4 Intergovernmental Relations and Monetary Management

INTRODUCTION

As pointed out in Chapter 1, fiscal policy in China has virtually played no role in stabilizing the economy since the central fiscal authority has faced increasing fiscal imbalance and was overburdened by other objectives. During the course of the decentralization, the main task for macroeconomic control has been performed by the monetary policy. Unfortunately, the monetary policy has not functioned well: it has failed to stabilize the economy when necessary and, on many occasions, it became the cause of macroeconomic instability. Repeated inflationary pressures occurred during the 15-year reform period, with the retail price index shooting up to 18.7 per cent in 1989 and 21.8 in 1994. At the same time, output has also fluctuated significantly and frequently.

This chapter argues that the central bank *per se* is not to be blamed for the excessive monetary growth that created repeated high inflation; rather, the institutional features of the current central–local monetary relations generate this result endogenously. A central–local monetary game is presented as a theory to explain how regions take advantage of the central bank’s lack of commitment to a pre-announced credit policy by forcing the central bank to revise the credit ceiling upwards, thus creating inflation. This game also explains how reform cycles – the alternating of decentralization and recentralization – over the past decade could be a consequence of the central–local monetary interaction and why reform cycles have coincided with the monetary cycles.

This chapter will also examine the implications of the 1994 monetary reform. This reform, if successfully implemented, will address a number of important drawbacks of the old system that led to the central bank’s weak control over money supply. In particular, the establishment of the new central bank branch system, the centralization of personnel management of the central bank branches and specialized banks, and the separation of policy lending from commercial lending are all in the right direction. Nevertheless, further reforms towards a more independent central bank, the application of indirect measures for monetary control, and the elimination of various structural distortions that led to a conflict of interest between the center and the localities...
will be necessary for an effective monetary management system in the 1990s.

The first section describes the evolution of China’s financial sector development before 1994. The second section provides an overview of the central bank’s monetary control mechanism under the decentralized banking system. The third section presents some evidence of macroeconomic fluctuation and its link with the money supply. Using a game theoretic framework, the fourth section discusses how China’s decentralized banking system has substantially weakened the central bank’s ability to control money supply. The fifth section extends the central–local monetary game to explain reform cycles in China. The sixth and seventh sections look at the 1994 monetary reform and its implications for the central bank’s monetary control. The last section concludes.

FINANCIAL SECTOR DEVELOPMENT BEFORE 1994

Along with the decentralization and market-oriented reforms in other aspects of the economy, China’s banking system has also changed significantly since the early 1980s. Before 1983, most investments in fixed assets were direct transfers or grants from the government budget. In 1983, direct grants were replaced with interest-bearing loans to agriculture, construction, and production enterprises in an attempt to solve the soft-budget problem of state enterprises. Consequently, the banking system gradually became the primary channel through which investments were financed and the central authorities exercised macroeconomic control. At the same time, the importance of budgetary expenditure in economic adjustment has declined rapidly.

Various specialized banks were created or re-established during the 1980s. The Agriculture Bank, the Construction Bank, and the Bank of China were separated from the operations of People’s Bank of China (PBC, or the central bank). Each of these institutions was to provide service to a designated sector in the economy. This approach prevented competition between the banking institutions and required the prospective customers – the peasants, the industrial enterprises, and the trade or foreign-invested companies – to deal with a single institution.

China’s banking system now comprises a wide variety of specialized banks. Under the PBC, the major specialized banks and non-bank institutions are the Agricultural Bank, the Bank of China, the Construction Bank, the Industrial and Commercial Bank, the Rural Credit Cooperative, the Urban Credit Cooperative, the Bank of Communications, the China International Trust and Investment Corporation (CITIC), the Guangda Finance Corporation, and the People’s Insurance Company.