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The Changing Role of Money in China and Its Implications

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Economic development is highly correlated with financial sector development. But the emergence, development, and economic implications of different financial structures are not well understood. This paper analyzes the emergence and development of China's financial structure since the beginning of the economic reforms. By focusing on the functions of money, monetary policy, and financial intermediation, it argues that although agricultural and industrial reforms in the early 1980s have led to significant changes in the financial system, financial liberalization has progressed little since. The creation of new financial institutions and markets throughout the 1990s and the recent abandonment of some of the traditional administrative control instruments do not signify a systemic change as the underlying functions remain constrained.

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Introduction

Empirical studies invariably find an intricate link between indicators of financial sector development and economic growth. The faster the deepening of the financial sector, the higher the growth rate of the economy. Financial markets and financial intermediaries are viewed as performing certain functions affecting real variables. Financial markets and financial intermediaries themselves are the response to market friction such as information and transaction costs.[1]

But how the financial structure of an economy comes about in practice is not well understood and has not been explored in great depth. "We do not have a sufficiently rigorous understanding of the emergence, development, and economic implications of different financial structures" (Levine 1997, 702), where the term "financial structure" covers "the mix of financial contracts, markets, and institutions" (Levine 1997, 703). In the People's Republic of China (PRC), financial institutions and markets have proliferated rapidly and financial practices have undergone numerous changes since the beginning of the economic reforms in 1978. But we in fact lack a rigorous understanding of why financial reform occurred, how it proceeded, and what its limitations and implications are.

The literature concentrates either on describing actual financial transition experiences or on offering policy recommendations on how to switch to a market-based financial system.[2] While we have some understanding of how the socialist financial system operated,[3] financial system reform during economic transition is often viewed as a step into an abyss from which best to move to a market economy as quickly as possible. McKinnon (1993, p. 223), for example, finds that "in their rush to decentralize decision-making, privatize, and dismantle the apparatus of central planning, reformers inadvertently upset the pre-existing system for sustaining macroeconomic equilibrium. The ability of the reform government to collect taxes and control the supply of money and credit is unwittingly undermined by the liberalization itself." This paper suggests, quite to the contrary, that in the case of the PRC the financial system has been actively used by the government to supplant the dismantled apparatus of central planning in the real economy, and that the status of reform in the financial system may be the deliberate outcome of an attempt to sustain macroeconomic balance and economic growth.

In order to make sense of an otherwise profusion of financial reform events, this paper evaluates financial sector development in terms of changes in the functions of money, financial intermediation, and monetary policy. (See Chart 1, explained in more detail below.) Particular functions of money determine the functions of financial intermediation and monetary policy, which in turn yield a particular financial structure. Financial reform in the PRC has proceeded by lifting one set of restrictions on the functions of money. This led to changes in the functions of financial intermediation and monetary policy with subsequent changes in the financial structure. However, some restrictions on

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the functions of money are still in place today; these restrictions prevent the development of more market-oriented financial intermediation and monetary policy.

The next section examines how the PRC's pre-reform financial system operated. The third section explains the emergence of China's financial structure in the 1980s and 1990s by focusing on the changing functions of money in the early 1980s. The fourth section investigates whether the most recent financial reform measures represent systemic changes rather than cosmetic alterations without consequences for the functioning of the financial system. The last section concludes.

The Pre-Reform Period Financial Sector: Extension of the Physically Planned Economy

The PRC's modern financial system has its origins in the socialist, planned economy. This section explains the producer vs. consumer goods dichotomy in socialist economic theory and policy, and derives the implications for the financial sector.[4] It focuses on the restricted functions of money with the consequences for financial intermediation and monetary policy. How the PRC's modern financial system emerged through a change in these functions is the subject of the next section.

The centrally planned economy is characterized by two distinct circuits, the household circuit on the one hand and the inter-enterprise circuit on the other hand. (See Chart 2.) In the household circuit enterprises make all wage and salary payments to households in cash according to plan; all enterprises are state-owned and follow nationwide wage and salary scales. Households use their cash receipts to save and to consume (as well as to purchase agricultural producer goods). In the absence of household checking accounts, all withdrawal of household savings deposits and all households purchases are in cash.

In the inter-enterprise circuit, enterprises buy producer goods from other enterprises. They are not allowed to purchase consumer goods except for well justified and specially approved purposes. All payment is made through the transfer of deposits between bank accounts, using "transfer," or "book" money; enterprises are subject to rigid cash administration through earmarked accounts in the few instances of cash use, such as for wage payments.

The set of functions of money in this economy differs from the set of functions of money in a market economy in two major respects. (See Table 1.) Money in this economy is a medium of control. Money fulfills a control function in that each individual monetary transaction is either planned or subject to government supervision. In the household circuit all wage and salary payments are planned. In the inter-enterprise circuit all monetary transactions follow the physical plan. The two circuits are controlled separately. Consumer goods (in the household circuit) can only be bought with cash, producer goods (in the inter-enterprise circuit) only with transfer money.

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Chart 1:
Dynamics of Financial Intermediation

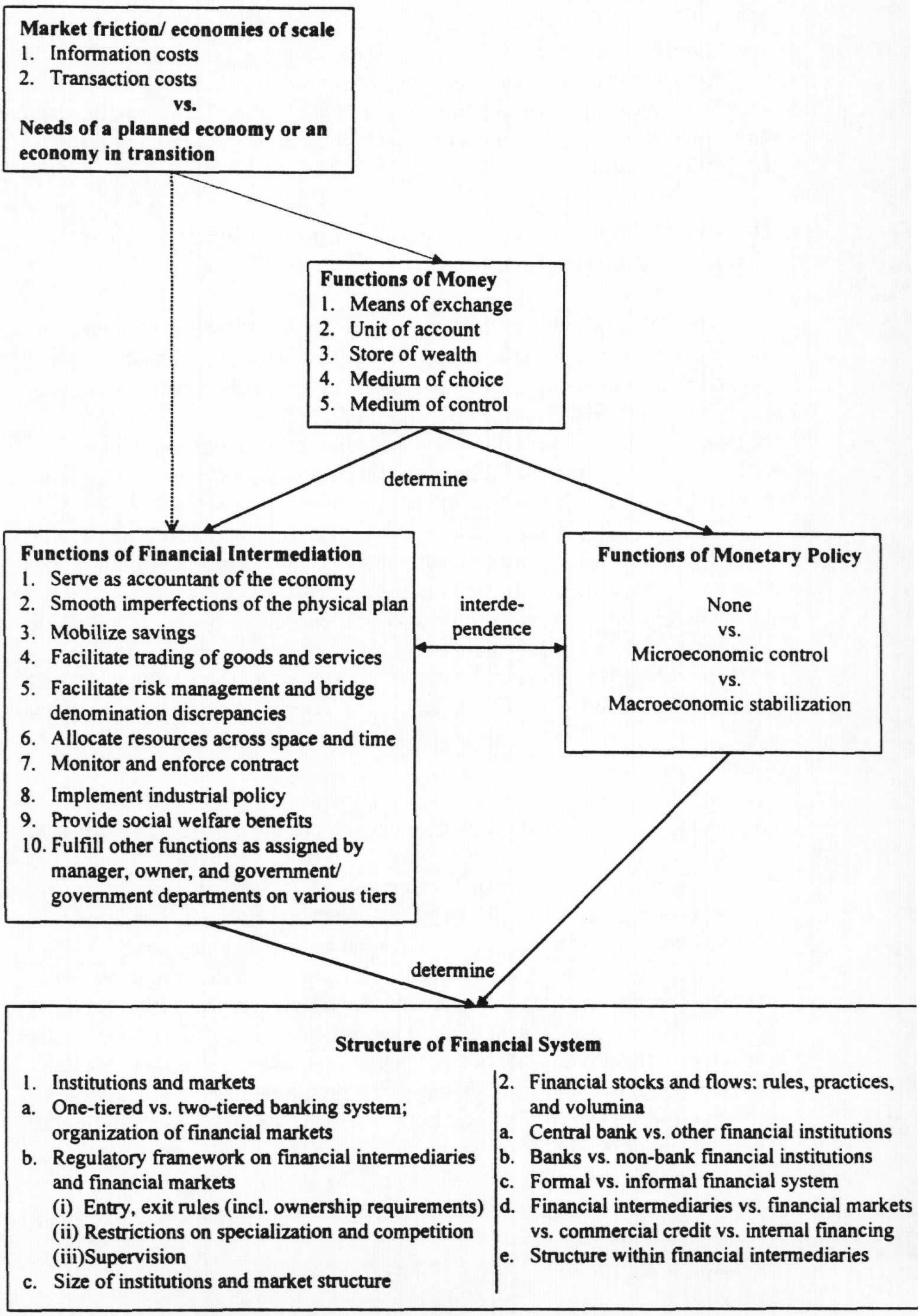

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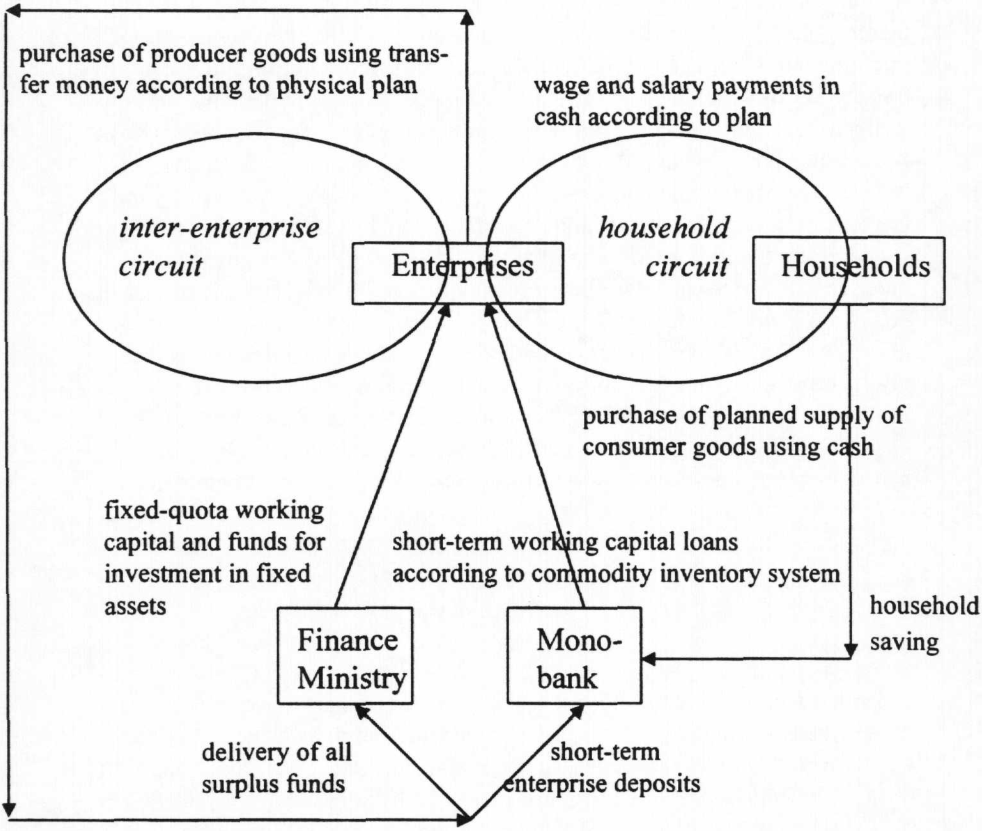
Chart 2:
Inter-Enterprise and Household Circuits in the Centrally Planned Economy



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For enterprises, money carries neither the medium of choice function nor the store of wealth function. Enterprises have access to their transfer money in bank accounts only if the underlying physical transaction has been approved by the relevant state organ. Enterprises cannot decide themselves when to use their money, and what to use it for.[5] Similarly, government departments may claim the enterprises' transfer money at will.

The control function of money and the lack of medium of choice function for enterprises have implications for monetary policy. Wage and salary payments in the household circuit are subject to strict controls. However, since the planning authorities cannot perfectly account for future household consumption decisions, imbalances between the supply of and the demand for consumer goods may arise. Nevertheless, with household income barely above subsistence level, the supply of consumer goods has to meet little more than the—easily predictable—demand for food and everyday household goods. Excess purchasing power is channeled off through the sale of relatively expensive, rationed luxury goods as well as through savings campaigns.[6] To be on the safe side, prices are state-determined and fixed. In the household circuit there is thus no need for active monetary policy.[7]

In the inter-enterprise circuit imbalances between the demand and supply of producer goods cannot arise as long as all transactions scrupulously follow the physical plan. Disturbances in the implementation of the physical plan, however, may lead to imbalances in the physical sphere. They are of no consequence to the monetary sphere as long as the use of transfer money requires approval by the relevant state organ. In addition, prices are state-determined and fixed. Transfer money in the inter-enterprise circuit serves only as "lubricant" of which a sufficiently large amount has to be kept at hand. In the inter-enterprise circuit thus there is likewise no need for active monetary policy.

Since the existence of financial markets would contradict the concept of a planned economy, financial intermediation in this economy is exercised solely by financial intermediaries. Financial intermediaries implement the control function of money in that they serve as accountants of the economy; a glance at the accounts allows an immediate update over fulfillment of the physical plan. The absence of the medium of choice function of money for enterprises is reflected in the financial intermediary's close scrutiny of each individual disbursement of cash (except savings withdrawal by households) and of each transaction using transfer money.

Financial intermediaries smooth imperfections of the planning system by extending short-term working capital loans in accordance with the commodity inventory system.[8] (The finance ministry supplies all funds for investment in fixed assets as well as fixed-quota working capital directly to the enterprise.) However, the financial intermediaries have little decision-making authority since the allocation of loans simply follows the instructions of the planning, fiscal, and production hierarchy. The volume of loans is not constrained by the volume of deposits as the financial intermediaries are free to create money as needed.[9]

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Financial intermediaries finally strive to maintain a high savings rate in order for the government to be able to minimize the production of consumer goods,[10] and they facilitate trade by providing cash to the household circuit and sufficient amounts of transfer money to the inter-enterprise circuit. (In Chart 1 the first four functions of financial intermediation are characteristic for the centrally planned economy, while functions three through seven are for a market economy.)

Without the need for monetary policy or the fulfillment of any significant allocative function by financial intermediaries, the banking system is reduced to a monobank, in the PRC the People's Bank of China (PBC). Between 1969 and 1977 the PBC was furthermore integrated into the Finance Ministry.

Emergence of China's Modern Financial Structure: Reforms in the Real Economy Lead to Changes in the Role of Money

The PRC's pre-reform period financial system was inherently stable. But once economic reforms in the real sphere began, the monetary system came under pressure to change.[11] The reform period brought about a fundamental change in the functions of money: as enterprises were given the right to make their own production and investment decisions, transfer money had to acquire the medium of choice function. (See Table 1.) This had a number of consequences for the functions of monetary policy and financial intermediation, and finally the financial structure.

In the early 1980s enterprises began to supplement planned wage and salary payments with bonus payments. (See Chart 3.) The total wage bill increased and became a priori indeterminate.[12] Rising household income meant that the share of easily planned food and everyday household good purchases in total household expenditures declined. The planning bureaucracy subsequently lost partial control over the extent of cash disbursement and withdrawal by the banking system.[13] The loss of control was exacerbated through the illegal use of cash by enterprises. Imbalances in the household circuit became more likely and could now, with prices successively freed, lead to inflation in the consumer goods market.

The need for active monetary policy in the household circuit arose, while monitoring and enforcement of the cash plan continued. Monetary policy in the household circuit focused on withdrawing excess cash by setting appropriate, centrally determined, nationwide uniform interest rates on household deposits. Between 1978 and 1999 these interest rates were adjusted eighteen times.[14]

In the inter-enterprise circuit the planning and production bureaucracy gradually lost control over physical transactions. The volume and distribution of transfer money, now a medium of choice, began to matter in that excess transfer money could lead to imbalances in the real sphere. Beginning in 1985, prices for producer goods were partially freed in the dual-track price system; by 1993, market-determined prices governed 81.1% of the value of all producer goods sales.[15] Imbalances in the producer goods sector could furthermore through the price of materials and the volume of wages and salaries spill over into the consumer goods sector. Inflation became a threat.

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Table 1:
Functions of Money

	Market economy	People's Republic of China			
		pre-reform period (before 1978)		reform period	
		household	enterprise	household	enterprise
Medium of exchange	Y	Y	Y	Y	Y
Standard of value	Y	Y	Y	Y	Y
Store of wealth	Y	Y	N; government may claim funds	Y	Y
Medium of choice					
when to use	Y	Y; except for rationed goods	N; determined by plan	Y	Y; but government may interfere directly in case of state-owned enterprises
for what to use	Y	Y; but limited to consumer goods and agricultural producer goods	N; determined by plan and limited to producer goods	Y	Y; for state-owned enterprises limited to producer goods, with investment subject to government approval
Medium of control	N	*limited to use of cash, not suitable for purchase of producer goods *cash plan applies	*limited to use of transfer money, not suitable for purchase of consumer goods; all cash receipts must be promptly submitted to the bank *credit plan/ commodity inventory system applies	*still largely limited to use of cash, now suitable for purchase of both consumer and producer goods; use of debit cards *cash plan applies	*state-owned enterprises are limited to the use of transfer money, not suitable for purchase of consumer goods; all cash receipts must be promptly submitted to bank *credit plan applies

Y: Yes; N: No
The 'medium of exchange' function is also known as 'means of payment' function. The 'standard of value' function comprises the functions of unit of account and measure of relative value

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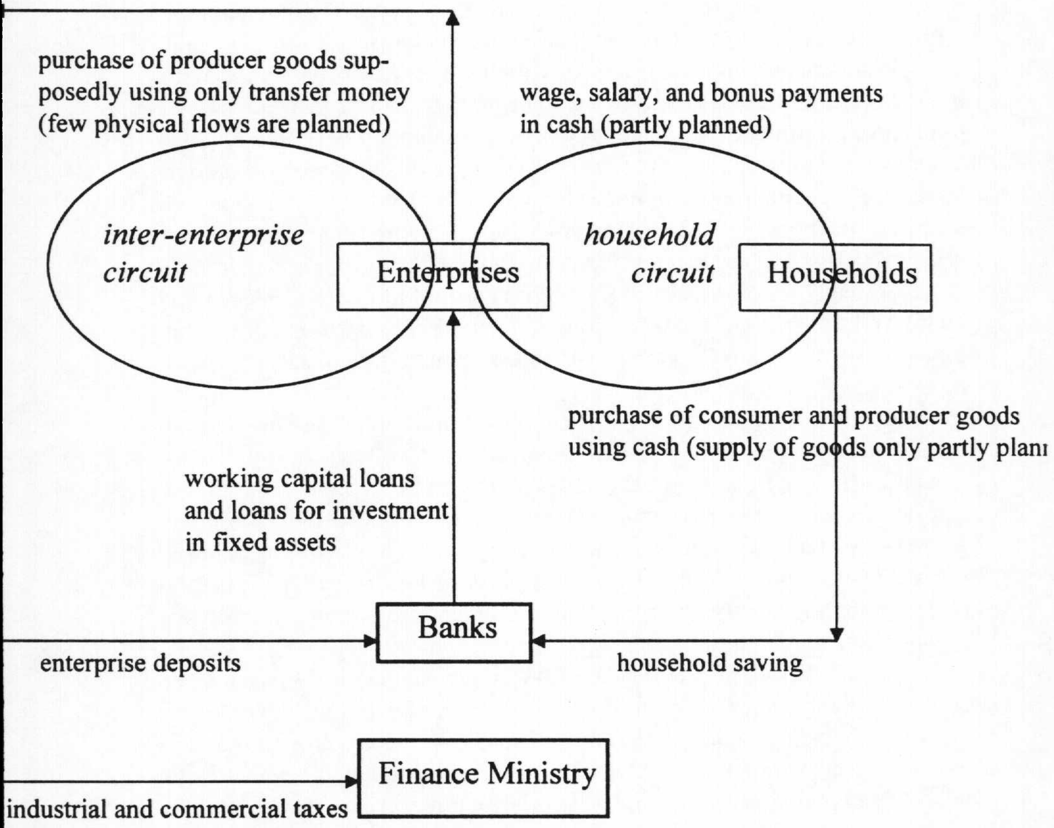
Chart 3:
Inter-Enterprise and Household Circuits After 1983/84



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The need for active monetary policy in the inter-enterprise circuit arose. As the use of transfer money by enterprises had to be deregulated, it was the extension of *additional* transfer money (credit) to individual enterprises which became central to monetary policy. Economic reform led to a reduction of microeconomic control in the real sphere (partial abandonment of the physical plan and price controls); monetary policy in 1984 took over this transaction-specific, microeconomic control task through an elaborate credit plan system with earmarked loans for individual projects and enterprises.

With transfer money turning into a medium of choice, the financial link between enterprises and superordinate ministry as well as finance ministry had to be severed. Enterprises making their own production decisions could no longer submit all surplus to the finance ministry; a finance ministry receiving less funds could no longer provide enterprises with fixed-quota working capital and investment funds. This led to two reforms in the fiscal system. Enterprises were first allowed to retain funds through partial profit retention in 1979. A 'tax instead of profit delivery' (*ligaishui*) reform followed in 1983 through 1985. At the same time, the task of providing working capital and investment funds fell to the banking system in an effort to 'switch from budget appropriations to credit' (*bogaidai*).

The reforms in the fiscal system implied a much larger volume—and in part a different type—of business for financial intermediaries. Financial intermediaries came to satisfy more than 80% of all working capital needs of enterprises but had no experience with lending criteria except with the 'commodity inventory system' at a time when all monetary flows simply followed implementation of the physical plan. No decision-making mechanisms were in place to determine the allocation of loans to investment projects except the traditional, physical planning system.

Given this lack of experience in allocating resources and given the perceived need for microeconomic control, now exercised through the monetary system, all lending authority became subsumed in the credit plan. Lending decisions incorporated industrial policy measures through an elaborate system of preferential access to credit for priority projects and backbone enterprises; working capital loans at times were barely disguised social welfare payments to enterprises starved of funds since the discontinuation of budget appropriations.

Drawing up the credit plan involved not only the financial intermediaries but also the line ministries superordinate to the borrowing enterprise, the finance ministry of the corresponding tier government, and, in the case of investment projects, the planning commission and the economic (and trade) commission hierarchy. The State Planning Commission (SPC) and ultimately the State Council reserved the right of final approval for the nationwide credit plan. While loans thus were extended in name by financial institutions, in practice lending decisions were made outside the financial system by the traditional planning and production hierarchy.[16] The PBC continued to set all interest rates, subject to State Council approval, at nationwide uniform levels. Fi-

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nancial intermediaries extending loans in accordance with the credit plan drawn up together with or under instructions from other government departments could not be assigned the lending risk. They thus had little incentive to monitor the use of the loans and to enforce repayment.

At the same time as the banking system became inundated with new lending tasks, the PBC exerted strong pressure on financial intermediaries to attract savings deposits from households in order to prevent the build-up of inflationary pressures in the consumer goods sector. On the one hand financial intermediaries faced a limit on overall credit plan lending as well as quotas on different types of loans within this overall limit, while on the other hand the PBC provided the financial intermediaries with insufficient refinancing to fulfill these loan quotas and the overall limit.[17] This led financial intermediaries to exert strong efforts to attract savings deposits. (Financial intermediation thus entered a stage where the first two functions in Chart 1 were cast aside and the eighth through tenth function rose to prominence, while the fifth through seventh function are not yet developed.)

The changes in the functions of financial intermediation with an increase in the volume and a diversification in the type of banking business led to a change in the institutional structure. As early as 1979 the Agricultural Bank of China (ABC) and the Bank of China (BoC) re-emerged from departments within the PBC as separate institutions directly under the State Council.[18]

Since the PBC fulfilled both commercial and central bank functions, it increasingly faced difficulties in objectively determining the appropriate volume of transfer money—which now mattered. Furthermore, ABC and BoC complained about the preferential treatment of the PBC's own commercial departments when it came to refinancing decisions. Finally, the PBC had little administrative authority over ABC and BoC which on the provincial and subprovincial tiers enjoyed a status equal to that of the PBC branches. In September 1983 the PBC was therefore turned into a solely central bank; the commercial banking departments of the PBC were renamed Industrial and Commercial Bank of China (ICBC).[19] In 1985 the People's Construction Bank of China (PCBC), formerly a division within the finance ministry in charge of administering the budget appropriations to investment projects, joined the ABC, BoC, and ICBC as the fourth "special" bank.

Development of the PRC's Modern Financial Structure: Changes in Financial Structure But Not in Underlying Functions?

From the mid-1980s to the late 1990s a number of financial reform measures were implemented. However, the concept of two separate moneys was never fully abandoned, and both cash and transfer money continue to be a medium of control.[20] While implementation of the cash plan and supervision

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over cash flows are deteriorating, the centrally approved credit plan on the volume and distribution of transfer money is still in effect, albeit since 1998 only in 'indicative' rather than 'imperative' form. The PBC supposedly abandoned credit limits and quotas in favor of money supply targeting with as sole objective currency stabilization (in order to promote economic growth; NPC 95/3/18, Art. 3). Since the passing of the Commercial Bank Law in 1995 (NPC 95/5/10) the special banks are supposed to have turned into 'commercial banks,' making lending decisions based on economic criteria.

But governments concerned about their state-owned enterprises and local economic development continue to interfere in bank lending decisions.[21] After the financial conference of Mid-November 1997 it was announced that starting 1998 the provincial heads and municipal mayors would no longer have any authority to issue instructions to bank directors.[22] Explicit policy loans are now supposedly only extended by the state development banks. Yet the state commercial banks continue to extend loans which are policy loans in all but name. For example, the ICBC since 1994 extends loans to loss-making state-owned enterprises so that these can pay a basic living allowance to their employees.[23] In June 1996 the PBC assigned 300 key large and medium-sized state-owned enterprises as well as large and medium-sized state-owned enterprises in seven cities to individual state commercial banks; the banks are expected to supply sufficient funding.[24] With the proliferation in financial institutions reflecting little more than the creation of financial institutions attached to lower-level tier governments, the pattern of assigning enterprises to individual financial institutions continues on provincial, municipal, county, and township tier.[25]

A tradition of banks as accountants and facilitators of plan fulfillment does not strengthen their authority. Thus banks need continued government support when collecting interest payments and principal from their main borrowers, the state-owned enterprises. In recent years this led to explicit lending contracts between banks and governments, with the bank promising loans to government-selected state-owned enterprises and projects in exchange for government quasi-guarantees of loan repayment.[26]

Banks' limited experience in selecting borrowers and in monitoring and enforcing loan contracts is aggravated by limited access to enterprise information. To amend the information deficit the PBC – true to its traditional practice of exercising microeconomic control – in April 1996 began to issue "credit licenses" to all borrowing enterprises; the license must be renewed at the PBC every year. The credit license contains enterprise information relevant for lending decisions and is to be made available to banks when applying for a loan.[27] But the credit license system has met with strong opposition by enterprises as well as banks which do not want to reveal their past and present lending practices to the PBC. The PBC itself does not have the staff to sufficiently supervise credit licenses and in practice implementation of the regulation has therefore lapsed.

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The transition from an 'imperative' to an 'indicative' credit plan for the four state commercial banks reflects little more than an acknowledgment that credit limits in the past few years could not be fully enforced.[28] Within each bank, the credit plan remains imperative as it suits the centralized credit approval structure within each bank in place since 1994.[29] Explicit government industrial policy regulations restrict lending to desirable industrial sectors and projects. The lending limit of the 'indicative' credit plan has not yet met its test, in part because banks have been trying to meet the in 1994 newly implemented ratio requirements, such as a loan-deposit ratio of below 0.75, but also because they are reluctant to assume responsibility for lending in a still rapidly changing economic environment.

Commercial banking remains hampered by continued central control over interest rates. The central government actively adjusts interest rates to regulate the demand for consumer goods and thereby influence the inflation rate. Controlled interest rates together with strict limitations on interbank money market transactions and bank participation in the stock market also help stem inter-regional flows of funds to the most productive regions of China, mainly the coastal regions, that would endanger investment and production in the interior provinces. In this heavily regulated financial environment, private banking has been outright prohibited.[30] Private banks might not only evade the plethora of restrictions but also endanger the stability of the state-owned financial sector burdened with policy tasks.

The limitations to financial intermediation have resulted in an astounding bad loan problem in the state commercial banks. A member of the central Party school in 1995 suggested that "according to today's most conservative estimate," the share of non-performing loans in all bank loans is about 25%; "some scholars even think this figure to be around 47%." At end-1995 a 47% share of all loans was equal to 80% of all household savings deposits and 41% of GDP.[31]

Since mid-1998 the government has countered with a number of measures. In fall 1998 the four state commercial banks received a 270b yuan capital injection, raising their equity from 2.45% of their combined assets at the end of the second quarter of 1998 to 6.15% at the end of the third quarter.[32] After 50 years of almost exclusive lending to state-owned enterprises, banks were finally encouraged to lend to private households for car or house purchases, and to small- and medium-sized enterprises independent of ownership form.[33] Chinese Communist Party (CCP) financial work committees were set up in all four state commercial banks in order to strengthen independence as well as supervision; these report to the CCP Central Committee financial work committee as well as the CCP Central Committee discipline work committee.

But banks have become increasingly cautious now that they are held responsible for at least some of their lending. The annual growth rate of state bank loans fell from its level above 20% between 1993 and 1997 to 15% in 1998.[34] As economic growth in 1998 threatened to slip below the 8% target, the central government in August issued – outside the regular budget – new

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bonds worth 100b yuan to finance infrastructure investment, equivalent to 6.51% of all investment by state-owned units in China in 1998. These quasi-government, quasi-guaranteed projects then attracted several hundred billion yuan of bank loans.[35] In 1999 the government finally tackled the past bad loan problem head-on by turning bad enterprise loans into equity held by four resolution trust companies. By end-1999 these were poised to take over approximately 5% of the four state commercial banks' loan portfolio.[36] Banks are supposed to make a clean new start.

But their main clientele remain the state-owned enterprises; thus, for example, the state commercial banks on behalf of the government continue to keep close track of cash disbursements to state-owned enterprises. Industrial policy tasks as outlined above continue to restrict bank operations. Discretionary government instructions abound; thus, for example, the state commercial banks following central government orders buy treasury bills, state development bank and resolution trust company bonds. The central bank continues its microeconomic policies from extending poverty alleviation loans to twisting commercial banks' arms for particular lending purposes. The fundamental change in the functions of money and therefore financial intermediation and monetary policy brought about in the early reform period by the need to give enterprises decision-making autonomy remains by far the most significant financial reform measure. All other developments since, implemented gradually throughout the past approximately 15 years, have so far not added up to a final push towards market-oriented functions of money, financial intermediation, and monetary policy.

Conclusions

A focus on the functions of money, financial intermediation and monetary policy yields a number of conclusions on how the development of the PRC's financial sector came about. At a first stage of economic reform, decentralization of decision-making authority in the real sphere required money to acquire the medium of choice function for enterprises. This change in the functions of money in turn led to changes in the functions of financial intermediation and monetary policy, and ultimately to changes in the financial structure.

While the real economy faces a physical constraint (no more products can be distributed than have been produced or stored), no such hard constraint exists in the monetary sphere. This allowed the delay of painful reforms in the real economy, such as the reform of inefficient state-owned enterprises, through the accumulation of non-performing loans. Economic reform appeared successful and gained momentum and support. The government maintained its administrative, microeconomic allocation and control mechanisms over the economy, only now through the monetary sphere.

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The pressure to liberalize the financial system further is high. By the late 1990s, in the aftermath of the Asian financial crisis, the extent of non-performing loans was too formidable to be ignored any longer. Non-performing loans attribute a clear price to the continuation of administrative, microeconomic allocation and control mechanisms. At the same time, tight central control over the financial sector hampers the development of an increasingly complex economy. Lower-level tier governments responded by extending the formal financial sector through the establishment of local financial institutions. In the second half of the 1990s, an informal financial sector sprang up in the countryside which the central government has since tried to bring under its control.

Yet recent reform measures, while improving the health of the financial sector and redressing the worst mis-allocation of funds, are still based on the principle that the financial sector is a tool of the state to implement various policy and control objectives. Formal financial sector development is still not so much directly driven by market friction (information and transaction costs) as by the needs of a transition economy in the eyes of the government.

The underlying mechanisms of financial sector development discussed in this paper urge caution in the interpretation of indicators of financial structure, such as the ratio of savings to GDP. A high ratio of savings to GDP – and China's ratio of 120.53% in 1998 exceeds that of the US at 38.11% by far – need not imply a high degree of sophistication in financial intermediation, which then supposedly implies strong economic growth.[37] Given the extent of bad loans in China's state-owned banking system and the implicit government guarantee for the banking system, much of the deposits in the PRC's banks simply reflect government debt. China's fast rate of economic growth thus may be highly correlated with measures of financial depth, but the underlying mechanisms are simply expansionary government policies.

Notes

1. Chant (1992) clarifies the conditions under which market friction leads to the emergence of financial intermediation. On the link between financial intermediation and economic growth see, for example, the review articles by Levine (1997), Berthelemy and Varoudakis (1996), and Gertler (1988). Empirical studies include, among others, Levine and Zervos (1998), Thornton (1996), King and Levine (1993a and 1993b).

2. For example, Caprio, Atiyas, and Hanson (1994), describe financial reform in a number of developed and developing (albeit not transitional) economies with a concluding chapter on lessons and strategies. Cole and Slade (1991) derive generalizations about financial system reform from the experiences of Indonesia, Turkey, and Korea. Miurin (1995) describes Russia's banking reform and its effects.

Caprio and Levine (1994) and McKinnon (1993) offer policy recommendations for transitional economies, Sametz (1991) for the PRC, Claessens (1996) for the choice between radical and gradual banking reform in transitional economies, Sundararajan (1992) for central banking reforms in formerly planned economies, and De Melo and Denizer (1997) for the transition in monetary policy instruments.

3. Sigg (1981) and Bank of China International Finance Research Institute (1991) cover

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the socialist banking system of the former Soviet Union in great detail. For the case of the PRC see De Wulf (1986) and Cheng (1981).
4. Kornai (1979) uses this dichotomy to explain the phenomenon of shortage, but devotes only a few lines to the implications for the financial sector.
5. On the medium of choice function see also Dembinski (1988). Dembinski (p. 284) defines the medium of choice function as follows: "This function means that anyone who possesses money is entitled by this fact alone to choose the way in which he will spend it. For the sake of analysis, the permitted range of choice can be splitted into two dimensions: the diachronic one, which specifies the period of time during which this choice has to take place, and the synchronic one which specifies the class of transactions that can be chosen from."
6. Savings in the PRC in the pre-reform period were on a rather small scale, suggesting no major imbalance on the consumer goods market. In 1978, total per capita savings deposits (not distinguishing between rural and urban population) were equal to 16.4% of average rural per capita annual disposable income and equal to 6.9% of average urban per capita annual income. For comparison, the percentages in 1998 were 197.9% and 78.9%. (ZGTJNJ 1999, 317) Per capita currency in circulation in 1978 was equal to 16.5% of average rural per capita annual income and equal to 7.0% of average urban per capita annual income; the percentages in 1998 were 41.5% and 16.5%. (ZGTJNJ 1999, 111, 317, 624; China Financial Statistics 1952-1987, 5)
7. The monetary or planning authorities could have used interest rates on household deposits to influence household consumption decisions, but perhaps there was no need—between 1959 and 1979 interest rates in the PRC were adjusted twice, and then only marginally (ZGJRNJ 1990, 167).
8. The commodity inventory system specifies that (working capital) credit be extended directly to the user in accordance with specific plans and for specific purposes on the basis of material inventories held by the economic unit. Enterprises are required to promptly pay back their loans to the banks when the commodities that were used to back the loan are transferred outside the enterprise. (See De Wulf 1986.) The commodity inventory system represents the socialist economy's application of the "real bills principle."
9. The centrally planned economy thus upholds a very peculiar version of the banking school. Bank branches can autonomously issue transfer money and cash. But rather than being separate banks each issuing its own, competing money—ultimately checked by the limitations set through a gold standard or other reserve specie in an open economy—all branches of a bank issue the same type of money without reserve or exchange requirement. The absence of the constraints maintained by the banking school does not matter due to the restricted functions money plays in the planned economy and due to fixed prices which perform as an additional safety mechanism.
The origins of the banking school version adopted in the PRC can be traced back to Karl Marx (Marx 1971; Chapter 34) and to the Soviet banking system (see, for example, Sigg 1981; Chapter 4).
10. Walter (1985, 290) argues for the case of the PRC that after an unsuccessful credit reform in 1956 "the People's Bank [the only financial intermediary] came to focus primarily on developing its savings operations, which, in contrast to the credit reforms, enjoyed strong local Party support."
11. The secondary literature on economic reform discussions suggests that throughout the 1980s reform of the monetary system was not a topic of interest in itself. For example, Wu (1994) in her book on economic transformation, covering the various economic schools in the PRC throughout the reform period, not once refers to the

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monetary system. Hsu (1991) in his account of the discussions on economic reform among academics in the PRC during the 1980s likewise does not mention monetary reform.

12. The central government tried to maintain an upper limit on bonus payments by levying a steep bonus tax. Bonus payments equaling up to four months of wage and salary payments were free of tax, marginal bonus payments equivalent to a fifth month of wage and salary payments carried a 30% tax, those equivalent to a sixth month of wage and salary payments a 100% tax, and those exceeding the equivalent of six months' wage and salary payments a 300% tax. (SC 84/6/28)

13. For example, while in 1978 easily planned wages, salary payments and agricultural procurement accounted for 55.1% of all cash disbursement by state banks, this percentage dropped to 13.3% by 1998; the share of easily planned sales of goods and services in all cash receipts (receipts of cash by state banks) at the same time dropped from 79.2 to 12.7%. The share of the relatively unpredictable withdrawal and depositing of savings (both in cash) as share of total cash disbursement and receipts by banks rose from 9.6% and 10.7% in 1978 to 64.2% and 63.1% in 1998. (See *China Financial Statistics 1952-1987*; ZGTJNJ 1999, 625.)

14. See *Jinrong shibao* 97/10/28 and 99/12/6 as well as ZGJRNJ 1997, 493, and ZGTJNJ 1998, 533. During two periods of high inflation, savings deposits of three or more years maturity were inflation-indexed; the first period lasted from 88/9/10 to 91/12/1, while the second began on 93/7/11 with the inflation subsidy dropping to zero in May 1997.

15. See ZGWJNJ 1997, 482.

16. According to Montes-Negret (1995, 31), the Industrial and Commercial Bank of China in the early 1990s could autonomously decide on less than 20% of its lending. According to Xiao (1997, 371), approximately 40% of all state bank loans in 1991 were "policy loans" (defined in the source as particular lending categories). These loans range from the loans extended to 240 enterprises under the "double-guarantee system" (the state guarantees all inputs, the enterprise guarantees all outputs) with no decision-making authority for the bank, to agricultural procurement loans for which the government only determines volume and purpose.

Not all policy loans are explicitly labeled "policy loans." Local governments and lower-level tier ministries are participating in, if not making some loan decisions; financial intermediaries may not want to lend to enterprises which do not have borrowing approval from their superordinate ministry.

17. The transition in the credit plan system occurred in two stages. At the first stage (1984-86) banks faced both a credit and a deposit plan with refinancing of the difference guaranteed by higher-level branches of the same bank and ultimately the central bank. Deposits attracted in excess of the deposit plan could be turned into working capital loans by the bank branch itself (*duocun duodai*). In 1987 the deposit plan was abandoned, refinancing through the central bank no longer guaranteed, and the credit plan limit became fully binding.

18. The establishment of these "special" banks was in part due to the agricultural reforms in 1978/79 and the opening up to foreign trade in the early 1980s, requiring specialized banking services, but also to the fact that these banks had already existed as separate entities in the years before the cultural revolution. A further reason may have been the desire to avoid concentration of power in an increasingly large and complex financial sector. On the institutional changes and some of the potential reasons for these changes also see Sheng (1989, 37-40) or Qin (1993, 47-57).

19. The State Council justified this move by the need to change the "present situation

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of dispersed administration and use of funds." A further aspect was the avowed separation of government and enterprises (*zhengqi fenkai*). The PBC acting as solely a central bank was viewed as an extension of the government controlling – through its conduct of (microeconomic) monetary policy – special banks operating like enterprises (*qiyehua*).

20. The ABC in mid-1997 prided itself on having strictly adhered to the cash disbursement plan in the first half of the year (*Zhongguo chengxiang jinrongbao* 97/7/21). The most recent regulation on the use of cash by enterprises is still in effect (PBC 88/9/23), although it is frequently not enforceable, especially with rural collective-owned enterprises and individual-owned enterprises.

21. *Jinrong shibao* 97/3/29 carried an example of how a county government tried to pressure a rural joint credit cooperative (*lianshe*) to extend loans to county enterprises which would then pay taxes to the county government. It threatened (and in part proceeded) to cut off electricity and water supply to the joint credit cooperative, to stage an investigation of the credit cooperative's lending behavior, and to expel the children of the head of the joint credit cooperative from the local school.

22. See *Ming Pao* 98/1/11. Banks are traditionally viewed as secondary in rank to productive enterprises and their superordinate ministries, and thus as service institutions for state-owned enterprises. The question of rank reaches back to the early years of the PRC. See, for example, Walter (1985) on the failure of the 1956 credit reforms and the subsequent low status of the monobank PBC. After the failed reforms, "the PBC continued to supply working capital to enterprises virtually on demand" (p. 289).

The establishment of bank branches follows the government administrative structure, and branches may only collect deposits and make loans within their locality. Activities across the borders of the locality must be reported to the PBC. On local financial protectionism see, for example, Ding and Liu (1993).

23. The ICBC headquarters issues maximum quotas on such loans to each province; if these quotas are not sufficient, the locality may exceed them but should (in urgent cases a posteriori) obtain approval from headquarters. These policy/ special loans are only extended if the local finance or labor department subsidizes the interest payment. Final repayment of the loan is left unclear. (ICBC 13 June 1994)

24. See *Jinrong shibao* 97/1/9.

25. The central government can primarily rely on the four state commercial banks, the provincial government on trust and investment companies as well as regional commercial banks, the municipal government on urban cooperative banks, the county government on rural credit cooperatives, and the township government on rural cooperative funds.

26. For example, in late 1999 the ICBC Sichuan provincial branch entered a contract with the Yibin municipal government in which it guaranteed Yibin municipality a certain share of the annual increase in its province-wide lending. The municipality promised support in attracting deposits, collecting interest payments and principal, and safeguarding bank assets. (*Jinrong shibao* 99/11/15)

27. See PBC 95/11/30 and various reports in *Jinrong shibao* such as on 96/3/31, 96/7/21, and 96/12/2.

The regulation was first applied in two hundred large and medium-sized cities and then extended by some provinces further down the administrative hierarchy. For the license to be valid, enterprises must submit their balance sheet and profit and loss account for inspection to the PBC annually. When applying for a loan or extending a loan, the bank enters the relevant information in the credit license.

28. Already in 1986-88, credit limits were once merely indicative targets, with overshooting not being penalized. Later on, credit limits were again more strictly enforced.

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(Mehran 1996, 41) For the discrepancy between credit plan limits and actual credit outstanding see Fan et al. (1993, 25) and Xie (1997). In the years 1985 to 1996 actual year-end credit outstanding exceeded the plan by between 21 and 109% (in 1995 and 1985, respectively).

29. See, for example, *Jinrong shibao* 97/12/20 which states explicitly: "The abandonment of the imperative plan only holds for the commercial bank as a legal person, and does not mean that all tiers of the commercial bank follow deposit-loan ratios and other asset-liability ratios, as if the big bank could be split up into many small banks."
As recently as late 1997 ICBC branches in a particular county were penalized by the Party cell in the municipal PBC branch for exceeding their credit plan limits; some branch directors were suspended for three years. (*Jinrong shibao* 97/11/30)

30. As recently as 1992 the SC agreed to a PBC instruction explicitly stating that "individuals cannot establish banks or non-bank financial institutions and cannot undertake financial business." (PBC 92/12/10). Likewise, *Renmin ribao* on 6 July 1995 stated that China does not allow the establishment of private banks (according to ZGJRNJ 1996, 17). Newly established nationwide commercial banks such as Huaxia and Minsheng Bank have slightly more complex ownership structures with as owners state-owned enterprises and non-state enterprises under the (state-run) All-China Federation of Industry and Commerce, respectively, but remain if not directly state-owned then state-controlled.

31. See Zhou (1995), 1f; ZGJRNJ 1996, 429; and ZGTJNJ 1996, 42.

32. See ZGRMYHTJJB vol. 15 (1999-3), 21.

33. Despite the publicity, the volume of such loans has remained small. In mid-1999, 82.15% of total lending by all state banks was to state-owned enterprises (including urban collective-owned enterprises); individual-owned enterprises accounted for only 0.36%, rural collective-owned enterprises, the typical small or medium-sized enterprises, for 2.56%, and a category 'others,' presumably including consumer loans, for 1.01%. (*Zhongguo jinrong* 8/99, 37)

34. See ZGJRNJ 1998, 509; and *Zhongguo jinrong* 2/99, 38f.

35. The same pattern repeated itself in 1999, with the government in late 1999 issuing 60b yuan of government bonds to finance infrastructure projects beyond the planned budget expenditures; this is reported to have induced additional bank lending of more than 200b yuan. (*Jinrong shibao* 99/11/20) On the investment data see ZGTJNJ 1999, 184.

36. The State Economic and Trade Commission by late 1999 has approved and recommended 394 enterprises for a debt-equity swap total of 358.7b yuan, which compares to total loans by all state banks at mid-1999 of 7158.9b yuan. (*Jinrong shibao* 99/11/21 and *Zhongguo jinrong* 8/99, 37)

37. For example, Levine and Zervos (1998) find a "strong, positive link between financial development and economic growth and [that] the results suggest that financial factors are an integral part of the growth process." On the data see ZGTJNJ 1999, 55 and 624; Federal Reserve internet database (www.bog.frb.fed.us) and *Economic Indicators* (November 1999).

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