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The Evolving Role of Monetary Policy in China

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Summary

Monetary policy is one part of the range of indirect policy instruments that are increasingly being relied upon in China, as a result of the process of economic reforms that was launched in 1979. Previously, the main role of monetary policy was to support the implementation of the physical plan, while maintaining financial stability. Credit was granted whenever it was deemed necessary for plan implementation, and the monetary authorities monitored the various uses of the liquidity thus created. They especially focused on the volume of cash in circulation, as it was the only means of payment in the economy that was not controllable by administrative means.

However, the ongoing reforms are giving the various agents in the economy greater material incentives to organize their activities so as to supply those goods and services that are in demand rather than in response to centralized planning directives. The banking system is being reformed to support this process. The paper explains how the monetary authorities are being given greater responsibility for assuring macroeconomic balance, and how credit policy is being assigned the role of stimulating greater efficiency in resource allocation. The reform of the banking structure and the development of monetary policy instruments supporting these new responsibilities of the banking sector are discussed, and the implications of these developments for the targets of monetary policy are examined. Monetary developments in the 1979-85 period and the enhanced scope for financial intermediation are briefly described. The paper concludes that while much progress has been made in the process of monetary reform, the full benefit of the automaticity of monetary policies will only be obtained gradually, and in tune with the reforms of the whole economic system, in particular the price system.

The Evolving Role of Monetary Policy in China

I. Introduction

In December 1978, China started a process of economic and social reform with far-reaching consequences. In the process, individual producers--farmers, providers of services and industrial enterprises--were granted greater material incentives, and enjoyed enhanced authority to organize their production, acquire inputs and dispose of their output in such a way as to increase their profitability. While the broad objectives of this reform were clear at the outset, the specific reforms only developed gradually; experiments were launched, evaluated, expanded nationally when judged beneficial or modified, even dropped, when found inappropriate. As a result of these changes, the role of mandatory planning--although still important--is declining, and new policy tools that operate more through economic levers than through administrative directives are gradually being developed. As part of this process, the policy instruments, intermediate targets, and institutional framework of monetary policy are undergoing substantial changes. Credit policy, which prior to the reforms was largely accommodating, has begun to play a more independent role, in conjunction with a more active use of interest rates. New specialized financial institutions have been created, culminating in the establishment of the People's Bank of China (PBC) as a separate central bank as of January 1984.

This paper discusses the operation of monetary policy before and after the reforms. Monetary policy prior to 1979 is considered in Section II, which describes the primary features of the pre-reform economic system, discusses the principal objectives and policy instruments, and analyzes the achievements and limitations of monetary policy in such a system. The subsequent evolution of monetary policy is reviewed in Section III, which describes the major changes in the economic system after 1979, examines the effects of these changes on monetary institutions and policies, including their impact on the process of financial intermediation, and discusses their implications for the conduct of monetary policy and the choice of the most appropriate monetary targets.

II. Monetary Policy in China Before 1979

1. Primary features of the economic system

The instruments and objectives of monetary policy as conducted up to 1979 need to be considered in the context of the model for the central planning of resource allocation that China had adopted in the early 1950s. In that model, all key resources are allocated according to a central plan; output targets are set for the different sectors of the economy; detailed interenterprise supply and demand relations are outlined; and the attainment of the plan targets is the major criterion against which the performance of enterprises and regions is judged. The role of monetary policy is to support the implementation of the physical plan while maintaining financial stability. Therefore, credit policy is largely accommodating, in that it provides the economy with the minimum amount of liquidity necessary to satisfy the transactions requirements implied in the physical plan, given the prevailing administrative controls and the price, production, and distribution systems. 1/ While implementing this credit plan, monetary policy must prevent an excessive accumulation of liquidity outside the enterprise sector. The role of monetary policy in this model contrasts with its role in market economies where monetary operations also affect the allocation of resources in the process of maintaining financial stability.

The task of supplying funds to the enterprise sector was divided between the budget and the banking sector, following the division of responsibilities which had been adopted in the Soviet Union in the 1930s. 2/ The budget was to supply, in the form of grants, all investment funds plus the minimum working capital (quota capital) required by the enterprise sector. The banking sector supplemented these funds when enterprises required temporarily larger amounts of working capital (above quota capital), but did not supply any investment funds. The banks charged a low interest rate on the funds they provided; these charges were not intended as rationing devices but were necessary as the bank had to pay interest to attract household savings and, to a lesser degree, to induce enterprises not to spend their liquid funds. In the absence of investment lending, bank credit was basically of a short-term nature; this was often regarded by Chinese observers as conferring an added advantage of security, in that it protected the banks against the potential withdrawal of short-term deposits. 3/

This division of responsibility for the provision of funds followed from the arrangement whereby the profits of state enterprises belonged to the State, which determined the use of such funds through budgetary allocations. The budget charged no interest on the funds it provided, because their allocation was determined by planning considerations rather than by relative profitability. Nor was it necessary to provide for the repayment of principal, since the budget already had a full claim on all enterprise profits.

1/ See Donald R. Hodgman, "Soviet Monetary Controls Through the Banking System" in Franklyn D. Holzman, Editor, Readings on the Soviet Economy (Chicago: Rand McNally & Co., 1962), p. 110.

2/ In this section, the past tense is used for expositional purposes. However, many of the features of the pre-1979 monetary policy are still valid at present.

3/ See the references in Hang-Sheng Cheng, "Money and Credit in China," Federal Reserve Board of San Francisco Economic Review, Fall 1982, page 22.

To ensure that the liquidity supplied to the enterprise sector was not excessive, the budget provided only the minimum amount of working capital necessary for enterprises to operate, plus the amount of investment funds determined by the planning authorities. It was the responsibility of the banking sector to supply the enterprises with additional funds required by the lack of synchronization between enterprise receipts and payments and to ensure that such funds were not more than strictly necessary. In extending credit, the banking sector aimed at ensuring financial stability by providing credit according to the "commodity inventory system" (see below). In addition, the banking sector closely supervised the financial transactions of the enterprise sector and, by prohibiting interenterprise credit, maintained a monopoly over credit creation.

A further characteristic of China's economic system that was common to many other planned economies was the existence of a dual payments system designed to keep liquidity developments in the enterprise and public organization sector separate from those in the household sector. This system specified which payments were to be made through bank transfers and which could be made in cash. Bank transfers were to be used as the only means of settling accounts within the enterprise and public organization sector, and between this sector and the Government. All such transfers were subject to bank supervision so as to ensure that the transactions involved conformed with the physical and financial plans. No checking accounts were permitted and all transfers were to be made through entries in the books of the banking sector.

The "cash" circuit pertained to the payment flows between the enterprise and government sector, on the one hand, and the household sector, on the other, as well as payments that took place within the household sector itself. Households were free to hold on to their cash balances or to use them as they desired; but because of the absence of investment opportunities and other financial assets, the use of cash was in fact limited to financing current consumption or to increasing bank deposits. Holdings of cash by enterprises and public organizations were subjected to administrative restrictions. 1/

The organizational structure of the banking sector during the period before the introduction of the reforms underwent several changes. At times, all banking operations were centralized within the People's Bank of China (PBC); at other times, separate specialized banks were also operating, but always under the direct supervision of the PBC. In any event, banks did not compete among themselves, as each was given its own sphere of responsibility, and enterprises were assigned one bank with which to do their banking business. Also, the interpretation of

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1/ Enterprises were allowed to hold currency equivalent to three days of currency needs in the localities where a bank branch existed; otherwise, they were allowed to keep cash equivalent to up to two weeks' needs.

the role and independence of the banking sector vis-a-vis the other organs of the state varied over time in line with shifts in general economic policy, as will be illustrated in the last part of this section.

2. The operation of monetary policy

In a developed market economy, the central bank regulates the liquidity in the economy by influencing both the assets and the liabilities of the banking sector. This is done by changing the discount rate or the reserve requirements of the commercial banks, or by open market operations. These policy instruments affect the allocation of resources through the working of market forces. Preferential credit and interest rate arrangements are sometimes relied upon to shelter particular sectors and regions from these market forces.

In pre-1979 China, the situation was different; resource allocation was decided by the Planning Commission, while the goal of monetary policy was to facilitate plan implementation. Hence, alongside the physical plan, there was a financial plan made up of three complementary parts, namely, the budget, the credit plan, and the cash plan. Consequently, the operation of monetary policy in this system could best be described as the set of rules and practices adopted to implement the credit and cash plans.

a. Credit plan

The credit plan was the financial counterpart of the physical plan, and provided a breakdown of the credit required by the different regions and enterprises within these regions to implement their output targets. While the credit plan specified the aggregate amounts of credit to be granted to these various sectors, actual credit operations were guided by the "commodity inventory system," which was introduced in 1955 and derives its name from the major aspect of the credit criteria on which it is based. According to these criteria, credit should be extended directly to the user according to specific plans and specific purposes, and on the basis of material inventories held by the economic unit. 1/ Combined with the requirement that enterprises promptly pay back their loans to the banks when the commodities that were used to back the credit demand are transferred outside of the enterprise, adherence to this principle was supposed to ensure that only the required credit would be extended. 2/ The implementation of this principle required that the banking sector closely supervise the utilization of credit.

1/ Carl E. Walters, "The Structure and Functions of the People's Bank of China," paper prepared for the Workshop on Law and Economy in the PRC at Harvard Law School, August 28-30, 1978, p. 17.

2/ This is a version of the real bills' principle.

For the authorities, the "commodity inventory system" of granting credit in a centrally planned economy had an advantage over strict quantitative credit allocations, because it did not require that detailed credit allocations be set in advance, which in any event would have been difficult because of the inherent variability of production. Furthermore, such a credit policy had a flexibility that was not available with quantitative controls. It could adapt automatically to plan overfulfillment or underfulfillment and to plan misspecification. This flexibility was useful to the authorities, as the physical plans were not always comprehensive or internally consistent. Because the People's Bank of China was a de facto monopoly bank, with interenterprise credit prohibited and no consumer credit extended, the implementation of the credit plan was relatively uncomplicated. However, as will be discussed later, the commodity inventory system did not necessarily prevent excessive credit expansion; for instance, enterprises could often obtain credit to finance the production of goods that did not match demand.

In the implementation of credit policy, a distinction was made between financial credit, which was the credit extended to the budget, and enterprise credit. Enterprise credit was granted to finance that part of the excess inventories that arose out of conditions beyond the control of an enterprise, such as seasonal factors or transportation bottlenecks. Inventory accumulation caused by inefficiencies in the enterprises themselves was not eligible, in principle, for bank financing. Enterprise credit, backed by commodity flows, was not considered inflationary since the commodity flows provided a mechanism for the withdrawal of purchasing power from the economy. On the other hand, credit extended to cover budgetary deficits was regarded as a source of inflationary pressures. Whereas enterprise credit was extended "to meet the demands of the advance in production and expansion of commodity circulation,....[financial credit]...forcibly imposes on the circulation field by the state... [and] becomes redundant--affecting the stability of finance and prices." 1/ This was so because budgetary credit was regarded as infusing purchasing power into the economy, without at the same time providing for a mechanism for its withdrawal. Hence, it was to be avoided. In practice, however, the banking sector had little choice but to finance budgetary deficits when they arose. 2/

b. Cash plan

The cash plan covered the various factors that influenced the amount of cash in the economy. The monetary authorities attached great importance to the volume of cash in circulation, as currency constituted the only freely available source of purchasing power. The bulk of the

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1/ Lin Jiken, "Persist in Issuing Currency in Line with Economic Principles", Jingji Yanjiu (Economic Research), No. 1, January 20, 1981, pp. 60-61 (FBIS May 11, 1981, p. 83).

2/ Domestic bank financing of the deficit occurred in 10 out of the 29 years during the period 1950-78.

currency in circulation was in the hands of consumers; an unduly rapid expansion in cash holdings relative to available supplies of consumer goods was regarded as a sign of excess demand pressures, although these pressures would not directly lead to increases in the administered prices that applied to most consumer goods. The cash plan was derived from the quantity theory of money treated as an identity. If the velocity of money is assumed to be constant, prices are fixed, and the volume of retail sales is determined by the national plan, then the quantity equation (MV = PQ) provides the stock of money (defined as currency in the Chinese literature) required by the price and output objectives. In contrast to the "transaction approach" of Irving Fisher and the "asset or Cambridge approach" which viewed the quantity of money in the economy as affecting prices and outputs, the Chinese literature did not view money as affecting either of these. 1/

Once the overall target for currency in circulation was established, it was up to the banking authorities and others to implement this target. However, the direct role of the banking sector in the execution of the cash plan was limited and can best be analyzed by considering its influence on the various factors that affect the amount of cash in circulation. The cash plan specified both the factors that caused currency to leave the banking sector and those that caused it to flow back to the banking sector. Chart 1 illustrates the process. The main factors causing cash to be put into circulation were the payment of wages to staff and workers, the purchases of farm products by state organizations, and their purchases of some minor industrial and mining goods produced in the rural areas. The drawdown of savings deposits by individuals was the other major source of cash inflow into the economy.

Withdrawal of currency from circulation was mainly done through sales of consumer goods to the public and through increases in savings deposits. Taxes paid were a minor source of the flow back of currency to the banking sector, as was the income from the service trades.

In formal terms, the cash plan can be represented by the following identity.

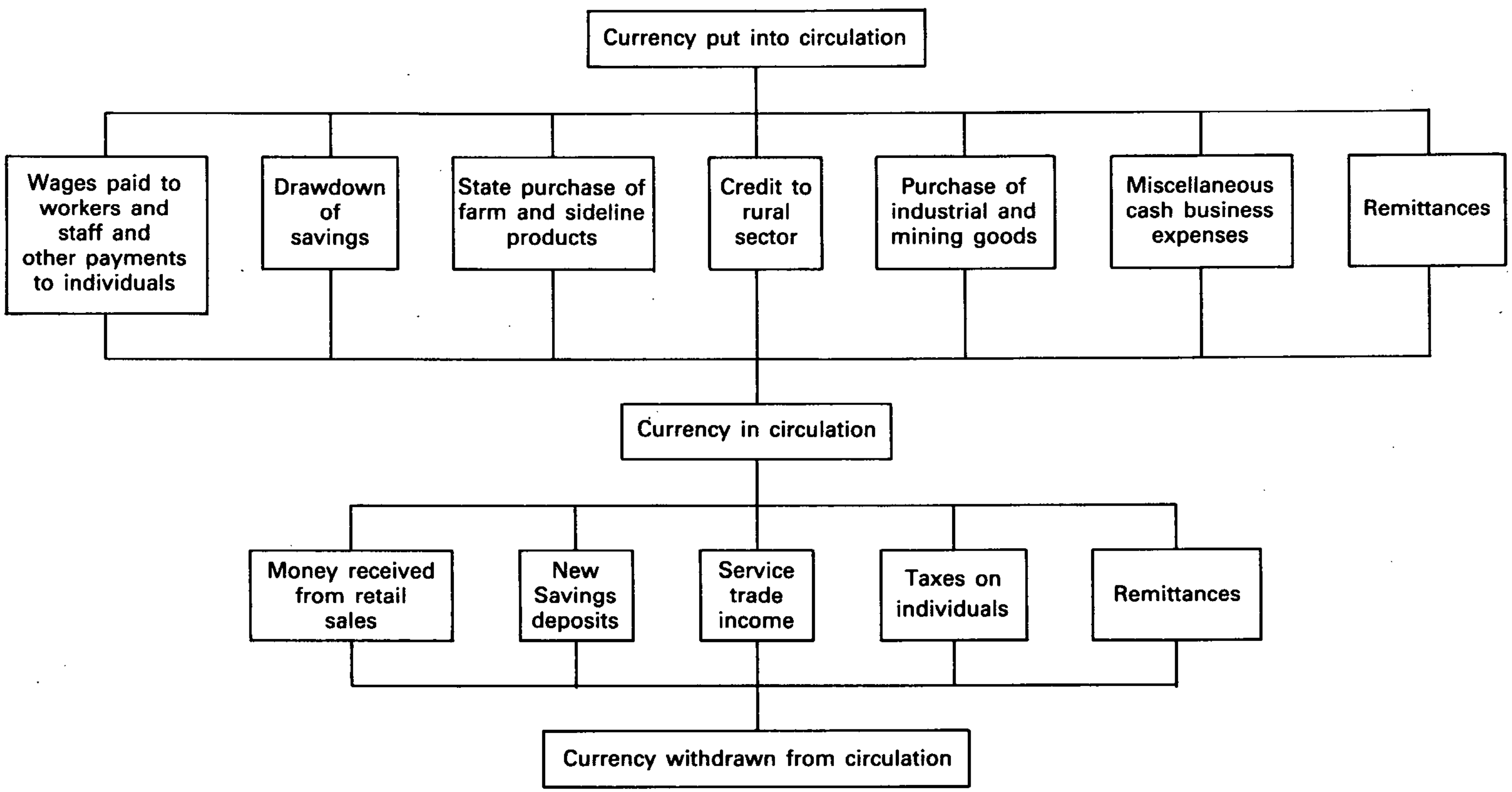
$$(1) \qquad \Delta\, Cash_h = P_a . Q_a + W.N + T + \Delta\, DC_h - P_c . Q_c - \Delta\, DEP_h$$

where P_a is the average procurement price of agricultural products and Q_a, the quantity purchased by the state; W is the average wage rate and N the level of employment; T is net government transfers to households; ΔDC_h is the change in credit to households; P_c, the average price

1/ This view is more fully explored in Hang-Sheng Cheng, op. cit., pp. 25-27.

CHART 1

CHINA
CURRENCY FLOWS



Source: People's Bank of China, "A Financial Survey of the People's Republic of China," *Zhongguo Jinrong,* June 1981, p. 13.

of consumption goods, and Q_c, the quantity of such goods purchased by households; and ΔDEP_h is the change in household time and savings deposits.

Most of the factors affecting the volume of the currency outstanding were beyond immediate bank control. The wage bill depended both on the wage level, which was controlled mainly by administrative regulations, and on the level of employment, which was a function of the production targets provided for in the plan. Similarly, outlays of currency for agricultural procurement depended on the fluctuations of the harvest and the value and volume of procurement. Furthermore, the distribution of output between consumption and investment goods was largely unaffected by monetary policy. Since bank credit to households was negligible, the role of the banking sector in executing the cash plan was therefore limited to attracting bank deposits from the household sector and monitoring the various other flows of cash in the economy. The large magnitudes of these flows relative to the stock of currency complicated this task, greatly taxing the few monetary policy instruments at the bank's disposal. In 1977, for example, retail sales were seven times larger than the total outstanding stock of currency, while both the wage bill and the value of agricultural procurement were more than twice as large. Although the movements in these variables were not totally independent--for instance, it required the payment of wages to produce consumer goods--they were not controlled by the banking sector, so that a slight variation in any of these variables could profoundly affect the volume of cash in circulation.

While the banking sector could not directly influence many of the factors causing injections and withdrawals of currency, it was required to monitor these flows closely. When it detected deviations from the magnitudes included in the cash plan, it generally could not itself correct the deviation--e.g., it did not stop the payment of excess wages, or withhold credit used to procure agricultural products--but alerted the appropriate supervisory agency that these deviations had occurred and then proposed remedies. While not of a directly monetary nature, this monitoring activity was of crucial importance in maintaining financial stability, as no other agency had this overall view of financial flows.

c. Monitoring the credit and cash plans

Given the impossibility of monitoring all transactions, the monetary authorities used some summary indicators to monitor the adequacy of enterprise credit and currency in circulation and their conformity with the credit and cash plans. With respect to credit policy, a widely used indicator was the turnover rate of working capital, i.e., the ratio of the enterprise's output to the bank supplied (or total) working capital. The turnover rate of each enterprise was compared with the rate for the sector in general and the rate realized by the enterprise in the past. In this way, the level of working capital for any enterprise operating with turnover rates below one or both of these reference points was scrutinized. Such scrutiny did not automatically lead to a reduction of working capital so as to bring the turnover rate to the desired level, which might interfere with production. It did, however, prompt special investigation by the bank, which, for instance, could lead to the discovery that inventory levels were excessive because of the production of undesired or defective products; in such a case, the bank would alert the supervisory authorities whose responsibility it was to correct the situation.

The adequacy of the level of currency in circulation was judged against the ratio of retail sales to currency in circulation, with separate consideration of the ratios in the urban and the rural areas. 1/ This approach considered that cash is held only for transaction purposes, and any drop below a target level--often the one realized in a period considered as financially stable, such as the First Five-Year Plan (1953-57)--was seen as a sign that the level of household liquidity was excessive. However, the effectiveness of this method of monitoring currency in circulation was hampered by substantial variations in the velocity of currency over time (Chart 2).

3. Pre-1979 monetary policy: an overview

a. Overall developments

In market economies, an excessive monetary expansion is generally reflected in domestic price inflation and/or a deterioration in the balance of payments. In China, during 1953-78, consumer prices rose by an average of 0.6 percent a year, 2/ and balance of payments deficits were relatively small and quickly reversed. However, this record had little to do with the operation of monetary policy per se. Most prices were controlled; foreign trade was conducted by centralized trade corporations that operated according to planning directives rather than responding to relative prices; and external capital flows were also strictly controlled. Consequently, an excess supply of money would generally have little direct impact on domestic prices or the balance of payments; rather, it would be reflected in the incidence of shortages in the goods market.

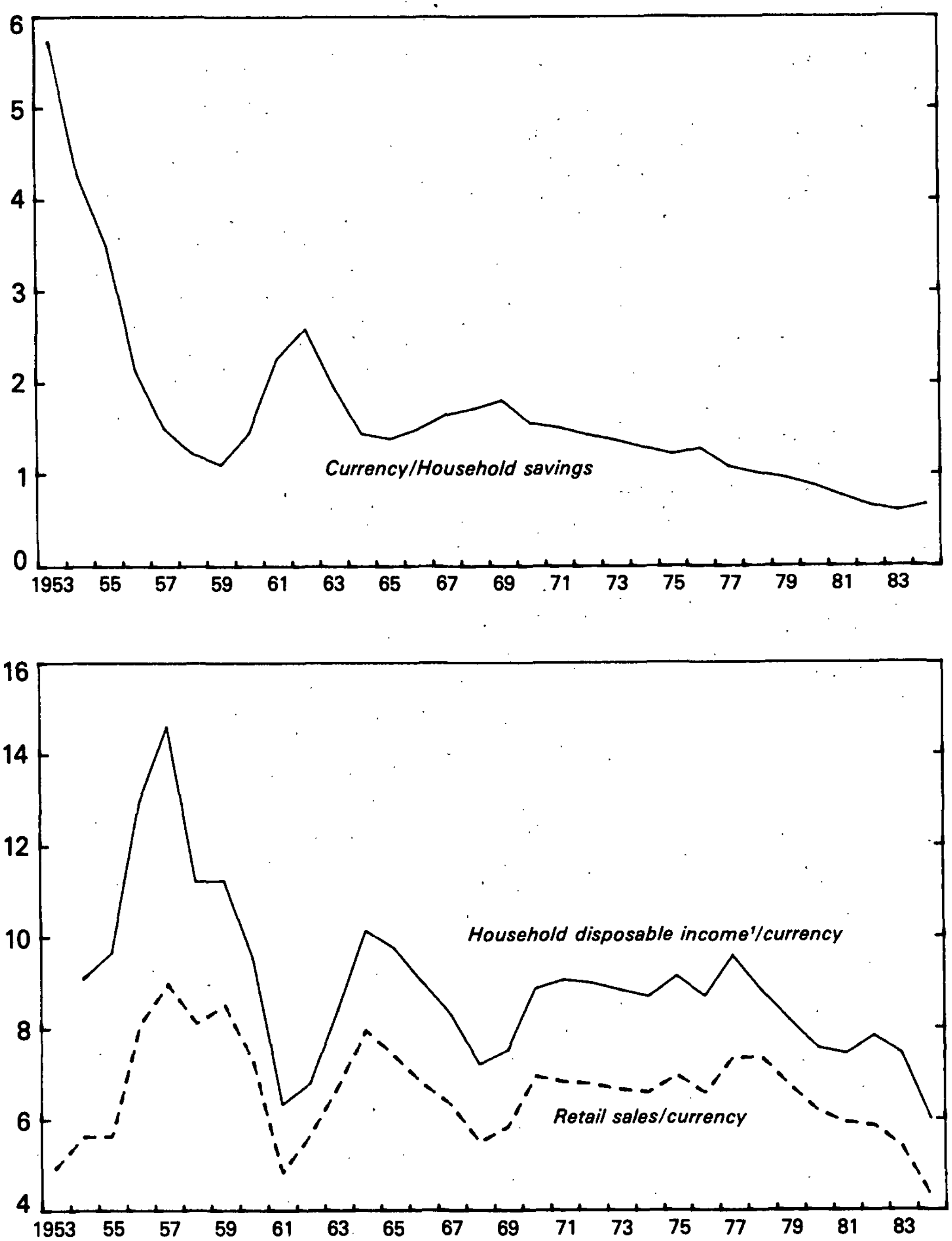
1/ Shi Lei, "Resolutely Carry Out the Policy of Currency Stabilization," Zhongguo Jinrong, No. 2, 1982.

2/ Based on data published in the State Statistical Bureau Yearbook, 1983. For the view of selected western economists on the phenomenon of price stability in China before 1979, see references in Gavin Peebles, "Inflation in the People's Republic of China 1950-82," The Three Banks Review, No. 142, June 1984, pp. 37-38.

CHART 2

CHINA

SELECTED MONETARY DEVELOPMENTS, 1953-84



Sources: *State Statistical Yearbook;* and staff estimates.

[1] Retail sales plus increases in household savings and currency, adjusted for income in kind.

Moreover, in a system in which monetary aggregates largely reflected decisions taken in the real sector (i.e., the physical output plan and administrative decisions on wages and prices), the task of defining what constituted an excessively expansionary monetary policy is not an easy one. Nevertheless, there were two periods--during and right after the Great Leap Forward (1958-59) and during part of the Cultural Revolution (1966-76)--when the banking principles and financial rules which constituted the normal operation of monetary policy (as outlined in Section II.2) were subordinated to the political exigencies of the moment so that increased production was pursued irrespective of financial consequences, and instability emerged. A discussion of the factors underlying this instability will help illustrate the limitations on monetary policy in the pre-1979 period; we will concentrate here on the period of the Great Leap Forward.

During the early part of 1958, local authorities found fault with the prevailing credit policies. For these authorities, increases in production and overfulfillment of output targets, often without regard for the economic implications of such actions, had become priority objectives and a means of adhering to the party line. This view gained wide acceptance, and the cautious credit policies of the banks came to be seen as sabotaging the Great Leap; as a result, banking authorities were instructed to use their credit policy to support the Great Leap Forward. This came to be interpreted as meaning that the banks should grant credit every time the demand was backed by a claim that the credit would result in higher production; the normal rules for monitoring enterprises' use of working capital (e.g., the "commodity inventory system" and the monitoring of turnover rates of working capital) were no longer applied, and credit was granted indiscriminately. Furthermore, the supervision of credit activities was moved from the center to the provinces and, in many cases, to the branch offices, and it became nearly impossible for a bank manager to refuse credit. Bank credit was often used to finance uneconomical investment projects, while the budget started running sizable deficits. As a result of the rapid credit expansion, currency in circulation rose 140 percent between 1957 and 1961 and the velocity of money fell sharply (see Chart 2). 1/

By the time the failure of the Great Leap Forward was officially recognized, the financial situation was in disarray. To restore financial stability, large amounts of debt were cancelled, banks reverted to the "commodity inventory system" of credit creation, the budget deficits were eliminated, and large increases in administered prices were implemented to absorb the excessive amounts of currency in circulation. Largely because of these officially enforced price increases, recorded inflation rose to 16 percent in 1961. Consumers reacted by withdrawing large amounts of bank deposits, which fell by about 20 percent between the end of 1959 and the end of 1961, and by a further

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1/ Xue Muqiao, "Why Do We Have a Financial Deficit in an Excellent Production Situation," Renmin Ribao, September 2, 1980.

25 percent by the end of 1962. Within a few years, however, the renewed discipline restored financial stability; consumer prices fell in 1963 and 1964, and household bank deposits began to rise from 1963 onwards.

b. Key features of pre-1979 monetary operations

There are three salient features characterizing the operation of pre-1979 monetary policy that are becoming of even greater importance as the role of monetary policy increases as a result of the economic reforms. These are: first, the implications of combining "soft budget" constraints and taut physical planning with an accommodating credit policy; second, the usefulness of regarding credit to the budget as something totally different from enterprise credit; and, third, the implications of maintaining a sharp distinction between the enterprise and household sectors in the formulation of monetary policy.

Taut physical planning with its premium on achieving quantitative output targets rather than profitability tended to lead enterprises to engage in inventory hoarding and precautionary investments. 1/ Inventory hoarding served as an insurance against delays in deliveries and was both a cause and a consequence of perennial shortages, while precautionary investments helped an enterprise cope with the continuously increasing output targets set by the planning authorities. Compounding the large demand for credit resulting from these pressures was the fact that the existence of an enterprise was not jeopardized if losses occurred, as either budget support or liberal bank credit or both were used to keep such enterprises afloat. In the absence of "hard budget" rules to enforce bankruptcies or reorganizations, large amounts of bank credit were at times absorbed by loss-making enterprises. Moreover, even when production did not match demand, producing enterprises were able to dispose of all their output, either to the marketing and supply firms (for industrial inputs) or to the commercial departments (for consumer goods). Therefore, to the extent that supply and demand were mismatched--which was often the case--credit to these commercial units also tended to be excessive. The provision of investment funds to enterprises in the form of budgetary grants only further stimulated enterprises to acquire large amounts of funds, which at times were diverted to working capital.

Hence, an accommodating credit policy interacting with the system of central planning practiced in China in the pre-1979 years tended to generate excessive liquidity, the use of which then had to be checked through tight control of the use of transfer money, rationing, and other administrative means. This placed a heavy burden on the few monetary instruments the banks had at their disposal. Furthermore, because bank monitoring of credit did not cover the credit provided through the budget, a large but varying portion of total working capital outstanding

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1/ These issues are described in Janos Kornai, Economics of Shortage (Amsterdam, North Holland, 1980), especially pp. 100-104.

was not included in the monitoring process; the frequent diversions of investment funds toward financing of inventories also often escaped bank scrutiny. Hence, the turnover rates used to monitor enterprises' use of working capital were less than comprehensive.

The distinction between enterprise credit that was regarded as supporting production and budgetary (financial) credit that was regarded as destabilizing did not take account of the close relations between the enterprise sector and the budget. Because of this relationship, it was possible at times to avoid or reduce recourse to budgetary credit by shifting the responsibility for providing working capital to the banks, and by letting banks finance investments. At other times, the budget recorded as budgetary revenue profit transfers and tax payments that did not correspond to the true financial situation of the enterprise sector, since they were made possible because of the bank-financed stockpiles of unsaleable inventories held by commercial enterprises. In such cases, the banking sector had to step up its credit and indirectly financed budgetary expenditures. 1/ Hence, the distinction between enterprise credit that was "good" and credit to the budget that was "bad" did not help to monitor the adequacy of the overall credit and liquidity situation in the economy.

The distinctions made in Chinese monetary policy analysis between the enterprise sector and the household sector, and between the credit and cash plans, were considered useful for monitoring purposes. Yet, these distinctions failed to take account of the fact that household purchasing power was basically a function of the credit policy adopted, and that household purchasing power was composed of more than cash in circulation. Although this issue was noted by Chinese analysts, 2/ it did not receive the attention required to fully gear monetary policy toward controlling demand pressures. Moreover, as is argued in Section III.3, the usefulness of these distinctions was reduced as the economic reforms proceeded.

1/ Lin Jiken, "Persist in Issuing Currency in Line with Economic Principles," Jingji Yanjiu, No. 1, January 20, 1981, pp. 6-63, Ge Zhido, "On the Problem of Balancing the Budget," Jingji Yanjiu, No. 1 (January 1981) p. 58, and Huang Jubo, "A Problem in Seeking a Unified Balance Between State Revenue and Credit Supply," Renmin Ribao, February 17, 1981, page 5.

2/ See references given by Katherine Hsiao, Money and Monetary Policy in Communist China (New York, Columbia University Press, 1971), pp. 72-73.

III. Monetary Policy Since 1979

The reforms of China's economic system that have been underway since 1979 have entailed the gradual development of new tools of macroeconomic management. As a part of this process, the influence of monetary policy on the level and composition of aggregate expenditures is increasing and the nature of both the policy instruments and targets facing the monetary authorities are gradually changing. This development of more indirect policy instruments is not yet complete, and has been subject to temporary, partial reversals in direction as the authorities sometimes reverted to more direct administrative controls when confronted with excess demand pressures or with unwanted trends in resource allocation. Moreover, the order in which the various economic reforms are being implemented also influences the effectiveness of monetary policy; in particular, the fact that reform of the price system has been at a slower pace than the decentralization of economic decision-making has complicated the task of demand management using policy instruments acting through market mechanisms. Consequently, monetary policy continues to play a more circumscribed role than in market economies, to the extent that administered prices and soft budget constraints persist. Nonetheless, the direction of change is clearly toward a greater use of market forces and a consequent more independent role for monetary policy.

The role of monetary policy is being revised at two different levels. First, the monetary authorities are being assigned much greater responsibility for assuring macroeconomic balance--a task that prior to the reforms had been primarily achieved through the planning mechanism and through administrative regulation of wages and prices. To achieve this task, the newly-established central bank is gradually developing new policy instruments to control the credit activities of specialized banks to ensure their consistency with overall financial stability. Second, within this framework of macroeconomic balance, credit policy is being assigned the role of stimulating greater efficiency in resource allocation; with this aim, the specialized banks are gradually being given greater power to extend or refuse credit on the basis of financial criteria and to vary interest rates.

1. Changes in institutions

The banking system was gradually restructured during 1979-84, as a first step in widening the role of monetary policy in pursuing the objectives of macroeconomic stability and improved efficiency of resource use. The Agricultural Bank of China (ABC) was revived as a separate institution in charge of banking operations in rural areas, and the role of rural credit cooperatives (RCCs) in extending credit was gradually increased. The Bank of China (BOC) was granted greater operational flexibility in the financing of foreign trade and in support of the export sector; it substantially expanded its lending in both domestic currency and in foreign exchange. The People's Construction

Bank of China (PCBC), the primary function of which had been the disbursement of budgetary funds for investments in state-owned enterprises, also began to extend loans on the basis of its own deposits, collected through the provision of banking services to construction organizations.

The China International Trade and Investment Corporation (CITIC) was set up in 1979 to promote joint ventures between foreign investors and Chinese partners; it has since made a number of loans to such joint ventures in addition to some equity participations. Some provinces also set up trusts aimed at attracting foreign investments and these also began to make loans--albeit on a small scale--on the basis of domestic and foreign bond issues. Moreover, various domestic trust and investment corporations were established under the supervision of the different banks, in order to channel the surplus financial resources of enterprises and localities into new investment activities.

As a transitional measure in the decentralization of banking operations, local branches of the PBC were granted greater independence in their credit activities in 1980. 1/ They were still allocated goals in terms of total deposits and total loans that were derived from the overall cash and credit plans, but the key target was now set as the difference between the level of deposits and the level of credit outstanding at the end of the year. Branches that succeeded in attracting more deposits could extend more credit rather than having to remit these funds to a higher level of the bank. Since a large proportion of any credit expansion would return to the same branch in the form of increased deposits, the new arrangements made it possible for the bank branches to create a multiple expansion of credit on the basis of an initial increase in deposits.

Most important, in January 1984 the PBC became China's central bank, and its commercial banking functions were transferred to the newly-established Industrial and Commercial Bank of China (ICBC). This permitted a greater distinction between macroeconomic policy-making and the day-to-day concerns of credit management. More recently, the specialized banks were given greater freedom in managing their credit activities and are now allowed to transfer funds between different branches in response to variations in demand for credit. 2/ 3/

Another key element of the financial reforms has been the increased emphasis on the banking system rather than on the budget as a means of channeling financial resources to enterprises. Bank credit has been

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1/ "Reform the Banking System and Promote the Four Modernizations," Sichuan Ribao, July 7, 1980.

2/ "Plans to Adopt New Method in Managing Credit Funds," Remin Ribao, October 17, 1984.

3/ "Preliminary Regulations for the Control of Credit Funds", Zhongguo Jinrong, December 1984.

increasingly substituted for budgetary grants in the financing of both the normal working capital of enterprises and fixed investments. New budgetary grants for working capital are now restricted to a few exceptional cases and it is envisaged that interest charges will be levied on the outstanding stock of working capital previously supplied through the budget. The banking sector has been put in charge of the overall supervision of enterprises' working capital, irrespective of the initial source of financing. 1/

In a departure from the tradition of the commodity inventory system of credit management, short- and medium-term bank loans to finance fixed investments have grown rapidly in recent years; by 1984, loans for fixed investment accounted for about one eighth of total outstanding bank credit to state and collective enterprises. Moreover, budgetary transfers for investment projects, which had previously been in the form of grants, have been increasingly made as interest-bearing loans. 2/ Together with the reforms that allowed enterprises and local governments to retain a greater share of their receipts, the increased use of bank credit meant that the share of total investment financed outside the budget increased sharply. Between 1979 and 1984, the share of total fixed investment by state-owned units financed outside the state budget increased from an estimated 35 percent to about 60 percent. Consequently, the potential influence of monetary policy on the level and allocation of investment resources--through credit policies and other influences on the liquidity position of enterprises and local governments--has been greatly enhanced.

Interenterprise credit was also formally permitted, albeit on a limited basis. Although the stringency of regulations governing such credit varied over time, it was generally restricted, in principle, to the sale of overstocked items. However, there is little indication as to its quantitative importance. 3/

2. Changes in instruments

Now that lending operations have been transferred to the specialized banks, the task of controlling movements in monetary aggregates faced by the PBC is in some respects similar to that of central banks in other developing countries where there are few marketable financial

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1/ In the Chinese literature, these reforms are referred to as the "unified management of working capital."

2/ "Carry Out Across the Board the Credit System for Capital Investment Projects," Jingji Ribao, January 29, 1985.

3/ William Byrd, China's Financial System: The Changing Role of Banks, Westview Press, 1983 (Boulder, Colorado), pp. 64 and 117, quotes several references in the Chinese literature that indicate that unauthorized, involuntary trade credit may have been significant during certain periods, even before the introduction of the economic reforms.

instruments and only limited flexibility in interest rates is permitted. Control over the volume of credit is the most important instrument of monetary policy, but it is supplemented by other measures, including some increased use of interest rates and by the issue of treasury bonds. In other respects, however, monetary policy is substantially more complicated in China than in most other developing countries. In particular, the widespread prevalence of "soft" budget constraints and distorted relative prices makes credit management more difficult. Also, the opportunity cost to a state enterprise of drawing down its bank deposits to finance investment expenditures or increased wage payments is often quite low, since generally there are few alternative uses for such deposits. The economic reforms brought about a large increase in these deposits, and also reduced administrative controls over their use. Consequently, in their efforts to control the effects of this increased liquidity on the level and composition of expenditures, the authorities have also had to rely on some ad hoc policy instruments, including the temporary freezing of some deposits and the imposition of special taxes.

The PBC relies on three principal means of controlling the total volume of credit that can be granted by the specialized banks. First, it sets quantitative restrictions on the credit activities of the specialized banks through its implementation of the credit plan. The main office of the PBC determines the overall credit plan for each specialized bank, including the target level of outstanding credit and deposits and the target level of borrowing from the PBC. Within the overall credit limit set by the PBC, the specialized banks assign credit ceilings to their regional branches (at the level of the province or autonomous region). 1/ On the basis of these regional ceilings, the PBC issues notices on the permitted level of borrowing by the specialized banks' branches from the regional branches of the PBC. The specialized banks are permitted to switch outstanding credit between loan categories within the scope of the overall loan-deposit balance. These overall quantitative credit controls can be supplemented by additional restrictions on certain types of credit. In practice, however, the banks have sometimes exceeded their credit ceilings, and did so by a substantial margin during the last quarter of 1984. There are no formal penalties for exceeding the ceilings.

Second, the PBC can supplement these quantitative restrictions on credit by setting redeposit requirements for the specialized banks. The banks must redeposit a specified proportion of their deposits with the PBC; in effect, this constitutes a reserve requirement for which deposits with the PBC are the only acceptable reserve asset. For 1984, these redeposit rates were set at 40 percent of urban household deposits, 20 percent of enterprise deposits, and 25 percent of rural deposits, including the redeposits of the rural credit cooperatives with

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1/ "Preliminary Regulations for the Control of Credit Funds," Article 7, Zhongguo Jinrong, December 1984.

the ABC. 1/ In 1985, the redeposit ratios were reduced to a uniform 10 percent for all banks. The setting of the redeposit ratios influences the money multiplier in the new fractional-reserve banking system.

Third, the PBC controls the volume and terms of its lending to the specialized banks. Under the new arrangements, the PBC's credit to banks now affects base money (a concept which was of no relevance prior to the establishment of a separate central bank, since most lending was undertaken by the PBC itself). However, during 1984, the PBC charged the same annual interest rate (4.32 percent) on borrowing by specialized banks as it paid on their redeposits, so that there was no financial disincentive to borrowing from the PBC. In 1985, the PBC's lending rate to banks was increased (to 4.68 percent for lending up to the limits included in the credit plan and to 5.04 percent for any additional lending); the rate paid on redeposits remained unchanged. 2/

In practice, delays in separating the accounts and operations of the PBC, in its new role as a central bank, from the rest of the banking system caused difficulties in implementing the system of required redeposits and in monitoring and controlling the volume of its lending to the specialized banks. As will be discussed later, these difficulties contributed to a rapid monetary expansion in late 1984. In 1985, new clearing arrangements for the specialized banks were introduced in an effort to improve the effectiveness of the required redeposits system and to increase the PBC's control over its lending to the banks. Each specialized bank now has a separate clearing account with the PBC, and can no longer automatically run up overdrafts through the clearing account. Also, the system of required redeposits was extended to cover the People's Construction Bank of China.

Also, beginning in 1985, the regional offices of the PBC have been encouraged to organize a type of clearing house for short-term interbank funds, by temporarily releasing a specialized bank's excess deposits and permitted but unutilized credit to other specialized banks. 3/ The time limit on such loans is 10 days and interest charges are linked to the PBC's lending rates. This arrangement might eventually evolve into a fully-fledged market for interbank funds.

1/ "People's Bank of China Promulgates Provisional Regulations on Several Questions Concerning the People's Bank of China Functioning Exclusively as a Central Bank," Zhongguo Jinrong, No. 4, 1984, pp. 12-14.

2/ "Preliminary Regulations for the Control of Credit Funds," Zhongguo Jinrong, December 1984.

3/ "Preliminary Regulations for the Control of Credit Funds," Article 17, Zhongguo Jinrong, December 1984.

Sales of treasury bonds were introduced in 1981 as an additional instrument to control liquidity by reducing bank financing of the fiscal deficit. 1/ Initially, the bonds were sold only to state-owned and collective enterprises and various government units; an element of compulsory savings was involved since purchase quotas were assigned according to each organization's after-tax profits or liquidity. Sales to individuals were begun in 1982 and about half of the approximately Y 4 billion of bonds issued annually during 1982-84 were sold to individuals. The annual bond issues were the equivalent of around 1-1 1/2 percent of broad money supply during this period. The planned bond issue was increased to Y 6 billion for 1985 with the increase aimed at individual buyers, especially in the rural areas, in an effort to reduce their liquidity. 2/ To make the new bond issue more attractive, interest rates have been raised by one percentage point (to 5 percent for institutions and 9 percent for individuals) 3/ and the maturity period has been lowered (to five years from between six and ten years previously). Unlike earlier issues, the 1985 bonds can be discounted at banks to allow investors to recover their funds in cases of emergency, and can be used as collateral for bank borrowing.

While the PBC used these new instruments to control aggregate credit expansion, the specialized banks came to rely more heavily on interest rates as a policy tool to promote the more efficient utilization of credit and to influence the liquidity position of households and enterprises. Interest rates on loans and deposits have been raised on several occasions since 1980, and were again raised significantly in 1985. 4/ The PBC sets the structure of interest rates, but the specialized banks have been given some leeway to vary lending rates according to the financial position and efficiency of borrowers. Thus, in mid-1983, a system of more flexible interest rates on working capital loans was introduced whereby banks could charge rates up to one-fifth higher than normal to enterprises whose working capital exceeds the norm and up to one-fifth lower for enterprises that succeed in economizing on working capital. However, since the price system is such that the profitability of an investment does not necessarily reflect its true costs and benefits to the economy, the use of interest rates as a means of rationing scarce financial resources is still limited; moreover, a variety of preferential interest rates, generally between about 2 and 4 percent, are used for high-priority sectors.

1/ Treasury bonds had also been issued in the 1950s.

2/ "Treasury Bonds Aimed at Individuals," China Daily, December 19, 1984.

3/ On a simple interest basis.

4/ One-year time deposits by individuals are paid an annual rate of 6.84 percent, and one-year deposits by enterprises and institutions are paid a rate of 4.32 percent; working capital loans (of under one year) are charged a rate of 7.92 percent and fixed asset loans of over one year are charged rates of 8.6 to 10.8 percent, according to maturity.

Also, branches are now allowed greater flexibility in allocating their overall credit target between different loan categories. In principle, they have also been given greater authority to deny credit for the financing of excessive stocks and are encouraged to restrict credit to inefficient enterprises: "Banks may make use of methods such as extending or refusing loans, increasing or decreasing loans, lengthening or shortening the terms of loans, raising or lowering interest rates, rewarding the good and penalizing the bad, and destroying the 'supply system' and the practice of eating out of 'one big pot' in funding." 1/ In practice, however, it could still prove difficult for the specialized banks to resist the strong pressures to expand credit, as was illustrated by the rapid expansion of credit that took place in late 1984. Moreover, any closure or merger of inefficient enterprises--especially large ones--would still normally have to be decided directly by the authorities, rather than being imposed by a cutoff of bank credit.

The authorities have also introduced a number of more ad hoc policy measures to limit the use of enterprise and local government deposits, in part because the new indirect monetary instruments were not yet fully effective. All funds to be used for the financing of investment in new plant and equipment are to be first deposited in special accounts with the PCBC, which supervises their use and makes disbursements on the basis of progress in construction; since 1984, the funds must be deposited six months in advance of their use. Also, in 1985, the requirement that enterprises conduct all their wage payments through separate bank accounts was reinstated, in an effort to prevent enterprises from diverting deposits designated for other purposes into wage payments.

3. Implications for the conduct of monetary policy

a. The analytical framework

The changing nature of monetary policy in China is sometimes masked by the unchanged outward form of much of the terminology and procedures. The main focus of policy formulation remains the setting of the overall cash and credit plans; however, the underlying policy tools through which the authorities attempt to fulfill these plans are undergoing substantial change. Prior to the reforms, most of the factors affecting changes in households' currency holdings were not monetary in nature, but reflected the production and distribution goals of the physical plan, as illustrated in the identity for the cash plan (discussed in Section II):

$$(1)\ \Delta\,Cash_h = P_a \cdot Q_a + W \cdot N + T + \Delta DC_h - P_c \cdot Q_c - \Delta DEP_h$$

1/ "Strive to Implement the 1985 Credit Plan," Zhongguo Jinrong, January 1985.

Under the reforms, however, as production units are granted greater independence in their production and investment decisions, and are given greater latitude in setting wage, employment, and--to some extent--price levels, then credit policy begins to play a more active role. Substituting the budget constraints for the government, enterprise, and external sectors into identity (1), one obtains 1/

$$(2)\ W\ Cash_h = W\ NDC_g + W\ DC_e - W\ DEP_e + W\ DC_h + W\ R - W\ DEP_h$$

and where NDC_g represent net credit to government, DC_e is gross credit to enterprises (and local governments), and R is the net international reserves of the banking system. This alternative identity is increasingly relevant as the reforms proceed, as enterprises become more responsible for the financial consequences of their actions, and the importance of direct administrative instructions declines. Moreover, it will be argued in the next section that the most appropriate monetary aggregate to adopt as a target of monetary policy has also changed as a result of the reforms, thereby altering the variables that it would be relevant to include on the left-hand side of identity (2).

Identity (2) is a form of the basic identity of the monetary survey, which is more familiar to students of market economies than is the analysis in terms of injections and withdrawals of cash contained in identity (1). Obviously, identity (2) was still formally correct even prior to the reforms, but was less relevant then in analyzing the causes of movements in monetary aggregates since, to a large extent, changes in credit were not an independent policy tool and budget constraints were "soft". Rather, planning decisions concerning the real variables on the right-hand side of identity (1) were reflected in the financial variables of the right-hand side of identity (2). In contrast, since the reforms, the monetary authorities dispose of more instruments than before to influence credit to enterprises and households and, in principle, changes in these instruments cause responses that affect the real variables of identity (1).

In practice, of course, the distinction between the pre- and post-reform operation of monetary policy is less clear-cut. Even prior to the reforms, there was generally some scope for using policies such as credit restraint to limit enterprises' expenditures, except during periods like the Great Leap Forward and the Cultural Revolution; since the reforms, credit and interest rate policies are still less effective tools for influencing aggregate expenditures and resource allocation than in most market economies because of the continuing direct influence exerted by the State on certain aspects of resource allocation.

1/ The analysis of the next two paragraphs were derived from that in T. Wolf, "Economic Stabilization in Planned Economies: Toward an Analytical Framework," Staff Papers, March 1985, pp. 78-131.

b. Targets of monetary policy

The ongoing economic reforms also imply changes in the targets of China's monetary policy and in the effects of these targets on the economy. Prior to the reforms, the principal target adopted by the authorities was to maintain the growth of households' currency holdings broadly in line with available supplies of consumer goods, in order to keep shortages in the consumer goods market within bounds. Since the reforms, the increased financial autonomy of enterprises and local governments has meant that developments in their liquidity position have a greater impact on their expenditures. Together with the need for greater emphasis on developments in households' bank deposits, which are a fairly close substitute for cash, this implies that broader monetary aggregates than household currency holdings should become increasingly important in setting targets for monetary policy. The increased importance of individually-owned and small collectively-owned enterprises has also caused the distinction between household and enterprise liquidity to become more blurred. In terms of identity (2), both household and enterprise deposits might more appropriately belong on the left-hand side of the identity, as policy targets. However, the uses to which enterprise liquidity can be put continue to be more circumscribed than in market economies. Enterprises' cash holdings are still curtailed strictly and their bank deposits are still divided into separate funds which are earmarked for specific purposes; some recent policy measures--such as the reintroduction of special bank accounts for the wage fund and the channeling of investment funds through the PCBC--have been designed to strengthen this separation between the various funds.

Although the formal analytical framework and the most appropriate targets of monetary policy for China may now be closer to those of market-oriented developing countries, there are several reasons why the actual task of setting and achieving targets for monetary aggregates will require further investigation. First, the setting of monetary targets suited to internal and external financial equilibrium requires that the equilibrium demand for money can be broadly predicted. But, in China, historical relationships between the various monetary aggregates and measures of income or output may not provide a good guide for the future, because the reform process has altered substantially the demand for financial assets. Other countries undergoing substantial economic and financial reforms have encountered similar difficulties.

The increased importance of market transactions by individual production units has greatly increased their demand for liquid assets. This is most evident in the rural areas where the shift from collective production and distribution, much of which was in kind on the basis of accumulated work-points, to a household-based system with greater emphasis on cash payments has caused a large increase in the demand for currency. A major transformation also occurred in enterprises' demand for bank deposits. Indeed, it could be argued that, prior to the reforms, an enterprise's demand for financial assets was not a behavioral function at all--in the sense of being derived from the enterprise's decision of what share of its total assets to hold in real and financial forms--but instead was determined by the components of the physical plan and the requirement to turn over all financial surpluses to the State.

In fact, the various measures of velocity have declined steadily in recent years, but it is difficult to judge how much of this was due to the underlying shifts in demand and how much, if any, to excess monetary expansion (Chart 2). 1/ Trends in various sectoral shortages may provide some indicators of overall aggregate demand conditions, but it is difficult to distinguish shortages that are due to an inappropriate structure of relative prices from those that are due to excess aggregate demand.

A second difficulty for monetary policy is that in a system where most prices are fixed, external trade and capital flows are controlled, and there are few domestic financial assets other than money, an excess supply of money may exist for long periods of time. This not only complicates further the task of estimating the demand for money on the basis of historical relationships, which might have reflected disequilibrium conditions. It also makes more difficult the task of setting appropriate monetary targets during a period like the present, when China gradually is introducing a greater degree of price flexibility.

A third potential difficulty, encountered in some East European economies among others, is that the demand for money may not be stable because any attempt to impose credit restraints results in a proliferation of voluntary and involuntary interenterprise credits and other cashless settlements that increase the velocity of circulation. Of course, the problem of unexpected changes in velocity is not unique to centrally planned economies, but can be especially prevalent in them because of the predominance of state-owned enterprises that would normally not be allowed to go bankrupt, so that there is no obvious limit to the amount of interenterprise debt that they can accumulate. In China, however, such interenterprise credit does not appear to represent a major problem at present, although no information is available on its exact magnitude.

1/ The PBC has set as a basic task of the 1983-87 period to "...acquire a clear understanding of the new conditions affecting currency circulation so as to make appropriate adjustments:" Zhang Tuanyu, "China's Banking in 1982," in Almanac of China's Economy, 1983.

Nevertheless, arrangements other than interenterprise credit to offset the impact of credit restraints have apparently been quite common; for instance, some enterprises with financial difficulties have been allowed to reduce their tax payments to enable them to repay their bank credit. Such examples of soft budget constraints are perhaps unavoidable so long as the price system does not reflect true opportunity costs in the economy, since it is difficult to separate the conduct of overall monetary policy from consideration of its impact on particular industries. Credit restraints will tend to have the greatest impact on low-profitability, but possibly high-priority, industries and less impact on industries with larger financial surpluses, but which may be of lower priority. In such situations global monetary instruments tend to be supplemented by more selective intervention during the period of transition to greater reliance on the price mechanism for resource allocation. However, there are drawbacks to such selective intervention: first, there are no clear-cut guidelines to which industries should benefit, so that resource allocation is not necessarily improved; and second, selective intervention to offset the impact of credit controls may tend to undermine the global monetary targets. During a period of transition to a more flexible price system there may be some advantages to making these interventions explicit in the form of budgetary subsidies.

4. Developments in monetary aggregates, 1979-85

The change in the nature of monetary policy brought about by the systemic reforms is reflected in recent monetary developments. Since 1979, China has experienced two periods of rapid growth in monetary aggregates and strong aggregate demand pressures--in 1980 and in the second half of 1984. In both instances, a reduction in direct administrative controls over enterprise decision-making generated strong demands for credit that were at least partially accommodated by the banking system. The resulting monetary expansion was accompanied by a deterioration in the balance of payments and an acceleration of price increases largely reflecting upward adjustments in administered prices. On each occasion, the authorities acted to reduce demand pressures both through the new, indirect macroeconomic policy instruments and through selective administrative measures.

Credit expansion accelerated in 1979 and 1980 as the greater decision-making autonomy of enterprises led to stronger credit demands; fiscal deficits and hence credit to the Government were also larger than in preceding years because of the partial retention of profits by enterprises and the higher subsidy payments caused by the increases in key agricultural producer prices. As a result, the growth rate of broad money supply accelerated to over 24 percent in 1980 (Table 1). The authorities responded by tightening quantitative credit controls, increasing interest rates, and introducing the sale of treasury bonds, as well as by introducing more stringent vetting of investment projects. Much of the burden of adjustment fell on the budget; in 1981, fixed

Table 1. China: Monetary Survey, 1979-85 1/

	1979	1980	1981	1982	1983	1984	1985 June
	(In billions of yuan; end of period)						
Foreign assets (net)	-1.6	-2.8	2.7	16.1	24.0	27.0	15.1
Domestic credit	213.0	258.4	293.5	322.2	363.1	468.1	472.9
Claims on government	9.0	17.0	17.0	17.0	20.0	26.1	25.9
Claims on non-government	204.0	241.4	276.5	305.2	343.1	442.0	447.0
Broad money 2/	147.7	183.3	217.3	244.2	290.7	376.4	383.5
Of which:							
Currency in circulation	(26.8)	(34.6)	(39.6)	(43.9)	(53.0)	(79.2)	(75.8)
Enterprise deposits	(46.9)	(57.3)	(67.4)	(71.8)	(84.1)	(133.4)	(...)
Deposits of the PCBC at the PBC	13.1	17.2	22.9	28.5	30.0	33.3	26.1
Other items (net)	50.6	55.1	56.0	65.8	66.4	85.3	78.4
	(Percentage change from twelve months earlier)						
Domestic credit	15.1	21.3	13.6	9.8	12.7	28.9	32.6
Broad money 2/	9.7	24.1	18.5	12.4	19.0	29.5	33.0
Of which:							
Currency in circulation	(26.3)	(29.1)	(14.5)	(10.9)	(20.7)	(49.4)	(54.4)
Enterprise deposits	(...)	(22.2)	(17.6)	(6.5)	(17.1)	(58.6)	(...)
Memorandum items:							
Growth of real national income	7.0	6.4	4.9	8.3	9.8	13.9	...
Change in official cost of living index	2.0	7.4	2.5	2.0	2.0	2.7	...

Sources: IMF, International Financial Statistics (IFS); and Statistical Yearbook of China, various issues.

1/ Incorporating the consolidated balance sheets of the PBC, the ABC, the operations in local currency of the BOC and, since 1984, the ICBC. The operations of the PCBC and the RCCs are not included. Totals may not add due to rounding.

2/ Defined to include bank deposits of various quasi-government institutions.

investment financed through the budget declined by 28 percent while investment financed by enterprises' own resources or from bank borrowing fell by only 9 percent.

In the second half of 1984, the relaxation of central administrative controls over wage bonuses, and the announcement that the role of mandatory planning was to be further reduced generated strong demand for bank credit to finance increases in wage payments and investment expenditures. 1/ The banking system's ability to resist these demands was hampered by difficulties in enforcing the system of quantitative credit controls and in monitoring the PBC's lending to the specialized banks, which were discussed earlier. Consequently, domestic credit and broad money grew by around 30 percent during 1984, with over two-thirds of the increase occurring in the last quarter. Narrower monetary aggregates, in particular currency and enterprise deposits, grew even more rapidly. Loans and deposits of the institutions that in 1984 were not covered by the system of required deposits--namely, the People's Construction Bank of China (PCBC) and the rural credit cooperatives (RCCs)--grew even more rapidly than those of the specialized banks. Once again, the authorities reacted to the growing aggregate demand pressures by tightening both indirect economic policy instruments and direct, administrative controls. On this occasion the primary emphasis was on tightening credit policies: the system of reserve requirements and controls over PBC lending to the banks were strengthened, as discussed earlier; the political authority of the PBC was increased to enable it to resist demands for additional credit; and interest rates were further increased. As a result, the growth of money and credit slowed during the first six months of 1985.

5. Financial intermediation

The structure of savings generation has changed dramatically as a result of the reforms. The greater decentralization of financial resources, together with increased expenditures on subsidies, caused a sharp fall in savings generated through the current account surplus of the state budget, from 15 1/2 percent of GDP in 1978 to 6 1/2 percent in 1984. In contrast, household financial savings have increased substantially, rising from the equivalent of 1 percent of GDP in 1978 to 9 percent in 1984. A large share of savings is also generated by the retained earnings of enterprises and by surpluses on the extrabudgetary operations of local governments; in 1984, these were the equivalent of about 11 percent of GDP.

1/ These issues were discussed in Report on the Work of the Government, speech delivered by Premier Zhao Ziyang to the Third Session of the Sixth National People's Congress (NPC), March 27, 1985; and Report on the Draft 1985 Plan for National Economic and Social Development, speech delivered by State Councillor Song Ping to the NPC on March 28, 1985.

The shift in the composition of savings away from the budget has increased the importance of providing adequate financial intermediation, most of which takes place through the banking system. The increased independence of banks and the creation of the various domestic trust institutions and joint ventures were attempts to provide this needed financial intermediation. However, this more decentralized intermediation process did not ease the misallocation of resources, to the extent that the prevailing price structure was not an adequate guide to true opportunity costs in the economy. The tendency to overinvestment in profitable, but at times low-priority, sectors (such as various processing industries) while sectors to which the Government attached a high priority (such as transport and energy) received less investment became even more apparent. For example, as already indicated, most of the cutback in investment expenditures during 1981 occurred in those projects financed directly through the budget.

The Government's initial response to this situation has sometimes been to recentralize partially its control over investment allocation through administrative controls and, in 1983, through the introduction of new taxes on the extrabudgetary receipts of enterprises and local governments. However, this response tended to hamper the development of more effective means of financial intermediation, indicating the need, in the longer term, to develop a price system that provides more accurate signals for resource allocation.

IV. Conclusion

Financial reforms in China were initiated as part of a process of structural reform of the economy designed to place greater emphasis on indirect planning methods and to devolve decision-making powers to lower-level entities. These reforms have been gradually introduced since 1979 and, according to the October 1984 Central Committee Decision, they will accelerate in the coming years. However, despite the introduction of reforms, the Chinese economy still reflects many of its pre-1979 characteristics: mandatory planning regulates the allocation of a significant share of resources; many prices do not reflect their relative scarcity and remain fixed by the State; and enterprises are not yet truly independent entities responsible for their profits and losses. Hence, the Chinese economy is neither an economy in which market forces are the dominant influence on resource allocation, nor a fully centrally planned economy. It can best be described as an economy in transition, but one for which the direction of change has been clearly announced.

In this transitional stage, with its increasing emphasis on market forces and indirect macroeconomic instruments, it is evident that the traditional Chinese monetary policy would become increasingly dysfunctional. Yet, full reliance on the automaticity of monetary policy and its instruments as they operate in market economies would also have been difficult, since the present economic environment often provides signals that are at variance with the way in which such a monetary policy operates. In particular, the distorted price system under which profitability is not a good guide to underlying opportunity costs, makes it difficult to allocate credit through the interest rate mechanism alone and hinders local bank managers in their assessment of a borrower's creditworthiness. Such assessments are essential to the operation of a banking system where indirect instruments are to play a major role. Similar problems are caused by the greater concern many enterprises still have for the achievement of quantitative targets than for profitability, and by the obstacles to enterprise closures. Hence, the full utilization of monetary policy will have to proceed in line with progress in the reform of the other sectors of the economy. Moreover, the events leading to the rapid credit expansion in late 1984 indicated that the process of developing the new instruments of monetary policy is still far from complete.

These reservations do not imply that the reforms of the financial system implemented since 1979 have been inconsequential. The new system with its specialized banks and somewhat greater autonomy for provincial and local branch managers is a significant improvement over the highly centralized structure of the past, and is a prerequisite for efficient implementation of a less discretionary credit policy. The substitution of loan financing of investments--either through the budget or through the banking sector--and the more active use of interest rates for enterprises has already prompted enterprises to take a closer look at some of their credit requests. More important perhaps, it is gradually familiarizing the enterprises and bank managers with the monetary tools of the future, pointing out the direction in which their relations would have to evolve. The reform of monetary policy in China is thus revealed to be a gradual process, one that is being built up and experimented with, but one that, of necessity, will have to develop in line with the rest of the economy.