

Developments in the Reform of China's Banking and Financial Systems

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I. INTRODUCTION

A nation's banking and financial institutions are intimately related to that nation's evolving economic structure and development.

Thus, banking and financial reform is of critical importance to China's overall economic restructuring. Briefly stated, the People's Republic of China has traditionally maintained a product-economy management system¹ under highly centralized control,² characterized by management in kind³ and mandatory planning.⁴ Under this type of centralized economic system, China's banks have traditionally played the essentially passive roles of bookkeepers and cashiers, with the result that China's banking and financial systems have long remained undeveloped. Nevertheless, significant reforms are currently underway.

Before 1978, the government's approach to the national economic system required the centralized allocation of national resources while maintaining a rigid control over the economy. The government established targets for enterprises according to its overall economic plan, which enterprises were obligated to fulfill. In addition, there was only one bank in China—the People's Bank of China (PBC). Under this economic system, the function of the PBC was simple: to distribute credits needed by enterprises to meet their production goals.

A new stage for China began in 1979 when the country embarked on a program of broad economic restructuring and development. In accordance with economic restructuring, the government began to reduce the scope of mandatory planning while extending greater decision-making powers to state-owned enterprises. This general economic restructuring has required significant changes in China's banking and financial systems, thus setting the stage for banking and financial reform. In addition to, and in tandem with,

1. "Chanping Jingji Guanli Zhidu." In a centrally planned economic system of management, materials and resources are allocated based upon the needs of the participants and not upon the value of those materials and resources. Cf. Lie Zhouong, *Shilun Jiazhi Liu de Hong-guan Guanli*, 5 JINGJI WENTI TANSUO 6 (1988).

2. This "highly centralized control" involves state management on both micro- and macroeconomic levels. See A DICTIONARY OF ECONOMICS 385 (G. Bannock, R.E. Baxter & R. Rees eds. 1972).

3. "Shiwu Guanli" as opposed to "Jiazhi Guanli" (management based on value). Management in kind is a feature of economic planning that involves assessing the needs and supplies of materials based on local level requests. For example, under a system characterized by "management in kind," a municipality may request 100,000 tons of cement. The value of the requested goods is ignored. Various kinds of goods can only be exchanged according to the directives or targets of the annual plan as set by government planning commissions. Under a "management based on value" system, a municipality would instead request 2,000,000 Renminbi of cement. See Lie, *supra* note 1, at 6.

4. "Zhilinxing Jihua" as opposed to "Zhidaoxing Jihua" (guided planning). Mandatory planning has binding legal force upon enterprises as well as upon other economic participants, i.e., government departments at various levels. See THE DICTIONARY OF ECONOMICS & MANAGEMENT 827 (Ma & Sun eds. 1985) [hereinafter DICTIONARY].

reform of the banking and financial systems, general economic restructuring began in China's rural and urban areas, and in other significant areas of China's economy.

For example, in the rural areas,⁵ reform broke the system of ownership commonly characterized as "large in size and collective in nature,"⁶ which had suppressed the enthusiasm of farmers under the people's communes and the egalitarian distribution system.⁷ Since rural reform began, the popularization of the household rural responsibility system⁸ has greatly enhanced agricultural productivity. By the end of 1983, 97.1% of the total households had joined the new system.⁹

Reform in the countryside sparked reform in China's urban areas. The "Resolutions on Implementing the Economic Restructuring,"¹⁰ approved by the Third Session of the Chinese Communist Party Central Committee, strongly affirmed the Central Committee's commitment to the goals of invigorating China's domestic economy and opening itself to the outside world. The Resolutions also proclaimed the expansion of economic restructuring to China's urban areas.

In addition to reforming China's rural and urban areas, a commodity monetary economy¹¹ has been promoted generally through the development of several alternative forms of ownership,¹² through the strengthening of management autonomy in state-owned enter-

5. See Zhonggong Zhongyang Guanyu Jiakuai Nongye Fazhan Ruogan Wenti de Jueding (Decisions of the Central Committee of the Chinese Communist Party on Some Questions Concerning the Acceleration of Agricultural Development) in ZHONGGUO JINGJI NIANJIAN (1981).

6. "Yi Da Er Gong," a popular political term first employed by Chairman Mao to describe the priorities of the commune system.

7. I.e., the PRC's egalitarian compensation system in which each worker received almost equal pay regardless of how hard one worked. Differences in compensation, to the extent they existed, were often based upon a worker's attitude and political views or standing in addition to the worker's efficiency. See *DICTIONARY*, *supra* note 4, at 197.

8. "Jiating Jingying Chenbao Zheren Zhi." See generally Pan Jingcheng, Liu Wenhua & Song Jinbuo, ZHONGGUO JINGJI FA (China's Economic Law) 151 (1985).

9. NEW MILEAGE, NEW ACHIEVEMENT, comp. by State Statistical Bureau, Red Flag Publishing House, p. 96. [The author provides all statistics in this article. Because of the author's access to such statistics, the *Journal* assumes that these statistics are correct.]

10. This resolution was adopted by the Third Plenum of the Twelfth Central Committee of the Chinese Communist Party on Oct. 20, 1984. See *Zhonggong Zhongyang Guanyu Jingji Tizhi Gaige de Jueding*, RMRB, Oct. 21, 1984, at 1.

11. "Shangping Huobi Jingji" is another term for market economy. In China, this term means a government-controlled market economy.

12. I.e., private, collective, joint-venture (state-state, state-collective, state-private, state-foreign, collective-foreign, private-foreign, collective-collective, collective-private), or solely foreign proprietorship. See THE CONSTITUTION OF THE PEOPLE'S REPUBLIC OF CHINA, arts. 6, 11, 18 (1982).

prises,¹³ and through the establishment of market mechanisms. More specifically, bank credit has been expanded,¹⁴ which has been followed by the establishment of various financial institutions and a central bank system, and by the development of financial markets.

In order to facilitate the regulation of China's economy at the macrolevel, the banking system, the credit system, the interest rate system, and the exchange rate system have been endowed with great importance, and the Chinese government has emphatically called for further banking and financial reform. Thus, an integral part of China's overall economic restructuring is the reform of its banking and financial systems that began in 1979.

However, despite the passage of almost a decade since reform of the banking and financial systems began, it should be noted that banks in China have not completely transformed their role as book-keepers. In order for the banking system to be utilized as a lever for economic development and technological innovation, banks must be granted full-fledged banking functions.¹⁵

Despite the need for further reform of the overall economy, significant progress has been made in the development of the banking and financial systems. As elementary and imperfect as it is, reform of these systems in China has thus far proven to be effective and must be continued in the future.

II. BANKING AND FINANCIAL REFORM IN THE CONTEXT OF OVERALL ECONOMIC RESTRUCTURING

A. *The Goals of Overall Economic Restructuring*

The short-term objectives of China's banking and financial reform have been gradually identified through experimentation. Banking and financial reform must be compatible with China's overall economic restructuring, which aims at establishing a new, vigorous, "socialist economic system with Chinese characteristics."¹⁶ During the Seventh Five Year Plan,¹⁷ the goals of China's economic restruc-

13. State-owned enterprises may make their own microeconomic decisions to a greater extent in the emerging but still highly regulated market. See State Council Provisional Regulations on Strengthening the Management Autonomy of State-Owned Enterprises noted in Zhao Ziyang, *Report on the Work of the Government*, BEIJING REV., May 12, 1984, at iv.

14. See C. RISKIN, CHINA'S POLITICAL ECONOMY 320 (1987).

15. H. Zheng, *Foreign Banking in the People's Republic of China*, 21 INT'L LAW, 444-45 (1987).

16. This is a political phrase commonly employed in the PRC. For an example of the usage of this phrase in connection with the construction of the Chinese legal system, see Vice Premier Qiao Shi *Speaks on Law Research*, FBIS, May 27, 1986, at K28.

17. Outline of the Five Year Plan for 1986 to 1990 was adopted at the Fourth Session of the Sixth National People's Congress on March 25, 1986. See *The Seventh Five-Year Plan of*

turing consist of three parts:¹⁸

1. Enterprise Autonomy and Invigoration

China needs to further invigorate its enterprises, especially its large and medium-sized ones, by enabling them to become relatively independent economic entities and socialist commodity managers and producers with independent management decisions and full responsibility for their profits and losses. While public ownership¹⁹ must be maintained, measures promoting other forms of management, at both the micro- and macrolevels, should be encouraged. These measures include: properly reducing mandatory plans, reducing and exempting adjustment taxes, increasing depreciation rates, reinforcing managers' responsibility, implementing different kinds of economic responsibility systems, and reforming salary and labor systems. These measures will extend productive and managerial autonomy to enterprises, thus providing them with the capacity for self-accumulation, self-development, and self-progress. At the same time, we must improve the operating atmosphere and strengthen the self-discipline of enterprises. Only by promoting horizontal economic collaboration among enterprises, based on the principles of voluntary participation, mutual benefit, and common progress, can we gradually form groups and conglomerates of enterprises at different levels. Thus, China's industrial structure should be rationalized with a responsible exploitation of resources and a proper utilization of funds and technology, together with a simultaneous rational utilization of productive forces.

2. Development of Commodity Markets

China must further develop its socialist commodity markets and improve its market system. In addition, China should continue to reduce the types and quantities of commodities which are distributed and allocated by the state. A contract system by which the state places orders for goods with enterprises also needs to be perfected. Active steps must also be taken to circulate goods over wider areas and departments, and to enlarge the market for consumer goods and production materials. Furthermore, China should establish and

the People's Republic of China for Economic and Social Development in THE FOURTH SESSION OF THE SIXTH NATIONAL PEOPLE'S CONGRESS, APRIL 1986 [hereinafter Plan].

18. The author here summarizes the goals of economic reform set forth in this Five Year Plan. See *id.* SELECTED READINGS OF IMPORTANT MATERIALS SINCE THE TWELFTH NATIONAL CONGRESS OF THE COMMUNIST PARTY OF CHINA 949 (1986).

19. Public ownership (Gongyouzhi) includes not only state ownership (i.e., ownership by the whole people) but also collective ownership (i.e., ownership by the members of the collective unit). See *DICTIONARY, supra* note 4, at 468.

develop financial markets, technical and labor markets, and real estate markets. The key point in China's efforts to establish and perfect a socialist market system,²⁰ however, lies in China's further reform of its pricing²¹ and price-managing systems.²²

3. Macroeconomic Control

A new socialist macroeconomic control system²³ should be established with state control over enterprises gradually shifting from direct control toward indirect control over the economy. During the period of the Seventh Five Year Plan, we must improve, where necessary, all economic, legal, and administrative means to control and adjust the national economy. Another task is to alter the planning system by properly reducing the proportion of mandatory planning and expanding the scope of instructive (monitoring) planning and market adjustment.²⁴ As a result, the emphasis in economic planning should gradually shift toward economic policy and levers such as prices, duties and taxes, credits, interest and exchange rates, and wages for overall macroeconomic control and adjustment.²⁵

B. Overall Economic Restructuring Results Already Achieved

The overall plan for economic restructuring discussed above has resulted in great changes in China's economic system in recent years.

20. Socialist market economy (Shehui Zhuyi Shichan Jingji) is the same as commodity monetary economy or highly regulated market economy. See Lie, *supra* note 1, at 6; *supra* note 11.

21. The pricing system (Jiage Tizhi) is the system of pricing of all goods in the Chinese economy. In the past, virtually all prices were determined by the State Plan. Currently, non-crucial commodity prices are determined by supply and demand, as are the prices of a portion of crucial commodities (i.e., rice, oil, steel, etc.). The State still maintains the power to determine the prices of a significant portion of the crucial goods by means of the State Plan. See DICTIONARY, *supra* note 4, at 432.

22. Under the price-managing system (Jiage Guanli Zhidu) prices are determined or approved by various price managing bureaus according to the importance of the goods to the Chinese economy and to Chinese political stability. *Id.* at 435.

23. "Shehui Zhuyi Hongguan Jingji Guanli Zhidu." See 10 GUOWUYUAN GONGBAO 293 (1986).

24. Market adjustment (Shichang Tiaojie) is the notion that enterprises should adjust their business activities according to the changes in the market. See DICTIONARY, *supra* note 4, at 213.

25. In his Report delivered at the Thirteenth National Congress of the Chinese Communist Party, Acting Secretary General Zhao Ziyang pointed out:

At present, our main task in deepening the reform is to implement the institutional reforms in the systems of planning, investment, allocation of materials, finance, monetary affairs and foreign trade in different phases with focus on the transition of the managerial mechanism of enterprises, and in this way gradually establish the basic framework for a planned commodity economy.

BEIJING REV., Nov. 9-15, 1987, at 34.

Most recently, the share of China's economy characterized by highly-centralized planning has been reduced to 50%, compared with 100% only nine years ago.²⁶ The number of industrial products controlled by the state's mandatory plan was reduced to about 60 this year from more than 300 in the past.²⁷ The number of goods and materials distributed by state stipulation has been reduced to 26 from 256 in 1984,²⁸ while the proportion of goods and materials distributed by the state in relation to total goods and materials available has been annually decreasing.

Various economic levers are playing increasingly important roles in the economy. More attention is being paid to the importance of banks in the national economy. Funds used for expanding reproduction,²⁹ which include fiscal funds³⁰ and working funds³¹ (but which exclude funds raised by enterprises themselves), are obtained from two sources: 1) bank loans, and 2) funds allocated by the Ministry of Finance.³² The share of bank loans has been increasing. In 1986, the ratio of bank loans to funds used for expanding reproduction (excluding funds raised by enterprises themselves) increased to 68.4% from 23.4% in 1978. The share of funds allocated by the Ministry of Finance accordingly decreased to 31.6% from 76.6%.³³

III. BANKING AND FINANCIAL REFORM: GOALS, DEVELOPMENTS, PROBLEMS

A. *Goals of Financial Reform*

China's transformation from a product economy to a commodity economy, from in-kind management to value management, from

26. See H. HARDING, CHINA'S SECOND REVOLUTION 111-13 (1987).

27. *Id.*

28. *Id.* at 111.

29. Expanding reproduction is translated from "Kuoda Zaishengchan." In Marxist political economic theory, the entire process of economic activity consists of three steps: manufacturing, exchanging, and distribution. Only manufacturing produces value; exchanging and distribution are not value-producing activities. After distribution, a new economic activity begins, which is known as reproduction. There are two types of reproduction: simple reproduction, which means that the reproduction remains in the same size as the original production, roughly analogous to depreciation allowance plus working capital or reinvested earnings without capital expenditure for expansion purposes. Expanding or expanded reproduction is where the reproduction is greater than the original production. Expanded reproduction is roughly analogous to reinvestment plus working capital and depreciation allowance. See *DIC-TIONARY*, *supra* note 4, at 301.

30. *Id.* at 446.

31. *Id.* at 893.

32. *Id.* at 445.

33. Annual Report of Financial Administration Department, People's Bank of China, 1987.

direct administrative intervention³⁴ to indirect control through economic means, requires banks to play an increasingly important role. As Zhao Ziyang pointed out in his report of the Seventh Five Year Plan, the function of banks in macroeconomic management should be significantly reinforced. We should gradually establish a powerful and flexible system for financial control and adjustment through financial restructuring, giving full play to the role of the financial system in raising funds and financing, guiding the flow of funds, improving the efficiency of fund utilization, and regulating aggregate social demand.

In his report to the Thirteenth National Congress of the Chinese Communist Party, Zhao Ziyang again emphasized that we should intensify the reform of China's monetary system, strengthen the status of banks and their role in the system of macroeconomic control, and exercise proper control over the volume of credit funds supplied in accordance with sound policy relating to currency circulation.³⁵ Under the jurisdiction of the PBC, together with the full participation of state-owned banks, efforts should be made to develop various monetary means for accumulating and distributing funds. Such efforts would promote coordinated economic growth and help to rationalize China's economic structure.

The goals of China's banking and financial reform have been shaped in accordance with the needs arising from China's overall economic restructuring. The key points of China's framework for banking and financial reform are as follows:

1. Multi-tiered Financial Adjustment System

China should establish a multi-tiered financial adjustment and control system, which should be powerful and flexible and which should rely mainly upon indirect control in order to raise and utilize available funds efficiently, maintain a basic balance between society's aggregate supply and demand, and maintain basic growth while preserving structural rationality in China's economy.

2. Credit System

China should establish a credit system, based primarily on banking credit, which employs different channels, approaches, and monetary means to accumulate and distribute funds. The PBC should

34. Administrative intervention (*Xinzhen Ganyu*) means government control of economic activities of enterprises without economic rationale.

35. See *Plan*, *supra* note 17.

facilitate the horizontal circulation³⁶ and flow of funds and gradually develop multi-tiered financial centers³⁷ which focus on major cities and markets of varying scales in a manner compatible to the conditions of the country.

3. Socialist Financial Institution System

China should establish a socialist financial institution system led by the central bank, with multi-functioned and specialized banks playing a primary role. In addition, insurance and other financial institutions should coexist and cooperate. The gradually increasing role of the central bank, together with the enterprisation of banks and financial institutions, will help the state to implement its monetary policies while enabling various financial enterprises to accumulate and allocate funds independently, thus gradually combining their own "rights with responsibilities" and their own "risks with benefits." Such relationships will increase the motivation and dynamics of internal operations as well as exert external pressure through appropriate competition.

4. Technologically Advanced Financial Management System

China needs to establish a financial management system based on modern science and technology. Staff training must be improved in order to increase the number of senior financial managers. Modern technology, such as computers, should be employed to perform scientific management and provide quick access to information, convenient services to clients, and good economic results. Such improvements will provide excellent financial services, which in turn will enhance economic development.

B. Achieving the Goals of Banking and Financial Reform

In order for China to achieve its goals of establishing and improving the four "systems" discussed above, particular attention must be paid to the following issues in the gradual transition from the old financial system. In addition to acquiring additional modern equipment and training financial managerial personnel, we should also emphasize three important aspects of financial reform: establish-

36. Horizontal circulation of funds is based upon horizontal economic ties (Henxiang Jingji Lianxi) which involved transactional relationships among enterprises outside the scope of state planning, as opposed to vertical economic ties, which are between government supervisory organizations and enterprises under their jurisdiction.

37. I.e., a hierarchical structure of geographic financial centers that serve specific markets, whether national, provincial, or local in scope. See T. Gottschang, *Economy in CHINA BRIEFING*, 1987 35-6 (J. Major & A. Kane eds. 1987).

ing financial markets, facilitating the process of enterprisation of specialized banks, and establishing and improving a financial macrocontrol system based on indirect control.

The establishment of financial markets is the crux of financial reform. This task can only be achieved with the invigoration of financial enterprises, primarily through the enterprisation of specialized banks. If financial institutions are not run as genuine enterprises, we will be unable to reform China's funds rationing system and to eradicate the problem of "eating from the same big pot."³⁸ Under these circumstances, we will not be able to rationalize the relationships between the central bank and specialized banks, between banks and enterprises, or even between the central leadership of specialized banks and their operating units.

If the establishment of financial markets and the enterprisation of specialized banks are successfully achieved, we can invigorate microlevel financing. But financial invigoration at the microlevel must be coordinated with the intensification and improvement of financial control mechanisms at the macrolevel. Inflation caused by microlevel financial regulation would defeat the purpose of financial reform. The dialectical relationship between regulation and deregulation must be acknowledged. Invigoration of microlevel financing must be subject to macrolevel financial controls. In addition, these macrolevel controls should gradually shift from direct to indirect mechanisms. This shift is a prerequisite for both the formation of financial markets and the enterprisation of specialized banks.

C. Recent Developments in China's Banking and Financial Reform

The goals of banking and financial reform discussed above have been formulated through the course of continued study and practice. Compared to China's banking and financial system prior to 1979, significant changes have occurred during the past nine years. These changes have taken place mainly in the following areas:

1. Institutional Developments

The central bank and other various financial institutions have become more developed. A financial system with Chinese characteristics is taking shape. Previously, China had only one bank, namely the PBC, which functioned both as an issuing bank³⁹ and as an ordinary bank.⁴⁰ The September 17, 1983 promulgation of the decision of the

38. See C. RISKIN, *supra* note 14, at 349-50; H. HARDING *supra* note 26, at 115-16.

39. DICTIONARY, *supra* note 4, at 255.

40. I.e., as a commercial bank. *Id.* at 984.

State Council enabling the PBC to function solely as a central bank⁴¹ marked the establishment of China's central bank system. As the country's central bank, the PBC is a state organization that exercises leadership and control over the nation's financial affairs. It is the government bank, the banks' bank, and an issuing bank directly responsible to the State Council. Meanwhile, several other banks have been established or reestablished,⁴² such as the Industrial and Commercial Bank of China specializing in urban business, the Agricultural Bank of China responsible for rural financial affairs, the Bank of China handling foreign exchange business, the People's Construction Bank of China engaged in long-term investment and loans, and the Investment Bank of China that distributes loans provided by the World Bank. The China International Trust and Investment Corporation as well as more than 500 local trust and investment, leasing, and financial companies⁴³ also have been established. While rural credit cooperatives are becoming widespread, the number of urban credit cooperatives established throughout the country since 1980 has also increased, reaching 1,500.⁴⁴ Urban credit cooperatives focus their services on collective and private enterprises.

In July 1986, the State Council decided to reestablish the domestic part of the Bank of Communications of China as a full bank handling both Renminbi and foreign exchange business.⁴⁵ The Bank has been reestablished as a joint-stock bank,⁴⁶ which is part of the experiment of financial reform.

2. Bank Deposits as a Source of Investment Funds

Prior to the recent banking financial reforms, lending activities of

41. 21 GUOWUYUAN GONGBAO 808 (1983). The PBC's role as the central bank was reaffirmed in January 1986 when the State Council promulgated the Interim Bank Regulations of the People's Bank of China. See Zheng, *supra* note 15, at 439. See also F. Chu, *Banking and Finance in the China Trade* in FOREIGN TRADE, INVESTMENT AND THE LAW IN THE PEOPLE'S REPUBLIC OF CHINA 344-45 (M. Moser ed. 1987) [hereinafter FOREIGN TRADE].

42. For a description of the various specialized banks and their functions, see Chu, *supra* note 41, at 344-55.

43. *Id.* at 352-53.

44. Annual Report of Financial Administration Department, People's Bank of China, 1987. See also *supra* note 9.

45. The Bank of Communications was founded in 1908 in Shanghai. The bank's operations were transferred from Shanghai to Beijing in 1951. In 1956, apart from the bank's Hong Kong branch, the Bank of Communications was incorporated into the People's Bank of China and the People's Construction Bank. The Bank of Communications was separately reestablished in July 1986. *Diyijia Quanguoxing de Gufenzhi Qiyehua Zhonghexing Yinhang*, 4 ZHONGGUO JINRONG 21 (1987).

46. I.e., the bank raises capital by issuing shares. *Id.* See also *Shanghai Jinrong Shichang Fazhan Xunsu*, 7 ZHONGGUO JINRONG 21 (1987). The Shanghai branches of the Industrial and Commercial Bank of China and the Agricultural Bank also have issued stock. *Id.*

banks were very limited. Banks merely provided loans to enterprises to meet the enterprises' temporary and seasonal shortages of working capital. However, since 1979, banks have been making loans for the purchase of fixed assets.⁴⁷ In 1986, the increase in the amount of fixed asset loans accounted for 17.9% of the increase of total loans.⁴⁸ The outstanding amount of such loans has reached 97.6 billion Renminbi.⁴⁹ Meanwhile, banks have begun to pay more attention to deposits and have taken various measures to increase them. The total amount of bank deposits increased, on average, by 10.1% annually between 1953 and 1978, while the corresponding increase rate between 1979 and 1985 went up to 21%, and reached 26.7% in 1986.⁵⁰ By the end of 1986, the total amount of credit funds had increased by 3.3 times over that of 1978,⁵¹ thus becoming an important source of funds for China's economic development.

3. Diversification of Forms of Credit

In the past, only bank credit was permitted in China while commercial credit between enterprises, private credit, and other forms of credit were all considered illegal. However, this situation changed after 1978, providing a stimulus to the formation and development of financial markets. Today, bank credit is no longer the only form of credit available in China, due to the emergence of commercial credit, consumer credit, state credit, and private credit.⁵² Financial instruments and patterns of financing are becoming increasingly diversified with the development of various forms of commercial paper, financial bonds, and enterprise bonds.⁵³

47. *Guowuyuan Pizhuan Zhongguo Renmin Yinhang Guanyu ge Zhuanye Yinhang Fafang Guding Zichan Daikuan Fengong Wenti de Baogao de Tongzhi* (State Council Notice on the People's Bank of China's Announcement of a Report Relating to the Question of the Specialized Banks' Ability to Issue Loans on Fixed Assets) (promulgated May 30, 1984) in *CAIMAOJUAN, ZHONGHUA RENMIN GONGHEGUO XIANXING FAGUI HUIBIAN 1949-1985* (Finance and Trade Volume, Collection of the Current Laws and Regulations of the People's Republic of China 1949-1985) 369 (1987) [hereinafter *Collection*].

48. 5 *JINRONG YANJIU* 3-5 (1987).

49. *Id.*

50. *Id.*

51. *Id.*

52. *Zhonghua Renmin Gongheguo Yinhang Guanli Zanxing Tiaoli* (Provisional Regulations on Bank Management in the People's Republic of China) (promulgated by the State Council Jan. 7, 1986) in 1 *JINRONG FAGUI SHOUCE* (Handbook of Financial Laws and Regulations) 1 (1986) [hereinafter *Handbook*].

53. *Id.* at art. 24. See also *Qiye Zhaiquan Guanli Zanxing Tiaoli* (Provisional Regulations on Enterprise Bond Management) (promulgated Mar. 27, 1987) in 5 *ZHONGGUO JINRONG* 17 (1987).

4. Rationalization of Banks' Interest Rates

Before banking and financial reform, banks' interest rates in China remained at low levels with very few brackets and were always fixed for long periods of time.⁵⁴ Since reform began, however, interest rate policy has gone through adjustments that have enabled interest rates to function as a lever in regulating the supply and demand for funds. As a result of these adjustments, there are more brackets and classifications of interest rates, and interest rate levels have been raised.⁵⁵ The structure of lending rates has been adjusted according to the maturities of loans, eliminating the irrational past practice in which interest rates decreased as the maturity of loans increased. Floating interest rates tied to the economic results of borrowers have been applied, and penalties will be imposed on enterprises that violate the system of credit fund management and/or which fail to sell their products.⁵⁶

5. Diversification of Banks' Sources of Funds

The old funds supply system⁵⁷ has been fundamentally changed through the reform of the credit fund management system. For many years, banks submitted deposits to their headquarters, received targets for loan making, and requested funds when they needed them. This kind of credit fund management had many shortcomings. Therefore, since 1985, the central bank has begun to adopt a method of dividing funds among specialized banks and linking the amount of loans made by them to that of their deposits. The central bank will no longer be the only supplier of funds to specialized banks, which should maintain their own fund balance by absorbing deposits and borrowing in financial markets. While the central bank still provides necessary financial assistance, banks should not rely on such assistance exclusively for their own lending needs.

6. Development of Domestic Insurance Industry

The domestic insurance business has resumed in China, and an economic compensation system has been established.⁵⁸ In 1959, China's domestic insurance business was abolished and all damages

54. See Handbook, *supra* note 52, at arts. 42-5.

55. *Id.*

56. *Id.*

57. The old funds supply system refers to the distribution of funds among state-owned banks which was carried out in accordance with the state plan.

58. See *Banking, Finance, and Foreign Exchange*, 2 COMMERCIAL, BUSINESS AND TRADE LAWS: PEOPLE'S REPUBLIC OF CHINA 6-7 (O. Nee ed. 1987); Baoxian Qiye Guanli Zanxing Tiaoli (Provisional Regulation on the Management of the Insurance Industry)

were covered by the state. However, the state was unable to assume this responsibility, resulting in adverse consequences to China's economic stability and standard of living. Since resuming operations in 1980, China's domestic insurance business has developed rapidly, especially during the past two years. In 1986, the People's Insurance Company of China (PICC) provided more than 100 insurance products and received approximately 5 billion Renminbi, a 45% increase over 1985.⁵⁹ In its handling of more than 2.5 million claims and its paying out of 1.23 billion Renminbi in compensation in 1986,⁶⁰ the PICC has helped thousands of enterprises and households which have suffered damage to resume production and their normal lives in a timely fashion. Additionally, the international insurance business in China has also expanded remarkably.

7. Increase of International Economic Cooperation

Prior to 1978, China's economy was closed to the outside world, and financial contact with foreign countries was minimal. The state had neither domestic nor foreign debts. Since economic and financial reform, the previously isolated bank management system has been changed and international financial contacts have been developed. After the restoration of its legal seats in the International Monetary Fund and the World Bank in 1980, China joined the African Development Bank and the African Development Fund in May 1985⁶¹ and became a full member the Asian Development Bank in March 1986.⁶² In addition, China's financial institutions have begun to raise funds in international financial markets through the issuance of bonds. The Bank of China, as a specialized bank in the foreign exchange business, has developed many new financial products and has increased the number of its subsidiaries overseas from 184 in 1978 to 310 in 1985.⁶³ The Bank of China has now established correspondent relations with more than 1,235 banks in 152 countries and regions in the world.⁶⁴ The PICC has developed reinsurance relationships with more than one thousand insurance companies from more than one hundred countries and regions of the world, and it has participated in interna-

(promulgated Mar. 3, 1985) in Handbook, *supra* note 52, at 161; Xu Dixin, *Dui Woguo Baoxian Shiye de Renshi*, 12 ZHONGGUO JINRONG 8 (1986).

59. See JINRONG YANJIU, *supra* note 48.

60. *Id.*

61. MULTILATERAL TREATIES DEPOSITED WITH THE SECRETARY GENERAL at 328, U.N. Doc. st/leg/Ser.E/6, U.N. Sales No. E.88.V.3.

62. *Id.* at 336.

63. See Chu, *supra* note 41, at 347.

64. See JINRONG YANJIU, *supra* note 48.

tional insurance activities in Asia and the Asian Pacific region.⁶⁵ Meanwhile, financial institutions from other countries have established dozens of representative offices in China in addition to several bank branches in China's Special Economic Zones, thus further promoting financial cooperation between China and other countries.⁶⁶

8. Monetary Policy Used as a Means of Macroeconomic Control

Before banking and financial reform, while China's economy was highly planned and centralized, economic activities were regulated through planned targets and administrative orders rather than through economic means. Banks, therefore, were mere bookkeepers of the state. With the intensification of economic reform, however, China's central bank increased its efforts to achieve effective macroeconomic control. Most importantly, the central bank attached greater importance to the formulation and implementation of monetary policy, giving priority to monetary stability and economic development. In addition, the central bank has begun to use economic means for regulation and control of economic activities. A reserve requirement system has been established, and interest rates for lending to specialized banks have been increased, as have the brackets of such interest rates, thereby encouraging specialized banks to gain greater access to social funds. The central bank is also attempting to integrate the control of Renminbi and foreign exchange so that the targets of monetary policy can be realized through foreign debt management,⁶⁷ exchange control, and exchange rate management.

9. Increase in Bank Autonomy

Banks were previously regarded as state organs with no operational autonomy. Economic accounting⁶⁸ was neglected and fund management was characterized by the practice of "eating from the same big pot." Since 1978, however, the internal management of banks has been undergoing changes and new methods of enterprisation have been practiced. On a limited experimental basis, some grass roots banks are being treated as enterprises with independent accounting and autonomy in operation. In addition, the management respon-

65. *Id.*

66. See Chu, *supra* note 41, at 356-61.

67. Foreign debt management (Waizhai Guanli) involves maintaining a ceiling of the foreign debt China can incur within a certain period. The ceiling is determined by a preset factor of the foreign exchange revenues China takes in. See Zhang Guanghua, *Guanyu Jiaqi-ang Woguo Waizhai Guanli de Jige Wenti*, 6 ZHONGGUO JINRONG 43 (1987).

68. Economic accounting (Jinji Hesuan) is used in its broad sense, i.e., that banks should be economically responsible or accountable for their own performance. See *Legal Developments*, CHINA LAW AND PRACTICE, May 6, 1987 at 18.

sibility system⁶⁹ is being applied to banks on an experimental basis across the country.

10. Development of Economic Information Systems

The PBC, together with other banks and financial institutions, has established economic information systems over the past several years. Through the collection and analysis of financial information, banks are now capable of improving economic efficiency through economic forecasting. In addition, institutes of banking and finance have been established at various levels. Research on banking and finance is having a great impact on financial reform and is playing an important role in the training of banking personnel.

11. Development of Financial Legal Regime

In recent years there have been significant improvements in the area of financial and banking legislation. The State Council has promulgated several provisional laws and regulations, including: Provisional Regulations on Bank Management;⁷⁰ Regulatory Provisions on Foreign Bank, Sino-Foreign Joint Bank in the Special Economic Zones;⁷¹ Regulations on Loan Contracts;⁷² and other regulations on insurance, shares and bonds, and foreign exchange management. The PBC has also enacted several provisions governing the management of the Insurance Investment Corporation.

D. Problems with Banking and Financial Reform

Banking and financial reform affects various aspects of China's economy. In the process of reform, many of the following issues must be gradually resolved:

69. Management responsibility system (Jinying Zherenzhi) refers to a system in which the management of the bank signs a management responsibility contract with higher authorities, a parent bank, to pay profits and tax to that parent bank, which in turn forwards these payments to the Ministry of Finance. The parent bank will also confer certain autonomy rights to the management of the local bank. This type of contract is between: 1) a bank branch office at any level and 2) its immediate superior bank branch office. See *Shixing Chengbao Jinying Zherenzhi, Jiaqiang Jianhang Qiyehua Bufa*, 7 ZHONGGUO JINRONG 27 (1988).

70. Handbook, *supra* note 52.

71. Zhonghua Renmin Gongheguo Jingji Tequ Waizi Yinhang Zhongwai Heze Yinhang Guanli Tiaoli (Regulation on Foreign Banks and Sino-Foreign Joint Venture Banks in the Special Economic Zones) (promulgated Apr. 2, 1985) in Handbook, *supra* note 52, at 34.

72. Loan Contract Regulations, *summarized in CHINA LAW AND PRACTICE*, Feb. 26, 1987, at 31.

1. The Relationship Between Macroeconomic Monetary Management and Microlevel Enterprise Invigoration

The central bank's macroeconomic adjustment mechanism needs further reform. The most important mechanism by which the central bank may exercise macroeconomic adjustment continues to be the control of the money supply through administrative prescription. Such a system poses a dilemma for the central bank. An excessive administrative expansion of the money supply risks overheating the economy. However, an excessive administrative contraction of the money supply risks impeding economic development. In short, administrative control over the money supply is not sufficiently flexible and responsive to changing economic needs.

During the fourth quarter of 1984, for example, China's economy overheated due to overexpanded investment and consumption, which required excessive growth of the money supply. These problems emerged in part as a result of overly ambitious efforts to pursue a high rate of economic growth, together with an overexpansion of bank credits and insufficient measures for monetary control.

In 1985, the central bank implemented a tight monetary policy, which controlled the growth of the money supply and bank credits. While this more restrictive monetary policy simultaneously sought to give preferences to priority construction projects and enterprises that were expected to achieve better economic results, such prioritization was not always achieved at the implementation stage. Because refinancing continued to be allowed for projects and enterprises with poor economic performance,⁷³ due to China's reluctance to allow inefficient projects and enterprises to go bankrupt, the shortage of funds available to efficient projects and enterprises, caused by the more restrictive monetary policy, was exacerbated.

Under the difficult circumstances created by the restrictive monetary policy implemented in 1985, a monetary policy with a greater emphasis on "different treatment to different enterprises"⁷⁴ was adopted in the first half of 1986. Thus, it appears to be an important theme that microlevel invigoration of enterprises must be pursued in order for effective macrolevel financial management to be possible.

73. Such refinancing continued in large part due to the conceptual incompatibility between the principle of bankruptcy and the socialist concept of public ownership, and because the government was concerned with the social costs associated with unemployment and economic displacement. See H. HARDING, *supra* note 26, at 116-17.

74. See C. RISKIN, *supra* note 14, at 365-66.

2. Vertical Versus Horizontal Allocation of Funds

The vertical distribution of funds is somewhat incompatible with horizontal economic integration of the economy and the development of a market system. The development of horizontal ties between enterprises and the gradual formation of a market system has broken the pattern of regional and sectorial ownership.⁷⁵ As a result of this change, a horizontal flow of funds and an evolution of a fund market must be promoted in order to ensure the efficient allocation of productive factors.⁷⁶ In 1977, the Chinese banking system was significantly altered with the division of the PBC into four major specialized banks with branches throughout the country.⁷⁷ However, the scope of business activities of these specialized banks was administratively divided, and the quotas of credits allowed to each of these four banks were vertically distributed. Such vertical allocation of funds through the specialized banks has hampered the horizontal flow of funds. For example, once the central bank adopts a policy to tighten the money supply, the specialized banks have to restrict their extensions of credit, without regard to the specific credit needs of their own jurisdictions.

3. Continued Inefficient Utilization of Funds

Funds continue to be inefficiently utilized due to insufficient reforms in the system by which funds are allocated. Under the old system, there was neither competition nor jurisdictional overlap between banks. An enterprise only could open accounts with and borrow from a single bank. That bank had sole responsibility for fulfilling the credit needs of the enterprise. As a result, if the bank suspended loans to the enterprise, it would hamper the production of the enterprise, or, even worse, push the enterprise into insolvency. Moreover, there was no established system to guard against default on bank loans or to make credit conditional upon the economic feasibility of enterprises. These unsound economic practices have contributed to poor economic results from the use of loans.

75. Regional ownership (*Difang Suoyouzhi*) describes the phenomenon where, because the government in various regions and at various levels has management rights over the activities of the enterprises according to their size, it appears that the government actually owns the enterprises. Sectorial ownership (*Buman Suoyouzhi*) describes the phenomenon where the government does not manage the enterprise directly; rather, it delegates its managerial power to the departments of each government level. Therefore, it appears that the government departments in fact own the enterprises. The departments are set up by the government to manage specific industries. These two phenomena existed in the typical state planning system.

76. See C. RISKIN, *supra* note 14, at 357-58.

77. See Zheng, *supra* note 15, at 438-43.

4. Lack of Incentive Within Financial Institutions

There have been inadequate incentives within the financial institutions to improve themselves. For a long time, China's banking system has been managed solely through administrative measures. Banks still have excessively large branch networks and are largely overstaffed. Between different levels of bank branches, as well as within individual bank units themselves, there has historically been no established system whereby power, responsibility, and interests have been well-integrated. The same has been true with respect to other financial institutions. Individual units at the grass roots level have not had adequate autonomy in operations, making loans, changing interest rates, retaining after-tax profits, hiring, firing, awarding and punishing employees, or setting up interior banking departments. Such lack of autonomy and the separation of "rights from responsibilities" and "risks from benefits" have directly impeded the effective accumulation of funds, as well as the rational allocation of funds to the most efficient enterprises and construction projects. The result has been poorer quality of service and lower operational efficiency.

5. Problems in Foreign Exchange Management

The existing foreign exchange controls do not satisfy the needs of opening to the outside world and invigorating the domestic economy. The purchase, payment, and allocation of foreign exchange are conducted in accordance with administrative prescription.⁷⁸ Therefore, market mechanisms have no role in the process. Enterprises do not yet have full autonomy in managing their foreign currency. Thus, foreign exchange cannot be efficiently employed, and exchange rates and interest rates on foreign exchange loans cannot be fully utilized as economic levers. The central bank is thus constrained in using foreign exchange management as an important instrument for reaching its objectives of domestic monetary policy.

6. The Need for Greater Coordination Between Banking and Financial Reform and Overall Economic Restructuring

Banking and financial reform is not yet sufficiently coordinated with China's overall economic restructuring. Because predetermined investment decisions and project plans largely determine the ultimate size of money supply, banks lack sufficient autonomy to manage their funds. Such monetary policy driven from the demand side interferes

78. See C. Conroy & M. Moser, *Selected Legal Aspects of Financing Transactions with the People's Republic of China* in FOREIGN TRADE, *supra* note 41, at 387-88.

with the ability of banks to efficiently control monetary policy from the supply side.

In a moderate inflationary context, interest rates on deposits and bonds should be raised⁷⁹ to encourage savings (thus reducing consumption and aggregate demand) while at the same time raising the costs of investment funds, thus limiting investment to only the most efficient enterprises and projects.⁸⁰ Because interest rates on loans in China currently cannot float freely, and because price controls on products limit the ability of enterprises to bear the costs of interest rate fluctuations, such monetary policy cannot be fully and effectively implemented. Reform of China's pricing system is, therefore, integrally related to banking and financial reforms.

Management of China's fiscal deficit also needs greater coordination with its monetary policy. The central bank could maintain greater control over money supply if, instead of financing fiscal deficits through overdrafting and borrowing from the central bank by the Ministry of Finance, such deficits were financed by issuing bonds to the public.⁸¹

7. Underdevelopment of Financial Legal Regime

As discussed above, much progress has been made in establishing new financial laws and regulations. However, further reforms are needed. For example, although financial markets and the use of commercial paper have been developing rapidly, a corresponding development of laws and regulations is still lacking. In addition, further promulgation of regulations to implement enterprise and bankruptcy laws are needed in order to respond to the rapid development of bond and other long-term fund markets.

IV. PROPOSED MEASURES TO FURTHER BANKING AND FINANCIAL REFORM

The objectives of China's banking and financial reform will only be achieved if further measures are taken. Based on China's situation, the following measures should be emphasized in order to further

79. Handbook, *supra* note 52, at arts. 42-5.

80. See B. Naughton, *False Starts and Second Wind: Financial Reforms in China's Industrial System* in *THE POLITICAL ECONOMY OF REFORM IN POST-MAO CHINA* 241-44 (E. Perry & C. Wong eds. 1985).

81. The author here refers to the present situation where borrowing by the Ministry of Finance is regarded as a "fiscal borrowing," over which the central bank has no control. See Guowuyuan Bangongting Guanyu Jiaqiang Yinhang Jinrong Xindai Guanli Gongzuo de Tongzhi (General Office of the State Council Circular on Strengthening of Bank Management of Financial Lending) (approved June 27, 1985) in Collection, *supra* note 47, at 401.

banking and financial reform and to shorten the transitional period from the old system to the new one.

A. Strengthen the Role of the People's Bank of China

The role of the PBC must be improved and strengthened in the system of macroeconomic control. If one accepts the theory that all money in circulation (including money on deposit) is injected into the economy through the extension of credit, improving the ability of the central bank to effectively control the issuance of credit is the crux of improving macrolevel financial management. Control over credit is a key instrument for the central bank in its regulation of money supply to meet the aggregate demand for funds. In such macroeconomic management, several extremely important issues deserve our special attention:

1. The Need for a Stable Monetary Policy

First, China's money supply must be constrained by the "social bearable capacity" of its economy. As we know, the basic function of money in circulation is to serve as the medium of exchange. "Social bearable capacity" in this context refers to the level of money supply required corresponding to the total value of commodities produced by the economy at a certain period, taking into consideration bearable price increases and the normal velocity of money. According to this principle, the growth of accumulated funds for investment⁸² should not be allowed to exceed the growth in production of capital goods, and the growth in consumption should not be allowed to surpass the growth in production of consumption goods. Judging from China's recent economic performance, however, the rate of increase of consumption⁸³ has unfortunately exceeded the growth rate of national income. Therefore, all sectors of China's economy should strive to reduce consumption and share in the common task of slowing the growth of aggregate demand.

Every effort should be made to maintain a relatively stable monetary policy which avoids large fluctuations of the money supply. The ultimate objectives of monetary policy are to stabilize prices, to promote coordinated economic growth, and to maintain a balance of payments. These objectives may be achieved primarily through the regulation of the money supply by the central bank. Thus, control

82. Accumulation funds refer to that part of the national income which is used to increase fixed capital assets, working capital, and material reserves. See C. RISKIN, *supra* note 14, at 145 n.5.

83. *Id.* at 279-80.

over the appropriate growth of the money supply has been among the most important means for controlling inflation.

The following conditions must be maintained in order to achieve a stable monetary policy: First, the growth of the money supply should be determined by such factors as a reasonable economic growth rate, bearable price increases, and the change in monetary velocity. Second, once the appropriate level of money supply growth is determined by these factors, the demand for funds must be reduced to meet money supply, rather than money supply being expanded to meet uncontrolled demand.

Money supply should be flexibly adjusted in accordance with targets for economic growth. Such targets should be reasonable and not overly accelerated. In determining money supply, inflation should only be allowed to the extent bearable by the economy. While an increase in money supply may reduce the velocity of money, such a reduction is not an inevitable result of the process of monetization and commercialization. Thus, it is not always appropriate to assume such a reduction of money velocity in calculating the appropriate growth of money supply.

2. Indirect Versus Direct Control

China should utilize flexible economic policy instruments. A socialist economy is a planned commodity economy which guides the market by direct and indirect planning while allowing market forces gradually to influence enterprises. Thus, once macroeconomic objectives are set, they should be realized primarily through economic levers. Direct control should be gradually replaced by indirect control.

For the central bank, specifically, indirect control means control of the money supply and control of the total volume of lending by direct control over the monetary base. According to China's experience, as long as the central bank can properly regulate the amount of lending to specialized banks, it can indirectly regulate the money supply. What needs to be improved, however, is the method of allocating funds. The central bank should not be the exclusive source of funds available to specialized banks. These banks should be required to resort to financial markets, increasing deposits, and issuing bonds in order to satisfy their own financial needs and to maintain a balance between their liabilities and assets. The principle should be that the more deposits they absorb, the more lending they can extend. The monetary base should be strictly controlled by the central bank. The central bank may periodically finance various financial institutions

according to such indicators as price, interest rates, the demand for funds, and current economic conditions. Financial management of the specialized banks by the central bank can be achieved through economic means, such as establishing a ceiling on lending, a lending rate, a discount quota, and a discount rate, which can be used alternatively and flexibly to regulate the total volume and structure of lending by specialized banks. With the development of financial markets, the amount of funds allocated through market mechanisms should be expanded accordingly, in order to maximize the amount of funds which will be efficiently allocated.

3. The Relationship Between Foreign Exchange and Money Supply

China's foreign exchange should be managed in connection with the management of domestic money supply. Since China adopted its open-door policy, external economic transactions have been gradually increasing. There is no doubt that international price and exchange rate fluctuations will affect China's balance of payments, which in turn will affect domestic price and investment levels, the state budget, and other aspects of economic development. In addition, domestic credit expansion, China's money supply, and the stability of Chinese currency will be seriously influenced.

In China, export commodities are first purchased by domestic export agencies with Renminbi. Foreign exchange earned by such agencies should be converted into Renminbi. In addition, loans obtained from foreign sources must be supplemented by Renminbi.⁸⁴ These examples demonstrate that the management of foreign exchange cannot be separated from that of Renminbi.

Optimally, foreign reserves should be increased to guarantee external payments needed for the importation of capital goods in support of domestic production. Thus, maintaining a favorable balance of payments is an important objective of the monetary policy which is not only related to foreign exchange but also to domestic money supply as well. In short, reform of China's banking and financial systems should include the reform of its foreign exchange and external debt management systems.

4. Recognition of Market Imperfections

It is clear that, at present, China's commodity economy is still

84. This is because Chinese enterprises and construction projects which use foreign loans to purchase foreign goods also need Renminbi to purchase input from the Chinese market, such as equipment, facilities, land use, and labor. See Chu, *supra* note 41, at 367-73.

not well-developed, that various market mechanisms are not perfect, and that financial markets are at very early stages of development. Therefore, China should not follow completely the models of Western industrialized countries, which may not be suitable to China's specific situation. China should pursue its own path, in accordance with its actual conditions.

For example, in addition to controlling the money supply, as a transitional measure, the central bank must control the total volume of lending as well as the demand for funds in order to achieve rough balance between aggregate demand and aggregate supply. Under present conditions, the main policy instruments available to the central bank are relending to specialized banks and adjusting reserve ratios. Open market operations and discount windows could not be effective. In support of tightening fiscal and credit policies, the central bank raised its relending rate in the fourth quarter of 1988 from 10 to 12 percent.⁸⁵ The next step should be to establish different brackets of interest rates according to different types of deposits.

B. Expand Financial Markets

The exploration, establishment, and development of financial markets should be enhanced. At present, efforts are being made to invigorate China's money market, including an inter-bank lending and borrowing market, a commercial paper market, and a short-term bond market.

The inter-bank lending and borrowing market refers to financing among financial institutions to cover short term cash flow shortages. The free flow of funds between different financial institutions will facilitate the allocation of money to different localities at different times, and thus accelerate circulation. This will increase the velocity of money, which in turn will increase the availability of funds without increasing the actual money supply. Such circumstances will help to satisfy the urgent need for funds and enhance efficiency. Thus, priority should be given to encourage financing activities between various industries as well as different provinces and municipalities on the basis of inter-bank lending. The formation of central-city-based financing networks⁸⁶ at different levels throughout the country should also be encouraged.

The commercial paper market deals primarily with the trading of commercial paper, the participants of which include industrial enter-

85. THE ECONOMIST INTELLIGENCE UNIT, COUNTRY REPORT: CHINA AND NORTH KOREA, No. 2, 1988, at 22.

86. See Gottschang, *supra* note 37, at 35-36.

prises in addition to financial institutions. Neither commercial credit nor banking credit is legally sufficient if it is not evidenced by the issuance of documents. The lack of such documents creates the danger that the flow of money could be separated from the flow of commodities, thus inducing credit inflation. Therefore, it is a fundamental task of financial reform to insure that the flow of credits is evidenced and limited by the existence of relevant documents in credit transactions between different financial and non-financial institutions and enterprises.

In China, shortages of capital for construction will exist for quite a long time. Under the present situation, characterized by the considerable increase of funds outside the state budget⁸⁷ and the lack of guidance over self-financing capital construction,⁸⁸ exploring possibilities for establishing and regulating the long-term money markets may enable us to develop an efficient way to regulate the scale and structure of investment, and to enhance the efficiency of investment.

At present, experimentation in the issuance of stock is confined to complex enterprises and a few approved collectively-owned enterprises. Greater importance is attached to the bond market,⁸⁹ however, which includes treasury bonds, key-project bonds,⁹⁰ financial bonds,⁹¹ and corporate bonds.⁹²

China's long-term fund market should develop together with the reform of its investment system. Enterprises and financial institutions should be gradually given the responsibility to invest in themselves, to receive investments, and to invest in other enterprises. The state will still be responsible for investing in key construction projects, infrastructure projects, and public utilities. By entering into the financial market, enterprises may issue bonds to raise funds and finance projects. They will make their own evaluations and decisions on investments and take sole responsibility for risks incurred, linking the

87. The funds outside the state budget (*Yusuan wai zijing*) refers to government and enterprise funds which are not managed under the national budget. Formerly, almost all funds were managed by the central government's budget. During reform, central government departments and local departments and enterprises are allowed to manage a portion of their funds outside the state budget. See C. RISKIN, *supra* note 14, at 362-64.

88. Before reform, all capital construction projects were financed by the state. Now, government organizations and enterprises are allowed to sponsor their own construction projects, for which they are now responsible, thus they are "self-financed." See *id.* at 362-66.

89. See H. HARDING, *supra* note 26, at 123-24.

90. I.e., bonds for large-size projects issued by government agencies or departments usually in the utilities, oil, coal mining, or transportation industries.

91. Financial bonds are issued by state financial institutions, i.e., national banks (including the central bank and four additional specialized banks) and state-owned investment and trust companies.

92. Corporate bonds are bonds issued by enterprises.

costs of funds they are willing to pay with the efficiency of the projects in which they invest. This will not only alleviate the government's fiscal burden of providing investment funds, but it will also bring market mechanisms and financing costs into full play to regulate the investment structure. This will encourage the flow of funds to efficient projects. With the diversification of financial assets, the secondary market may be correspondingly opened to provide investors and managers with additional options and liquidity to further invigorate the fund markets. Meanwhile, China should continue to develop the insurance industry, especially life insurance and pension insurance, to serve as additional steady and long-term sources of funds.

Due to experimentation in recent years, inter-bank lending and borrowing markets have been established in certain central cities like Wuhan, Shenyang, and Guangzhou. Exchange centers of commercial paper, located in different cities, have recently begun to operate on a trial basis. Primary markets for stocks and bonds have also recently begun on a trial basis. The aggregate value of stocks and bonds currently issued is well over 60 billion Renminbi.⁹³

The development of a secondary securities market is also under way. Presently, there are more than 40 financial institutions in 24 cities which trade in securities.⁹⁴ However, because China's financial markets have just been established, many problems still need to be resolved. For example, the difference between stocks and bonds is not yet well-defined or well-understood by the public; the issuance of some bonds is presently connected with lotteries; some stocks require issuers rather than shareholders to assume all risks; the number of types of negotiable securities are still too small; the difference between the selling and purchasing price of securities is too large; and there is a lack of blue-chip securities.

To solve these problems, we are now taking steps to train personnel, to study and promulgate relevant statutes and regulations, to establish certain authoritative credit rating agencies, to use economic leverage to guide the market, and to use policies to regulate all transactions so that the healthy development of China's financial markets can be assured.

C. Promote Reform and Enterprisation of Specialized Banks

The reform and enterprisation of specialized banks should be promoted. Several problems currently exist in China's specialized

93. Annual Report of Financial Administration Department, People's Bank of China, 1987.

94. See Zheng, *supra* note 15, at 445-46.

banks: specialized banks are not responsible for their own profits and losses, the operating results of specialized banks are not linked to their own profits, and loans are made regardless of risk. These problems reduce the ability of banking institutions to accumulate funds efficiently and to allocate them rationally to the most efficient enterprises and construction projects.

The enterprisation of specialized banks should be concentrated at the city branch level (or at the county sub-branch level in the Agriculture Bank of China). Because major cities in China serve as economic centers for different geographical regions for the collection and distribution of commodities, materials, and funds, the invigoration of city branches is of great importance in the formation of domestic financing and remittance networks. Increasing the circulation of funds in cities is of crucial importance in breaking up the boundaries which currently exist between various regions and industries, which impede fund circulation and create economic spheres.

The basic requirements for the enterprisation of specialized banks include the integration of their rights, interests, and responsibilities. Specialized banks must be allowed to become real economic entities with autonomous operations, solely responsible not only for incurring profits and losses, but also for taking risks and accumulating funds. Under such circumstances, banks would be able to adjust their operations in accordance with changes in the economy. In order to realize this goal, the first step should be extending credit funds to grass roots branches of specialized banks, giving them specified amounts of capital, and allowing them to operate independently. The internal financing relationships within the networks of specialized banks should develop into ones of lending and borrowing.

A second step of enterprisation is analogous to the decentralization of state-owned enterprises. Banks should be allowed independently to conduct business; to grant loans; to float interest rates; to manage retained after-tax earnings; to appoint, to dismiss, to reward, and to discipline staff and officials; and to establish departments within banks.

As a third step, "rights and responsibilities," as well as "risks and benefits," should be made inseparable. An economic responsibility system and a loan risk system⁹⁵ must be established and improved in order to discipline the credit behavior of the banking enterprises. This should be done according to the principle of "risk and benefits" in order to compel banks to make loans in accordance with the creditworthiness, efficiency, and repayment capacity of borrowers.

95. See C. RISKIN, *supra* note 14, at 366-67.

Such measures would promote the safety, integration, and efficiency of loans.

A fourth step should be to reform the current practice under which all expenditures of individual branches are ratified and allocated by the headquarters of specialized banks. Such functions should be conducted at lower levels.

A fifth step should be to develop new types of financial institutions and to permit business overlap between them. Development of such institutions has begun in recent years. A large number of urban and rural collective financial institutions and non-bank financial institutions, which are solely responsible for their profits and losses, have been established. The establishment of the Communications Bank as a joint stock corporation engaged in comprehensive credits and loans has introduced competition into the Chinese banking system. China's banking enterprises should gradually expand their scope of business overlap and develop competition in order to break the monopoly situation that now exists and to increase pressure on management.

Finally, banking enterprises should seek to separate ownership from management on a trial basis. The entrance of some grass roots bank branches into the responsibility contract system is a good start.⁹⁶ This sort of experimentation should be further expanded.

D. Rationalize Interest Rates

China's interest rate system should be gradually rationalized in order to utilize its potential function as a regulator of the national economy. The basis on which general interest rates are currently established is not the average rate of return. Since China's pricing system is unreasonable, and its market system is still imperfect, an interest rate based on rates of return will not evolve automatically. In China, unlike in market economy countries, interest rates have not been determined according to the price level⁹⁷ and the supply and demand of funds. Rather, interest rates are determined according to a combination of price levels, the cost for banks to absorb funds, and the bearing capacity of enterprises. When the pricing system and an enterprise's internal mechanisms do not function smoothly,⁹⁸ the cost of funds (i.e., interest rates) cannot be decided by the market.

96. See *supra* note 69.

97. I.e., interest rates have not been adjusted according to the rate of inflation. See Naughton, *supra* note 80, at 241-44.

98. I.e., when enterprises do not care about their operation results. See H. HARDING, *supra* note 26, at 285-86.

Accordingly, the reform measures relating to interest rates should be implemented soon.

Presently, interest rate management is divided into three classes. The first class, the unified interest rate, is used mainly by specialized banks, although a different rate for working capital may be floated. The second class of interest rates floats according to the market. Included in this class are the inter-bank lending rate and other rates, as well as the rate for rural credit cooperatives. The third class of interest rates floats within limits set by the PBC.

In summary, interest rates in China will not be allowed to float with complete freedom. All of these methods for interest rate determination may be tested in special places and economic zones. The savings rate of interest should be adjusted according to the changing rate of price levels.⁹⁹ A negative rate of interest, i.e., an interest rate to depositors below the rate of inflation, cannot be long maintained without discouraging savings. In addition, the interest rate of newly issued short term bonds and CDs should be slightly higher than the price index in order to attract purchasers. With regard to deposits from enterprises, more types of enterprise time deposits should be established, and interest rates on savings should be increased in order to encourage deposits by enterprises.¹⁰⁰

In order for interest rates to be used as a main lever for economic adjustment, interest rates on loans must be charged according to a loan's maturity. A higher interest rate should be charged for longer term loans. In addition, interest rates should be differentiated by the government in accordance with its economic plans. China must subsidize those enterprises with good economic results and limit those with bad economic results, support those which can produce the products needed in the market, and limit those whose products cannot be sold in the market.

E. Improve Foreign Exchange and Loan Management

Maintaining foreign exchange balance is one of the important objectives of China's monetary policy. Reform of the foreign exchange system must be coordinated with other reforms of the country.

99. I.e., the interest rate on savings will be set by the government in accordance with the rate of inflation. See Handbook, *supra* note 52, arts. 42-5.

100. In China, enterprises are required to deposit their surplus funds into specified banks with interest rates much lower than individual savings rates. See Gottschang, *supra* note 37, at 37.

1. Improve the Foreign Exchange Retention System

An important means to retain foreign exchange is to encourage further exports. In the future, the government's policy should be to maintain foreign exchange balance and to reduce the government's regulation of foreign exchange, to the extent that responsibility for obtaining the foreign exchange needed for commodities currently imported by the central government is delegated to local levels.¹⁰¹ With such reforms, imports will be more efficiently coordinated with foreign exchange earnings and expenditures. Additionally, certain regulations will allow free floating foreign exchange markets in Special Economic Zones and other special sectors, such as foreign enterprises, as designated by the government.

2. Utilize Foreign Exchange Rates as Economic Levers

Foreign exchange rates should be utilized as economic levers. Assuming a market context with other conditions remaining constant, domestic inflation in China will depreciate the Renminbi. Conversely, a decrease in domestic prices will cause the Renminbi to appreciate. This latter condition could be unfavorable to China to the extent that it discourages exports and encourages imports, thus negatively impacting China's balance of payments. China's inflexible exchange rate lever has not yet been fully utilized to devalue the Renminbi in order to encourage exports and increased foreign exchange earnings. Under China's present circumstances, however, such foreign exchange levers should be utilized with moderation since an excessive devaluation of the Renminbi could overly increase the costs of necessary imports to Chinese construction projects and enterprises. Devaluation of the Renminbi might not only impede construction projects and reduce domestic inflation, it could also exacerbate inflation.¹⁰²

3. Establish a Balance of Payments Plan

The central bank should set up a foreign exchange reserve fund and a foreign exchange credit fund. Such funds could serve as a medium for international payments, as a source of working capital to support the foreign exchange business of specialized banks, and as a lever of adjustment to intervene in foreign exchange markets.

101. Under this new system, since the local governments will retain a certain amount of foreign exchange, the importation of some goods needed locally will be the responsibility of local governments. See H. HARDING, *supra* note 26, 137-39, 151-53.

102. I.e., exchange rate fluctuations must occur within socially bearable parameters. See *id.* at 151-55.

F. Establish a Foreign Debt Supervisory System

As China's foreign debt increases, the importance of a foreign debt supervisory system increases. The direct foreign borrowing of every region and sector of the economy must be reported to the State Administration for Foreign Exchange Control through an efficient information channel.¹⁰³ In addition, a statistics reporting system relating to the contracting, balance, repayment, and the guaranteeing of foreign debts is needed in order to supervise and forecast foreign borrowing needs for the future. Furthermore, advanced managing of foreign debts must be maintained through short-term, mid-term, and long-term borrowing plans.

V. FUTURE PROSPECTS

China is now in the primary stage of socialism.¹⁰⁴ The primary stage is not the initial phase in a general sense, which every country goes through in the process of building socialism. Rather, China is in a primary stage of socialism in a particular sense, being at the specific stage which it must necessarily go through while building socialism under the conditions of backward productivity and an underdeveloped commodity economy. It will be at least 100 years, beginning in the 1950s when the socialist transformation of private ownership of the means of production was basically completed, until the time when socialist modernization will have been accomplished. This entire period is included in the primary stage of socialism. The basic line of the Chinese Communist Party in building socialism is as follows: to lead the people of all our nationalities in a united, self-reliant, intensive, and pioneering effort to turn China into a prosperous, strong, democratic, and culturally advanced modern socialist country by making economic development while adhering to the four cardinal principles¹⁰⁵ and persisting in reform and the open policy. To fulfill this basic line, we must concentrate on modernization, persist in a comprehensive reform, adhere to the open policy, vigorously develop a planned commodity economy with public ownership playing the dominant role, endeavor to build democracy on the basis of stability and unity, and endeavor to build a society with an advanced culture and ideology under the guidance of Marxism.

103. See Chu, *supra* note 41, at 369-70.

104. See *Quarterly Chronicle and Documentation*, 113 CHINA Q. 144 (1988); *Analysis of China's Socialism in Primary State and Development Strategy*, NEW CHINA Q., Jan. 1988, at 17.

105. The Four Cardinal Principles are: 1) Commitment to Marxism-Leninism Mao Zedong Thought, 2) Leadership of the Chinese Communist Party, 3) Socialism, 4) Dictatorship of the Proletariat.

Ever since the Third Plenary Session of the Eleventh Central Committee in 1978, we have been carrying out a strategic plan for economic development. This plan involves three steps. The first step is to double China's GNP of 1980 and solve the problem of food and clothing for our people. This task has been largely fulfilled. The second step is to double the GNP again by the end of this century, thus enabling our people to lead a fairly comfortable life. The third step is to reach the per capita GNP level of moderately developed countries by the middle of the next century. This will indicate that modernization has been basically accomplished and that our people have begun to enjoy a relatively affluent way of life.

Upon completion of these three steps, China will continue to advance. In our effort to achieve the objective of the second step, we will find many favorable factors as well as quite a few difficulties and contradictions. The crux of all the contradictions is poor economic results. Only by doing sound, practical work to improve economic results and make progress year by year, can difficulties such as China's large population, relative inadequacy of resources, and serious shortage of funds be gradually alleviated, and the reasonably rapid development of the economy ensured. Therefore, we must steadfastly carry out the strategy of steady growth and coordinate development, while emphasizing economic results and improvement of quality. It is certain that, as required by the strategy of social economic development, the financial system will play an increasingly important role in the national economy.

First, banks and other financial institutions have already become major fund-raising channels for China's construction. With the deepening of economic structural reform and the improvement of the people's living standard, social idle funds¹⁰⁶ will gradually increase and the marginal propensity to save in the household sector will also increase. Therefore, intermediate financial institutions will collect increasing amounts of funds which can then be invested in those industries and enterprises that are efficient or that urgently need to be developed as part of the national economy. Funds will accrue by increasing service networks, enhancing quality of service, and competing for deposits. This way, China will begin to solve the shortage of construction funds and promote the adjustment of the economic structure for the purpose of optimizing the distribution of resources. By the third quarter of 1987, the total value of the banks' credit had reached 912.45 billion Renminbi—an extremely large monetary

106. I.e., funds held by the public which are not being put to economic use.

force.¹⁰⁷

Second, a flexible and efficient economic regulation system is forming to guarantee the national economy's smooth and stable development. The methods of financial adjustment are being perfected and are maturing. Monetary policy is becoming increasingly important in the national economy, which is the inevitable result of increasing reforms and the development of the commodity economy. In several decades, China's financial industry will make great progress. Increasingly more functions will be handled by banks, especially the central bank.

Third, no mature and perfect market system can exist without a financial market, and collecting and accumulating funds and regulating the economy would be impossible without one. China's financial market is in its primary stage, but it has already shown its potential for growth. Inter-bank markets, commercial paper markets, short-term bond markets, and long-term investment markets will grow vigorously as the process of reform, commercialization, monetization, and modernization of the national economy progress. It is clear that the inter-bank markets and the short-term bond markets at present have not caught up with economic development. Speeding up reform and establishing long-term investment markets are essential.

Fourth, China will open wider to the outside world in the future. China is a developing country. With the promotion of international specialization, China will gradually enter the world market, take part in international economic and financial exchange, attract and use foreign funds actively, and learn from other countries' experiences. Shortages of construction funds is a long-term problem China now faces in its modernization drive. Although domestic saving is our major source of construction funds, attracting more foreign funds is also included in China's long-term policy. We encourage foreigners to come to China to invest and establish any one of three types of enterprises: foreign enterprises, Chinese-foreign joint ventures, and Chinese-foreign cooperative enterprises. At the same time, we will continue to accumulate funds for China's construction through borrowing from foreign countries and international financial institutions and through issuing foreign-currency bonds in international financial markets.

Fifth, China is becoming a society based on law. Economic and financial activities must be within the law. At present, financial laws are far behind the development of the financial industry. In the long-run, it will be difficult to develop financial business smoothly without

107. JINRONG XIAOXI BAO (Financial News) Oct. 29, 1987, at 1.

a comprehensive legal system. Therefore, the PBC, as the central bank of China, must learn both from practice and foreign experience in order to speed up the process of financial legislation. At present, our task is to draft a set of laws, rules, and regulations related to financial activities. It is estimated that by 1989 the central bank will draft and issue more than 20 regulations, such as "Bond Regulations,"¹⁰⁸ "Stock Issuing and Trade Regulations,"¹⁰⁹ and "Trust and Investment Rules." Among these, some are presently being implemented on a trial basis. After being practiced for some time, they will be amended, then turned into formal regulation systems in the future.

Sixth, China, in need of economic and financial development, will require large numbers of persons who are good at economic and financial management. They should have new ideas, have foresight, and be enthusiastic. As reforms progress, personnel shortages will become more serious while resistance from those holding old views decreases. A group of new entrepreneurs and bankers is urgently needed to staff China's economic and financial development. They will be the promoters and the backbones in China's modernization drive. Modernization will be inhibited without them. Personnel training will be one of the strategic goals in China's primary stage of socialism. In several years, or in several decades, it is certain that large numbers of competent bankers will emerge in China.

As our country pursues its road of overall economic restructuring, it is essential that we pave the way by maximizing our efforts in pursuing banking and financial reforms.

108. See *Guowuyuan Guanyu Jiaqiang Gupiao Zhaijuan Guanli de Tongzhi*, 5 ZHONGGUO JINRONG 16 (1987). For more information about the developing legal framework for bonds, see H. ZHENG, *CHINA'S CIVIL AND COMMERCIAL LAW* 359-63 (1988).

109. For a general discussion of the developing legal framework for stock- and shareholders, see H. ZHENG, *supra* note 108, at 356-59.