FRBSF WEEKLY LETTER

Number 94-44, December 30, 1994

Gradualism and Chinese Financial Reforms

In discussions of the optimal pace of transition from a socialist to a market economy, those favoring a "gradualist" approach often point to the experience of the People's Republic of China. By crossing the river from a centrally planned to a market economy "one stone at a time," as the saying goes, the Chinese appear to have made significant progress towards market reforms without suffering the large output declines faced by countries pursuing more rapid "cold turkey" reforms in Eastern Europe. Indeed, the pace of economic growth in China since Deng Xiaoping's historic 1992 call for deeper economic restructuring and greater experimentation with markets has been staggering. Real GDP grew at a 13 percent annual rate in 1992 and 1993, and double-digit real GDP growth is forecasted again for 1994.

In spite of its dramatic growth performance, the current economic situation in China suffers from the limited control the Chinese central government appears to enjoy over its own monetary policy and the rapid inflation that is emerging as a result. In the first eight months of 1994, prices rose at a 26 percent annual rate nationally.

Policymakers commonly respond to high inflation rates by slowing the pace of reform. Indeed, China reverted back to numerous price controls this fall in an effort to dampen inflation. These price controls are welcomed by the large "state-owned enterprise" sector, half of which is currently estimated to be operating at a loss, since their output prices are already controlled by the government while their input prices often are not. Consequently, by pursuing such inflation-fighting measures as reversion to price controls, Beijing also is effectively pursuing a gradualist path towards reform by aiding firms in the state-owned enterprise sector to avoid bankruptcy.

It might seem, then, that Chinese officials are faced with an undesirable choice between faster reforms and runaway inflation. However, in this *Weekly Letter,* we argue that this is not the case. We examine the problems experienced in the Chinese financial sector during the reform period, and explain why the reforms undertaken in this sector fail to address the fundamental source of China's inflation problems. We argue that a faster pace of reform is compatible with controlling inflation in China.

Problems in China's financial system

China's ongoing need to support the state-owned enterprise sector is a major cause of the nation's inflation problem. State-owned enterprises accounted for 60 percent of the country's total fixed investment in 1993. The state-owned enterprises provide lifetime employment, as well as numerous benefits such as housing and pensions to its workers. It is estimated that shutting down the unprofitable state-owned enterprises alone would result in laying off more than 100 million workers with no benefits. Consequently, political pressure has led both central and local Chinese banks to contribute massively towards maintaining the operation of these state-owned enterprises through the extension of loans of dubious value. The resulting increases in the money supply have generated inflation. This pressure has been exacerbated by the lack of independence of the Chinese banking system, and in particular the People's Bank of China (PBC) from the State Council.

The problem also is aggravated by the structure of the Chinese banking system. Banks are responsible for issuing "policy loans" to finance the deficits of the Ministry of Finance and the losses of the state-owned enterprises. The government dictates both the allocation of capital

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and the terms of lending to the banking system. The result is that an estimated 40 percent of the loans extended to the state sector are listed as nonperforming.

The process of reform itself also has contributed to inflation. As reform progressed, decentralization diminished the control of the PBC headquarters over the activities of its branch offices. This allowed local governments to pressure local PBC banks to extend credit of dubious quality to local financial institutions.

The situation became critical in 1992 and the first half of 1993. Local branches of the PBC found themselves under heavy pressure to issue loans not included in the central government's investment plan. These funds sometimes were used for highly speculative activities, including real estate ventures and stock market speculation. Indeed, there were reports that branches of the PBC not only failed to regulate this activity, but also were active participants themselves. This forced the PBC to issue additional loans to finance planned investment, further increasing the money supply.

Financial reforms

The government sought to curb many of these problems in its financial sector with a 16-point program for reform of domestic financial policy in July of 1993. The plan restricted credit extension by the banking system, particularly the ability of local financial institutions to engage in speculative activity. In addition, the plan enhanced the ability of the central government to allocate credit towards its priority investments.

The financial system also has been restructured to allow the PBC to function similarly to the central banks in developed countries, such as the Federal Reserve System in the United States, with the mandate to conduct domestic monetary policy through manipulation of bank loan rates, open-market operations, and changes in bank reserve requirements. However, the PBC will not enjoy the independence associated with the central banking systems in many developed nations. The central bank still will be required to implement the policies of the State Council.

In addition, China is converting its four specialized banks—the Bank of China, the Agricultural Bank, the Industrial and Commercial Bank, and the People's Construction Bank of China—into commercial banks. These banks are currently encouraged both to perform as profitable institutions and to offer liberal loans to the unprofitable state-owned enterprises. Under the new system, these banks will be allowed to make their loan decisions independently and will be responsible for their profits and losses. Policy-based lending activities will be undertaken by three newly created financial institutions: the State Development Bank, the Export–Import Credit Bank, and the Agricultural Banks of China. These banks will be bond-financed and hence will place no direct pressure on the domestic money supply.

Current financial system performance

The reforms of the Chinese financial system appear compatible with a gradualist path of reform. They correct a number of particularly glaring deficiencies from the previous system which led to poor credit allocation decisions and eventual loss of control over the financial system. At the same time, the State Council maintains some control over the PBC and the reforms call for some policy-based credit extension to take place independent of the central bank. However, the Chinese experience subsequent to the July 1993 reforms reveals the pitfalls in this gradualist reform policy.

Initially, the 16-point plan was somewhat successful in tightening credit. However, the tighter credit created problems when farmers harvested a bumper crop. Banks had difficulty paying farmers for their mandated crop production. Combined with the mandate under the plan which forbids banks from issuing IOUs to farmers, as had commonly been done in the past, banks found their working capital constrained. This reduced the magnitude of credit banks were able to issue to the state-owned enterprise sector, which relied on new loans to pay suppliers or to finance outstanding debt. Particularly hard hit were the raw materials sectors; they faced reductions in lenient loans, which threatened to create shortages. This phenomenon has been termed "triangular debt," where unprofitable state-owned enterprises, which are kept in operation through cash infusions from the banking sector, fail to make required payments to other unprofitable firms. The central bank responded to the liquidity shortage largely caused by the 16-point austerity plan by claiming victory over excessive growth and resuming expansion of the money supply. In the November 1993 Central Committee plenary session, calls again were heard to speed up the pace of reform, with references to the 16-point plan notably absent. The backtracking on the austerity plan resulted in a renewed expansion of the money supply and a rapid increase in inflation in the beginning of 1994.

In 1994, the government repeatedly switched between austerity policies designed to address the growing inflation problem and expansionary measures designed to avoid unemployment. In March, a State Planning Commission report outlined a plan for lowering the inflation rate to 10 percent through reductions in capital expenditures and bond financing of deficits. This bond financing is possible only through forced sales of government bonds at rates well below urban inflation rates. In addition, political pressures led Prime Minister Li Peng to announce in October of 1994 that local governments would be responsible for maintenance of "acceptably" low food prices. In practice, this implies the reinstatement of price controls and the subsidization of production. These subsidies may yield government deficits requiring monetization, implying further pressure on prices.

Conclusion

While the financial reforms being pursued by China should improve the operation of the financial system, they do not address the problems associated with maintaining the operations of the large unprofitable state-owned enterprise sector. As long as this sector requires continuous infusions of funds to stay afloat, the Chinese government will be required either to forgo other expenditures, such as much needed improvements in infrastructure, or monetize these expenditures by increasing the money supply. Consequently, the reforms of the financial system do not address a fundamental source of inflationary pressure, namely, the policy of maintaining the operation of unprofitable state-owned enterprises. Over the long run, more rapid reform, in the form of closing unprofitable state-owned enterprises, may lead to less inflation rather than more.

However, one should not understate the difficulty associated with closing these enterprises. Under the current system, a large portion of the losses of the state-owned enterprises are policy induced, stemming from price controls and poor management incentives. Consequently, the fact that a state-owned enterprise is currently losing money may not be sufficient evidence to motivate closing it down.

In addition, the government is particularly sensitive to the political difficulties associated with the displacement of 100 million workers. Current estimates suggest that the agricultural sector also is on the verge of releasing a large quantity of labor. Chinese officials estimate that only 200 million of the current 450 million workers in the agricultural labor force can be profitably employed in that sector. It will take time to absorb these laborers into the growing sectors of the Chinese economy, such as the very successful market-oriented township and village enterprises and special economic zones. Therefore, the Chinese government is determined to keep the state-owned enterprises open. Some efforts to improve the productivity of this sector without closing plants have taken place. The government has attempted to merge failing enterprises with healthier ones. There have also been limited movements towards privatization of state-owned enterprises through the issue of equity.

In the meantime, the burden of a gradualist path of reform appears to have fallen on the Chinese financial system in the form of the current rampant inflation. As in most inflationary regimes, the fundamental source of this inflation is unsustainable fiscal policy, in this case, using government funds to bail out failing sectors of the economy. Reform of the structure of the banking sector alone cannot bring inflation down.

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Printed on recycled paper with soybean inks.

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