Financial Sector Reforms in China

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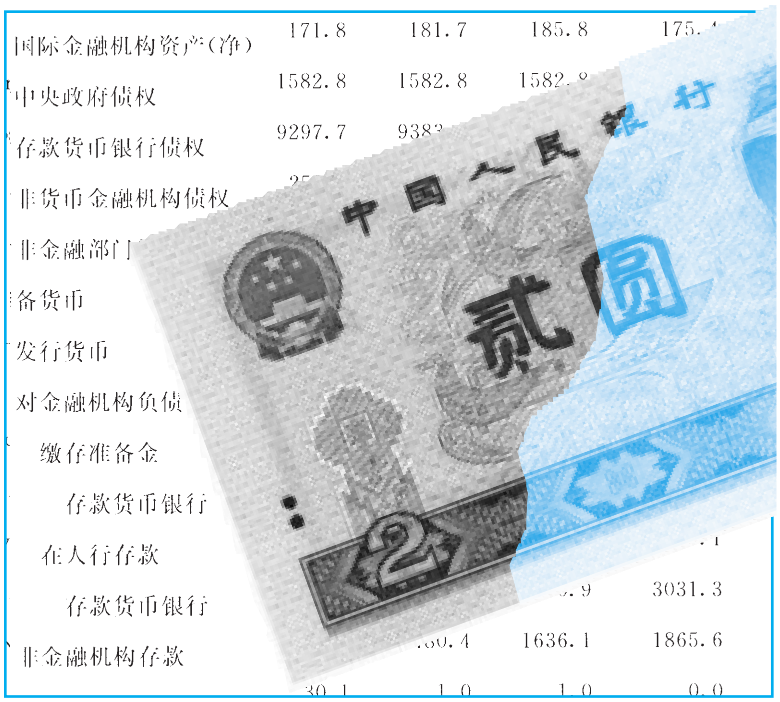

China's financial reform—an integral part of its transition to a market economy—has been characterized by pragmatism and gradualism. During the first decade of reforms, policymakers have emphasized institutional development, with the result that real market development has lagged behind.

IN 1978, CHINA embarked on a gradual but far-reaching economic reform. Since then, China's economy has been significantly modernized and opened up to the rest of the world. The reform process has affected all sectors of the economy. In addition, the concept of reform itself has also evolved. The most dramatic change took place in 1992, when the Party officially recognized that a market system was not incompatible with the ideals of socialism and subsequently proclaimed the idea of establishing a "socialist market economy." The concept of a socialist market economy implies an economy in which market mechanisms govern economic interactions but the public sector maintains ownership of the most important means of production.

In the wake of this decision, the Chinese leadership outlined and approved a comprehensive reform strategy for the remainder of the century. This strategy explicitly mentioned financial reform as a key element in efforts to create efficient financial markets in order to strengthen the authorities' capability to carry out macroeconomic management using indirect monetary instruments.

Major achievements since 1978

Financial sector development is a complex and multifaceted process. It involves the balanced development of three essential ele-

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ments: institutions, instruments, and markets. Banks and other financial institutions—as well as the financial infrastructure, including the payments system—need to be established. A range of financial instruments need to be developed and made available to market participants to invest and trade. Development of the market presupposes the free operation of the price/interest rate mechanism.

Institution building started in the early years of reform with the establishment of a two-tier banking system. Gradually, the People's Bank of China (PBC) was divested of all its "commercial" activities. In 1984, the PBC became China's central bank. However, monetary and credit policy continued to take the form of a credit plan that was implemented through a set of credit quotas for each bank and direct bank financing of enterprises. Since the credit plan was an aggregation of sectoral and local financing needs done from the bottom up, an expansionary bias was inherent in the system. This impaired the PBC's ability to manage monetary developments—a problem that was not really addressed until 1992–93, when work on a new central bank law started. Central banking received a new impetus in 1995 when this law was enacted, giving the central bank the legal foundation to operate in a market environment under the leadership of the State Council.

Despite the above-mentioned dilemma, monetary policy's role in macroeconomic management has significantly increased. The PBC has introduced reserve requirements and lending facilities to commercial banks to support its monetary policy actions, which remained guided by the credit plan. However, the effectiveness of the credit plan has been decreasing since the late 1980s, mainly because its institutional coverage has lagged behind the expansion of the banking sector. In 1994, direct central bank lending to the government was discontinued, and preparations for increased reliance on indirect monetary policy instruments were started in earnest. These changes have signaled the start of the phasing out of the credit plan.

In the early reform years, four state-owned specialized banks—the Agricultural Bank of China (ABC), the People's Construction Bank of China (PCBC), the Industrial and Commercial Bank of China (ICBC), and the Bank of China (BOC)—were established to improve the allocation of financial resources to specific sectors. Starting in 1984, selected new banks were permitted to operate alongside these four banks, which, at the same time, were formally allowed to diversify their operations. During the second half of the 1980s, a flourishing network of nonbank financial institutions (NBFIs) emerged. Since then, the four state-owned specialized banks have been used to implement the government's financial policies, as laid out in the credit plan, and other banks and NBFIs have enjoyed more freedom in their operations.

The establishment in 1994 of three policy lending banks intended to channel credit to infrastructure and other priority areas, and the enactment of China's new commercial bank law in 1995 are meant to encourage market-based management and pricing principles. Chinese lawmakers also intend to separate banking from other business. New legislation designed to regulate and streamline NBFIs is being formulated.

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The development of financial instruments has been limited to the capital market. No nationally integrated money market has as yet been developed, and most banks lack the skills to develop new products that could create competition in the financial sector. Local interbank centers have been emerging since 1986. Although they have played a useful role in the local redistribution of surplus funds, they have not operated as interbank markets in the traditional sense. Since NBFIs and even some enterprises can participate, these centers often serve as channels for long-term financing of nonbank and nonfinancial institutions, thereby circumventing the credit plan.

The absence of nationally organized money markets—one of the salient features of China's financial sector in the early 1990s—is related to its slow start on interest rate liberalization, its lack of a modern payments and settlement infrastructure, and the banks' inefficient administrative organization. The lack of nationally integrated interbank and money markets has, in turn, hampered efforts to achieve the transition to indirect instruments of monetary policy. In the absence of an interbank market where surplus funds could be redistributed, the existing indirect instruments have been used to channel liquidity from one region or entity to another. The authorities have regulated liquidity by adjusting reserve requirements and using the PBC's lending facilities for banks while maintaining relatively stable interest rates.

Capital market development, though, has become one of the striking features of China's reform process. In 1981, the authorities resumed the issuance of government securities, mainly to complement financing provided through the credit plan. Shortly thereafter, the authorities permitted the issuance of other types of bonds—including enterprise bonds—and enterprise shares, even though they remained strictly controlled in order to avoid conflicts with the priorities set in the credit plan. Since 1988, secondary markets in bonds and stocks have been allowed to operate, which has further boosted capital market development. The stock exchanges of Shanghai and Shenzhen have become the exponents of China's flourishing capital market activity.

For most of the period since 1978, market development and liberalization have lagged behind institution building, at least in the domestic financial sector. An attempt at liberalizing interest rates during 1986–88 (banks were allowed to set lending and deposit rates freely within specified margins above the administered rates) was brought to a temporary halt in the midst of the inflationary developments of 1988–89. Since the early 1990s, banks and NBFIs have again been granted the freedom to vary lending rates within prespecified margins, with the width of the margin depending on the type of institution.

Market development has made significant strides in the foreign exchange sector. The establishment of swap centers in 1986 marked the introduction of an embryonic foreign exchange market in China. Until 1992–93, turnover in this market, which was organized under the supervision of the State Administration for Exchange Control, grew steadily. A new phase started at the beginning of 1994, when the exchange rates between the different swap centers (swap rates) were unified and one national foreign exchange market was created. At the same time, the official rate and swap rate were unified.

How were reforms introduced?

Like reforms in other sectors of the Chinese economy, financial reform has not followed a rigid, comprehensive blueprint but instead has been characterized by pragmatism and gradualism. In short, reform in China has been evolutionary rather than revolutionary. The size and diversity of the country, as well as the decentralization of decision making early in the reform process, have allowed policymakers to adopt small-scale experimental approaches—which were subsequently adopted, in some instances, on a national scale—and be selective in starting specific reforms.

Examples of this approach in the financial sector include opening local interbank centers in selected cities in 1986 and secondary markets in government securities in six cities in 1988. In both instances, other cities were allowed to pursue these courses of action after the authorities had received sufficient indications that the initial experiments had been successful. The establishment of stock exchanges at the end of the 1980s is a third example. The local authorities in Shanghai and Shenzhen initially encouraged the development of stock exchanges in their cities without support from the national authorities. In 1990, the central government recognized Shanghai's as the nation's major stock exchange experiment. In 1991, it went on to recognize the development of the Shenzhen exchange. At the same time, stock exchange experiments in other cities were put on hold.

Selectivity in undertaking reforms is closely linked to the experimental approach. From the beginning, the Chinese authorities have selected certain provinces or regions to play leading roles in the reform process. The Special Economic Zones (SEZs) are the most striking examples of this: they were allowed the autonomy to offer special (financial and other) advantages to attract foreign investors. Branches of foreign banks could be opened in the SEZs. Credit quotas were more flexible, and bank branches were allowed more freedom in setting their lending and deposit rates in SEZs than elsewhere in China. As a result, economic growth in the SEZs has far outpaced that in the rest of the country.

Intermediate control mechanisms have been established to smooth the transition from one economic system to the other and to familiarize economic agents with the features and mechanisms of the newly emerging system. Examples are the establishment of a two-tier pricing system (1984), the introduction of a swap market in foreign exchange retention rights (1986) to improve the use of foreign exchange, the introduction of indirect monetary policy instruments (1984), the granting of more freedom to the banks in setting interest rates (1986), and the establishment of local interbank markets to encourage banks' liquidity management (1986).

Assessment

Financial development in China started from a very low level, since the financial sector was almost nonexistent. Seen against this background, China's record of financial sector development is impressive; nonetheless, its agenda for further reform remains highly challenging. An assessment of China's achievements in developing its financial sector reveals that the authorities have thus far devoted more effort to institutional development than to the process of creating markets, including the liberalization of financial operations, while the development of financial instruments has been confined to the capital markets. This perceived imbalance in development arises principally from the position of China's financial system at the end of the 1970s and the authorities' preference for an intermediate macroeconomic control system.

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The monetary sector in particular was at the heart of this control mechanism whereby, de facto, control techniques of a planned economy continued to dominate and market-based techniques served only a complementary role. This combination reflected the authorities' desire to use the newly established financial sector, for as long as possible, as the main vehicle for an interventionist economic development strategy. The line adopted by the Chinese leadership with respect to the role of the emerging financial sector in the economy is very similar to the approach taken by the authorities of several other East Asian countries and reflects a conviction that maintaining tight control over the sector's price mechanism would ensure that it remained an important vehicle in the government's financial allocation policies. This control has continued to take the form of administered interest rates, directed credits, and accompanying interest rate subsidies.

Agenda for continuing reform

The upshot of the strategy adopted thus far is that future financial reforms will need to emphasize liberalization measures focused on interest rates and the exchange system.

The strategy adopted by the Third Plenum of the Fourteenth Central Committee of the Communist Party in March 1993 implicitly recognized that if the imbalance between institution building and market liberalization in the financial system were protracted, it could become an impediment to further liberalization and a better allocation of financial resources in the Chinese economy.

To be successful, domestic and external financial liberalization will need to be underpinned by other reforms, including an accelerated commercialization of state-owned banks, establishment of effective banking supervision, and reform of the accounting system used by the banks. Liberalization, in turn, will give a new impetus to money and capital market development and the concomitant development of new financial instruments. These reforms, taken together, will facilitate the development of indirect monetary policy instruments, which will complete China's transition to a market-based financial system.

In 1995, preparations started for the development of a nationally integrated interbank market in 1996 and a phased liberalization of interest rates that is to be completed by 2000. Both projects are to some extent intertwined, since the first phase of interest rate liberalization will focus on interbank rates. A phased interest rate liberalization, starting in January 1996, will allow the authorities to address problems posed by the precarious position of the state-owned enterprise sector—the main reason why interest rate liberalization was postponed for a long time.

Lessons learned

What lessons can the rest of the world draw from China's experience with the development and reform of the financial markets?

• First, China's 15-year experience clearly underlines the importance of building a widely and deeply developed banking system. Starting from a system in which a few "banks" operated as government departments assigned to implement the authorities' credit plan and, in fact, had a mere accounting role, the authorities have managed to establish a fairly diversified financial sector with universal and regional banks and a variety of NBFIs. While this sector has contributed to the country's high savings ratio and its rapid pace of monetization, it has fallen short as a mechanism for channeling financial resources to the most productive sectors.

• Second, one aspect of institution building that did not receive sufficient attention during the first decade of reforms is the enactment of legislation to support financial market development. Central bank and commercial bank laws were enacted as recently as 1995, while other key legislation, covering such subjects as NBFIs and negotiable instruments, is still in preparation. The lack of a solid legislative underpinning has certainly had an adverse impact on China's financial reforms. For instance, as emerging market forces began to have an impact and the financial system expanded, the need to strengthen the supervisory authority of the PBC was strongly felt. Initially, the PBC's relationship with the state-owned banks was only that of *primus inter pares*. The PBC managed gradually to establish its authority over the banks and the newly emerging parts of the financial system. Yet the country's political and administrative structure and the tendency to decentralize decision making, in combination with a lack of supporting legislation, initially gave the local authorities more influence over PBC branches and branches of the specialized banks than the PBC's own headquarters had. This unsatisfactory situation was finally addressed by the 1995 central bank law, which established the authority of the PBC headquarters over its branches and the financial sector as a whole.

Likewise, the lack of solid legislation has delayed the commercialization of the state-owned banks. Their protracted dependence on the government and its policies has resulted in their failure to develop financial sophistication and prevented them from making more effective use of market instruments in their operations. In addition, their internal administrative and managerial structures, which have given branches a high degree of independence vis-à-vis headquarters, make it difficult for these banks to operate as one integrated entity within a market environment. Technical factors, such as the lack of modern accounting practices, aggravate these problems.

• Third, a gradual approach to liberalization has perhaps been postponed for too long and may have led to distortions elsewhere in the economy. While the government tried to keep a firm grip on financial market development to ensure that the banking sector remained a major vehicle for its financial policies, it could not prevent market forces from making themselves felt and, on occasion, interfering with the government's plans. The emergence of the NBFI sector has no doubt enriched the financial landscape but it has also posed challenges to the government, which was forced to include certain types of NBFIs in its credit plan to ensure continued adequacy of control. In the government securities market, the "market" itself initiated secondary market trading, which was afterwards allowed officially, but this development also posed some new challenges for the government. For instance, the market increasingly wanted to see secondary market price movements reflected in the prices of primary issues, whereas the government tried to stick to its administratively set prices. In 1993 and 1995, for example, the government had to raise the interest rates on its securities when they were issued, in order to meet the market's demands.

For a long time, political resistance to interest rate liberalization was strong, mainly because of the weak financial position of the state-owned enterprises. The importance of liberalization as the next step in the reform process has now been recognized. This explains why further reforms in China could now, more than during the first 15 years of its reform, benefit by applying the lessons learned by other countries—in particular, the East Asian countries—that liberalized their financial systems and adopted market-based monetary policy techniques. F&D

This article is based on a longer paper by the authors and others, "Monetary and Exchange System Reforms in China: Achievements and Agenda for the Future," forthcoming in the IMF's Occasional Paper series.