest. Under these conditions, the credit quota remains the single tool; control over relending is loose and interest rates are inflexible.

The PBC branches, organized by administrative jurisdictions, are pressured by local governments and strongly motivated to decentralize, which is contrary to the central bank’s authority. Meanwhile, the regional PBC branches, by overseeing the specialized banks by administrative jurisdiction, fragment the system and negatively affect not only the large banks but macroeconomic regulations.

Due to financial needs, the PBC branches retain profits for their viability and salaries, but this conflicts with the international practice of an independent central bank. As a result, the central bank loses its neutral position and is motivated to expand credit.

13 In May 1993, DMRS conducted various financial reform studies with experts from SRC, PBC and SPC. This paper, which represents most of the findings, was submitted to the State Council in August 1993.
Administrative and management functions. These are not separated in the specialized banks. Authorized operations suffer from insufficient autonomy, while unauthorized operations lack effective constraints.

The specialized banks combine policy and commercial banking. Policy tasks are not guaranteed by the credit quota, and they disguise the risks and losses of commercial businesses, which is not healthy for the specialized banks’ operations or for policy lending objectives.

The specialized banks have conflicts of interest and are motivated to expand credit, but no mechanisms exist to limit the risks. When funds are scarce for planned lending, interbank lending increases; the State sets interest rates and differential rates for interbank lending, but branches of the specialized banks lend at much greater de facto rates, due to high demand. The income from the differential rates goes to nonstate institutions. The lack of transparency with the actual interest rates leads to corruption and other problems in the banking sector.

While the call for universal specialized banks is strong the government has not decided to publish regulations with respect to business classifications. Thus, a large amount of credit is transferred from the specialized banks.

An imbalanced financial market. Regulations for entering the market have not been clearly defined or implemented. As a result, some investors enter into inappropriate operations: For example, enterprises participate in the interbank market. This market is losing its original character and becoming a credit market apart from the banks, because interbank loans are granted for long periods and interest rates are high.

The corporate securities market is not operated in a standardized or transparent manner. Various channels of internal financing are out of control and increasingly enlarged given the weak market oversight. The government bond market lacks the banks’ support, and the MOF’s market operations affect the reputation of government bonds. Thus, the bond market is experiencing a severe recession.

The financial market as a whole is out of order, and prices are distorted. Interest rates are far too low, affecting macroeconomic stability; as planned rates are only nominal, market rates prevail.

A review of the financial system’s problems indicates the key to reform is to continue restructuring the central bank and developing a double-tier banking system. The reform must first eliminate local government’s interference in financial activities (which affects macroeconomic stability). To achieve this, authorities must aim to (a) develop macroregulations so the central bank can independently exercise monetary policy under the guidance of the State Council; (b) separate policy banking from commercial banking, with state-owned commercial banks as the main bodies coexisting with financial
institutions; and (c) develop a financial market that is open but uniform, competitive but orderly and strictly regulated.

To achieve these objectives, PBC’s functions must first be transformed to focus on the central bank’s regulation and oversight; second, at the time the policy banks are created, the commercialization of the state-owned specialized banks must be accelerated; they must also be autonomously operated, bear their own risks, be accountable and restrained. Further, financial markets should be completed, including the money, bond, stock and securities markets, to compete on the basis of orderly and standardized management.

Financial Reform in the Ninth Five-Year Plan

Reform of the financial system should be completed by the ninth five-year period in order to establish an efficient modern system for rapid and stable economic growth. The objectives are to:

- Create consistent instruments and objectives for the central bank’s monetary policy. The bank should control the money supply by adjusting base money and interest rates, and should replace quota limits by window guidance. The organizational system should be consolidated into a structure with a head office, regional (across provinces) branches and monetary regulation boards at the municipal and county levels.

- Commercialize the specialized banks and only retain branches in the large economic districts (an economic district usually covers four to five provinces). Accounting and other operational regimes should follow international customs. Major commercial banking groups should become internationalized.

- Complete the organization of the policy banks. At the same time, PBC should relinquish its function of regulating regional economies and industrial structures. Also, the legal reserve ratio should be reduced.

- Set up a national, standardized and unified financial market and enlarge the coverage of the existing stock market. Begin futures operations and provide good quality services for commodity futures operations. Approve laws to standardize the monetary, stock, bond, securities, credit and insurance markets.

- Complete the reforms needed to create a standardized foreign exchange market and make current accounts convertible.
Stages of Financial Reform

The central and local PBC is the key defect with respect to macroeconomic stability. Therefore, the central bank’s restructuring must be at the center of the reform and a double-tier banking system must be created.

Emergency measures. The key measures to cope with overheated investments and inflation and thus sustain economic growth are to recall bank loans and reduce credit. This way, payment difficulties can be eased and the base money supply reduced.

PBC must immediately centralize credit rights and decentralize the supervision of institutions and operations. In particular, it must take hold of credit authority, only relend to head offices of specialized banks and stop relending to nonbank financial institutions (after it recalls its current loans). Meanwhile, responsibility for overseeing specialized banks and other financial institutions should be decentralized to PBC branches at the provincial and municipal levels.

Also, PBC should stop allocating transregional funds to specialized banks. Its branches should no longer be responsible for managing reserves and supplying cash to the specialized banks’ branches, when they experience payment difficulties. Rather, the specialized banks’ head offices should manage the reserves (the reserve ratio must be retained at 5 percent and above) and intrabank allocations of capital. Bank presidents must be responsible for any payment problems so as to protect the banks’ good will and social stability.

PBC must create a system to regulate base money in response to the growth of the money supply, while strictly controlling the scale of credit and clearing up its interbank loans. Each financial institution must obtain a certain amount of government bonds, according to its volume of deposits. The supply and withdrawal of base money should be realized through issuing government bonds, mortgaging the policy banks’ financial bills, rediscounting bills and relending credit, etc., instead of through a single credit control.

Interest rates of deposits and loans must be raised, which will increase savings, withdraw cash and reduce the growth of M1, as well as reduce social capital and lower market interest rates. In the short term, interest rates for one-year deposits should be raised to 10 to 12 percent, and one-year loans to 12 to 15 percent.

The policy banks and policy investment system should be created in the near future. During this year, the State Long-Term Development Credit Bank and Import-Export Bank should be organized and by next year, an agriculture policy bank should be established. A special account management system must be created in the specialized banks before the policy banks begin to operate. The latter must not be profit-oriented and should operate with the principles of repaying principal and interest. With the State guiding industrial policy and plans, the policy banks should be autonomous and
responsible for their risks. They should introduce market bidding and commercial trust, where possible.

PBC’s head office and branches must separate from profitable financial, investment and other business institutions affiliated with them, at least in areas of finance and personnel.

The method of managing credit quotas must be improved. From now on, PBC’s quota for relending to specialized banks should be determined by the debt ratio in the total debt of the banking system. This will reduce the random quality of the credit quota allocations.

At present, given the irrational relation between banks and MOF, the central bank may issue financial bonds for adjusting interbank funds only for this year. In the future, it should use its open market operations for this purpose. To stop treasury overdrafts and borrowing from PBC, government bonds subscribed to by all financial institutions should be part of the credit scale, which can be adjusted when necessary.

Large and important cases of illegal fundraising must be prosecuted. The public should have information about the risks of various investment instruments. It must be stressed that fundraising, securities and equity dealing without permission of the financial authority is not legally protected. At the same time, equity issue requirements should be relaxed, and the approval procedure simplified and accelerated.

The state should offer some portion of its shares on the stock market and speed up the approval of applications for initial public offerings. This will increase the supply, restrain the inflated prices, and cool off the overheated market.

**Short-term financial reforms.** In the near future, branches should be opened in large economic districts, and those at the county, regional, municipal and provincial levels should be gradually closed. PBC’s banking Supervision Board should be created at the local level. PBC district branches should supervise monetary policy and the trading of government bonds while the Board should supervise the banks it registers and conduct research. In the reorganization, PBC’s financial services’ operation should be separated into, for example, an independent notes transport company and settlement center. Another national commercial bank should be opened to absorb PBC’s redundant staff. PBC’s new internal structure should be designed according to its macroregulatory functions.

The existing national banks—Bank of China (BOC), Industrial and Commercial Bank of China (ICBC) and Agricultural Bank of China (ABC)—should reduce their size after transferring policy operations to the newly established policy banks; they could emphasize playing the role of large banks. The specialized banks could organize themselves into bank groups and integrate with international banking. The People’s
Construction Bank of China (PCBC) and the China Investment Bank (CIB) should assign their policy operations to the policy banks and reorganize themselves as long-term credit commercial banks.

Municipal and rural cooperative banks should be set up as local commercial banks and registered and regulated by the monetary supervision bureau. Branches of the municipal cooperative bank at the municipal and local levels and rural cooperative bank at the municipal, county and town/village levels should all be independent entities. Rural cooperative funds should be community mutual fund institutions.

Regional commercial banks should be further developed. Besides the existing ones in the southeast, a few more should be established in the northeast, central and western regions. The income tax of these banks should be the central tax, and PBC should not provide them with loans.

The profit-retention system should be abolished in all PBC branches. Such profit should be turned over to the treasury and overhead costs, such as salaries and benefits, should be allocated from the budget at a level similar to that of other financial institutions.

A supervisory board of state commercial banks should be established to oversee use, value maintenance and growth of the bank funds. In the future, bank bankruptcies should be legal, but should be accomplished as a debt and equity purchase or merger. PBC should no longer interfere with the personnel policies of specialized and commercial bank branches; rather, it should examine their operations and propose penalties for illegal financial activities.

A mechanism should be devised that allows the central bank to regulate the demand and supply of funds by adjusting the base interest rate. It should adjust the specialized banks’ deposit interest rates and their floating limits according to macroregulation targets and demand and supply.

The specialized banks, as autonomous entities, should be able to apply floating interest rates to their loans (in a limited range); other commercial banks should also be autonomous. Commercial banks must manage their assets’ risks, introduce asset/liability management and set aside loan-loss provisions.

PBC’s regulation of the specialized banks’ asset risks must be strengthened; it must establish binding requirements on the quality of loans and change the asset/debt structure of the specialized banks.

**Regulations must be introduced through operations.** Securities, trust and insurance institutions affiliated with the banks and other institutions must be subject to
separate regulations with separate registrations and operations. They must be responsible for their profits, losses and risks.

The development of PBC's satellite settlement network should be accelerated; a membership settlement center should be created for banks and postal saving funds.

**BUSINESS SCOPE AND ORGANIZATION OF POLICY BANKS**

One of the prerequisites for transforming the SBs into state commercial banks is separating commercial banking from policy banking, which should be assumed by the newly established policy banks: These should consist of the State Development Bank, which would provide credit for high priority projects, the Import-Export Bank, which would finance the export of large orders of electrical machinery, and the Agricultural Development Bank, which would provide loans for agricultural products, poverty assistance and agricultural development projects.

In regulating the policy banks, one point must be stressed: They should not compete with commercial financial institutions, engaging in any business the latter are willing to do.

Strictly defined, the policy banks are not banks and should not be labeled so. For example, in Japan, many policy financial institutions are considered finance companies, except for the Development Bank of Japan and the Import-Export Bank.

Specifically, they should not accept household savings deposits, open current accounts for businesses, transfer or settle payments, or remit money for firms and individuals. Rather, they should focus on examining and managing policy lending and be ordinary clients of commercial institutions. In so doing, they should open accounts and deposit their funds in commercial banks and agricultural cooperative banks, which have branches all over the country; these funds would be transferred to recipient accounts when projects are approved by the policy financial institutions.

It is obvious that policy financial institutions do not need to open branches. The Agricultural Development Bank may need some agencies in the counties to check credit, given the nature of its business. But these agencies are not bank branches. They should be structured according to their scope of business, which must be clearly defined, so as to avoid being overstuffed or operated in a costly manner (and thus a burden to the State).

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14 This article was written by Liu Ying and published in the *Financial Times* (Beijing), January, 10, 1994.
CONFERENCE ON COMMERCIAL BANKING REFORM: A SUMMARY

Main Issues

Conference participants pointed out that the key issue of transforming the state banks (SBs) into commercial banks is not simply separating their policy operations, but rather developing operations and internal constraints appropriate for commercial banks. This means the banks must have clearly defined property rights and independence. Also, they should become special firms dealing with money, seeking profit and efficiency, and providing incentives to employees; macroregulatory functions should not be stressed. Mechanisms must be established to manage risk.

Some argued that the transformation will require adjusting the structure of ownership, that the SBs need to be transformed into joint stock companies, with the State holding controlling shares.

It was also stressed that the transformation of the SOEs, which are major clients of the banks, is the precondition of banking reform. With SBs dominating the financial sector, publicly-owned regional banks should be developed, and various banks should compete with each other.

Managing Assets/Liabilities and Asset Risks

It was agreed that regulatory methods must be adopted to meet safety requirements for banking operations and for integrating with international financial markets.

Managing the asset/liability ratio and asset risks consists of the central bank supervising these aspects, along with the commercial banks’ self-supervision. The former should focus on regulating the safety and liquidity of the banks’ operations, while the latter on regulating efficiency, safety and liquidity management. In other countries, two sets of indicators exist: One is the central bank’s requirement of asset/debt ratios and risky asset ratios in the commercial banks’ total assets; the other is the commercial banks’ own internal regulations for these items, which are set to optimize profits in a context of safety and liquidity.

The main issue for the commercial banks lies in the central bank’s reform, which should adapt to the market economy and change its functions. To control the money

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15 This is a summary report of a conference on November 15-16, 1993, in Beijing, with 20 delegates from PBC, ICBC, ABC, PCBC, BOC, BOCOM, Merchant Bank, Development Bank of Shenzhen and China Financial Institution, the Central Fiscal and Financial Institution and the Chinese Academy of Social Sciences. The report was written by DMRS, the conference sponsor, and the Department of Program and Information of ICBC, the cosponsor.
supply and supervise other banks, the central bank should use indirect instruments. Thus, in the short term, PBC must: (a) reduce or stop regulating the credit plan, and introduce asset/liability and asset risks management in the commercial banks; (b) clear up the problems associated with risky loans made previously; (c) improve the regulations for writing off bad debts, together with MOF; (d) based on the new accounting system, resolve the problem of the banks’ supplementary credit funds; and (e) control base money and ensure macroeconomic stability.

Structure and Competence of Commercial Banks’ Offices

National commercial banks must be maintained in order to guarantee that macroregulation can be conducted by the central bank. However, the size, organization, level and efficiency of the SBs must be adjusted in order that they operate rationally and efficiently.

National commercial banks should be a legal person with one level (headquarters). The current four levels of institutions within the SBs now have a strong local flavor and varied inclinations. However, in the near future, they should move to a three-level system: a head office, a branch office and a subbranch office. A final goal should be to establish two-level organizations with a head office and municipal branch office. The allocation of the commercial banks’ funds internally may be guided by monetary incentives but the banks’ branches should not be treated as independent institutions.

The head office of a commercial bank should be responsible for allocating funds within the whole bank, regulating the branches’ supply of capital and overseeing the safety of bank operations. It must centralize a certain amount of the branches’ funds. In this respect, ICBC proposed a complete systematic regulatory design, which includes the following: (a) it would distribute and readjust the bank’s credit quota; (b) it alone would deal with PBC’s relending to the bank, conduct some large-scale operations, guide the lending direction and adjust loan structures; (c) it would regulate the bank’s capital at the center, introduce a two-tier capital allocation system, and select one city as a relay station (for neighboring cities) to make up for head office delays in allocating capital; and (d) it would open a department to do business directly and establish an efficient information feedback system.

Relations between Commercial Banks and PBC

In general, the conference participants felt that in the relation between commercial banks and PBC, the latter must fundamentally change from providing administrative instruction to supervising business and macroregulating the former. Also, it should concentrate on making monetary policy, supervising banking operations and auditing, and should not compete with commercial banks or intervene in their business.
PBC's relending should be to the head offices of national banks and not to small commercial banks. Some pointed out that national banks should not be confined to the four SBs, and small banks should be encouraged to develop as national banks.

**Internal Clearance of Commercial Banks**

Some delegates discussed the clearance systems in other countries, where it appears these coexist at various levels. Large banks have their own systems and use the public clearance system for intrabank services; commercial banks may join the system voluntarily. This kind of public system, which is independent and has no direct links with the central bank, provides clearance services for small banks that do not have their own (due to the costs).

In China, large banks should have their own clearance system to ensure that operations are regularized, although the joint clearance arrangement should not be canceled. At the same time, PBC must complete an independent national clearance system that provides services for intrabank clearance. However, commercial banks should not be forced to join it. Also, it should not be required that large clearances above a certain limit be handled by PBC. The current regulation that PBC handle hundreds of thousands of payment transfers has many problems, such as slow payments, serious delays and errors with the operation, and poor quality service, which affects the flow of capital.
PART IV: GOVERNMENT BOND ISSUES

ABSTRACT

Changing the method for issuing and trading government bonds is the fundamental way to secure government financing. It is also the only alternative for establishing a central bank macroregulation mechanism and developing standard commercial banks in the socialist market economy.

Since 1981, government bonds were mainly sold through administrative channels to individuals, and little attention was paid to the impact of interest rates on the bond market. Since the bonds could not be traded, neither a sound primary market nor an efficient secondary market developed, which made it difficult to issue government bonds. For a long period, the shortfall in taxes had to be financed by MOF overdrafts and borrowing from the central bank. In turn, this forced the central bank to increase its base money supply, which undermined macroeconomic stability.

The change should involve financial institutions’ issuing (and underwriting) bonds to investors. The term of the issue should be determined by bidding to reflect demand and supply. This would guarantee a successful issue and a situation in which the financial institutions hold the lion’s share of government bonds in their portfolios.

If the bonds are issued successfully, this will prevent MOF from borrowing and accumulating overdrafts in the central bank and cut off the direct link between fiscal deficits and the base money supply; it will ensure the central bank’s autonomy in managing base money. Where financial institutions hold the bonds, the central bank may accept them as collateral when it relends to them; this will allow it to inject or withdraw base money from the economy by buying or selling bonds through its open market operation.

The large amount of government bonds held by the banks may serve as a secondary reserve and improve their asset structure, increase the assets’ liquidity, and guarantee payment. The banks will not need to draw on their payment reserves frequently and this will help control the money supply. Conditions for managing assets and liabilities will be created in the meantime.

If the financial institutions hold a large amount of government bonds, a large volume will be traded, and capital and money markets will take shape. The price of these trades will reflect the demand for and supply of capital and will improve interest rates.
If a government bond market is established, this would allow for trade among the banks' head offices and meet their need to guarantee payments and centrally mobilize funds within each bank. Thus, it would enable banks in China to operate more like standard commercial banks.

In brief, changing the method for issuing government bonds will resolve many problems at once.

**CHANGING THE METHOD OF ISSUING AND TRADING GOVERNMENT BONDS IN 1993**

In 1993, the fiscal deficit will reach 20.5 billion yuan. The success of government bonds is therefore critical.

**The Difficulty in Issuing Government Bonds**

Of the 37 billion yuan three-year government bonds issued in 1993 by MOF at 9.5 percent, 7 billion yuan will be aimed at institutions and 30 billion yuan at individuals. Under current market and financial conditions, it will be difficult to sell them at these terms. First, in December 1992, the price of five-year 1992 government bonds dropped to 92.8 yuan for those with a 100 yuan face value, i.e., the return was 15.01 percent, which was higher than the 9.54 percent annual lending interest rate in the SBs.

Second, about 8 billion yuan of various bonds purchased by the financial institutions (which joined the syndicate in 1992) could not be sold and 4 billion yuan of fiscal bonds are waiting to be issued. The underwriters who purchased government bonds in 1992 are clearly reluctant to purchase any more in 1993.

Third, the money market is tight, and the average rate of interbank loans already reached 9.5 percent on the market. It is widely anticipated that interest rates will be high, given the announcement of a 10 percent rate for special one-year, large deposits.

Under these conditions, to continue with the existing plan to issue the 37 billion yuan of bonds primarily to individuals would mean either increasing the rate of return or selling by administrative allocation. Raising the rate would increase the issuing costs and fiscal burden because interest payments would be 0.75 billion yuan more a year and 2.25 billion yuan in three years if the rate moves, say, from the 1992 rate of 9.5 to 12 percent. With respect to the administrative allocation, this would be a step backward and would encounter great resistance.

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16 This paper, written by Lou Jiwei, is one of the first that describes the necessity and techniques of issuing government bonds to financial institutions.
Thus, the current method of issuing government bonds will drive the rate of return higher than for other securities, a phenomenon only seen in China. In the United States, for example, individuals only account for 15 percent of total bondholders. Also, government bonds are not linked with the central bank’s monetary policy, which differs from common international practice.

Changing the Method of Issuing and Trading Government Bonds

We suggest that government bonds should be targeted at institutions rather than individuals, so as to take advantage of the benefits explained earlier. Our reasons are as follows:

- Most government bonds could be issued to financial institutions at 9.5 to 10 percent, with a three-year maturity;
- Enterprises may discount their government bonds in banks without using their credit quotas, as long as a repurchase agreement (RP) is signed;
- Banks may get funds from PBC by having their government bonds rediscounted and signing an RP;
- Project loans and relending of PBC must be limited in scale and be made only for necessary policy credit;
- After the central bank’s credit lending is deducted from the base money, the amount remaining should be the intermediate target for government bond buying and selling;
- PBC must regulate the discount rate and price of bonds it buys and sells;
- The short-term fiscal deficit must be covered by short-term treasury bonds (three to six months), not by borrowing from PBC, and the return rate can be floating;
- The trading of government bonds among financial institutions could be enhanced. Banks holding government bonds could meet their short-term funding requirements by selling bonds to other banks on the market, so as to ease borrowing pressure on PBC and thus reduce the supply of base money.
- PBC must continue its loan quota control and also begin to use the rediscount and open market operations; this should change the current situation in which the money supply is much larger than the scale of credit.

Expected Consequences

The above measures would produce the following:
• Interest rates of government bonds could be maintained at approximately the level planned;

• Government bonds are at an advantage, given their higher liquidity (since financial institutions and enterprises would prefer holding them);

• PBC’s control of the money supply would be transformed from a direct to an indirect method, which would facilitate the effort;

• The relation between public finance and banks would be rationalized.

Although the above measures are manageable, the key issue is that PBC’s relending to SBs and nonbank institutions must be strictly controlled.

**A Design for Issuing and Trading Government Bonds**

**Background**

The mechanism to issue government bonds needs to be changed, urgently. Since the first government bonds were issued in 1981, progress has been made with the different methods used. These include administrative allocation with tradability, institutional underwriting in 1991 and 1992, and trading in the stock market and the Securities Trading Automated Quotation System (STAQ) system. However, these methods are still far from meeting the needs of the market economy and the demand of central government financing. Thus, it is thought that more government bonds need to be issued, and an irrational mechanism would cause problems.

A new instrument is needed for the central bank’s regulation of the money supply. The loan quota control now used must be supplemented with new indirect instruments to improve the effect of macroregulation. However, no tools are available for the central bank to conduct open market operations. The short-term financial bonds PBC will issue this year are not an object of the open market.

The problem of bank payments must be solved. The payment reserve rate of specialized banks was 3 to 5 percent, which was quite high by international standards, and cash was not expected to be scarce. However, a shortage occurred because many specialized banks had insufficient assets of high liquidity (since they were not managing their liquidity). In developed economies, the reserve rate is only 1 to 2 percent but the banks can cope with payment difficulties by selling out their government bond holdings;

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17 This reform proposal was put forward by DMRS and refers to the difficulties encountered in issuing government bonds by administrative methods, in the first half of 1993.
a regulation exists with respect to the share of highly liquid assets they must retain, out of their total assets.

Proposals

**For issuing bonds.** The government should primarily target institutions, such as financial institutions and mutual funds. Such bonds have the lowest risk of all financial instruments and can be used as collateral and short-term credit among banks. Only when bonds are widely held by financial institutions can they become liquid; and, the increase in the amount held means an increase in the banks’ liquid assets. Individual buyers usually purchase small amounts and redeem them in time, causing the issuing cost to be high.

The price of government bonds should be determined by the underwriters’ bidding. The main reason why this year’s issue was difficult was that inflation is expected to be high and rates of return of internal fundraising, the stock market and real estate are as high as 15 to 20 percent. Thus, government bonds with an interest rate of 12 percent and allocated by administrative order can hardly be attractive.

**More categories needed.** First, short-term treasury bonds should be issued to increase the flexibility of the central bank’s open market operations. Futures and options should be developed, which would reduce the investment risk and promote the government bonds.

The date of issue and method of paying interest should be changed. As an investment tool, government bonds should be convenient to investors. The issue date should be fixed, not once but a few times a year, and interest should be paid not only at the maturity date, but every year or half year.

Given the developed economies’ low interest rates, a considerable amount of government bonds could be issued to foreign investors.

**For trading bonds.** The business of government bond mortgages and buying and selling among financial institutions and between them and enterprises should be developed. Enterprises may have their government bonds discounted in banks without being regarded as using credit quotas, as long as an RP is signed. Banks may get funds from PBC by having their government bonds rediscounted and signing an RP. Banks holding government bonds may meet their short-term funds requirement by selling them to other banks on the market, thereby easing borrowing pressure on PBC and reducing the supply of base money.

The technology of trading bonds must be improved. Experiments should be carried out on issuing and trading paperless government bonds, so as to develop a modern system of transfer and clearance.
Coordinating government bonds and monetary policy. Government bonds or policy bank securities should be collateral for other banks borrowing from the central bank. Large holdings of the bonds by institutions creates the condition for the central bank’s open market operation, by which it can adjust the base money supply.

PBC’s project loans and relending must be limited in scale and only made for necessary policy credit and the state purchase of agricultural products; the latter should be done by discounting bills (i.e., finance only what is spent).

After the central bank’s credit lending is deducted from its strictly controlled, base money injection scale, the amount left should be the intermediate target of the government’s bond operation.

PBC should adjust the ratio of mortgage loans of the government bonds and state policy bank securities, and trade them at market prices.

The volume of government bonds purchased by financial institutions should be counted in their credit quota, or they would become added credit, and therefore exceed the quota. Thus, the quota should be enlarged if it is not high enough to include the purchase of government bonds this year. After this year, requirements with respect to the credit quota and volume of government bonds purchased should be determined and noted to the institutions at the same time.

Short-term fiscal deficits must be covered by short-term treasury bonds (three to six months), not by borrowing from PBC; a floating rate of return can be applied. PBC should offer some special credit quota to encourage financial institutions to buy short-term fiscal government bonds.

A market for government bonds and state policy bank debt should be developed. Financial institutions may obtain funds by selling government bond holdings and signing RPs.

PBC must continue its loan quota control, at the same time as it begins to rediscount and operate in the open market; this would change the current situation, in which the money supply is much larger than the scale of credit.
SOME ISSUES RELATING TO GOVERNMENT BONDS\textsuperscript{18}

The New Regime

Government bonds should be targeted primarily to financial institutions and mutual funds.

Government bond prices should be determined in the market by underwriters' bidding.

Short-term bonds should be issued (one, three and six-month maturities), and futures and options should be developed in due time to reduce the risks and facilitate the issuance of the bonds.

Enterprises may have their government bonds discounted in banks without having them applied against their credit quota, as long as an RP is signed. Financial institutions holding government bonds may meet their long-term need for funds by selling the government bonds on the market, and short-term need by selling them and signing RPs.

Government bonds issued to institutions have a paperless form. A financial satellite net should be employed to set up a transfer and clearance system.

The short-term fiscal deficit must be covered by short-term treasury government bonds (three to six months), not by borrowing from PBC. PBC should arrange some special credit quota to encourage financial institutions to buy short-term government bonds.

Borrowing by other banks from the central bank should be guaranteed with government bonds or policy bank securities. The central bank should adjust the base money supply through its open market operations.

PBC should adjust the mortgage rate of government bonds and policy bank securities from time to time, selling and buying them at market prices.

PBC may continue lending for the state purchase of agricultural products and payment for foreign exchange next year if the agriculture policy bank is not created by that time. However, no loans should be made for other purposes.

PBC should establish the requirement for the purchase of short-term government bonds together with the credit scale next year.

\textsuperscript{18} This was an internal report submitted by DMRS in an attempt to push forward the government bonds and financial reforms in 1994.
The outstanding balance of PBC’s long-term relending to the specialized banks should be transformed to the balance of government bond holdings. In turn, the Treasury should transform the debt of the specialized banks to PBC into equity investment to the specialized banks so as to solve the banks’ problems of undercapitalization.

**Expected Effect of the New Regime**

Financial institutions’ large holdings of government bonds will provide the base for the central bank’s market operation. However, the existence of short-term government bonds is not the precondition for open market operations. The central bank may turn the long-term government bonds into short-term financial commodities by signing RPs (trading them). In developed economies, the central bank can use extralong-term government bonds (10- and 20-year maturities) in their open market operations.

Also, large holdings of government bonds may ease the payment problems and thus end the use of payment reserves. The use of excess reserves will increase the money supply without increasing the base money controlled by the central bank. Holdings of government bonds will apply as a secondary payment reserve, which could serve as an emergency payment without increasing the money supply.

In addition, large holdings could provide a new channel for financing or transferring credit among banks. Lacking such a channel, banks would use the interbank market for credit activities and illegally turn this money market into a de facto capital market, raising the level of risk for banks and distorting interest rates.

The issue of government bonds would no longer be done by administrative allocation; the cost of issuing them would be reduced, with institutions rather than individuals being the main target.

**The Most Pressing Issues**

PBC should work out regulations for the banks’ liquid assets. The ranking of assets should be cash, payment reserves in the central bank, government bonds, policy bank securities and other bonds.

The amount of government bonds that banks should purchase can be calculated on the basis of the share that government bonds represent in the banks’ total assets. For example, if the share stipulated is 10 percent, then the amount they should purchase would be 200 billion yuan: The total volume of government bonds and policy bank securities to be issued next year can be calculated (70 to 90 billion yuan government bonds, 50 billion yuan Development Bank debts and some Import-Export Bank debts), and all could be purchased by financial institutions. Attention should be paid to the bonds’ maturity structure, particularly to the short-term bonds, not only with respect to short-term public financing needs but also to the banks’ needs to hold and cash them at
maturity. A certain part of bank assets should be in the form of government bonds, with RPs or short-term government bonds.

The government bond RP market and short-term bond market should be set up in the near future. The government bond market for those with over one-year maturity will differ from the government bond RP market. The former is a long-term capital market while the latter a short-term, interbank money market. A certain share of the government bond transactions must be conducted at the short-term market, in order to guarantee safety and low risks for the banks.

**SUGGESTIONS FOR GOVERNMENT BONDS IN 1994**

In 1994, 100 billion yuan of government bonds will be issued, placed mainly with financial institutions. At the same time, the central bank will begin its open market operations. This represents a profound change in the way government bonds are issued and traded, as well as in the relationship between public finance and banking. It is expected to have a major impact on the effectiveness of macroregulations and the safety of the banking system. The key steps will be to make the government bonds the secondary payment reserve in commercial banks and to change the issuing and trading methods so as to increase the bonds' liquidity.

**The New System**

The measures to be taken with respect to issuing and trading the bonds include the following:

- MOF will no longer overdraw from the central bank;
- All government bonds will be underwritten by financial institutions;
- The central bank will introduce government bond mortgages, along with buying and selling them;
- All banks will begin to manage asset/liability ratios and asset risks;
- Government bonds will become the secondary payment reserve in commercial banks;
- Markets for issuing and trading government bonds will be developed;
- Some short-term government bonds will be issued.

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19 This report was written in November 1993 and submitted to a meeting of the State Council.
To introduce these measures, some elements need to be addressed. First, the payment reserve ratio should be significantly reduced. At present, the ratio required by the central bank is 5 to 7 percent. In other economies, commercial banks hold a large amount of government bonds as the secondary payment reserve, while the payment reserve ratio is only about 1 percent. Thus, the ratio should be reduced to about 2 percent or even 1 to 2 percent next year when the banks begin managing assets/liabilities and asset risks. At the same time, they will need to retain a certain amount of government bonds, about 60 to 80 billion yuan, with a bank deposit of about 200 billion yuan.

A well-designed mechanism will motivate the banks to hold the government bonds, even with their low rate of return. The requirement to manage the assets/liability ratio next year will make only 75 to 80 percent of the banks’ deposits available for lending, and at least 20 percent of their assets will need to be highly liquid, to guarantee their safety. The banks then will choose between cash reserves, government bonds and interbank loans (these have a time limit of one week), with 13 percent of deposit reserves and 2 percent payment reserves fixed by the central bank. Government bonds will be preferred to cash because there is no return from the cash reserve—only a high cost. In this scheme, the bonds’ interest rate should float between the rates for payment reserves and deposits.

The interbank market should be the primary arena in which the bonds are traded, with participation limited to head offices. The central bank will relend only to the head offices of the national commercial banks. The specialized banks’ head offices will be responsible for the banks’ payments and safety with efficient instruments. Trading will occur only in a Beijing market. This should be not be difficult to establish, since PBC and head offices only need to agree on the way in which prices are offered, sought, confirmed and signed (the latter by the RPs), which would be assisted with some hardware. The existing clearance net can be used for settlements. It is unnecessary to follow the example of the stock exchange, which created a visible exchange center.

Last, there must be a guarantee that the bonds will be cashed in time and not delay institutional holders. Long-term government bonds should represent a large share in the total but short-term ones (three- to six-month maturities) will also be traded, to meet the needs of public financing and facilitate the liquidity of the holders’ portfolio. The central bank should be autonomous when using government bonds as a monetary policy instrument and should be able to set the mortgage rate. In most cases, credit relending should cease.

**Expected Effects**

A large number of bonds will be issued at low cost, mainly to financial institutions, postal savings and pension funds (about 80 to 100 billion yuan), with only a small portion to individuals.
The banks' ability to guarantee financing and payments will be improved. Interbank lending will become the major source of funds for current clearance, while bond transactions can serve for interbank financing. Also, the banks can adjust their credit mutually by reducing the time between selling and purchasing the bonds.

The new system will improve the relationship between the treasury and banking sector, as well as the effectiveness of indirect macroregulations. This will be critical to next year's economic stability, since, with a current payment reserve ratio at 11.08 percent, introducing assets/liability ratio management will bring a new round of credit expansion. When joined by a government bonds issue of over 100 billion yuan, this will imply an expansionary fiscal policy and may lead to overheating of the economy, if the trading is not transformed from its current bias for individual buyers. However, with the new mechanism, monetary policy could be tightened, because the excessively high payment reserves would be absorbed by government bonds. It is recommended that a large volume of bonds be issued at the beginning of next year, and preparations should proceed with greater speed.

**Changing the Way Government Bonds are Issued and Traded**

It is crucial that the issuing and trading of 100 billion yuan of government bonds in 1994 be successful. A suggestion has been made that banks open a "government bonds saving account" with higher interest rates than other deposit accounts, and that the funds received be used to purchase government bonds. Depositors would be free to withdraw their money at any time. However, this scheme presents some problems.

First, there is the question of how to assign the quota of the "government bonds saving account" to each bank, head office and branch, if volumes are restricted for this kind of account. Some households may not be able to open such accounts due to a shortage in the banks’ quotas, which would be unfair.

Second, if there is no ceiling on such accounts, they will attract all new deposits and even some old ones because of their higher interest rates. As a result, deposit interest rates will rise.

Third, this kind of account means the banks will owe household depositors, while they in turn are owed by MOF, when they purchase government bonds with the funds from this account. In the end, it means the bank will be lending to MOF.

Thus, it is not an appropriate resolution to the problem. Instead, all government bonds must be underwritten by financial institutions (underwriters), and then distributed...
to retailers, i.e., financial institutions that do not participate in the syndicate. Finally, the bonds must be sold to various investors.

To establish the government bond market, the following should be stressed:

- Instead of paying interest at maturity time, it should be remitted once a year, regularly, as is done worldwide. This would promote holding the bonds as a long-term investment;

- MOF might consider issuing bonds on credit to securities and investment trust companies, so their purchasing power will depend not on their own capital but on their ability to sell to final buyers (or the underwriters might underwrite more than they can afford with their own capital). They could repay MOF at the end of the bond issue, when they are paid by the final investors;

- One week of issuing government bonds is too short for the underwriters to sell them. Thus, it should be extended;

- According to the 1994 plan, 20 to 30 billion yuan will be issued to individuals, who can neither receive interest payments regularly nor transfer the bonds on the market: The holders cannot sell or buy them and make marginal profit. This will reduce the bonds’ attractiveness. Thus, individual holders should be allowed to sell their government bonds to financial institutions at current market prices, and supervision over the government bond window should be strengthened;

- As planned, of the more than 10 categories of government bonds issued in 1994, only one (a three-year maturity, in paper) will be issued to individuals; the other four will be issued to institutions and individual investors purchasing large quantities. This classification, that separates individual government bonds from institutional ones, should be abandoned, and all categories except six-month, short-term bonds should be made available to individuals through the underwriting of financial institutions;

- Individuals should be allowed to choose government bonds in paper or paperless forms. For the latter, buyers should be able to open accounts in financial institutions with a government bond book, to record the categories and amount of their holdings;

- The central bank may buy a portion of old government bonds to lower their return rates on the secondary market and thus promote new issues. Investors would buy the old bonds instead of the new issues if the rate of return on the old ones is higher;

- Information should be provided to potential buyers about the location of the sales agents, their business hours etc., to facilitate trading.
Developing an efficient government bond market is the way to make them transferable and liquid. Unlike the stock exchange, the bond trade would occur at the OTC market, and would thus be scattered. The market would have two tiers: One for trades between individual holders and financial institutions and one, the so-called government bonds open market, for trades among financial and nonfinancial institutions. The bond market would be decentralized and invisible, operated through the communication network. It would thus be called the "telephone market;"

The invisible trade among financial institutions would be linked with the government bond registration and settlement companies that register the underwriting of new bonds and provide settlement and account transfer services for existing bonds. The Registration and Settlement Company of the Shanghai Stock Exchange should not handle this task; rather, a new national central registration and settlement company should be set up, making use of PBC’s satellite financial communication network. The existing NET company may be transformed into such a company. This would help the central bank and MOF obtain access to complete information of nationwide government bond issues, holdings and trades;

The latest information on government bond transactions, such as prices, should be published every day in the business offices of the financial institutions and in newspapers, and broadcast on television prime time (for example, after the weather forecast) to keep people well-informed and avoid unfair competition.

**Base Money Supply and Short-Term Government Bonds**

The first aim of the central bank’s monetary policy is to stabilize the value of the currency; it should be achieved by controlling the money supply, through injecting or withdrawing base money, rather than by covering fiscal deficits or issuing government bonds.

By cutting the direct link between base money and public finance, the reverse mechanism by which the central bank must release base money to cover fiscal deficits will be eliminated. However, base money can still be released by the central bank to purchase government bonds, since this is one of the channels for its release.

The state's fiscal capacity is determined by its share in the money supply. Newly released base money, B creates K times of new money M by the bank's creating credit, the formula is then M=K·B. If B is spent on new bonds, the issue will go successfully. That is, 1/K amount of the newly released money will be absorbed by MOF before it goes into credit creation. More important, the cost of issuing government bonds will be

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reduced significantly if B is spent on the bonds. If the amount of newly issued base money is less than the amount of new government bonds, the gap would be 2 billion yuan, which would have to be absorbed by the State through a larger share, in either existing money or base money; i.e., a certain amount of money would be transferred in the central bank from the accounts of the financial institutions that underwrite the government bond issue, to the treasury account.

Government bonds may be issued several times a year in order to coordinate with the central bank’s release of base money. The best choice is to spend the new base money in short-term government bonds. In Japan, the government issues two-month, short-term bills each week, of which 99.9 percent are subscribed to by the Bank of Japan.
PART V: FOREIGN EXCHANGE SYSTEM REFORM

ABSTRACT

The foreign exchange system will be an important element in the central bank’s monetary policy: It will further open the economy, promote rapid and sustainable growth and maintain balance of payments.

The existing foreign exchange regulations were devised in the planned economy and are characterized by centralized revenues and expenditures. Various changes have occurred since the reform began, such as the foreign exchange retention regime and opening of foreign exchange swap centers; these helped stimulate initiatives of export firms, encouraged foreign investment and developed foreign trade. However, some premature measures were taken, such as granting legal permission to export yuan, hold foreign exchange and open foreign exchange accounts; allowing a number of firms to open foreign exchange accounts; and acquiescing in the circulation of foreign currencies in domestic markets. These measures are different from those practiced internationally and the defects are appearing as interactions between China and the world increase. Further reform is needed.

International experience shows that achieving currency convertibility first occurs only with current accounts. In this stage, under a strict foreign exchange surrender regime, capital outflows are restricted under capital accounts, and the floating market exchange rate is regulated. Local currency is not fully convertible until the economy strengthens and expands internationally.

In China, the long-term goal of foreign exchange reform is a fully convertible local currency; it seems that convertibility under current accounts is an avoidable stage. To achieve this, conditions must be created for Yuan’s convertibility under current accounts, which include unifying the dual exchange rates, abolishing the foreign exchange retention regime and foreign exchange certificate (FEC), strictly regulating outflows under capital accounts, and introducing a regulated floating exchange rate based on the standard interbank market rate.

International experience shows that to achieve convertibility under current accounts, the key factor is not the size of foreign reserves but a stable currency and an exchange rate that reflects real demand and supply. Where attempts at convertibility failed, this was attributed to exchange rate controls and overvalued local currencies, which caused imports to increase and restored exchange approvals (for import). Such lessons must be heeded.
FOREIGN EXCHANGE REFORMS

Short-Term Objectives

In three to five years, the objective of foreign exchange reform is the yuan’s partial convertibility under a limited range of current accounts.

Current accounts consist of (a) imports and exports; (b) services for production and trade, such as air freight, shipments and communications; (c) export of labor services; (d) remittance of foreign direct investment (FDI) profits; (e) import and export of tourism; and (f) foreign exchange for personal use.

A limited range of current accounts means excluding items d, e and f, as they can easily result in capital outflows during the first stage of reform. Full yuan convertibility requires a longer time to achieve.

The reforms involve several critical measures. Those holding foreign exchange must surrender their receipts to banks at market floating rates; no exchange is retained and no exchange accounts are opened. When individuals need foreign exchange within the limited range of current accounts mentioned above, they may pay yuan and provide legal documents to the banks, which, in turn, will remit foreign exchange abroad on their behalf.

The floating rate will be set on the interbank market within the range that reflects the central bank’s base rate. Aiming at the balance of payments, the base rate is a weighted average of the exchange rates between yuan and “a basket of foreign currencies,” which consists of major foreign currencies and those of major trade partners. Foreign exchange is traded on the interbank market at floating rates within the prescribed limit. For its part, the central bank maintains a stable market floating rate by buying or selling foreign currency and adjusting the base rate when the fluctuation is too sharp.

Various restrictions must apply to some items under capital and current accounts. These include requiring permission to borrow from and invest abroad; also, remittances of FDI profit must be checked, personal use/export and volume of foreign exchange must be limited, and incoming tourists’ foreign exchange requirements must be controlled by “exchange memos.” Only appointed banks can be involved in international financial operations.

This paper was submitted to authorities in November 1992 and represents the earlier design of the foreign exchange reform.
Implementation Steps

Exchange retention is not an appropriate transitional step. It is not commonly practiced by other countries. Also, foreign exchange outflow would be very strong if the reform is not accelerated, because the public would have less confidence in the yuan. Under such conditions, it would be difficult to regulate foreign exchange.

Local authorities usually welcome the retention regime, but it would be difficult to control if the administration of foreign exchange is too localized. Also, transactions on the swap market would be small, have a high cost and subject to sharp fluctuations.

Thus, we suggest a straightforward move toward partial convertibility from the quota retention regime. The steps would be as follows.

- In the near future, the official exchange rate must be raised to integrate it or bring it closer to the market rate. This would reduce the current large gap between the two.

- The quota should be distributed to the banks appointed to buy and sell, but a limit must be set on the volume they may buy, to prevent hoarding.

- When the quota price is low, enterprises should be required to apply it during a particular period. At the deadline, the banks would purchase all the remaining quota. Neither the quota nor spot exchange retention regime will apply to newly received foreign exchange.

**Convertibility of Yuan**

Range of Convertibility

The major current account items include (a) imports and exports, (b) supplementary items of trade, e.g., air freight, shipments, insurance and communication services, (c) remittances of FDI profits and (d) tourism imports and exports and exchange for personal use. Convertibility under trade accounts refers to items a, b and c, a range that is wider than normal trade accounts and narrower than current accounts. A partially convertible yuan must be accompanied by a surrender of exchange and integration of dual exchange rates. If the retention regime continues, it would be difficult to distinguish which part of the retained exchange is used for current or capital accounts. Dual exchange rates mean foreign exchange is controlled under trade accounts, which implies no convertibility.

23 This report was written by DMRS for discussions on the foreign exchange reform plan in August 1993.
Regulation of Current Accounts

Foreign exchange controls are lifted within a stipulated range; in their place, quota restrictions are applied, or permission is granted for amounts beyond the range.

Foreign exchange required for import and export and associated items is usually approved, except in special cases. Most firms importing goods may pay yuan at market exchange rates to the banks, with legal documents; the banks will remit foreign exchange abroad in their behalf. Only a few goods require an import license; this is the responsibility of foreign trade regulation policy, not of foreign exchange regulation.

To remit FDI profits, the contracts approved by authorities when the enterprises were established must be followed. If more foreign exchange is needed than the amount stipulated in the contract, authorities must approve this.

With respect to tourism, incoming visitors must exchange their foreign exchange for yuan at entry and exchange their yuan (for foreign exchange) upon leaving, by producing the exchange receipt they completed on entering. More exchange bureaus are required.

Individuals traveling abroad can purchase a limited amount of foreign exchange, when identified with their passports and visas.

Enterprises with FDI

If foreign-funded enterprises are allowed to keep foreign currency accounts rather than surrender their export receipts to banks, this can create problems such as insufficient investment, capital outflow, arbitrary imports, and smuggling foreign exchange out of the country. It could also create incentives for domestic enterprises to participate in false joint ventures to take advantage of retaining export receipts. Further, these firms could form a special exchange rate when buying and selling among themselves, which would create a dual exchange rate.

Thus, these enterprises must surrender their foreign exchange; however, they should not be required to balance it themselves.

Foreign Bank Operations

Eighty foreign or joint venture banks operate in China, providing settlement services for the foreign-funded enterprises international trade. However, they are not permitted to do business in yuan.

If these enterprises are required to surrender their foreign currency, regulations must be modified to allow foreign banks to operate in yuan, although they would not be
allowed to buy or sell foreign exchange on the market. Rather, they must accept the market rate. In the event they have a shortfall of yuan, they could sell some foreign exchange to the banks handling currencies or to the central bank.

**Exchange Rates and Foreign Exchange**

Six national banks [ICBC, ABC, BOC, PCBC, the Bank of Communications (BOCOM) and the China International Trust and Investment Company (CITIC) Industrial Bank], seven small banks (Everbright Bank, etc.) and several big trust and investment companies should be authorized to deal in foreign exchange. About 20 financial institutions use PBC’s satellite financial communication network to establish foreign exchange quotations, and buy and sell foreign currencies. The central bank must stipulate their minimum level of holdings (of foreign exchange), that is, the number and amount of foreign currencies they must keep each day to operate smoothly. BOC’s foreign exchange must be strictly limited to prevent a possible monopoly, and any currencies above the limit must be sold to the central bank.

PBC establishes the base rate of foreign exchange by calculating a weighted average calculated on the 20 institutions’ trading prices from the previous day. Quotes to their customers should be set with marginal floating around PBC’s base rate. Institutions may set different rates.

The central bank should create the postreform foreign exchange market by combining the interbank market with the foreign exchange auction. According to current practice, 50 percent of export receipts must be sold to the central bank. This share is too high and should be lowered to 30 to 50 percent, which would allow the banks to hold enough foreign exchange to meet two weeks’ payments. Besides the 20 institutions’ operations, the central bank will auction part of the foreign exchange it purchased in the system, depending on each bank’s stock of foreign exchange and changes to the exchange rate. This would ensure that banks could make their foreign exchange payments and influence the exchange rate.

After the reform, the State Foreign Exchange Administration Bureau (SFEAB) will no longer participate in foreign exchange transactions; instead, it will supervise the enterprises’ foreign exchange receipts and their settlement with the banks, and focus on the banks’ receiving and disbursing foreign exchange so as to prevent capital outflow. Exchange payments in relation to the capital account should be prohibited, except for special cases.

International experience shows that the failure of currency convertibility is due to exchange rate controls and overvalued domestic currencies—which, in turn, leads to expanded imports. The postreform exchange rate must be floating and determined by balancing demand and supply.
Implementation Steps

At present, 13 banks are establishing a foreign exchange quotation system on the financial satellite network. PBC will no longer monopolize the buying of foreign exchange but will release a portion to other banks to adjust their supply and affect the exchange rate. More exchange bureaus should be created. The documents used in foreign exchange transactions should be redesigned, and policy on foreign-funded banks modified.

After January 1994, the official exchange rate should be abolished, dual rates should be integrated, and the practice of requiring permission to carry 6,000 yuan of foreign exchange aboard should be abolished. Prices marked in foreign exchange or FEC should be changed into yuan. The enterprises’ current foreign exchange holdings should be sold and the quota used within a limited time. Foreign exchange will need to be reported and surrendered. Individual foreign exchange deposits (category C) must be changed into yuan if used domestically, and subject to a ceiling, if carried aboard. Individuals will be encouraged to sell their foreign exchange to the banks.

FOREIGN EXCHANGE REGULATIONS, THE EXCHANGE MARKET AND CONVERTIBILITY OF YUAN

Foreign Exchange Regulations

A number of changes have occurred since the reforms began in 1979, such as the foreign exchange retention regime, and the opening of swap centers. New policies were imposed, such as granting permission to carry less than 6,000 yuan aboard; holding of and opening foreign exchange accounts; endorsing various firms’ opening foreign exchange accounts; and permitting the circulation of foreign currencies in domestic markets. These measures helped stimulate export firms’ initiatives, encouraged foreign investment and developed foreign trade. However, some differ from international practice, and the defects have appeared over time as interactions between the Chinese and world economies increased. The most apparent shortcomings are the following:

- The quota control and retention regime applied to export receipts discourages the transformation of the exporting firms and fails to facilitate the use of foreign exchange by the State or attract foreign investment;

- The existence of three channels to obtain foreign currencies—official, swap market and black market—results in multiple rates of foreign exchange, confusing price signals, conflicts and loopholes in foreign currency regulations, and speculation. The

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24 This DMRS report was published for internal use in September 1993.
distorted mechanism by which the price of foreign exchange is established makes it difficult for the official rate to function in adjusting the balance of payments. Thus, a shadow exchange rate, formed around the swap market rate, becomes the real determinant in foreign trade;

- The Government’s foreign exchange swap market does not correspond to international practice; indeed, most participants are nonfinancial institutions such as local governments, government agencies and enterprises, and banks and other financial institutions are not permitted to trade. Also, the administrative allocation of the quota, plus regional segmentation of trade, makes transactions inflexible and prices fluctuate sharply;

- Regulatory policy is confusing and ineffective; quota regulations require a very strict regime. However, weak supervision and enforcement, along with an enlarged foreign exchange retention experiment, decreases the rate of surrendering each year, and foreign exchange evasion is serious. At the same time, the strict control over current account expenditures and loosely regulated capital account expenditures led to a vast outflow of capital: In 1990-92, outflow was much higher than inflow, and foreign exchange is scarce: For example, in 1992, the net outflow of capital was about $10 billion. Further, allowing foreign currencies to circulate in some areas and foreign exchange accounts to be opened led to an uncontrolled black market exchange which reduced the position of Yuan. Based on incomplete statistics, the amount of HK dollars now circulating on the mainland is as high as 14 billion yuan, which accounts for nearly one third of the total amount of HK dollars issued; and, the amount of foreign exchange owned by households is over $10 billion. The current rule that permits yuan to be carried abroad allows the currency to be converted into foreign currency outside the country, while it cannot be converted into foreign currency domestically. This provides a legal channel for smuggling domestic currency abroad.

**Converting Domestic Currencies**

International experience shows that to achieve convertibility for domestic currency, the first stage should focus on only the current accounts of the balance of payments. This period involves strictly surrendering exchange, restricting capital outflows under capital accounts, and regulating the floating exchange rate. These measures are needed because domestic currencies do not become fully convertible until the economic strength and degree of internationalization are substantially improved. The period has three stages.

In the first, the official exchange rate must be adjusted to reflect the scarcity of foreign exchange. Usually, this means depreciating the local currency, and imposing a managed floating rate.
Also, the surrender of export receipts must be strictly enforced, and all foreign exchange must be sold to the central bank. In a few countries, special policies are adopted to satisfy the demand for foreign currency outside the country.

At the same time, control must be relaxed over items in the trade account: with appropriate certificates of approval, foreign exchange payments can be made by providing Yuan to the banks that send foreign exchange abroad.

Items that could lead to capital outflows must be strictly controlled: FDI profit remittances and borrowings from and investments abroad must be strictly checked before obtaining approval; the amount of foreign exchange needed by individuals for tourism must be approved and limited.

In the second stage, a restrictive foreign exchange regime should be continued, but the central bank would no longer be the sole purchaser of export receipts. Exporting firms may choose one of the many designated foreign exchange banks authorized for foreign exchange operations to which they will sell their foreign currency at a floating rate.

Banks may buy and sell foreign currency on the invisible interbank market, where the floating exchange rate is established at a balanced level.

The central bank must set the ratio of foreign currency that commercial banks can trade so as to prevent a few banks from monopolizing the market and to guarantee that it holds a certain amount. The central bank can stabilize the floating rate through its trade on the market.

Regulation of items under current account should be further relaxed and the domestic currency should be convertible in this range. At the same time, items that could cause capital outflows must be tightly controlled.

In the third stage, with the increase of economic strength and international competitiveness of major sectors, control over the capital account may be loosened and capital could flow out of the country to a limited extent. When the domestic economy is fully internationalized and the balance of payments has improved substantially, firms and individuals will be able to acquire foreign currency and the local currency will be fully convertible.

In none of these stages should foreign currency be used as a parallel means of payment (with the local currency).
Yuan’s Partial Convertibility under Trade Account

Undoubtedly, the foreign exchange system must be restructured as soon as possible. The long-term goal is the full convertibility of the home currency. However, it seems that convertibility under current account is a stage that cannot be avoided. In China, some premature measures were taken, such as legally permitting the export of Yuan, holding foreign exchange and opening foreign exchange accounts, allowing several firms to open them and permitting foreign currency to circulate in domestic markets. These measures were only taken in the late 1980s in some other countries and regions, including Japan, Korea and Taiwan (China). The circulation of foreign currency along with local currency is still forbidden in many countries where the latter is fully convertible.

It appears it would be difficult to begin the reform process in the first stage, as this would mean reversing many policies, which would be impractical and create shock and added costs. However, conditions should be appropriate in the second stage. The best way to combine the long-term objective to maintain the continuity of current policies would be to move directly to this stage, in which yuan are partly convertible.

The five measures that need to be applied are:

- While maintaining the official exchange rate and the retention regime, banks should be allowed to trade in the swap market and, using their information and capital, unify it into a national system. PBC would continue to use its foreign exchange to regulate aggregate demand and supply and influence market prices. Meanwhile, foreign currency would not be allowed to circulate, the experiment with foreign exchange retention for the exporting firms would be suspended and the export of yuan of 6,000 yuan and under, per person, would no longer be allowed.

- Beginning next year, the requirement that 20 percent (10 percent to local governments) of export receipts be sold to the central bank at the official rate should be ended; instead, they should be turned over at the market rate. Now, all export receipts can obtain yuan at the market rate and be retained by firms, which is equal to 100 percent retention. On the exchange market, authorized banks should become the major traders.

- After a short transitional period with relatively stable market rates, the official rate should be abolished. The quota for foreign exchange should be eliminated, along with the strict regime. Items traded under the current account should be deregulated, and yuan would be convertible.
• With a partially convertible yuan, households holding foreign currency should be encouraged to sell it to the government or deposit it in state banks. When they need to export currency, it should be allowed.

• SAEC must tighten its control of items under current account which may lead to capital outflow, such as FDI profit remittances and capital account transactions. The latter would require a permit, FDI profit remittances would need to be checked, personal use and export of foreign exchange would need to be limited (in both volume and use), and the foreign exchange requirement of incoming tourists must be controlled by an exchange memo. Only authorized banks should be involved in international financial operations. In addition, SAEC must supervise the firms’ export receipts so as to restrict capital outflow. At the same time, restrictions on foreign exchange requirements for imports should be abolished.

Through these measures, yuan will be the only currency circulating and will be convertible under the trade account. Foreign exchange will become an asset of the central bank and other authorized banks. Yuan will not be allowed to circulate abroad. The capital outflow will be unaffected and controlled by proper administrative means. Public confidence in yuan will increase with the growth of the foreign exchange supply and the exchange rate will be reduced in a few years.

**EXPORT RECEIPTS AND FOREIGN-FUNDED ENTERPRISES**

Partial convertibility of yuan in a limited range under current account is the major objective of next year’s reform. Experience in many countries shows that the key to success depends on whether the flow of foreign currency under capital account can be effectively blocked. Laws and regulations in Japan, Korea and Taiwan (China) all contain measures to prevent capital outflows: One of the most important is the requirement that all firms surrender their export receipts.

To determine if firms in China with foreign investment should be held to such a requirement, their features must be examined. First, as they are legal entities, they should have the same rights and responsibilities as domestic firms. In fact, many of their foreign investors oversee domestic firms. Also, many of the firms’ domestic investors were part of the original SOEs, collective enterprises or other types undertakings. Further, as 150,000 firms already had foreign investment by September 1993, the effect of such a regulation would be considerable.

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DMRS advocates a system that would include foreign-funded firms in the new foreign exchange regulatory system. This report discussed the various arguments and was published internally in December 1993.
If the firms with FDI were allowed to hold foreign exchange and keep foreign currency accounts, rather than surrendering their export receipts to banks, this could lead to reduced FDI, an outflow of capital, growth of channels through which this occurs, arbitrary imports, and smugglers’ exporting money by exchanging it into foreign exchange. Also, domestic firms would be motivated to create false joint ventures to retain export receipts. Further, these firms could establish a special exchange rate when buying and selling between themselves, which would create a dual rate.

Various arguments have been made for not including foreign funded firms into the surrender regime. If they are required to surrender their export receipts, it would be considered discriminatory treatment, which would hinder the inflow of foreign investment. Further, this would discourage them from keeping their income in China, and a large portion would be kept abroad. Also, if they are allowed to exchange currency freely under the current account, this would reduce their exports by removing some share of the domestic market, and national export receipts would decline.

However, we believe these concerns are unfounded for several reasons. First, excessive preferential policies to attract FDI are not appreciated domestically or abroad. In fact, the pressure to treat firms with FDI as national firms is increasing. Thus, surrendering their export receipts is consistent with the reform and international practice, and is a step forward, when compared with the current retention regime. Indeed, it will attract FDI and adjust its structure.

Second, only 30,000 to 40,000 of the 150,000 foreign-funded firms are contractually obliged to balance their foreign exchange needs. Moreover, these firms have connections to domestic firms through the swap exchange markets. Attempts by these firms to enter the domestic market are not hindered by current foreign exchange regulations. In the new system, if the retention regime is maintained, they can easily purchase foreign exchange from domestic firms, to balance their foreign exchange needs.

Third, the reason foreign-funded firms maintain their export receipts abroad is not the surrendering regime, but the requirement that 20 to 30 percent of the receipts be handed over without compensation, which affects the firms’ efficiency. Next year, when a single rate of foreign exchange is imposed, all export firms, including those that are foreign-funded, will have to address the cost of holding foreign exchange rather than yuan. Thus, as long as the exchange rate is reasonable and import requirements with respect to foreign exchange are met, most firms will be willing to settle their export receipts with yuan instead of maintaining them abroad. Compared to the present retention regime, the new system will be more useful to regulatory authorities in overseeing the foreign-funded firms’ surrender of exchange.

Since the beginning of the economic reform and opening of the economy, a number of measures have been taken to deregulate trade, such as relaxing imports, along
with border and barter trade regulations. Foreign-funded enterprises have been allowed even more autonomy in their import operations. Because inconsistent trade policies have created difficulties for the foreign exchange regulations, a great effort has been made to strengthen them; but, the result has been unsatisfactory. Excluding foreign-funded firms from the surrender regime could result in a partial convertibility system being created.

Finally, if foreign-funded firms are obliged to participate in the surrender regime, this will raise the issues of whether they will continue to enjoy their present favorable policies, and whether the new foreign exchange regulations can be devised and applied smoothly. It also will affect macroregulation. Thus, foreign-funded firms must be included in the surrender regime.

The Interbank Market for Foreign Exchange

China’s foreign exchange trade center (CFETC) will be located in Shanghai and initially link with Beijing, Tianjin, Hangzhou, Shenzhen, Xiamen and Chengdu. Eventually, it will link with over 10 regional cities and will use the communication line on the Asia 1 satellite rented by PBC. Besides the center in Shanghai, a reserve center will be located at the satellite ground station in Beijing, which will also serve as a monitoring center. The regional cities will transmit information through ground substations to Beijing, from where messages will be transmitted to Shanghai. There will be 210 seats at Shanghai’s foreign exchange center.

We believe the visible market is not appropriate; a foreign exchange market must ensure that the mechanism of establishing exchange rates is improved and the integrated rate is not separated again. Banks will play major part in foreign exchange trade under the surrendering regime, and an interbank market will be created through bank transactions.

International payments will be made at the banks’ head offices, and branches with international operations will need to report daily to the head office about their positions and selling of foreign exchange. The head office will calculate the bank’s total amount of foreign exchange (including surpluses in overseas bank accounts) and balance the account if necessary (for example, distribute foreign exchange in the current account to the capital account). The head office will not be able to determine the volume and price at which it will trade on the interbank market and adjust its capital denominated in yuan and foreign exchange through the trading unless it relates all information about its buying and selling to its customers. The head office will be responsible for guaranteeing the banking system’s payments and safety.

The nature of this procedure will determine the type of interbank market. Participants will be head offices, and CFETC will serve as "matchmaker and witness." Yuan clearance will be handled by the two banks through the PBC electronic clearance net system. Clearance in foreign exchange will be conducted by the overseas agent banks of the two banks. The center will not provide clearance service.

Potential participants of the interbank foreign exchange market will be the major state banks, some small banks and a few big nonbank financial institutions such as the trust and investment companies. Of these, four of the five state banks have their head offices in Beijing, head offices of CITIC Industrial Bank, Everbright Bank and Hua Xia banks are also located there, as are seven of the 10 largest trust and investment companies, which include CITIC, the Ministry of Foreign Trade and Economic Relation's Trust and Investment Company, and ICBC's Trust and Investment Company. Indeed, most foreign exchange trading occurs in Beijing.

The central bank will need to be involved in the market to buy or sell foreign exchange in order to regulate the demand and supply and influence the rate. It must also conduct statistical work, daily, while SFEAB must oversee the trading. These two institutions are also located in Beijing.

The interbank foreign exchange market should be invisible and only act as the mechanism for trade. It can be organized if the participating head offices rent a few special phone lines that would connect to the trading center (which has the necessary equipment), and set up trading practices such as offerings, price-seeking and confirmations. CFETC planned for Shanghai will not be necessary. A large room of 100 square meters will be adequate for such a market.

The invisible trading center should be located in Beijing. It is argued that a visible market with a nationwide network would increase the speed of clearance and overcome the problem of insufficient capital transfers of yuan in the banks. However, this is not convincing, because the invisible market can work within PBC's electronic clearance network. If the system is not satisfactory, clearance in a visible market would be even worse.

It is said that some banks hope to be involved in balanced transactions on the foreign exchange trading market, i.e., trading for marginal profit, not for adjusting the bank's stock of foreign exchange. Whatever is bought will all be sold the same day. In the early stages, this kind of business should be treated with caution, to prevent excessive speculation.

Also, some worry that BOC would have monopoly power over the interbank market. Indeed, it has been the only specialized bank for foreign exchange and trade, and would handle most foreign exchange settlements and payments. If it overpurchases, it could be the only seller on the market. Thus, two quotas must be set: One is a ceiling
Part V: Foreign Exchange System Reform

over purchases, and it must sell off the amount beyond this to prevent hoarding; the other is the quota for selling on the market, which it must sell to the central bank at the price it charges its customers. The central bank will sell this part of foreign exchange at a price that depends on the foreign exchange rate.

Third, ICBC, BOC, PCBC, BOCOM and most of the small banks indicated their head offices would be able to balance the banks' foreign exchange and participate in the interbank market with data about surpluses or deficits in their foreign exchange stock. ABC and another small bank have indicated their head offices cannot do this at present, and asked that their large branches be able to participate in the market as a transitional measure. However, this request is unreasonable, because it would be easy for their head offices to calculate the balance of all the banks' foreign exchange on the basis of balances provided by the few large branches. Further a bank could not qualify as a national bank, let alone one segmented into several regional banks, if its head office cannot manage to be well-informed, dispose of funds within the system, and be responsible for avoiding foreign exchange rate fluctuations.

Finally, the first quarter of 1994 will be the transitional period for replacing the old system with the new. As of January 1, the dual foreign exchange rates were integrated, and the surrendering system was adopted. And, as a transitional measure, a central bank surrendering scheme was introduced, i.e., other banks will purchase foreign exchange on behalf of the central bank. Firms with insufficient retained foreign exchange or counter-accounts must ask their agent banks or other financial institutions to purchase foreign exchange from the swap market, and obtain permission for every issue of foreign exchange needed. In addition, SFEAB will continue supervising the use of foreign exchange within the quota for the foreign exchange account. At this time, firms may find it inconvenient to obtain foreign exchange.

Banks will have to determine the amount of foreign exchange needed to sell and operate, and should begin their own foreign exchange operations, selling to export firms. They should purchase part of their foreign exchange with their own capital, instead of for the central bank. The foreign exchange needed by export firms, purchased from banks, does not need to be approved by SAEC. During the transition, the banks' share in the foreign exchange market should be gradually increased to enlarge the interbank market; for example, in February it would be 30 percent, in March, 50 percent, and in April, 80 percent, and the interbank market should play an increasing role in foreign exchange trading.
The Risks of Foreign Exchange Reforms

Reforming the foreign exchange system is risky but worthwhile. The degree of risk depends on the type of reform, and one should be chosen that minimizes risk and maximizes benefits. Three factors determine the extent of risk: (a) the type of foreign exchange holdings—whether compulsory complete surrendering, voluntary surrendering or partial surrendering; (b) the type of market—whether a centralized interbank market or decentralized clients; and (c) the range of convertibility—whether foreign-funded firms have access to the new system in which the home currency is convertible; whether current accounts only are convertible or include capital accounts; or convertibility only at home and/or abroad.

There is still debate about the best type for China. Some prefer a voluntary surrendering system, because, as argued above, compulsory surrendering will force firms to retain their export receipts abroad, which will make the exchange rate volatile. Although departments in charge of foreign exchange indicate that a centralized interbank market will be established, a market in which branches and bank clients may participate is actually being created. Authorities are not fully aware of the risk attached to some of these openings, which must be closed under the yuan’s partial convertibility, such as granting legal permission to export yuan or foreign exchange futures markets (both domestic and overseas).

We recommend a compulsory surrendering system, domestic convertibility of yuan under current accounts, a centralized interbank exchange market and the inclusion of foreign-funded firms in the new system.

Three Risks of the Voluntary Surrendering System

The first risk is related to the time lag between establishing public confidence and the introduction of the new system. Current account convertibility represents a government’s promise that it is determined to restrain inflation and not to balance foreign exchange by compulsory regulations. In this context, public confidence in the promise is the foundation of successful foreign exchange reform; the voluntary surrendering system means the government must offer a greater promise than it would with a compulsory system. But, the early stage of reform entails risk or even failure. There are rumors that the yuan will be depreciated to a rate of 10 to $1.

Voluntary surrendering means that firms can have foreign exchange accounts, which would make it difficult to regulate them. No country has tried to implement follow-up surrendering under a system of voluntary surrendering; and, under this system,

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27 This report was written by DMRS and submitted to the State Council in December 1993.
capital account regulations would be very loose. Where countries and territories were able to tightly control capital accounts, such as Japan and Taiwan (China), they imposed compulsory surrendering.

It will take time for the government and public to establish confidence in the new system, and at the beginning, both sides must be cautious. With a voluntary surrendering system, the government would be forced to choose between restoring exchange controls or significantly depreciating the currency, if there are excessive imports. Either decision would be risky and negatively affect the new system.

The second risk is that it would be impossible to introduce follow-up surrendering and strictly control the outflow of capital. Thus, the system would force authorities to tightly control the use of foreign exchange for current account transactions; this would mean that current accounts would not be convertible.

The third risk is that institutions that can safeguard the operation of the system and maintain suitable interventions could disappear. With voluntary surrendering, the market would be the only major force to cope with a large rise in the exchange rate (lack of confidence) and capital flight, because the government could only apply a deflationary monetary policy to stabilize the market. However, with compulsory surrendering, many instruments, such as follow-on surrendering, auditing of transfer prices and refusal of banks to pay for capital expenditures, can be applied. Tight monetary policy would also be adopted.

**Foreign-Funded Firms in the New System**

Currently the leading thought is to exclude foreign-funded enterprises from the new foreign exchange system, in part reflecting the reservations of foreign-funded enterprises toward the new system. However, some negative consequences could occur if foreign-funded firms were not subject to the new system. They could pay their current account items through domestic firms, and the capital payments of the latter could be channeled through the former. This has already happened in a large scale. With the convertibility of the current account, this would even be easier. Second, false joint ventures would increase, as foreign-funded firms would be excluded from the surrendering system. Third, for the same token, the effectiveness of establishing an over-the-counter foreign exchange account for foreign-funded enterprises to control foreign exchange is equally doubtful. (The over-the-counter account refers to the compulsory deposit up to one-half of the foreign exchange receipts of domestic exporters and all foreign exchange receipts of foreign-funded enterprises with the banks or foreign exchange authorities. Within the limits of the over-the-counter account, enterprises are granted the preferential right to redeem the foreign exchange.)
The Centralized Interbank Exchange Market

Along with the banks' compulsory surrendering and buying and selling of foreign exchange, there must be a double-tier exchange market: one between the banks and clients, and an interbank market. The latter should be centralized and not require a trading center, network of regional centers, or unified quotation system. One of the key points of the new system is that foreign exchange would not be used to price goods, in clearance and circulation. A clearance center is unnecessary. (See The Interbank Market for Foreign Exchange, in Part V for details on the operational procedures and advantages of the interbank market and concerns about a BOC monopoly of the market).

Other Issues

An yuan credit quota equal to the type C individual foreign exchange deposits and domestic firms' foreign exchange deposits should be increased. This would not expand aggregate credit because the amount of foreign exchange used for domestic credit payments would be reduced significantly, and aggregate purchasing power would not increase.

The banks appointed to carry out foreign exchange operations must be supplied with part of the base money at the early stage of the surrendering system.

Foreign banks registered in China should be allowed for yuan operations in limited areas when the surrendering system is imposed and foreign exchange is no longer a payment instrument. They could obtain their yuan by exchanging foreign currency with the central bank.

Some special exchange accounts could be opened. For example, overseas government loans, mixed government and commercial loans could be put in exchange accounts. Also, firms could have accounts to purchase foreign exchange, so as to repay foreign loans. These special accounts would need to be regulated.

With respect to the futures market, we do not recommend opening a domestic market linked with the overseas market at this stage, as it would lead to capital flight and excessive speculation. Instead, closed futures' markets of yuan to US dollars could be opened, to hedge risks.

The policy that permits the legal export of 6,000 yuan should be abolished, since it is premature at this stage.
PART VI: REFORM OF PLANNING, INVESTMENTS AND MANAGEMENT OF STATE ASSETS

ABSTRACT

The problems with respect to investments in fixed assets are (a) the uncontrollable scale of investment, lopsided growth of manufacturing industries as a whole, duplicated construction, and inferior quality of construction; (b) severe shortage of investment in infrastructure and fundamental industries, which constrains economic growth; and (c) inefficient investments, which have high inputs and low outputs.

These problems are mainly caused by the lack of restraining mechanisms, responsibility for risk and effective macroregulations. Investment reform will thus be a move toward increasing the enterprises' and banks' autonomy in decision-making; it will be accompanied by enterprise and financial reforms that will replace the system of state approval to one based on registrations. This will stop the government from directly intervening in investments. However, infrastructure that needs direct state investment will not be affected by these reforms. The severely expanded investments and unbalanced structure in the first half of 1993 meant the system had to change. Any breakthrough in this area could be in the form of the long-term policy credit system, the essential element of which is establishing a government long-term development and credit bank.

The aim of industrial policy is long-term development of the national economy. Microeconomic structure would be the policy focus, which would involve supply factors, dynamic development, industrial structures and economic factors. During the transition to a market economy, the top priority should be controlling macroeconomic aggregates; policies to upgrade and transform the industrial structure should be the second priority. Implementing industrial policy should be based on the view that the market must play a major role in the economy; thus the policy should be general, rather than focusing on specific industries.

Managing state assets is one of the most complicated tasks in the reform, and is closely related to changing the SOEs. The key issue is how to readjust and clarify the SOEs' property rights so they can operate efficiently in a market economy. In the transition, it could be useful to transform SOEs into joint stock companies. A system of public ownership could be reestablished by means of state-owned share holding companies, which trade shares. Public ownership rights could be wholly owned, controlling, or shareholding in various sectors.
FURTHER REFORM OF THE INVESTMENT SYSTEM

Establishing an investment system compatible with a socialist market economy is an important element of China's economic reform. Although numerous changes have occurred, many aspects of the planned economy remain: The government still controls investment activities by administrative instruments and directives.

Key Problems

Many investments have been made without definite objectives and much construction is redundant: They are inefficient and wasteful, due to the motivation of local governments and enterprises. The same can be said about the regional structure of industries. At the same time, investment in infrastructure and basic industries is limited and the industrial structure is unbalanced. As a result, investments periodically overheat.

The immediate source of these problems is the irrational system of investment; the more profound source stems from the economic system.

Managing Investments

Management involves decision-making, funding, construction, operations and turnover. Decision-making is still concentrated in government departments that manage by administrative means, scale control and project approval, while economic means are neglected or resisted.

Investments are regulated by many decisionmakers who do not bear the risk and investors are also not responsible; thus, no entity is accountable for the outcomes. In addition, too many sectors are involved in managing investment loans (controlled by the central government) and their responsibilities are not clearly defined. For example, the State Planning Commission (SPC) and State Economic and Trade Commission (SETC) are in charge of designing project proposals and allocating planned investments; MOF is responsible for providing funds; sectoral ministries are in charge of bidding and contracting and implementing projects; PCBC supervises funding; and the sectoral ministries appoint or hire managers for operations when projects are completed. However, no entity is concerned about whether the designed production capacity, operating efficiency and social efficiency are realized.

Investments are divided into two parts—capital construction and technology transformation—and are controlled by SPC and SETC, respectively. This artificially breaks the link between the two aspects of investment in fixed assets. In practice, it is difficult to distinguish between the two; as a result, disputes among the departments are common.

28 This proposal was written in March 1993, approved by leaders of SRC, and submitted to the State Council.
Reform measures such as the capital construction funds and state special investment companies have not been satisfactory. The old problems of administrative decision-making and fragmented responsibilities were not solved. Vague boundaries among various investments, such as equity investments, policy credits and treasury appropriations, that were part of the traditional system still remain, conflicting with the means of funding in a market economy and limiting the funding channels. Also, the system contains constraints, and long-term policy funding is not prioritized because losses from policy loans have to be covered by profit-making operations.

PBC is also involved in policy lending, which hinders monetary policy and opens a channel for issuing money for construction.

The economic system distorts investors' behavior. The SOEs' property rights are not clearly defined and they only assume responsibility for their profits or losses occasionally. Instead, they should be concerned about the efficiency of their investments, the return of capital and profits. They offer many excuses for not taking responsibility.

Bank lending to enterprises exhibits the same lack of attention to efficiency and the safety of their loans, and takes advantage of the central bank's revenues. The Government's intense intervention in the SOEs and banks makes matters even worse.

At present, local governments are extremely involved in managing industries, intervening through regulations and local branches of the banks.

The fiscal contract system classified taxes from production as local tax revenues and motivated local governments to develop manufacturing industries with high tax revenues as well as to have off-budget enterprises (since part of the taxes paid by these firms are not included in the budget). This caused investments to increase.

These problems cannot be eliminated by simply changing the investment system. To promote rational investments by enterprises and local governments will require a change in the economic system. This will include (a) price reform, so prices reflect demand, supply and production costs; also, the motive to invest, which stems from irrationally fixed prices, will be reduced; (b) tax reform, to change the category of turnover taxes, enlarge the VAT (thereby replacing the industry-biased product taxes), and eliminate the effects of adverse regulations on the tax system; structure taxes to guarantee equal competition, and prevent duplicated and inefficient small-scale construction; (c) reduce governments' administrative interventions and focus local governments on developing infrastructure, public facilities and cultural activities; (d) alter the fiscal contract system to eliminate local governments' motive to invest, introduce a standard tax-sharing system based on a division of government duties and responsibilities, change the tax system to reduce local governments' reliance on turnover taxes, and strengthen the Government's fiscal capability; (e) restructure the financial system to strengthen the central bank's regulation of the money supply and promote the
banks' independence and risk management; it is crucial that interest rates reflect capital
demand and supply and help control against overheated investments; (f) clarify the SOEs
property rights, establish a structure of separate ownership, control, possession and
operations, and build a constraint mechanism for the enterprises to manage their
investment risks.

Reform Priorities

Reform of the entire economy will rationalize investors' behavior and help change
the investment system. Still, the Government's long-term policy of managing credit will
not be automatically improved with reforms in other areas; rather, it will involve
reorganizing government and operating procedures at the central level. As mentioned
earlier, this area contains serious defects. Thus, the policy reform must occur before
other reforms in order to create conditions for the latter to flourish. The following
analysis focuses on the long-term policy of managing credit and offers suggestions for
creating a development bank.

Long-Term Policy for Managing Credit

The proposal includes building a mechanism of investment decision-making that
links rights with responsibilities and constrains risk; it replaces the situation where the
two are separated and the government directly intervenes.

It also includes classifying construction projects in terms of their return on
investments and profitability into three categories: (a) investments made independently
in the market by enterprises and banks; (b) those with long terms and high risks but low
profit rates, that must be backed by long-term credit with low interest rates; (c) those that
can hardly regain the capital and require budget funding.

Different regulations should be introduced for different types of investments. For
category (a), which involves projects in the manufacturing and service sectors, enterprises
and banks can decide independently on the length, interest rate of the loans and ratio of
their own capital in the investment. The loans do not require official approval, but the
banks must manage through boards of directors and supervisory councils, and risk must
be contained. For category (b), which includes investments in infrastructure and basic
industries with long-term capital returns, the enterprises or local governments should
apply for long-term credit; a development bank is thus necessary. For category (c), which
involves investments in hospitals, schools and cultural centers, the works should be
financed by budget funds. No new institution is needed to regulate investments in the (a)
and (c) categories, but organizations need to be adjusted for (b).

The Development Bank should concentrate on policy operations only to avoid
conflict with commercial lending in funds, projects and interest rates, etc.
Its design basically follows the World Bank model, which separates credit from equity investments and policy from commercial lending; the Development Bank can independently assess projects. The reform should begin with separating two entities: (a) PCBC should siphon off its policy lending to the Development Bank and shift its focus to providing long-term credit; (b) policy lending and equity investment in the state-specialized investment corporations must be separated with the transfer of the former operation to the Development Bank. The investment corporations should become holding companies in strategic industries' investments. As owners of limited companies that invest with equity and shares of other investors (such as local governments and enterprises), they may apply for loans from PCBC and policy loans from the Development Bank.

The Development Bank should be organized with branches in large regions. PCBC's existing branches may be transformed for this purpose. Specialized branches of PCBC located at priority construction projects should be administered by the Development Bank. With respect to capital sources, the Bank will rely on issuing government bonds and funds from the budget and PBC. The reformed PCBC will obtain funds by issuing government bonds, fiscal funding trusts and deposits from enterprises. It can retain its savings deposits which cannot be used for capital investment loans but for purchasing the Development Bank's bonds. PCBC lending should focus on nonpolicy loans for fixed assets.

The merit of this proposal is that it solves the problems by setting clear boundaries between commercial investments and policy lending. The Development Bank should follow the model of the Development Bank of Japan and the World Bank, and PCBC should follow the Long-Term Credit Bank of Japan. These banks will be compatible with a market economy.

Functions of the Development Bank

The Development Bank would be a state-owned financial company responsible for providing medium- and long-term credit for policy investments. Under the guidance of state project planning, it should operate independently when assessing projects and loans, and in its accounting. It should be responsible for its profits, losses and risks.

Use of capital. The Bank will provide medium- and long-term loans for infrastructure, regional development projects, basic industries and newly emerging essential industries. It will charge preferential interest rates on some loans with longer return periods and low profit rates. It cannot use its capital to obtain corporate shares or become a shareholder.

Sources of capital. These are: (a) development bonds, which are subscribed to by postal savings, insurance and social security surpluses, at the request of the State. Individuals and financial institutions are also encouraged to purchase them; (b) long-term,
interest-free bonds that are subscribed to rotationally by treasury capital investment funds; (c) foreign loans and securities issued in foreign currencies in international capital markets; (d) planned or seasonal borrowing from the central bank; (e) profits retained after taxes and other sources; (f) firms’ deposits; also, deposits of construction capital of the projects supported by the Development Bank and of special development funds approved by the state.

**Managing loans and controlling risks.** The Bank must implement asset/liability and asset risk management and operational regulations, guided by the State’s macroregulations and control of the scale of credit.

To manage assets, a team of experts from various sectors must be organized to conduct research and assess the lending projects. To regulate the loans within the annual investment plan, credit scale and ratio of sectoral lending set by the State, the Development Bank will decide on its loans independently. It should base its decisions on priorities, the projects’ return period and the Bank’s capital supply; it should adjust preferential interest rates somewhat and be responsible for its lending risks.

**Supervising organization and policies.** Under the leadership of the State Council, the Bank should establish a supervisory council which consists of the heads of SPC, SETC, MOF, PBC, SCRES, and the State Audit Bureau; the chairmanship should rotate among the members. Its task should be to ensure that capital is used according to state plans and policies, but should not interfere with the Bank’s daily operations. It would be responsible for supervising the State’s special investment corporations’ operations, investment directions and balance sheets (of capital).

**Relations with other state institutions.** MOF, along with SPC, should propose plans for regional development projects and endorse the Development Bank’s assessing and arranging the loans. Capital investments financed by budget funds will have different funding channels. For public facilities that cannot return the investment, funding should be allocated from the budget. New projects should be funded from enterprises’ operating capital. Remaining capital should be used for the Development Bank’s long-term, interest-free rotating bonds, which should constitute one of its sources of capital. The Bank’s profits should be eligible for a preferential corporate tax.

PBC will transfer its regional development loans and other direct lending to the Development Bank, and regulate the enterprises’ deposit reserves (in the Bank), using a relatively low ratio. PBC will control the aggregate scale of the Bank’s credit and provide funding of planned and seasonal loans. The period for examining the Bank’s credit scale should be long enough to account for long-term policy lending; thus, an annual check seems appropriate. PBC should accept the Bank’s bonds as collateral for any borrowing requirement, and the bonds may be used for its open market operations and fundraising. For this purpose, PBC should stop making short-term loans to specialized banks.
SPC and SETC should plan national investment totals and industrial policy, provide macro guidance for the Bank’s credit plans and determine the investment shares of the various sectors. Where capital investments and technology transformation are regulated by different agencies, SPC and SETC may offer project lending suggestions from which the Bank can select. The latter may deal with long-term loan applications from local governments and enterprises within the credit limit and report the lending to SPC and SETC.

The reformed PCBC will concentrate on nonpolicy medium- and long-term credit for fixed asset investments. It will lend for construction in various sectors, and act as the agent for allocating budget funds and entrusted lending. Different interest rates for the various sectors will be abolished, although where local projects cannot pay a high interest rate, their loans may be subsidized from local budgets. The State will no longer assign policy lending plans for fixed asset investments to the specialized banks, which may select projects and issue loans independently, within the credit quota. Enterprises that are entitled for PCBC and other banks’ fixed asset loans can also apply for medium- and long-term policy loans.

RESTRUCTURING THE MANAGEMENT OF STATE ASSETS AND REESTABLISHING PUBLIC OWNERSHIP

Building an Efficient Socialist Market Economy

Such an economy must be built on the basis of clearly defined property rights and responsibilities. SOEs are the foundation of the Chinese economy, holding over 200 billion yuan in assets. However, state ownership under a centralized planning economy has brought many problems, inefficiencies and a huge administrative hierarchy. After some changes at the SOEs, their performance has improved; but the unclear property rights, mix of administrative and management responsibilities, irrational organization, and inefficient operations are problems that have not yet been resolved. The efficiency problem is particularly acute. The SOEs’ losses have been severe, which increased the budget burden and deficits, and became a strong weight on the financial system, through the high debt incurred. The state sector grew at a far slower speed than the nonstate sector and is shrinking in relative terms.

In this context, two tendencies are worth noting. One is the dramatic siphoning off of state assets, either openly or in a disguised fashion, which allowed some individuals, institutions and overseas investors to get rich, quickly. Another is the SOEs’ use of outdated technologies, which affects the quality of the industrial structure and international competitiveness of the Chinese economy. That the SOEs dominate key

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29 This is part of an internal work report submitted to SRC in May 1993.
industries, such as energy, raw materials, heavy chemicals and machinery, challenges the country's future economic power and growth—if their performance does not improve considerably, in the near future.

The way to solve the SOEs basic problems is not simply to decentralize decision-making or profit-sharing with the state; rather is to transform the ownership structure and reshape public ownership.

**Reform of the Management of State Assets**

Reform in this sector will involve transforming SOEs into producers that take autonomous decisions and are responsible for profits and losses; however, public ownership will be maintained.

Economic theory states that independent property rights are the foundation of market operations. The key to reforming the management of state assets is to establish a theory of public ownership with independent property rights. Developing a modern joint stock corporation with a governance structure will change the concept of property rights to one where ownership is separated from the rights of possession, control and operations. Company managers will be able to operate and take decisions as part of daily management. Boards of directors will control the appointment of managers, setting of salaries and major decisions. Possession rights will belong to the company which will be responsible for its debt and assets. The company may mortgage and rent its assets and be responsible for profits and losses. It will be owned by shareholders, who may claim income and approve decisions made by the board of directors.

Based on this theory, the goal of reforming state asset management is to build a new structure that has four elements: (a) the ownership of state assets in shareholding companies belongs to the State; (b) a state agency authorized by the People's Congress as a state holding company owns the controlling shares (a direct holding of the State); (c) the state holding company as an independent legal entity holds shares of the original SOEs through controlling shares or shareholding (indirect holding by the State and direct holding by the legal entity); (d) the company as an independent legal entity possesses state assets and its managers have the right to operate it.

This type of structure will not change the nature of public ownership in the sense that the State will be the final owner of its assets. But, it will allow the enterprises to become genuine commodity producers in a market economy.

**Other Reforms**

The first is that a state assets system should be established with government agencies as the major players. One suggestion is that sectoral ministries could represent the State to control the SOEs' management and ensure that the value of state assets is
maintained and enhanced. Another suggestion is that the agency in charge of managing state assets be directly involved in the SOEs' operation, which guarantees that value will be added or maintained. Still another is to dissolve the sectoral ministries and replace them with sectoral general companies to manage state assets.

These recommendations have serious shortcomings, because they do not go beyond the traditional thinking with respect to administrative control of state assets. Also, they do not eliminate government intervention in the SOEs' operations nor do they separate administration from management. In addition, they have a strong flavor of sectoral monopolization, which hampers fair competition.

The second is that the SOEs should be transformed into nonstate enterprises. This could be done by developing the nonstate economy to push the process of transforming the SOEs. It would mean encouraging the integration of the state and nonstate sectors along with corporatizing the SOEs and finally turning them into individually owned or corporate entities.

This proposal rejects efforts to discover new structures of public ownership and instead stresses the natural evolution of the SOEs. State assets would be siphoned off, which would result in their unfair distribution, with no one responsible for them. Finally, the proposal has many technical difficulties: (a) the SOEs are major entities in huge basic industries with large amounts of capital, high risks and high technology requirements unsuited to private investors; (b) a long time would be needed to privatize the large state sector because it will require a huge amount of private capital and a long period of capital accumulation. Such an evolutionary reform would try public patience, and be unfeasible.

However, if the management of state assets cannot be carried out effectively, the second proposal could become a reality.

**Design and Principles for a New SOE Structure**

**Reorganize property rights.** A committee of public ownership should be organized under the People's Congress as the original representative of the owner. It could be called the top board of directors of state assets. Also, a number of state holding companies could be established. In the early stage of creating the companies, the committee could allocate a portion of state assets to the companies or issue certificates to them which would allow them to purchase state assets as the committee's investment in the companies. The committee would control the companies through wholly owned or controlling shares, and would appoint board members for these companies. Third, the state holding companies as independent legal entities would have the right to hold shares of the SOEs through controlling shares or share holding.

**Two principles.** Property rights should be defined by the public ownership committee. The state holding companies will form a legal entity governance structure,
and SOEs will be separated from the administration by maintaining shares in the holding companies.

To break up sectoral monopolies and diversify share holdings, a holding company can be organized in each sector and allocated one third of the SOEs’ shares; this would limit the share of the enterprises it controls in the sector. The remaining two thirds of shares would be allocated to other state sectoral holding companies. Another way is to set up many cross-sectoral state holding companies with each receiving allocation certificates of shares from the public ownership committee. The committee would impose a limit on each companies’ ratio of share holdings in one sector and the latter could choose to buy shares of any SOEs in any sector. Enterprises could hold each others’ shares and individuals could be shareholders as well. This way, an entity’s shareholders would be diversified, which is good for competition. This requires the SOEs be transformed into joint stock companies.

Transforming SOE Ownership

**Transforming medium and large SOEs into joint-stock corporations.** This process should begin with assessing the value and volume of state assets, and then turning them into capital stock and determining a company’s legal position. It is only on this basis that the state holding companies and other investors could obtain shares of the entities.

Select ways to organize the state holding companies. In general, they may be created as new organizations, or reorganized versions of existing state banks, insurance companies, foundations and investment companies. Various alternatives are available for the companies’ institutional design. A first question is whether the banks should hold shares. Those answering no argue that shareholding is a risky way to use bank capital that comes from deposits or bonds. Those supporting the option argue many banks hold shares of other companies in developed countries, such as Japan. In China, the reality that SOEs generally have a high ratio of bank debt suggests that by allowing banks to obtain SOE shares, the debt issue can be solved when it is turned into bank shares. The experience of big companies also supports this argument because banks that hold shares of other companies will facilitate development of big groups centered around them. We believe the latter resolution seems more feasible.

A second issue is how many tiers the state holding companies should have. There are over 1,000 medium and large SOEs under central government control and over 10,000 SOEs nationwide. If there are to be just over 10 primary state holding companies, this cannot meet the needs of the transformation. Thus, it will be necessary to have secondary state holding companies. The primary companies may hold shares of the secondary ones, and the latter may hold each others’ shares as well as those of the SOEs.
A third issue is the pattern of cross-shareholding of the state holding companies and the SOEs. One alternative is the pyramid pattern of ownership which allows hierarchically vertical and horizontal share holding. The state holding companies at the top will be powerful, which is ideal for creating groups of companies. Another choice is a net-like structure which allows both vertical and horizontal holding of shares and SOEs may hold shares of the state holding companies. The Japanese pattern is similar to this last one. We recommend that the first option be the major pattern and the second one approached gradually.

Reforming government functions. Establishing state holding companies that are distinct from the SOEs will require a change in government functions. Sectoral ministries should be dismissed, and their planning and management functions be simplified and transferred to SETC. SETC would serve as Japan’s Ministry of Industries.

As a transitional measure, administrative agencies in infrastructure and strategic sectors such as energy, transport, aviation and shipping may be maintained but with reduced staff.

An integrated three-in-one treasury, taxation and state assets fiscal system should be established. MOF should eliminate the departments in charge of enterprise accounting and set up a department of capital budgets that would levy corporate taxes, manage state assets and develop the capital budget.

The basic task of the State Asset Management Bureau would be to supervise state assets, protect the rights and interests of the company and conduct audits.

It would also establish a public ownership committee under the People’s Congress, which would have the right to appoint the board of directors of the state holding companies and make decisions on state investments.

Property rights and market competition. More companies must be established to enter the stock market; in the meantime, asset exchange institutions for legal entity shares should be established. The number of security exchanges and share of legal entity shares should be increased.

The property rights of local SOEs should be transformed and the principles of reforming the national SOEs (discussed above) applied.

Moreover, cross-shareholding relationships for state assets should be established between the central and local companies and among local companies so national resources can be efficiently allocated.
Public Property Rights

Public property rights can be realized in wholly owned, controlled-share or shareholding companies; the difference would be the extent to which the state holding companies control and influence the companies.

Transforming SOE property rights in different sectors and industries varies with the importance of the sector in the national economy, technology level, economic scale and production periods.

In defense industries, high-tech sectors and some special industries such as gold and tobacco, companies must be wholly owned and monopolized by the State and its authorized agencies.

In natural monopolies, such as infrastructure, firms must be wholly state-owned or state holding companies.

In energy, raw materials, heavy chemical industries and postal services, state holding companies and public cross-holding companies are appropriate forms of organization.

In other industrial sectors, shareholding companies could be adopted.

The financial sector should move from wholly state-owned companies toward shareholding companies.

Sequence of the Transformation

The first step is to assess and determine the state assets' capital stock. Step 2 is to establish two-tier state holding companies, reorganizing existing banks, insurance companies, foundations and investment companies. Step 3 is to change the State's institutional functions. Joint stock companies also need to segment their capital stock rights, have cross-holding and begin issuing public shares. In step 4, companies that are ready may begin trading property rights on the stock exchange, to promote optimal allocation of public property rights.

Reforming the management of state assets is a complex project which requires a detailed design and long preparations. Thus, work must begin as early as possible.
INDUSTRIAL POLICY AND ECONOMIC REFORM

Since the 1980s, the concept of industrial policy has been acknowledged worldwide. However, its role in a market economy is controversial, and policies in various economies differ. Thus, the concept, its functions and elements must be clarified to determine the position of industrial policy in the Chinese economy.

Basic Industrial Policy

In general, industrial policy is actually a set of policies aimed at promoting sophisticated industrial structures, rational organization, international competitiveness and a higher-quality national economy.

The elements involve policies to improve industrial structures. One aims to protect and support newly emerging or strategic industries, while another is to adjust declining industries.

Some aim to reorganize industries so as to encourage effective competition, counter monopoly practices, protect appropriate concentration, improve market stability, prevent and correct market defects.

Others aim to promote trade: They support comparative advantages in the national economy, promote exports, regulate imports, accelerate modernization of industrial structures and increase international competitiveness.

Some aim to support research and development of new technologies, encourage imports, absorb domestic and foreign advanced technologies, and promote innovation.

Policies focused on upgrading human resources aim to improve education, vocational training, retraining and information services.

Industrial policy in a market economy. Market failures create the need to impose industrial policy, particularly in the microeconomy, such as with monopolistic tendencies resulting from free market competition. In less developed economies, one rationale for adopting such policies is the "latecomer advantages theory" which argues these countries can learn from the developed countries and catch up with them in a shorter period at reduced costs.

Industrial policy can play three roles in a market economy. First, it can supplement, rather than substitute for the resource allocation function of the market mechanism and improve distribution of resources among sectors. Second, it can prevent

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30 This paper was submitted for a discussion in May 1993 and later published in Reform, No. 4, 1994.
and correct the market’s negative influence and improve market stability. Third, it can upgrade and transform industrial structures.

**Types of industrial policy.** Supplementary industrial policy is based on the market failure theory and helps where the market is not efficient. It does not play a significant role in the policy design, and is adopted by many developed economies.

The overtaking industrial policy is based on the *latecomer advantage* theory and *geese flying pattern* theory. Its function is to support strategic and newly emerging industries, and shorten the period in which industrial structures evolve and compete effectively. Such a policy is often applied in developing economies.

**Position of Industrial Policy within General Economic Policies**

Industrial and macroeconomic policies are the two major groups of policies whose objectives, elements, areas and effective time limits are different, but instruments are similar.

Macroeconomic policy regulates macro aggregates in a market economy, focusing on short-term adjustment of aggregate demand. Its aims involve price stability, full employment, economic growth and balance of payments. Fiscal and monetary policies constitute the two poles in the macroeconomic policy group.

Industrial policy regulates microeconomic structures, focusing on long-term development of supply factors, the dynamic evolution of industrial structures and improving the economic factors. Its goal is long-term economic development.

It is apparent that macroeconomic policy is the basic vehicle of regulation in terms of the economy’s routine operations; industrial policy plays an important part in economic development. Neither is subordinate to the other.

In a market economy, the two policies use similar instruments such as fiscal and tax policy, monetary and credit policy, income distribution policy and tariff policy. The nature of the instruments depends on the targets and effects.

In China’s transitional period, the priority is to ensure the control of macroeconomic aggregates through macroeconomic policy, and then shift the structure through industrial policy. Monetary policy should serve to regulate macro aggregates, fiscal policy should adjust economic structures and tax policy should remain neutral. Tax rates should not be set with complicated and differential classifications, because industrial policy should not be overly tilted toward some specific sectors. Credit policy used to promote industrial policies should be dealt with by specialized financial institutions, and overly complicated and differential interest rates should not be imposed on the banks.
The Problems with Industrial Policy

In general, industrial policy was used to promote the growth of heavy industry and relations among agriculture, light industry and heavy industry under the centralized planned economy. At that time, it was part of planning and was realized through directives. In the 1980s, the concept of industrial policy in a market economy was introduced and has been the subject of a good deal of research in China. In 1989, “The State Council’s Decision on Issues of Industrial Policy” was published, and industrial policy became an independent vehicle of economic regulation, playing a positive role in adjusting industrial structures and promoting exports.

However, the design and implementation of industrial policy was carried out within the traditional economic system in the transitional period; as a result, the aims were not achieved. For example, infrastructure and capital investments, as priority policy targets, did not improved, nor did the performance of enterprises or economic efficiency. Conversely, manufacturing industries such as household electronics, whose growth was to be controlled, are still rising rapidly.

Causes of failure. The policy contains shortcomings in its elements, scope and instruments. First, it did not target certain strategic industries; rather, it simply stressed structural adjustment to correct the current bottlenecks. Second, it did not set priorities; instead, it covered almost every sector, which was unrealistic. Third, many of its concepts were only principles, and no policy tools existed with which to realize them.

Defects in the existing economic system caused the industrial policy to fail. First, the present fiscal and tax systems do not allocate resources efficiently and distort industrial structures. Under the local fiscal and tax contract systems, local protectionism is inevitable; this distorts tax and price mechanisms and has an adverse regulatory effect. For example, high taxes were levied on some manufacturing industries in order to constrain their rapid growth. However, this caused even faster growth in some sectors, and local governments gained more tax revenues. Further, the system leads to duplicated construction which does not allow the structures to be optimized or enterprises to gain efficiencies of scale. Bargain and fixed figures in the revenue base of the contract system reduced central Government’s fiscal revenues, which weakened its financial capacity for structural regulation.

Second, decision-making with respect to investments is still concentrated in government departments and administrated by quota control and project approvals. Indeed, decision-making, funding, construction, operations and debt repayment of investment projects are not linked; thus, responsibility is not clearly defined and no mechanisms exist to constrain risks (in investments); this leads to investments without definite ends, duplicated construction, inefficiency and huge waste.
Third, SOEs have not become genuine market participants. They respond very little to market signals, which reduces the effectiveness of indirect macroregulation.

Fourth, because prices of energy materials and transportation are not deregulated or adjusted to the proper level, the pricing function cannot play a role in regulating supply and demand.

Fifth, governments at all levels have their own industrial policies with virtually the same content and different sector priorities. But with respect to the national economy, with every sector designated a priority, none truly occupy this position. Such a policy cannot be effective.

Key Aspects of Industrial Policy and Economic Reform

Industrial policy can play a part in shaping the market economy but will not replace market mechanisms for allocating resources. Some of the country’s economic problems, such as overexpansion of manufacturing industries and lack of economies of scale will not be corrected through industrial policy; rather they will need market mechanisms. Thus, enterprises and the macroeconomy need to be reformed in the near future to create conditions in which the market can allocate resources.

During the transition period, economic reform should hold a higher priority than industrial policy. If the macroeconomy is not restructured in advance, there will be few effective indirect instruments to apply to industrial policy, and the policy could produce distorted or negative effects. Also, SOEs would not respond to any indirect regulations if enterprises have not been reformed. In addition, industrial policy would have to rely on direct controls, which could restore the centralized planning system.

The relation between biased industrial policy and fair competition must be studied, because the two conflict, if not introduced properly. At present, industrial policy uses direct administrative controls over investments, imports, and foreign exchange, which are not compatible with market reform. Therefore, indirect tools must be increased, which should consist of differential tax rates, interest rates, foreign exchange rates, budget subsidies, accelerated capital depreciation, tax relief and deductions. However, these distort market signals and could produce negative results if not applied carefully.

The main problems are that (a) the tax policy is biased, (b) there are too many grades (of items) and rates, (c) the tax burden is uneven, (d) there are too many tax concessions, which damage unity and the standardization of the tax system, (e) the scope of policy lending is too broad, and (f) commercial and policy lending operations are difficult to distinguish. As a result, the use of capital is highly inefficient.
Suggestions for Industrial Policy in the Transition

The differences in the scope of the structural policy should be reduced and strategic industries should be given priority so as to promote a modern industrial structure. Review of strategic industries should be strengthened.

Trade policy should be enforced. Given the intense international competition and the effort to rejoin GATT, a list of domestically protected industries (by internationally accepted means) must be drawn up as soon as possible.

Functional industrial policies should be expanded. Industrial policies that focus on developing human resources, training, technological innovation and progress, and information services (to make the national economy more competitive) should be expanded. They should aim at enterprises and the workforce, particularly at small- and medium-size firms, and be implemented at the local government level.

Industrial organization policy should be improved. Large companies should be established at the same time as smaller and medium enterprises should be helped with technology, trade and information services.

Financial institutions for policy lending should be created in the near future. A Development Bank and Export-Import Bank should be organized to support basic, strategic and export industries. Policy banks do not need to be opened at each level of administration, but should be concentrated at the central level.

The pace of economic reform should be accelerated and the instruments of industrial policy should be changed from direct to indirect, with the various instruments coordinated.

A multitier system for implementing industrial policy at each administrative level should be established. The central government should be responsible for industrial policies and antimonopoly policies, while local governments (under central guidance) should implement functional policies.
PART VII: ANALYSIS OF ECONOMIC CONDITIONS AND POLICY RECOMMENDATIONS

ABSTRACT

In 1993, dramatic changes occurred in the Chinese economy at the macro level. In the first half of the year, the economy was overheated, and the main aim of the macroregulation suggested by the department was to stabilize it, regulating aggregate demand by measures that were compatible with the overall reform.

After Document No. 6 of the Central Committee of the Party and the State Council (on macroregulation) was published, we recommended that since the policy had made some progress, the base money supply should not be increased excessively; instead, a soft landing should be ensured for the economy. Price hikes should be maintained at a reasonable level in 1994, along with a comfortable environment for reforms in various sectors.

Papers in this section analyze macroeconomic conditions and macroregulations in 1993. Most have appeared as internal publications of the Central Committee of the Party and the State Council.

THE MONEY SUPPLY AND MACROECONOMIC MANAGEMENT31

The economy maintained rapid growth through September 1993: From January to September, national industrial output at the township and higher levels reached 2,037.06 billion yuan (at 1990 prices), increased by 19.3 percent over the same period last year, and the growth rate in September was 20.7 percent, compared to last September. During the same period, state-owned units' fixed asset investments grew by 36.3 percent, reaching 241.39 billion yuan. Total retail sales were 786.05 billion yuan, increasing by 14.4 percent.

Thus, investment was clearly the driving force on the demand side that sparked the accelerated growth. Indeed, the origin of the investment funds is the expanded money supply, which exhibited new features this year. For this reason, the departments managing the macroeconomy should be analyzing the causes further, and proposing macromanagement policies.

31 This research was conducted in the third quarter of 1993 and published internally.
A Brief Review of the Money Supply Expansion

The rapid growth of industrial output this year reflects the economy’s excessive aggregate demand. Its expansion was largely due to an increase of the broad money supply. The composition of broad money is fairly complicated, and our analysis and data show that changes in the items deposited in the national credit balance sheet generally reflect the dynamic tendency of the broad money supply.

From January to September, various deposits increased to 327.99 billion yuan, 68.22 billion more than in the same period last year. Lending grew to 196.32 billion yuan, 49.45 billion more than last year, and deposits grew faster than lending by 131.67 billion yuan. Thus, a large negative value (-159.20 billion yuan), appeared in the “others” item in the liability account of the credit balance sheet.

Research indicated that the appearance of a negative value was an inevitable result of the huge gap between the rise in deposits and lending. An important question is whether the gap (the surplus in bank deposits) will turn into purchasing power (expanding aggregate demand). If it does not, then credit quota control would be an effective way to regulate aggregate demand. Otherwise, it would be limited and negative, and the money supply would need to be controlled.

Evidence of Real Purchasing Power

In general, deposits by the financial institutions to the central bank will increase, unless the surplus serves to expand real purchasing power. However, this has not occurred. Changes in the central bank’s balance sheet show that although the financial institutions’ reserves increased, their deposits decreased even more rapidly. Compared with the end of last year, reserves increased by 41.89 billion yuan from January to September, while central bank deposits decreased by 49.00 billion yuan. Of this amount, specialized banks’ deposits decreased by 69.72 billion yuan. The net result was that financial institutions’ deposits in the central bank decreased by 7.10 billion yuan.

Where did the surplus in deposits go, if not to the central bank? The answer lies in the roughly -160 billion yuan on the liability side of the national credit balance sheet, which were largely funds borrowed by nonbank entities from specialized banks. Although the nonbank entities are eligible for the credit quota, their funds from interbank borrowing are much larger (than from the credit quota). This shows that a substantial part of interbank borrowing bypassed the credit quota control, flowed outside the banking system, turned into real purchasing power, and expanded aggregate demand.

Transforming Surpluses into Real Purchasing Power

Based on our research, bank deposit surpluses have several channels by which they are turned into real purchasing power.
The first is interbank lending to the many nonbank financial institutions (such as specialized banks', local trust and investment companies, securities companies, and investment development companies). These institutions determine the way their funds will be distributed, the interbank call market being an important source. For example, in July 1992, the supply of funds in these institutions was 38.96 billion yuan, of which 48.4 percent was net borrowing from specialized banks and nonbank financial institutions, while only 44.6 percent was from their deposits. The institutions invest the funds from the interbank call market, which are not under the credit quota control, in real estate, bonds, shares, and direct investments.

The second is a joint account opened by banks and enterprises into which the latter deposit funds and the former make loans, in the form of interbank lending; together they use these funds for lending or other investments and in so doing, bypass the credit quota control. For example, in a city in Henan province, an enterprise and bank deposited 50 and 80 million yuan, respectively, into a joint account; then, the enterprise obtained a loan of 130 million yuan from the account.

The third, fiscal lending, is achieved with fiscal tax revenues; it takes advantage of the gap between the time that fiscal funds are received and disbursed. Lending is done in two ways: one is direct, by local fiscal authorities, often in the form of short-term circulating funds; the other is trusted lending, through local trust and investment companies, which either lend the funds or invest in real estate, bonds, shares and elsewhere. From January to September, fiscal revenues grew by 21.8 percent over the previous year, with a net surplus of about 5 billion yuan; in the same period, deposits from fiscal authorities to the central bank dropped by 1.34 billion yuan, or 9.05 billion yuan less. We believe a substantial part of these funds could be accounted for by fiscal lending.

The fourth is off-account lending, which enables some financial institutions to bypass the credit quota control. For example, the bank (or credit cooperative) that borrows the funds does not record this in its account; rather, with the lender's cooperation, the funds are transferred directly into the account of the end borrower—the enterprise. Such a direct transfer of interbank borrowing to an enterprise is beyond the scope of the interbank call operation and avoids the credit quota control. It also disturbs the implementation of the state credit plan.

The fifth is interbank lending beyond the stipulated scope and period. Interbank borrowings are designed to make up for the financial institutions' shortage of reserves in the central bank, not to be used as credit funds. With this limited scope, interbank borrowings are short-term by nature, normally for one or three days, one week and so on. However, in practice, interbank borrowings can be used as credit funds, with periods as long as three months, and are often multilateral and successive; thus, long-term lending is often financed by short-term interbank borrowing.
These are some of the main channels for converting bank deposit surpluses to real purchasing power, and are largely legal. For example, nonbank financial institutions may buy and sell securities, invest in projects, finance real estate transactions, and participate in the interbank call market. The question is whether these activities supervised by departments that manage aggregate demand.

At present, the central bank manages aggregate demand mainly with credit quota controls. Since the above activities aim to avoid such control, is it an effective way to manage aggregate demand? As mentioned earlier, the aggregate increase in lending was 196.32 billion yuan from January to September, while the negative value of the “others” item on the liability side of the credit balance sheet was 159.20 billion yuan, much of which was converted into real purchasing power, and which subsequently expanded aggregate demand. To some extent, since the ratio of increased lending to increased “others” items (which would take a positive value if put on the assets side) is 1:0.81, this suggests that macroeconomic management of aggregate demand is ineffective due to the purchasing power formed outside the scope of the credit quota control. This deserves our serious attention.

It is worth noting that the negative value began to occur in the “other “items in the fourth quarter of 1988 when credit policy shifted to a quota control as its major instrument. The negative value has grown each year since then, reaching 66.59 billion yuan in September 1991 and 926.12 billion yuan in 1992. In the same period, net interbank lending grew from 30 to 70 billion yuan, and a larger amount is expected for this year. Thus, aggregate demand can hardly be managed if the control of money demand continues to rely on the credit quota regime.

**Improving Money Supply Regulations**

Although control of the credit quota cannot be abandoned at present, by itself it cannot regulate the aggregate scale of credit effectively. The multiplier effect of the broad money supply can be restrained to a limited extent by credit quota controls. Indeed, to control aggregate demand, the broad money supply must be controlled. The key point is that central bank lending must be reduced to tighten the money supply. To enhance the regulation of aggregate demand, we suggest several courses.

First, the central bank’s relending to specialized banks should be enforced. The central bank has already taken various measures to control the credit scale, such as tightly controlling relending in the second half of the year, requiring the repayment of relent funds from banks that made loans on the interbank call market, prohibiting financial institutions from investing in securities with interbank call funds, and preparing to issue financial bonds to financial institutions for withdrawing a portion of money. While these measures, along with tightening credit controls since August, have had some effect, they have not been sufficient. Relending regulations should aim not only to solve present
problems, but to seek methods that are compatible with managing the money supply, the major elements of which should control the short-term seasonal and daily interbank call market.

Second, short-term treasury bills should be issued to withdraw money from circulation. To enforce regulations over excessive deposits in the banks and thus control the money supply, authorities should issue part of the short-term treasury bills with 3 to 6 months' maturity so as to withdraw money through subscription by specialized banks and nonbank financial institutions.

Third, interest rates should be raised. The phenomena of excessive bank deposits passing through various channels to the real estate and stock market, reduced growth rates and ratios of households' saving deposits, lowered fiscal deposits, and enterprises use of borrowed capital for long periods (regardless of its efficiency), are all related to low interest rates (particularly lending rates). Nominal lending rates are not high, although real rates are not low; and, borrowers pay a substantial amount for their loans because longer-term loans are turned into short-term ones. Thus, raising nominal interest rates would correct these problems.

Fourth, the funding sources for financial institutions should be regularly audited. The central bank and head offices of specialized banks have set rules with regard to these sources, such as interbank call capital can be used for cash shortage balances, not for credit lending, and nonfinancial institutions cannot participate in the interbank call market. However, these rules are not adequately followed.

Fifth, the central bank should strictly control its direct lending. At present, the central bank arranges direct lending to the society every year, such as developmental lending. Specialized banks strongly object to this on the grounds it confuses government functions with management functions. Moreover, the funds coming from base money will expand the money supply, due to the multiplier effect. Control may involve a functional adjustment of the banks, public finance, the central bank and specialized banks. While this may not be accomplished immediately, it must be addressed in the next stage of reform.

1992-93: Analysis and Forecast of the Macroeconomy

In 1992, the economy entered the third period of high growth since the economic reform began in 1978. The new features of economic development and prospects have implications for future economic restructuring and reform.

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32 Written on February, 8, 1993.
Macroeconomic Situation in 1992

In 1992, 2,340 billion yuan of gross domestic product (GDP) was produced, a 12 percent increase over 1991. Industrial output and sales revenues at the township level and above were 2,838.1 and 2,687.3 billion yuan, respectively, both rising by 21.7 percent. Fiscal revenues and expenditures were 384.56 and 407.59 billion yuan (estimated), and grew at 6.5 percent and 6.9 percent, respectively. The estimated budget deficit is 23.03 billion yuan.

Present Economic Situation

The most notable feature of the macroeconomy in 1992 was high growth. Analysis of the business cycle shows that growth in 1992 reached the peak of the cycle and was the third period of high growth since 1978. In addition, growth rates of industrial output in the four quarters were accelerating from 18.2 percent in the first quarter to 18.5 percent, 21.7 percent and 27 percent in the other three.

Growth rates of light and heavy industries were 20.1 percent and 23.2 percent, respectively. Investment expansion was the major factor on the demand side: Investments in fixed assets totaled 730 billion yuan in 1992, increasing by 33 percent; the share in the state-owned sectors was 510.6 billion yuan, rising by 40.7 percent. Of this amount, investments in capital construction increased by 37.6 percent, replacements and renovations by 38.6 percent, and housing by 93.5 percent.

The investment expansion was financed primarily by an expanded money supply. M1 and M2 balances in 1992 were 1,219.2 and 2,299.4 billion yuan and grew by 303.4 and 494.1 billion yuan, or 27.4 percent for both. In 1992, 115.8 billion yuan in cash was put into circulation in net terms, and money stock in circulation at the end of the year was 36.4 percent over the previous year. The national credit balance sheets indicate that the increase of bank deposits of all kinds was 402.9 billion yuan, or 81 billion yuan and 27.1 percent higher than 1991. The increase in bank lending of all kinds was 354.7 billion yuan in 1992, or 65.2 billion yuan and 19.7 percent higher.

Macroeconomy in 1992

Statistical data suggests the economy in 1992 was already overheated. First, industrial growth hit its third peak since 1978, and the previous two peak rates had already overheated the economy. Although the economic structure had changed significantly, it and the supply of resources are still far from meeting the needs of such rapid growth.

Second, a relatively big gap between investment growth and the supply of capital goods led to a shortage of major materials and a rise in prices. Moreover, investments duplicated the old industrial structure, with the ratio of energy and materials in total investments declining rather than increasing (compared with the previous year). If this
trend continues, the structure could deteriorate. The most serious problem is that the investment mechanism is distorted, as there are few constraints on responsibilities and the returns are not secure.

Third, while imports surged due to the country’s rapid economic growth, export capability increased relatively slowly; in fact, the rate of growth of the foreign exchange balance fell to almost zero, and weakened the country's ability to make payments. The annual volume of imports and exports last year was 165.6 billion yuan, growing by 22.1 percent; of this, exports increased by 85 billion yuan (18.3 percent), while imports grew by 80.6 billion yuan (26.3 percent), or 8 percentage points more than exports.

Fourth, inflationary pressure intensified, despite the mild 5.3 percent growth in the retail price index (which is misleading). In 1992's rapid growth, demand was partly met by a large inventory that enterprises had accumulated in 1989 and 1990 because of excessive construction. In 1992, a good harvest also played an important part in supporting stable economic growth: Grain output was estimated to be 442.5 billion kg, 7.3 billion kg more than the previous year, while agricultural value added was to be over 560 billion yuan, or 3 percent higher. In addition, the present retail price index does not completely reflect the real situation, nor does it reflect changes in wholesale prices: It is an underestimate because the sample structure supposed to represent price changes was not adapted to changes in households’ structure of expenditures, which began in 1992 when the move to the market accelerated.

Two policies exacerbated the overheated economy: slack monetary policy and expansionary fiscal policy.

Various factors can be attributed to the slack monetary policy. The first is the money supply, which can be derived outside the banking system. In 1992, the M1 increased by 27.4 percent, as all types of bank deposits grew to 402.9 billion yuan. Broad money expanded considerably; and as control of monetary expansion through the credit quota system became limited, more and more channels outside the banks arose by which the money supply was derived. Reflecting the serious gap between bank deposits and loans of all kinds, a huge negative value appeared in the “other” item on the debit side of the national credit balance sheet. This indicates that bank deposit surpluses were converted into real purchasing power through many channels, such as interbank lending (by which funds go to nonbank financial institutions), joint accounts of banks and enterprises, fiscal lending, off-account interbank lending, and lending of stipulated scope and length.

The second relates to defects connected with requiring excessive deposit reserves. The amount of the financial institutions’ reserves in the central bank has declined dramatically. In 1992, it dropped by 29.5 billion yuan, compared with an increase of 73.0 billion yuan the previous year, a difference of about 100 billion yuan. Deposits of
specialized banks, in particular, dropped by 47.6 billion yuan (against a rise of 50.7 billion last year). The declines doubled the monetary multiplier, which rose from around 2.5 in 1991 to over 5 in 1992. Obviously, this was a significant reason for the large increase in the money supply: The base money supply of the central bank grew by 132.5 billion yuan, or 16.4 percent, in 1992. The decline of excessive reserves gave rise to a multiplier mechanism that expanded the money supply, which grew at a much higher rate than the base money supply.

Thus, specialized banks had enough funds to lend even though deposits grew at a lower rate, and the deriving capability of money outside the banking system was further strengthened.

The third factor is that the structure of capital in the central bank changed significantly. For example, funds in the form of foreign exchange declined by 11.1 billion yuan, compared to a rise of 61.2 billion yuan in 1991; at the same time, loans to nonbank financial institutions rose sharply by 12.7 billion yuan, while growth was only 2.3 billion yuan the previous year. Even worse, the excessive funds were not used to purchase government bonds; instead, they were used to speculate in stocks, real estate or high-interest loans, a reason why the money supply expanded.

Expansionary fiscal policy is also responsible for the economy overheating. The first factor is the defective tax system: While the economy grew very rapidly in 1992, fiscal revenues failed to rise at the same pace. In particular, product taxes grew slowly, by 3.9 percent in November, in contrast to a rapid rise in industrial output. SOEs’ corporate taxes dropped by 7.8 percent, and adjustment taxes declined by 0.5 percent, although SOE profits improved. Further, very few revenues have been collected from the overheated real estate sector, income from initial land transfers were largely off-budget revenues, and tax revenues on land-use decreased. Conversely, the turnover tax rose relatively quickly, a fact that reflected the increased income from land transfers in the secondary market.

The second factor is the tendency to use fiscal funds as credit capital. This happens mainly at the local level where fiscal authorities took advantage of the time lag between fiscal revenues and expenditures and lent the funds to projects that could register returns in short term. Thus, fiscal revenues could not be delivered to the treasury on time: In 1992, fiscal deposits in the central bank declined by 25 billion yuan. The expansionary fiscal policy stems from the economic system itself, which needs to be reformed.

Macroeconomic Policy Adjustment and Reform in 1993

Economic growth in 1992 benefited from a number of favorable short-term factors. These included inventories accumulated in previous years due to economic readjustment, a relatively high surplus of foreign exchange reserves and the import growth it could support, and increased demand from the former Soviet Union. These
factors may change or simply disappear in 1993. In the meantime, some phenomena are
feeding inflation: Aggregate demand may expand due to the monetary and fiscal policies
of the previous years which were relaxed for some period. Thus, macroeconomic policy
must be adjusted to maintain economic growth and avoid inflation.

The preconditions for economic development in 1993 include (a) full
employment, that is, realizing the capacity of aggregate supply and increasing people’s
living standards; (b) a foreign capital inflow similar to last year’s; (c) a foreign exchange
surplus similar to or slightly less than last year’s; and (d) an acceptable inflation rate, not
over 7 to 8 percent. Our forecast indicates that under these conditions, the economy
would be able to grow continually at a fairly high rate, with GNP increasing by 10
percent, amounting to 3,000 billion yuan. To this end, investment in fixed assets should
remain at no less than 860 billion yuan, a growth of 18 percent; retail sales of
commodities should reach 1,260 billion yuan, an increase of 16 percent; industrial output
at the township level and above should be 3,350 billion yuan, a growth of 18 percent,
with light and heavy industries growing by 16 percent and 20 percent, respectively; and
total imports should be $200 billion, a rise of 20 percent. Thus, monetary and fiscal
policies will need to be adjusted to achieve these targets, given the constraints discussed
earlier.

Because of the overrelaxed monetary policy of previous years, the money supply
has grown rapidly: M2, in particular, grew at an annual rate of 27 percent, and aggregate
demand expanded considerably. An adjustment is thus required; its target should be to
maintain economic stability and prevent inflation, strictly control the money supply, and
curb the rapidly increasing aggregate demand.

Policies that should be adopted are as follows:

- Raise interest rates of deposits and lending in the near future. Given inflation,
aggregate demand cannot be restrained by low interest rates. The practice of
government and enterprises as debtors taking advantage of households as creditors,
cannot last, and interest rates would have to be raised when inflation occurs.

- Increase the credit scale to sustain economic growth. However, credit quota controls
(as the main way to manage the money supply) must be strictly enforced without any
exemptions. Simultaneously, the structure of lending should be improved to increase
the efficiency of capital resources.

- Maintain a stable ratio of excessive deposit reserves of financial institutions in the
central bank. The base money supply should be regulated, considering the needs of
future years. Attempts must be made to avoid its increasing sharply, which would
lead to a higher ratio of reserves in one year and create expansionary pressures in the
next.
• Strictly control the central bank’s relending, especially to nonbank financial institutions. The latter should attract deposits from households and institutions and in turn, invest directly or in the securities market. In principle, the central bank should not relend to them unless to provide funds to underwrite treasury bills; in this case, the central bank may rediscount treasury bills held by these institutions.

• Coordinating with public finance departments, the central bank should regulate financial institutions’ reserves by open market operations, so the money supply can be controlled. From now on, treasury bills should be issued principally to financial institutions rather than to households and enterprises, as before. Repurchasing agreements must be signed when financial institutions discount their treasury bills in the central bank, which can then regulate the money supply through this means.

Fiscal policy adjustments should also attempt to tighten controls, along with fiscal reforms. First, expenditures must be strictly controlled: Besides restraining administrative expenses, government should reform its organizations. Close attention must be paid to keep local fiscal authorities from expanding aggregate demand through fiscal credit.

Second, tax collection and management must be reinforced. Land lease approvals must be strictly regulated so land taxes and duties are not drained from the budget. Also, the management of turnover taxes must be improved by abolishing various forms of contracts. Further, tax concessions and deductions must be restricted.

Third, regulation of off-budget funds must be enforced, especially to keep local fiscal authorities and enterprises from transferring funds out of the budget.

Fourth, tax reform should be accelerated and the power of the central fiscal authority in macroeconomic management should be strengthened.

Besides adjusting monetary and fiscal policies, price reform should be accelerated, capitalizing on the present optimal opportunity and introducing market prices in the near future. Price, fiscal, tax, financial and investment reforms should be coordinated to establish a system of macroregulation in a socialist market economy.

We must guard against another overheating of the economy to ensure stable economic growth in 1993. To this end, monetary and fiscal policies should be well operated.
THE CURRENT ECONOMIC SITUATION AND POLICY RECOMMENDATIONS

The current economic situation is precarious and there are abundant signs of overheating. In the first quarter, investments of state-owned units grew by 70.7 percent; bank cash payments for wages increased by 35.9 percent; prices of production goods rose by 39 percent; retail prices grew by 8.6 percent nationally, with a rise of 15.7 percent in 35 large- and medium-size municipalities; export growth was 7.4 percent, while imports grew by as much as 25.4 percent. These figures all set records.

The fiscal and financial situation is tense. Statistics show that fiscal revenues grew by 6 percent by mid-April, which would be negative if inflation was considered. Treasury bills issued only totaled 4 billion yuan compared to a scheduled 30 billion yuan by the end of April.

During the same period, the net cash input was 35.6 billion yuan, compared with a net withdrawal of 6 billion yuan. The total cash input is estimated to be over 150 billion yuan for the whole year. Bank deposits dropped sharply, the balance of deposits in both urban and rural areas declined by 4.5 billion yuan in March and showed no significant sign improving by April. Many banks experienced payment difficulties. The extra reserve ratio of all banks nationwide declined from 7.1 percent at the beginning of the year to 5.4 percent by the end of March, while some local branches of specialized banks registered a ratio below 2 percent. In some regions, banks do not have enough money to issue loans and pay enterprises and households when they withdraw their deposits.

Further, bank lending of all sorts reached 47.8 billion yuan, which is normal. However, only 6 billion yuan of PBC relending was recalled despite great attempts to achieve this. To the contrary, by the end of last April, PBC's recalled relending totaled 9.1 billion yuan, although 10.8 billion yuan was issued in the same month. At present, PBC has difficulties recalling its relending due to downpayments required to procure agricultural products. Given such conditions, monetary policy will relax further and the financial situation could hardly improve.

Various policies have been recommended.

- Deposit and lending interest rates should be raised as soon as possible: The former should be 12 percent and the latter about 15 percent. The 12 percent interest rate would be fairly attractive and accepted by households. The 15 percent rate would be appropriate, because enterprises accept real interest rates for various loans of 15 to 20 percent.

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33 This internal report was written in May 1993.
Specialized banks must guarantee payments; if not, the central will have to make up for the shortage by increasing the base money supply (as is done now). Thus, the specialized banks’ head offices must be strengthened in order to better regulate their funds. Local branches of PBC should not exercise excessive control over the specialized banks’ fund transfers across regions; instead, the latter must be responsible. In addition, PBC should not duplicate the specialized banks’ business, as this would be incompatible with the central bank functions and provide excuses for the specialized banks to leave the funding gaps to the central bank.

Some compulsory measures must be imposed on specialized banks and nonbank financial institutions to underwrite treasury bonds; for example, they should subscribe proportionally to the value of their assets. Financial institutions holding a certain amount of treasury bonds could sell them or discount them at the central bank when necessary. In this way, the difficulties involved with issuing treasury bonds would be eased, while specialized banks and nonbank financial institutions would have effective, liquid assets and their assets’ risks would be better managed. Compared with developed economies, whose ratio of extra reserves is usually 0.5 to 1 percent, China’s 5 percent ratio is not low. The measures to guarantee payments include a certain ratio of liquid assets to total assets (usually 20 to 30 percent are government bonds); management of assets’ risks (high-risk assets must be accompanied by a high stable debt); and powerful head offices that can regulate capital in their branches.

Besides the expedient measures, financial reforms must be accelerated to resolve the fundamental defects of the economic system.

VIEWS ON THE CURRENT FINANCIAL SITUATION

The current financial situation is in a precarious situation due to the following:

- The cash supply is excessive. Cash issued in 1992 totaled 115.8 billion yuan, 62.5 billion more than in 1991; cash input before the Chinese New Year was 101.6 billion yuan, 36.6 billion more than the same period last year. The problem began just after the New Year. Instead of the expected flow back, net cash input was 22.2 billion yuan by the end of March, and 36.147 billion by April 22. During the same period last year, the cash flow back was 2.1 billion yuan. If this continues, the cash supply will be over 150 billion yuan for the year.

- Banks are having difficulties making payments. In some areas, there is neither money for loans nor for withdrawals (of deposits) by firms and households.

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This report was written in April 1993.
The specialized banks’ reserve ratio of excessive deposits in the central bank declined remarkably. By the end of February, the ratio dropped to 5.7 percent, which is the lowest since 1990 (when it was 11.6 percent). It was 12.7 percent in 1991 and 7.1 percent in 1992.

The basic source of these difficulties is that the central bank implemented an excessively loose monetary policy that was ultimately constrained by various factors. Lending of various types in the state banks increased 273.1 billion yuan, 289.5 billion yuan and 352.6 billion yuan in the three years respectively, and lending balances grew by 22.2 percent, 19.0 percent and 19.8 percent a year.

In 1990 and 1991, the growth of lending was related to the economy: The banks were asked to increase their lending to industrial and commercial firms to support a high rate of growth. However, investments in fixed assets and the consumer market were in a recession, a good many circulating capital loans could not be recalled, and the banks ran short of capital. As a result, the central bank had to increase its relending to these banks, which rose by 88.1 and 82.3 billion yuan in 1990 and 1991, respectively, or by 21.1 and 16.3 percent.

Another problem was the rapid growth of exports which, with less growth in imports, increased the amount of spot foreign exchange settlements and the yuan occupied (the incremental amount was 31.4 billion yuan and 61.2 billion yuan, respectively, in 1990 and 1991). Thus, the central bank had to increase the supply of base money.

The results of the central bank’s increased relending were, first, a sustained high credit scale and an excessively high ratio of deposit reserves (of the specialized banks) in the central bank (5 to 7 percent is normal), because the former were unable to lend the funds they received from the central bank, due to credit quota. Growth of the reserves means that credit will probably expand further because the specialized banks will need to increase their lending whenever they have capital. This is alarming and the central bank should recall some of its relending to lower the ratio of the reserve to a level of, say, 7 percent.

In 1992, the economy changed dramatically. Industrial output grew rapidly, the ratio of sales to production increased, the consumer market recovered, the sales volume rose remarkably, imports grew quickly and spot foreign exchange settlements were reduced. This indicated that the conditions that forced the central bank to significantly increase its relending were abating, which allowed it to adjust its credit policy; because the specialized banks had deposited a large amount in the central bank, the latter could recall part of its relending. And, because the loose monetary policy of the two previous years produced inflationary pressure and the economy was overheating, it was suggested that interest rates be raised to prevent inflation.
However, events unfolded differently. In 1992, the central bank’s relending increased by 85.3 billion yuan and 14.5 percent, instead of scaling back. Even worse, its relending to nonbank financial institutions grew significantly, by 12.7 billion yuan, which was much more than in 1990 and 1991, when it was 1.5 billion yuan and 2.3 billion yuan, respectively. Much of it was used by the recipients to speculate in stocks and real estate, not, for example, to purchase government securities to support construction. Meanwhile, PBC provincial branch offices provided funds for institutions’ “funding offices” as required by local projects, which caused credit to expand even more.

As a result, more capital was required to invest in fixed assets because of the expanded scale; at the same time, high yields in stock and real estate drew capital away from savings deposits, and led to larger negative interest rates (of deposits), which reduced the effect of increasing interest rates. The exchange rate rose and the government was unable to sell its foreign exchange to lower it, due to a shortage of surrendered foreign exchange. More problematic, when the growing demand of existing projects drained the funds available for increased lending (creating limited funds with which to buy agricultural products), the central bank had to raise its relending. As a result, macroregulation was less effective. Faced with such difficulties and having lost the optimal time in which to apply adjustment policies, authorities would have to use traditional administrative measures, and the reform process would have to be postponed.

At present, the ratio of excessive reserves of the specialized banks’ deposits declined to about 5 percent, and in some cases only 3 percent, and many banks are having difficulty making payments. However, the lowered reserve ratio is not the main source of the banks’ payment problems. In developed economies, the commercial banks’ ratio of payment reserves is only 0.5 to 1 percent. However, their payments are guaranteed by other measures such as the ratio of circulating assets, of which 20 to 30 percent of the assets are normally government bonds, by the management of asset risks, and by the head office having the power to regulate the capital of its branches. These three measures do not exist in Chinese banking regulations. The central bank should require that the first two measures be applied, and the banks should be responsible for the third.

The following measures must be adopted immediately.

- The central bank should recall part of its relending (particularly to nonbank financial institutions), require that banks and other financial institutions supplement the short, excessive-deposits reserve, recall its loans and interbank call capital, and raise interest rates.

- Bills must be sent for agricultural products that were procured, and financing must be limited through discounting and rediscounting. This should prevent funds from being diverted.
• Measures must be introduced to make assets liquid, manage risks and exercise oversight.

• Specialized banks must be allowed to establish an internal liquidation system.

• With respect to investments in fixed assets, responsible financial institutions must control policy investments.

• PBC’s profit retention system and the practices of its branches, which do not focus on managing the specialized banks’ risks but rather on lending, must be changed.

• The problem of regional imbalances, with heavy credit flowing to coastal areas, cannot be solved by policies and changes in the financial sector. Rather, it appears the rich areas should no longer be given preferential treatment; instead, less developed areas should be assisted. Also, the fiscal and tax systems must be reformed.

**THE CURRENT ECONOMIC SITUATION: PROBLEMS AND POLICY SUGGESTIONS**

Since January of this year (1993), the rate of economic growth is rising rapidly. Further, aggregate financial expansion appears strong. Thus, decisions must be taken with respect to macroeconomic policy to prevent inflation and sustain growth.

**Current Conditions**

**The economy.** Industrial output continues to grow rapidly. From January to April, gross industrial output of the township level and above rose by 23 percent, compared to the same period last year. In April alone, the rate reached 25.2 percent, one the highest since the late 1970s.

Investment in fixed assets grew excessively and promoted expansion. From January to April, investments in the state sector grew by 68 percent; however, despite such rapid growth, the structure of investments has not improved noticeably. In the first quarter of this year, the share of investment in fundamental industries like energy and raw materials declined to 38.7 percent from 50.6 percent over the same period last year, while the share of investment in manufacturing rose to 16.3 percent from 16.1 percent.

The rise in imports far outstripped the rate of export growth. In the first quarter this year, foreign trade grew at 7.4 percent, but imports grew at 25.4 percent, which is one of a few records set recently.

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35 This report was requested by the leaders of SRC in May 1993.
In the consumer market, demand and supply of ordinary industrial goods was balanced, but the retail price index rose sharply. In the first quarter, it rose by 8.5 percent, while the workers' cost of living index in 35 municipalities grew by 15.7 percent in April, and then rose by 17 percent. The main reason was not a shortage of supply, but the cost-push, demand-pull of few commodities and price adjustments. Of 582 categories of industrial consumer goods, 95.5 percent had a balanced or surplus supply, while only 4.1 percent experienced shortages.

Major production goods are in very short supply, and prices have risen considerably. In the first quarter, the price of agricultural products (production goods) rose by 18.7 percent, ferrous metals, construction materials and timbers rose 28 to 38 percent, and fuel and energy grew by 31 percent. Other prices, such as for real estate, have also grown abnormally.

**Financial conditions.** The growth of the money supply has been rapid. Until now, the net input exceeded 50 billion yuan (with a total of 150 billion yuan estimated for the year), while in the same period last year, there was a net withdrawal of currency from circulation. With such rapid growth, the structure of the money supply is changing considerably: M1 (cash plus check deposits) rose by 41 percent, while M2 (M1 plus institutional fixed deposits and savings deposits) grew a bit more slowly, but still at a high of 30 percent, due to the reduced growth of saving deposits.

It is difficult to control the scale of credit effectively. While it was smaller than in the same period last year, expansionary pressures were still high. At the same time, there are few effective instruments to regulate the expansion other than the credit scale.

The banks' ratio of payment reserves dropped to the lowest level since 1990, and the possibility of a payment crisis increased. The ratio declined from 12.7 percent in 1991 to 7.1 percent in 1992, and 5.4 percent in the first quarter of 1993; the ratio of ICBC and ABC were only 4.1 percent and 4 percent, respectively. Some regional specialized banks have difficulties making payments.

**Fiscal conditions.** While production grew rapidly, fiscal revenue increased slowly: By the end of April, the rate was just 1.7 percent over the same period last year, which is far below GDP and industrial growth.

The debt has three aspects: Enterprises are in arrears for tax payments, the treasury cannot allocate finances and these must be made by banks, and the latter use the enterprises' tax payments for other purposes. Enterprises now owe a total of 18.2 billion yuan in taxes.

Fiscal expenditures grew sharply and fiscal financing capacity became strained: By the end of April, fiscal expenditures were 17.9 percent more than in the same period last year, and the central budget was registering deficits. Fiscal allocations to some
planned projects could not be made due to insufficient funds. Until April 20, only 4.6 billion yuan of the 41.7 billion of fiscal allocations for capital construction at the central level were issued, and over half the country’s counties and municipalities lacked currency to pay salaries.

The above analysis describes an overheated economy pulled by investment and constrained by bottleneck industries; prices have approached the brink of social tolerance, and overheated investments could spread to the consumer market if they continue. In an overheated economy, the fiscal situation is problematic, which serves to intensify the gap in income distribution and regional disparities. Thus, macroeconomic policy needs to sustain stable economic growth. For this purpose, the regulation of aggregate demand must be strengthened and some financial measures are required. However, financial controls have proved ineffective. Now, indirect instruments must be applied, which should be consistent with future economic reforms.

Analysis of Current Problems

The main problems relate to overheated investments, which are directly linked to the excessive money supply: The push by local governments and enterprises to expand investments forced the central bank to increase the money supply and loosely control money, which spurred the investments.

M1 must be addressed because it represents real purchasing power. First, M1 grew rapidly because of PBC’s loose regulation of base money. Its branches, which have broad responsibility to regulate money, acted in their self interest and made many loans— which accelerated the growth of the money supply. Second, financial institutions sought to lend capital outside of credit scale regulations and went to sectors with high yields and risks. Third, interest rates of deposits and loans were far too low, and enthusiasm grew for raising funds through the stock market, where yields were expected to be high. This reduced household savings’ deposits.

The financial institutions’ accounting systems are relaxed and inadequate to control the quality of assets and risks, and it is difficult to supervise PBC because it participates in profit-making activities. As a result, capital is subjected to high risks outside the credit scale regulation.

Suggested Policies

The main policy to cope with current difficulties is to control aggregate demand. For this purpose, the base money supply must contract. However, this would aggravate problems in the fiscal and financial sectors and with bank payments. The base money supply should not be relaxed to solve the payment problem, as it would induce inflation and cause even more serious payment difficulties. The alternate policy would be to
withdraw the capital to the banks, shrink credit and ease payment difficulties under the general scheme of contracting the base money supply.

Raising interest rates would be the most effective measure and is urgently needed. Thus, it is suggested that rates for one-year deposits increase 2.4 percent to reach 11.58 percent, while those for one-year loans increase by 3 to 4 percent. While rates for five- and eight-year deposits would remain unchanged, those for other terminal deposits should be raised accordingly. This would increase savings deposits, remove currency from circulation and reduce the growth of M1.

PBC should centralize its regulation of capital at its head office and decentralize oversight institutions’ responsibilities and operations (to its branches). Specifically, the head office should control M1, while specialized bank head offices should adjust the base money supply and credit scale.

Specialized banks should also assume responsibility for payment guarantees, and PBC branches should no longer deal with the banks’ payment difficulties. Bank presidents should be penalized when the banks have difficulty making payments; this must be strictly enforced to protect the banks’ good will and social stability.

Some major or important cases of securities fraud must be adjudicated in a timely manner. Households and individuals must be told about the risks associated with various financial instruments; the state should announce that all fund raising activities, securities and stocks not approved by authorities are not legally protected. At the same time, limitations should be relaxed with respect to issuing securities, and approval procedures should be simplified and acted on quickly.

PBC’s regulation of the specialized banks’ asset risks must be strengthened and binding examination rules and methods created. Loans for fixed assets that are disguised must be exposed, particularly in the real estate sector, a ratio of loans to this sector should be established, and the asset/debt structure should be changed.

Control of the credit scale and regulation of call capital should be tightened. The scale should not be relaxed without PBC’s permission. Interbank call capital can be used for the specialized banks’ capital balance with one-month terms only. Bank presidents who violate this must be penalized.

PBC’s methods of managing credit must be improved. The specialized banks’ annual credit scale should be determined on each bank’s share of debt (out of the banking system’s total debt), and the credit scale should no longer be determined arbitrarily.

Because the relationship between MOF and banks has not yet been rationalized, the central bank will issue financial bills this year to adjust the interbank capital balance. In the future, it should develop an open market. To halt MOF’s overdraft and PBC
borrowing, financial institutions should take on a certain amount of government securities, which should be included in this year's 380 billion yuan credit scale, and the scale could be adjusted later, if needed.

The organization of policy banks and financing should be accelerated. By this year, the long-term development credit bank and import-export bank should be established. Before the policy banks begin operating, policy lending in specialized banks must be managed from separate accounts.

The state should offer some public equity shares and accelerate the approval process for initial public offering applications to increase the supply of stock and cool down the market.

Apart from the above financial measures, some fiscal measures are needed. One of the more effective is to remove some tariff concessions, since these are regulated by the government and are easier to adjust. The first step may be to abolish tariff exemptions and deductions of planned imports by the foreign exchange plan; if necessary, the loss of revenue could be made up by a treasury financial allocation. Tariff exemptions and deductions must be reviewed and any unauthorized conventional exemptions and concessions must be prohibited.

The above measures should ease the current situation, especially that of expanded aggregate demand. They are expedient but necessary, and consistent with future reforms.

THE PRESENT ECONOMIC SITUATION AND POLICY SUGGESTIONS

Current Conditions

It is generally agreed that the economy is overheated: The high rate investment in fixed assets continues, the money supply is excessive, industrial production is accelerated, energy and raw material supplies are increasingly scarce, the price of retail and intermediate goods remains high, swap exchange rates are growing and household savings deposits have declined.

If these problems are not addressed, they could lead to macroregulations that could hinder economic development.

Cause of the Problems

It is generally thought the source of the problem is the severe lag in macroregulation. Reforms in the financial, fiscal, tax, investment and foreign exchange

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36 This report summarizes a discussion held by DMRS on macroeconomic conditions in June 1993.
systems lag far behind changes in microeconomy, which is still subject to irrational policies.

There is some debate about the immediate causes. Some believe that excessive investment in fixed assets is the source of the overheating: Since the beginning of this year, local governments have accelerated development and promoted economic development zones. These caused investments to grow rapidly and cause supply side shortages.

Many argue the problem is monetary policy. Given the excessive money supply for the last two years, particularly at the end of last year when the economy was overheated, the central bank infused excessive base money, which expanded aggregate demand.

Others argue the recent overheating in the equity market and real estate drew off a good deal of capital and raised interest rates (reducing the capital supply for real sectors) and also exacerbated the price hikes of labor and raw materials such as steel, which increased production costs. The current inflation is thus of a cost-push variety, and not just due to the excessive money supply.

**Regulatory Measures Needed**

It is generally agreed that the current overheated economy differs from those before it and past deflationary policies should not be applied. Instead, regulatory measures should be introduced to the market economy on the basis of deepening economic reforms and addressing development and reform.

A tight monetary policy is the first priority. The central bank must be responsible for controlling the money supply; however, this is difficult, given the existing macroregulatory system. The focus should be on controlling the scale of credit and volume of cash issued, although these are not the sources of the money supply. Also, introducing bank notes and changing payment transfers affect only the instruments of payment, not purchasing power, and cannot control aggregate demand.

Possible measures would be to: (a) raise interest rates further; (b) control base money and the central bank’s relending, and stop the latter to nonbank financial institutions; (c) continue controlling the credit scale and cash regulations, but not limit the volume of cash inputs (if depositors cannot withdraw their money, financial panic would ensue and lead to a run on the banks). When strictly controlling credit, its end use must be addressed; loans should be made for capital construction and development projects, but not to nonbank financial institutions for equity and real estate.

The impact of the overheated economy was addressed and it was agreed it must be cooled by various measures such as: (a) cutting off funds to the overheated sectors, for
example, limiting credit on investments in real estate and equity trading and constraining the ways that specialized banks are involved in these investments; (b) strictly regulating approvals for land leases and transfers, and tax collections, and reducing the extraordinarily high profit rates in real estate.

**Short-Term Reforms**

It was agreed that economic reforms must be accompanied by the present macroeconomic measures. Financial reforms must be applied immediately, so as to establish a banking system that meets the requirements of a market economy. First, a central bank must be established that can exercise macreregulations. This means not only transferring some of PBC's lending operations to other banks, but also changing the organizational structure of banks that organize branches by administrative level. Second, a commercial banking system must be established. Policy operations in specialized banks must be converted to policy banks, and specialized banks must be transformed into commercial banks with mechanisms to constrain risks.

Fiscal and tax reform must be expedited, because financial measures cannot play an effective role over the long run, if the fiscal and tax systems remain unchanged.

It is stressed that reforms in fiscal, tax, financial, foreign exchange, and investment systems are comprehensive and require sophisticated skills. They must be coordinated and designed in a uniform way, and introduced with determination and flexibility.

**FORECASTS OF ECONOMIC CONDITIONS IN 1993 AND RECOMMENDED POLICIES**

In the first half of 1993, economic growth reached a peak (see the first part of *The Current Economic Situation: Problems and Policy Suggestions* in Part VII). The publication of the No. 6 Document of the Central Committee and State Council on macreregulation, with 16 measures, changed public expectations and had positive results.

At present, the growth of industrial production is declining, the price of production goods is dropping somewhat, unauthorized fund raising and illegal interbank calls are under control, saving deposits are increasing (after interest rates rose), enterprise deposits have been reduced due to strict control of the base money supply and a decrease in lending capacity by the specialized banks, 98 percent of the summer harvest products have been procured and paid for (mainly in cash), the yuan exchange rate is stable, and the overheated real estate and development zones are cooling off a bit. In July, industrial output grew by 25.1 percent over the same month last year, and declined 5.1 percent

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37 This report was written in August 1993 and published internally.
against the June figures. Savings deposit surpluses in urban and rural areas increased 40.478 billion yuan over June, and 73.7 billion yuan over May. Net interbank calls of state banks were 73.224 billion yuan in July, 105.453 billion yuan in May, and 90.781 billion yuan in June. In July, the net monthly money input was 4.474 billion yuan and the amount accumulated was 57.233 billion yuan. Enterprise deposits in July were 716.145 billion yuan, 34.045 billion less than in June, and 62.7 billion less than in May. From January to July, accumulated fiscal expenditures and revenues increased by 9.2 percent and 5.3 percent, respectively, over the same period last year.

The remaining five months will be critical for ensuring a "soft landing" to the economy and providing a good environment for next year's macroregulatory reforms. The intermediate aim of monetary policy should be the expansion of M1, controlled at a level of about 26 percent. Base money must also be controlled, the ratio of extra reserves raised a bit, money multipliers stabilized and sharp fluctuations of the money supply avoided.

Various operating procedures should be addressed.

- There should be no hard limit on M0 supply, because it depends on household and enterprise preferences for cash and should not be directly controlled. Tight limits would lead to a payment panic, with an inclination for cash.

- Base money should continue to be strictly restrained by controlling investments in fixed assets. The central bank must cautiously relend to specialized banks and lending should be confined to maintaining a capital balance, with small amounts inserted each time.

- Specialized banks should guarantee payments for deposits of households and enterprises.

- Specialized banks must ensure the enterprises have the funds needed to produce by lending according to needs—to prevent circulating capital from flowing to the overheated sectors. A documentation system that can keep track of circulating capital must be imposed.

- Interest rates for loans should be allowed to float to an appropriate extent.

- Nonbank financial institutions should be eligible for interbank call within seven days, for the purpose of capital balances only.

- Exchange rates should be stabilized at an effective level. For example, the nominal rate should be raised to 9 yuan to $1, if the price index is still high.
The permit procedure for initial public offerings on the equity market should be accelerated.

Regulation of the futures market should be strengthened. Futures companies that cannot standardize their operations must be suspended. At present, only commodity futures can be introduced and financial futures should not be developed in the near future. None of the futures markets should be linked with the international market for speculative trading.

With respect to real estate construction, those that invested in operations (and did not just speculate for high profits), and which are nearly completed, should be financed (to finish the work). Where banks made equity investments, they must sell their shares.

Fiscal credit is the major cause of the gap between tax revenues collected and revenues received by the treasury, and it must be checked.

These measures will affect the economy for the entire year. GNP in 1993 is estimated to reach 2,900 billion yuan, growing at a rate of about 12 percent in comparable prices. Investment in fixed assets will be 1,050 billion yuan, increasing at about 38 percent; of this, investment by the State will be 640 billion yuan (excluding commodity housing investments), rising by about 38 percent. Gross industrial output will be 3,500 billion yuan and increase by 23 percent, total social retail volume will be 1,235 billion yuan, increasing by 22.5 percent.

In the second half of the year, imports and exports will be balanced (thereby avoiding trade deficits). The volume of imports (customs statistics) will be 93 billion yuan and exports 90 billion yuan, growing at 15 percent and 6 percent, respectively, compared with the same period last year; the foreign exchange surplus will be less than last year. Inflation will be constrained because of government policies, the demand-pull price rise of production goods will soon decline remarkably, while the cost-push rise of consumer prices will begin to drop a few months later. Fiscal revenues will increase only moderately and their share of GNP will drop to about 16 percent.

In summary, the overheated economy is rooted in the economy's defects and the lack of indirect regulatory instruments. The way to solve the problems is to deepen economic reforms, particularly of the financial, fiscal, tax and investment systems.
REINFORCE THE EFFECTIVENESS OF MONETARY POLICY

Fiscal policy and monetary policy are important economic policies for regulating aggregate demand. In a transitional period, the fiscal built-in stabilizer does not work effectively and plays little role in stabilizing the economy. Thus, it is necessary to reinforce monetary policy.

Macrolegulations have been effective. First, money supply regulations are basically in place. From May to September, the growth of M1 declined from 39.4 to 20.5 percent, and net interbank calls of the state banks were remarkably reduced: In April, the figure was 110.606 billion yuan, while in August, 55.05 billion yuan were recalled.

Second, the growth of investments and consumption began to decline and aggregate expansion was reversed. From January to May, completed capital construction and transformation investments grew by 66.4 percent; from June to August, the figure dropped to 64.6 percent. In the same period, fiscal financial allocations and loans on capital construction and transformation grew by 60.1 percent and 43.8 percent, respectively. This indicates that funding of investments is to some extent under control. On the consumption side, the rise of interest rates increased savings deposits, the growth of income from cash sales in the banks declined to 22.9 percent, and the growth of aggregate retail sales declined to 25 percent in August.

Fiscal revenues improved: These totaled 42.84 billion yuan in September, an increase of 32.9 percent over the same period last year.

Enterprises reduced their deposits and the supply of funds is tight. This is a necessary consequence of the macroregulations, which will reduce purchasing power and slow the growth of industrial production and inflation. However, the decline of enterprise deposits should not be too sharp, since the macroregulations are aiming for a "soft landing." At present, this decline has slowed somewhat: In August, the decrease was 10.6 billion yuan, while in September, it was only 0.58 billion yuan.

Economic growth and inflation are to some extent under control. In September, gross industrial output increased by 19.1 percent. In August, the cost-of-living index in 35 large and medium municipalities began to decline, while the retail price index rose slowly and is expected to decline in a couple months.

In the next few months, it will important to check the effectiveness of the macroregulations: The aim is to bring inflation down to 10 percent or less, while

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38 This report was written in October 1993 and published internally.
sustaining reasonable economic growth—for example, industrial growth of about 15 percent.

For this purpose, various macroregulations must be applied. With respect to the aggregates, the focus should be on changing M1, whose growth rate should be 15 to 18 percent. Changes to base money and money multipliers must be controlled.

Control of base money will lead to controlling the growth of M1 and the credit scale, which is borne out by the current phenomenon of “no funds but a surplus credit quota.” However, the growth of base money was still 14 percent in May, and in September it rose to 25.8 percent, which meant it was essentially out of control.

Effort must be made to stabilize the money multiplier, which is a ratio of M1 to base money and is related to the ratio of legal reserves and extra reserves, and cash outflow. It is reduced when the ratio of legal reserves and extra reserves are larger and cash outflows increase. At present, the ratio of extra reserves is rapidly being restored, and is sharply shrinking the money multiplier—which was 1.33 in May and 1.15 in September. Thus, the input of base money is excessive and should not be increased.

Adjusting interest rates on deposits had a substantial effect, removing currency from circulation. Now, rates on loans should be targeted. Rates for nonpriority projects and procurement should be raised to a positive real level, at 2 to 3 percent, which makes the nominal rate 17 to 18 percent. If this is not done, it will be difficult to control the base money supply, given the great demand for credit.

The banks’ skills must be strengthened, since poor management practices lead to payment difficulties, even with the high extra reserve ratio.

Management of the banks’ asset risks and liquidity must be stressed. They should hold some portion of short-term bills and government bonds, and the share of lending to fixed assets and real estate in the total lending portfolio must be strictly limited. In this way, the banks will be able to cope with payment fluctuations and reduce sharp changes in the ratio of extra reserves and pressure from heavy withdrawals lent capital in the form of loans.

Banks funds must be more efficient. Because illegal interbank call funds must be withdrawn, those that are legal with one-month terms should be protected; nonbank financial institutions should be allowed interbank call funds with a one-week term, in order to balance the supply of capital.

The elimination of PBC’s relending to nonbank financial institutions has moved very slowly, and 16 billion yuan remains. It must be expedited.
In September, fiscal revenues nationwide increased at an extraordinarily high rate, but the growth of central fiscal revenue was very slow. It seems this is due to expanded local fiscal power, with the contract tax base of 1993. Thus, the indicator of the growth of central fiscal revenue collected by local authorities must be included as one of the contract conditions.

**THE MACROECONOMY IN 1993 AND PROSPECTS FOR 1994**

**The Macroeconomy in 1993**

In this year, the economy sustained rapid and healthy growth. During the first half, because of overheating, the government adopted various macropolicy measures. In the second half, the situation improved.

**Aggregate supply and demand.** Economic growth was rapid: In 1993, annual GDP growth was 13.4 percent. Of this, primary industry grew by 4 percent, secondary industry by 20.4 percent and the tertiary sector by 9.3 percent. Of their shares in GNP, the three accounted for 21.1 percent, 51.8 percent and 27 percent, respectively, and the share of secondary industries increased remarkably. In national income, the share of consumption dropped and accumulation rose. These data indicate the supply capacity increased considerably and its structure changed.

Consumption demand was fairly high: Retail sales were 26.1 percent over 1992, and real growth after adjustments for inflation was 11.6 percent, which was relatively high, compared with previous years.

Demand for investment expanded: The volume of investments in fixed assets increased by 50.6 percent, while real growth was 22 percent. The investment ratio reached 37 percent, a record high in recent years.

Demand for imports increased. Trade deficits amounted to 12.2 billion yuan, and the total volume of imports was 29 percent over 1992.

These figures indicate the growth of demand in areas of consumption, investment and imports significantly exceeded the real growth of aggregate supply, and the economy overheated.

**Fiscal and financial conditions.** Fiscal revenues increased remarkably. The state budget showed that fiscal revenues (including domestic and foreign debt of 69.4 billion yuan) grew by 23.2 percent, and expenditures by 21.2 percent, while budget
deficits reached 20.5 billion yuan. A current account surplus of 72.6 billion yuan was converted to the construction budget.

The financial sector experienced sharp fluctuations. In the first half of 1993, conditions were severe, and normalized after the macroregulatory policy was adopted. At the end of the year, M1 grew by 21.6 percent, M2 by 24 percent and the cash input was 152.9 billion yuan, which hit a historical record. Lending of financial institutions to nonfinancial institutions increased 484.56 billion yuan, household savings deposits grew by 321.85 billion yuan and institutional deposits grew only 88.15 billion yuan.

Fiscal expenditures in 1993 and the money supply in the first half of the year grew rapidly, which signaled an expansion of aggregate demand. At the end of the year, the money supply grew normally, indicating the expansion was under control.

Inflation. The national retail price index grew by 13 percent, and household consumption prices increased by 14.7 percent. This inflation was demand driven, because the M1 supply grew by over 40 percent in the first quarter of the year and a large amount of funds from the illegal interbank call market was put in equity, real estate and other fixed assets (which increased investments in fixed assets by over 70 percent). The immediate result of excessive demand was a rise in the price of production goods, followed by a rise in consumer prices.

In the second half of the year, after a mild slowing down in September and October, prices rose again. This was due to (a) accelerated price reforms and the implementation of the new accounting system which hastened the process of rationalizing prices and realizing real costs, which increased the cost of products; and (b) looser control of the money supply by the banks after September, and a large amount of short-term loans directed to enterprises. This changed public expectations, and although the money supply did not increase significantly, factors such as speculation and monopoly practices pushed prices higher.

Macroeconomy in 1993

Basic macroregulations. Given the severe economic conditions in the first half of the year (see Part VII, Forecasts of Economic Conditions in 1993 and Recommended Policies), a number of measures were adopted.

- Administrative measures. Illegal interbank call loans were recalled in a limited time. Unauthorized fundraising activities were halted. Unauthorized investments in real estate and development zones were exposed and halted. Quota controls over bank credit were enforced.

- Economic measures. Interest rates of deposits and lending were raised twice and household term deposits of three years or more were linked to the index; fiscal
expenditures were controlled and tax collections reinforced; relending rights of PBC branches were suspended; requirements for the SBs to manage asset risks were proposed.

- Reform measures. Investment, fiscal, tax, financial and foreign exchange reforms were enforced.

Effects of the macroregulations. Since the above measures were imposed, economic conditions improved and began to return to the course that established deep economic reforms for 1994. Some of the effects include the following:

- The financial order is considerably improved and loopholes in the illegal interbank call market and fundraising are blocked;
- Growth of the money supply has slowed remarkably.
- Savings deposits increased rapidly, easing the banks' payment difficulties.
- The growth of investments in fixed assets declined and the number of new projects was reduced.
- Real estate, development zones and the equity market cooled off to some extent.
- The central bank manipulated the exchange rate by buying and selling foreign exchange, which made the rate relatively stable.

However, it must be noted that the enterprises' circulating capital is in increasingly short supply due to the macroregulations. Many factors explain the scarcity: For example, circulating capital was used for other purposes, and the enterprises did not respond adequately to the macroregulatory measures (although the main reason was the withdrawal of the circulating capital). To prohibit the illegal use of circulating capital and support its appropriate use, the State Council imposed a policy in the third quarter of 1993 whereby a large amount was lent to the enterprises' circulating funds. Although this eased the shortages, due to the more relaxed control of the money supply, the ratio of sales to production (in the enterprises) declined, inventories increased, and inflation began to rise.

Prospects for 1994 and Policy Initiatives

Economic reform will be critical in 1994. The Government's and economists' key concerns are how rapidly the economy will grow, if inflation will be controlled and how efficiently the new economic system will work.
**Economic growth.** Based on a forecast of aggregate supply, the growth rate is estimated at 9 to 10 percent. This appears appropriate because an overly high rate would expand demand and exacerbate inflation.

**Inflation.** Inflationary pressure will be high, because, (a) the base money supply increased relatively rapidly in 1993, and the ratio of extra reserves was high. In 1994, the base money supply will increase again, along with the unification of the exchange rates. This will cause the money supply to grow excessively; (b) treasury debt will grow considerably and fiscal policy will be relatively loose; (c) price reforms will raise the price of agricultural products (grain and cotton) and primary products (petroleum, natural gas and electricity); (d) the enterprises' new accounting system will include wages, bonuses and interest on loans in the costs and raise the rate of capital depreciation. This will increase real costs.

Thus, we estimate inflation in 1994 will be 10 to 13 percent, rising higher than in 1993.

**Operation of the new system.** In the first couple of months of 1994, the new system has worked fairly well: (a) the new fiscal and tax systems are running normally, revenues are increasing at a reasonably high speed, fiscal revenues and expenditures are basically balanced and the issue of government bonds is going well; (b) changes in the foreign exchange system are being made smoothly, foreign exchange reserves of the state are increasing remarkably, the yuan's exchange rate is rising somewhat and the interbank exchange market is functioning well.

**Direction of macroregulation policy.** Macroeconomic policies in 1994 must control inflation through reasonable economic growth. The following points must be addressed.

- Although investments in fixed assets should be controlled through fiscal and monetary policy, direct instruments are also required. If the number of investment projects is excessive, funds will be scarce, demand from local governments and other departments on the treasury and banks will increase, and fundraising will be used which will result in excessive aggregate demand.

- The 1994 budget plans to increase both expenditures and revenues, and issue over 100 billion yuan in government bonds. Fiscal policy will thus be expansionary. (a) Fiscal revenues (especially those of the central government), must be increased. Off-budget revenues should gradually be included in the budget. The Government's capacity to use macroeconomic regulations must be strengthened if public finance is to optimize resource allocation, distribute income fairly and stabilize economic growth. (b) The scale of expenditures must be reasonably controlled, and the structure adjusted and optimized with greater transparency. Expenditure in the construction account must be used for capital construction and infrastructure.
Part VII: Analysis of Economic Conditions and Policy Recommendations

Also, given a looser fiscal policy, monetary policy must be relatively tight. The key measure is to control the money supply and ensure a stable currency. The central bank must control the “gate” of base money: It must withdraw its relending to nonbank financial institutions, reduce direct policy lending, regulate its relending to the SBs and regulate the base money supply by buying and selling foreign exchange, i.e., it should sell part of its foreign exchange in periods of inflation to increase the supply of domestic currency and reduce the input of base money. The central bank must monitor the change in the ratio of extra reserves and maintain a relatively stable money multiplier. Policy lending should be reformed and the construction of policy banks should be completed. Floating interest rates should be implemented for short-term loans. An optimal time should be chosen for implementing monetary policy to avoid time lags and dramatic expansion or deflation of the economy.

On the supply side, emphasis must be placed on improving the quality and technological level of the labor force as well as the industrial structure, and increasing productive capacity.

Reforms of financial, enterprise and social security systems must be expedited.

GROWTH OF THE PRICE INDEX AND MONEY SUPPLY

Growth of the price index and the volume of the money supply are important indicators of the macroeconomy. Stabilizing prices is one of the major objectives of macroregulation, while stabilizing the money supply is the intermediate objective of monetary policy. The two indicators are related: An excessive supply of money raises prices.

The price index and money supply are time-based indicators. Their growth rates have been calculated by comparing the current month’s figure with that of the same month in the previous year. This method has shortcomings, since the result cannot reflect recent trends, which may influence macroregulatory policy to some extent.

A new method has been developed and used for the following calculation. The results of the two methods should be compared, along with their impact on macroregulatory policies.

The new method is as follows:

Given a monthly time series \( y(t), t=1, 2, ..., n. \)

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This internal report, written by DMRS, was completed in June 1994.
(a) Change of monthly ratio: \( c(t) = \frac{y(t)}{y(t-1)} \)
(b) Annualizes the monthly data: \( d(t) = [c(t)]^{12} \)
(c) Deducts seasonal and irregular factors of \( d(t) \), for the growth rate \( i(t) \).

Either the X11, Bayes or the time series structural space methods can be applied. This paper uses the time method with a one-time deduction of seasonal and irregular factors.

We will call the same period comparison “method 1”, and the new calculation “method 2.” Table 1 shows the growth rates of M1 and M2 with the two methods. From this table, it can be noted that,

• When the data fluctuate sharply, the results of the two methods differ substantially. The result of method 2 indicates an earlier tendency than that of method 1.

• The results of method 1 were influenced by the data of the same period of the previous year; the growth rates were smaller when the figures of last year were larger, and the figures of 1994 were good examples. Results of method 2 were more responsive to the current data.

**Table 1: Growth Rates of the Money Supply Calculated with the Two Methods**

<table>
<thead>
<tr>
<th>Year and Month</th>
<th>93.0</th>
<th>93.0</th>
<th>93.0</th>
<th>93.1</th>
<th>93.1</th>
<th>94.0</th>
<th>94.0</th>
<th>94.0</th>
<th>94.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth rates of M1 (1)</td>
<td>34.2</td>
<td>25.3</td>
<td>19.7</td>
<td>20.5</td>
<td>18.6</td>
<td>21.0</td>
<td>21.6</td>
<td>19.1</td>
<td>16.7</td>
</tr>
<tr>
<td>Growth rates of M1 (2)</td>
<td>8.00</td>
<td>4.00</td>
<td>5.00</td>
<td>10.8</td>
<td>17.1</td>
<td>22.7</td>
<td>25.1</td>
<td>27.2</td>
<td>29.7</td>
</tr>
<tr>
<td>Growth rates of M2 (1)</td>
<td>26.5</td>
<td>23.0</td>
<td>21.2</td>
<td>22.2</td>
<td>22.2</td>
<td>24.4</td>
<td>24.0</td>
<td>21.9</td>
<td>23.2</td>
</tr>
<tr>
<td>Growth rates of M2 (2)</td>
<td>18.2</td>
<td>17.7</td>
<td>19.4</td>
<td>22.6</td>
<td>25.5</td>
<td>27.8</td>
<td>28.4</td>
<td>29.2</td>
<td>31.5</td>
</tr>
</tbody>
</table>

*Source:* Author’s compilation.

Applying method 1, Table 1 indicates that current growth rates of the money supply are relatively low. The reasons are (a) last year’s figures were large; (b) given the change in statistical definitions, although adjusted by the PBC, the M1 range is narrower this year. The conclusion is that monetary policy is relatively tight. Applying method 2, growth rates were their lowest last July, then accelerated, and are now over 30 percent. Current monetary policy is loose.

What is the impact of the two conclusions on present monetary policy? We believe that monetary policy was not tight, particularly in April and May, since lending by state banks and rural credit cooperatives increased by 111.2 billion yuan. Indeed, the
reason the money supply expanded was the low interest rates, which in turn stimulated excessive demand. It is obvious that method 2 reflects the situation more accurately than method 1.

However, it must be noted that different methods of calculating seasonal and irregular factors used with method 2 produce different results, as do variations in the volume of data used. Moreover, method 2 requires a relatively large volume of data, and the calculation is somewhat complicated. Although it would be limited in practice, it is an important way to indicate short-term tendencies.

With respect to the price index, method 2 produced accurate results with the monthly data, while method 1 drew a different picture from what households felt about price changes. For example, in early 1993, while the public felt that prices grew dramatically, the price index produced by method 1 concluded that growth rates were not high. In March, April and May of 1994, the public's perceptions (about price hikes) concurred with the calculations derived in method 2—that growth slowed, the $c(t)$ of these three months was 0.9 percent, 1.3 percent and 0.7 percent, respectively; conversely, method 1 showed high inflation, using the low figures from the same period of the previous year. In January to May of 1994, the $c(t)$ of the retail price index was 10.2 percent.

Growth of $c(t)$ must be lowered—optimally into a negative figure—which is possible, due to seasonal factors. In the next few months, a tight monetary policy must be imposed to keep the real growth of M1 to 20 to 25 percent, and thus halt inflation.

**THE ECONOMIC SITUATION: PROBLEMS, POLICIES AND RECOMMENDATIONS FOR REFORM**

After three days of useful discussions, I shall summarize the outcomes and meet the challenge I set at the start of the conference, which was to devise a set of recommendations for policy. These will be presented in three parts: actions for the short term, reform of the institutional framework for macroeconomic management, and medium-term policy initiatives.

**Short-Term Issues**

The first point to emphasize is that the economy is overheated, as is evidenced by the accelerated inflation rate and the widening gap between the official and swap market exchange rates. Thus, the government must do more than it already has to change this

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41 This is closing speech by Mr. Shahid Javed Burki, Director of China and Mongolia Department, World Bank, at the conference on "Macroeconomic Management in China" held in Dalian, China, in June 1993.
course. Further, it is clear that the main source of the overheating is the excessive growth of fixed investment, facilitated by monetary policy. Timely action would offer the best chance to return the economy to a path of steady, sustainable growth. We believe that while China can rely to a greater extent than before on indirect instruments, some direct controls are going to be necessary.

A package of measures is needed to address conditions in the short term. The most important would be the following:

- Interest rates should be raised to positive levels on both deposits and loans because of a possible flight from bank deposits to other domestic and foreign assets, or into consumer goods. To this end, the one-year deposit rate needs to rise by at least 3 to 5 percent from its present level of 9 percent; other rates should also be adjusted with an appropriate spread for different terms. Lending rates should be raised even more, as they were increased less than 1 percent earlier. Consideration should be given to reintroducing index-linked deposits for maturities of one year or more, to remove depositors' fears that their savings could lose value.

  Current yields in the secondary bond market are about 14 to 16 percent and interbank market rates are 16 to 20 percent. These rates are another indicator of the extent to which present bank rates are out of line.

- The interest rate hike would also need to be reflected with government bonds. It may be useful to explore marketing these bonds via the financial system, as was tried last year, allowing the market to determine the appropriate rate. In any event, we see no reason for other financial transactions to be delayed pending completion of the bond sales.

- Given China's current industrial and financial structure, an interest rate increase alone may not dampen the growth in investment. Thus, it should be accompanied by comprehensive measures to tighten the financial system. These would include:

  - Enforcing banking system liquidity and prudential requirements, together with measures to reduce the liquidity of banks. This could be achieved by special deposits or by raising reserve requirements. These could be backed by a strong policy limiting PBC credit to other financial institutions; the granting of such credit should be the responsibility of PBC itself, rather than delegated to its branches.

  - Extending and enforcing licensing arrangements and regulatory procedures, such as reserve requirements, to nonbank financial institutions. There is no reason for such institutions to be exempted from these requirements.
- Rigorously enforcing more widely defined credit ceilings, which should be applied to all financial institutions involved in lending activities.

- Prohibiting undesirable practices such as the leakage of funds from the interbank market to nonbank financial institutions, with such prohibitions backed up by more frequent random checks on banks.

- Controlling investment with more direct means (particularly by state-owned units at the local level), should be considered. Work should begin now in the planning departments at the central and local levels, to determine investment priorities within the state-owned sector, which is the main source of expansion. While we recognize there will be resistance to enforcing Planning Commission controls over investment at the local level, a key task for the central government is to achieve consensus on the need for a reduced investment rate, a theme to which I shall return later.

- The external accounts have become much more affected by monetary policy, and more generally, by the level of confidence in the economy, than in the past. The widening gap between the official and swap market rates is a good indication of this, and especially of the impact of the low interest rate. This suggests the immediate acceleration of reforms of the foreign exchange system. We would recommend that government give up its access to export receipts at the present official rate, and trade entirely at the market rate. Moreover, the retention quota system should be abolished in the near future. This should help move China rapidly toward a unification of the exchange rate, which is a prerequisite for moving to a current account convertibility. The target date for unification of the two rates should be as soon as possible, but be preceded by the interest rate and exchange system reforms indicated.

- China has moved rapidly to open the capital account of the balance of payments, for example by allowing Renminbi to be exported by individuals going overseas. We fear this opening was premature, and has affected the short-term situation by encouraging capital flight and hoarding of foreign exchange. Maintaining capital account controls for a longer period seems quite normal to us, and therefore the government should consider rolling back these changes for a few years.

- We remain of the view that imports can have a strong role to play in absorbing excess demand in the short term, and that, assuming that monetary balance can be restored, trade liberalization would contribute both to short-term stability and to medium-term efficiency.

- Finally, the current price pressures should not slow the ongoing price reform process in any way. Indeed, price reform, especially in the area of energy pricing, would help curb excess demand. Therefore, the recent success in this area should be continued as intended.
Institutional Reforms

I observed in my opening statement that the overheated economy is symptomatic of the imperfect development of the instruments and institutions of indirect economic management in China. I therefore expressed the hope that we would look beyond the difficulties of the short term and focus on what has to be done over the medium term to prevent them from reoccurring every few years. These necessary steps are of two types, and first I will focus on the institutional changes that are needed if China is going to be able to improve macroeconomic management. I would also note at this juncture that for such institutional changes to be effective would require a well-functioning and well-qualified public sector, which will need to be adequately compensated. Increasingly, government will need to compare the remuneration it is offering with salaries being offered in the nongovernmental sector. Let me mention four areas of institutional priority:

**The People’s Bank of China.** The role of PBC would have to be reformed in various ways in order to turn it into a real central bank instead of the hybrid it is today. This requires the complete separation from PBC of all non central bank functions, and especially the profit-making activities such as ownership of securities’ companies and mutual funds. These activities derive from the profit retention system for PBC, and this should be abandoned, with profits being remitted to the Ministry of Finance. PBC’s functions and number of branches should be reduced considerably, and we would repeat the frequently made suggestion to reorganize the PBC branch network into a limited number of regional branches, as with the US system. Surplus branches and staff could perhaps be spun off into a new commercial bank. We are, in other words, recommending a fairly significant restructuring of the People’s Bank. The restructured PBC should focus on its primary role as a central bank: Maintaining price stability and the associated preservation of the value of the currency, and promoting the highest rate of growth compatible with this. We welcome the news that a Central Bank Law is to be passed soon, and hope that it incorporates these principles. We also hope that such a law will reinforce the autonomy of the central bank, by creating a Monetary Board to guide its work.

**Policy lending.** We recommend the removal of policy lending from the banking system. We note that this type of lending falls into two categories: first, subsidies, mostly on loss-making state-owned enterprises and for agricultural procurement. This type of lending belongs to the budget. The second category, priority investment, especially in long-gestation or very expensive projects, belongs to an institution similar to the “policy banks” described by Chinese economists, although we would usually call them development banks. Indeed, this is what the World Bank is itself. These investments could be financed by government-guaranteed bonds. This would obviously be accompanied by refocusing the attention of existing banks on
commercial activities. This will require much-strengthened supervision capability in the central bank, on which efforts should be undertaken immediately.

- **Asset diversification.** Many of the current problems of macroeconomic management have their origin in the buildup of deposits in the banking system, which are the only available assets for most households, whose savings have increased significantly during the reform era. Greater financial stability and ease of management would be derived from a diversification of assets for the household sector, notably through housing and pension funds, as well as various types of securities.

- **Macroeconomic policy formulation.** One issue that I raised in my opening remarks was the need for an institution below the level of the State Council to formulate macroeconomic policy. It would not be appropriate for the “foreign monks” to advise on which of the present institutions, if any, should evolve into this role, as this is an internal matter for China to determine; but it is clear to us that such an institution is necessary.

- **Ownership issues.** Macroeconomic management requires an appropriate microeconomic foundation. This means reforms will be needed to make enterprises (essentially the state-owned enterprises) more responsive to the signals provided by indirect economic instruments such as the interest rate. The key to this still seems to lie in the clarification of property rights. We feel there is considerable gain to be made from the corporatization of China’s state-owned enterprises under an appropriate and unified framework of corporate law. This should be accompanied by the creation of suitable ownership institutions. There would need to be a number of experiments in this regard to find appropriate models. We also feel that governments could be more aggressive in diversifying ownership of state assets.

**Medium-Term Reforms**

The institutional changes, which need to be begun soon, but which obviously will take time to complete, would also need to be accompanied by a range of related policy reforms. These are complex and can only be touched upon in this context.

Fiscal policy is the first of these medium-term reforms. There is an urgent need for putting fiscal reform high on the policy agenda of China’s leaders. We believe that the failure of recent reform experiments in this regard suggests that a new reform style may be necessary. This would entail the formulation of policy and its gradual implementation as enterprise and fiscal contracts expire. However, there is an urgent need now for reforms to equip the Chinese government with some sort of fiscal system that would permit it to utilize fiscal policy for the purpose of macroeconomic management. Such a system would have to be built in a way as to avoid the procyclical
features of the existing system. Further, it is important to stem the constant decline in the ratio of revenue to GDP. We recommend the following as areas of high priority:

- Rationalizing the tax structure, by broadening the base, especially through land and property taxes, personal income taxes, and a VAT with Chinese characteristics. This also calls for early implementation of the long-postponed “separation of taxes and profits,” with consideration being given to the grandfathering of earlier arrangements for the tax deductibility of principal repayments.

- In the area of enterprise taxation, the primary goal should be equal treatment of enterprises regardless of ownership, and we look forward to the early passage of the Enterprise Tax Law.

- Reforming center-local fiscal relations, with a move away from fiscal contracts. The number and scope of local taxes (such as property taxes), and central taxes (such as corporate taxes) should be expanded over time to cover as large a portion as possible of respective expenditure responsibilities, with an associated reduction in “shared” taxes. We are of the view that such a reform would probably require the creation of a national tax service.

- Improving the budgetary framework, by equipping the budget for its role as a policy tool. This would require three things in particular: unifying all government expenditures in the budget; directly linking the budget with the economic situation and outlook; and adopting modern budgetary techniques. In the meantime, it is vital for MOF to strengthen oversight of budget implementation to avoid the recurrent overruns, especially on administrative expenses.

Regional income policy is the second area I want to touch upon. We are concerned about the growing disparities between the coastal provinces and the rest of China. This has become most acute because of the recent boom occurring primarily in a relatively few provinces. We have several suggestions in this regard:

- First, such disparities would be ameliorated by an early completion of energy and grain price reforms, as the very low prices for these commodities have kept incomes down in these areas. Such a policy would, of course, have a variety of related benefits.

- In the medium term, the fiscal program should be designed in such a way as to provide the central government with sufficient resources to meet its income transfer objectives. We recognize that this will take time, given the weak starting point for the budget. In the meantime, a contribution to the transfer of resources from the prosperous to the poor provinces could continue to be provided through differential
credit controls. As the fiscal system develops, and as credit controls are lifted, this practice would fade away.

- Many inland provinces have their locational disadvantages compounded by a policy disadvantage. Treatment of foreign investment and the development of the market economy should, as minimum, not be biased against the inland provinces. This would be facilitated by central government action to ensure unrestricted movement of goods and capital between provinces by the development of an appropriate physical and institutional infrastructure.

Income policy is the third area. The move toward a market economy has raised a number of problems in the area of income distribution and the disappearance of the earlier social safety net. We feel that any solution to this problem should be compatible with the market economy, and that there is a danger of a "planning" solution being attempted in the form of a wage control policy. Rather, we consider that a solution should be sought in the following areas:

- The change in the structure of incomes calls for a strong effort in the area of personal income tax, which should cover wage and non-wage benefits to the extent possible.

- The proposed implementation period for proposed reforms in the areas of pension systems, unemployment insurance, housing reform, and health insurance is too long, and should be accelerated. These we consider to be of particular importance not only for the reform of the state-owned enterprise, but also for avoiding income inequality.

- The solution to many other problems emerging in this area as a result of the reform, such as the very high gains being made in such sectors as real estate and the stock market, would be better addressed by removing the artificial supply side constraints and thus reducing the rents to be earned from such transactions. The suggestion of moving to an auction system for land and property transactions seems to have considerable merit.

This is a very long and challenging agenda that we have put up, both for the short and medium term. Its adoption and implementation will require the emergence of consensus among policymakers at various levels of the government. It is essential for senior leaders to actively cultivate both a better understanding of the current economic situation, and to foster a realization that concerted action will ultimately benefit all areas.

Translating this agenda into action—particularly the items related to institutional and organizational reforms such as reform of the fiscal system, analysis of regional disparities, and the fourth analysis and reform of the state-owned enterprise sector in China—will require considerable additional analytical work. We look forward to discussions with the System Reform Commission and the Ministry of Finance to see how
we can follow up this conference with more detailed work to help define reforms in these key areas.

I believe that this conference has been very useful, and that the timing was very appropriate. We hope these deliberations will prove beneficial to China’s policymakers as they struggle first to overcome the present difficult situation of an overheated economy, and then to seek to put in place the necessary reforms to avoid a recurrence of such situations in the future. We in the World Bank very much look forward to the challenge of working with you in these areas, and lending whatever support we can to this most critical endeavor.
### MAJOR MACROECONOMIC INDICATORS IN CHINA IN 1991-93

#### Absolute Volume

<table>
<thead>
<tr>
<th>Indicators</th>
<th>1991</th>
<th>1992</th>
<th>1993</th>
</tr>
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<tbody>
<tr>
<td>Population (million)</td>
<td>1,158.23</td>
<td>1,171.71</td>
<td>1,185.17</td>
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<tr>
<td>GDP (billion yuan)</td>
<td>2,018.83</td>
<td>2,436.29</td>
<td>3,138.03</td>
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<tr>
<td>Aggregate social retail value (billion yuan)</td>
<td>941.56</td>
<td>1,099.37</td>
<td>1,359.26</td>
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<tr>
<td>Investment in fixed assets (billion yuan)</td>
<td>550.88</td>
<td>785.5</td>
<td>1,182.91</td>
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<tr>
<td>Fiscal revenues (billion yuan)</td>
<td>361.09</td>
<td>415.31</td>
<td>511.48</td>
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<tr>
<td>Budget deficit (billion yuan)</td>
<td>-20.27</td>
<td>-23.66</td>
<td>-20.50</td>
</tr>
<tr>
<td>Total value of export ($ billion)</td>
<td>71.91</td>
<td>85.00</td>
<td>91.76</td>
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<tr>
<td>Total value of import ($ billion)</td>
<td>63.79</td>
<td>80.61</td>
<td>103.95</td>
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<tr>
<td>Foreign Investment ($ billion)</td>
<td>11.554</td>
<td>19.202</td>
<td>36.773</td>
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<td>Foreign exchange reserve ($ billion)</td>
<td>21.712</td>
<td>19.443</td>
<td>21.199</td>
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<tr>
<td>Annual average per capita income in urban area (yuan)</td>
<td>1,713.1</td>
<td>2,031.5</td>
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<tr>
<td>Annual average per capita income in rural area (yuan)</td>
<td>708.6</td>
<td>784.0</td>
<td>922.0</td>
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<tr>
<td>Retail price index (previous year=100)</td>
<td>102.9</td>
<td>105.4</td>
<td>113.2</td>
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<tr>
<td>Consumer price index (previous year=100)</td>
<td>103.4</td>
<td>106.4</td>
<td>114.7</td>
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<tr>
<td>Volume of M0 (billion yuan)</td>
<td>317.78</td>
<td>433.60</td>
<td>586.47</td>
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<tr>
<td>Volume of M1 supply (billion yuan)</td>
<td>1,086.66</td>
<td>1,501.57</td>
<td>1,869.49</td>
</tr>
<tr>
<td>Volume of M2 supply (billion yuan)</td>
<td>1,934.99</td>
<td>2,540.21</td>
<td>3,150.10</td>
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#### Rates of Growth

<table>
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<th>Indicators</th>
<th>1991</th>
<th>1992</th>
<th>1993</th>
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</thead>
<tbody>
<tr>
<td>GNP</td>
<td>8.0</td>
<td>13.6</td>
<td>13.4</td>
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<tr>
<td>Aggregate social retail value</td>
<td>13.44</td>
<td>16.76</td>
<td>23.64</td>
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<tr>
<td>Investment in fixed assets</td>
<td>23.81</td>
<td>42.59</td>
<td>50.59</td>
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<tr>
<td>Fiscal revenues</td>
<td>9.01</td>
<td>15.02</td>
<td>23.16</td>
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<tr>
<td>Total value of export</td>
<td>15.82</td>
<td>18.20</td>
<td>7.95</td>
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<tr>
<td>Total value of import</td>
<td>19.57</td>
<td>26.37</td>
<td>28.9</td>
</tr>
<tr>
<td>Annual average per capita income in urban area (yuan)</td>
<td>12.50</td>
<td>18.59</td>
<td>27.15</td>
</tr>
<tr>
<td>Annual average per capita income in rural area (yuan)</td>
<td>3.24</td>
<td>10.65</td>
<td>17.60</td>
</tr>
<tr>
<td>Retail price index</td>
<td>2.9</td>
<td>5.4</td>
<td>13.2</td>
</tr>
<tr>
<td>Consumer price index</td>
<td>3.4</td>
<td>6.4</td>
<td>14.7</td>
</tr>
<tr>
<td>Volume of M0</td>
<td>20.17</td>
<td>36.45</td>
<td>35.26</td>
</tr>
<tr>
<td>Volume of M1 supply</td>
<td>24.2</td>
<td>35.9</td>
<td>21.6</td>
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<tr>
<td>Volume of M2 supply</td>
<td>26.5</td>
<td>31.3</td>
<td>24.0</td>
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*Source: Author’s compilation.*
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