Banking in China: Fiscal Policy Under Pressure

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Banking In China: Fiscal Policy Under Pressure
by Thor Roundy

The radical changes occurring in China can be both exciting and frightening. Attempting to keep in reign a skyrocketing economy, Chinese Leaders such as Liu Hongru and Zhang Wei have become modern day entrepreneurs in creating a new national economy. Like typical entrepreneurs, Chinese leadership is making decisions by the seat of their pants, attempting to control growth under volatile new conditions of reform.

Because of the volatility of reform, a high degree of instability is present in the Chinese system. In the face of inflationary concerns, increasing domestic demands, and the desire to continue economic growth, financial management presents one of the most basic concerns of Chinese leadership. How should the Chinese expand their banking and financial system enough to stimulate continued economic growth without sending the fragile new economy into a downward inflationary spiral?

In order to stimulate economic growth, the Chinese government has increased both the state budget and the money supply. The creation of more banks with greater individual autonomy has added to the monetary growth of China. Effective implementation of a stable fiscal and monetary policy rests in successful management of the new banking and financial system.

Inflationary pressure results from increases in state budgets.

Increases in government expenditure must be financed through
either an increase in taxes and other revenues, an increase in the money supply, or an increase in the issuance of government bonds. While the Chinese government has used increased government spending and investment as a tool to stimulate economic growth, it has also been forced to deal with the several consequences of larger state budgets.

An early concern of the Chinese government in the period from 1966 to 1979 was the ratio of the state budget to the national income. According to an article in Chinese Economic Studies, "excessively high ratios mean that the state budget has absorbed more funds from the national income, causing disproportion in the primary-round distribution of the national income." While low ratios (i.e. a smaller state budget) could potentially limit government investment and administrative ability, the article suggests that larger budgets necessarily require a reduction in worker income and consumption (1).

Budget deficits presented a serious threat to the Chinese economy in 1979 and 1980. According to Chinese economists, the budget deficits were responsible for the increased prices of many commodities. In order to combat the detrimental effects of the budget deficit, the People's Congress reduced the approved deficit from 8 billion yuan in 1980 to 2.72 billion yuan in 1981. Consequent to the reduction in deficit, the retail price index rose only 2.4 percent in 1981 as opposed to 6 percent in 1980 (2).

In 1979, economic reform increase pace within China,
consequently increasing the growth rate of the economy. Indications that China would be unable to sustain its phenomenal increases in economic growth began to appear in late 1984. According to Wu JingLian, "China's state revenue in 1984 showed an increase of 12 percent over the previous year, roughly on par with the 14.2 percent increase in the gross industrial and agricultural output values. On this basis, some comrades believed that China's financial resources could sustain the present exceedingly high rate of growth" (3). The perception of a smooth continuation in growth created a rationale for further economic liberalization which began in the second half of 1984.

Unfortunately, much of the statistical data which produced optimism in 1984 was of questionable validity. As Ekstein reveals in his book, *Quantitative Measures of China's Economic Output*, because price comparisons for goods do not accurately reflect the same values, it is nearly impossible to accurately coordinate the estimates of economic statistical data in divergent areas. By allowing the rate of economic growth to continue, the instability of the economy was increased. The inflation which began in 1985 has continued to worsen to the present.

In 1988 the state budget reached crisis proportions and the rate of inflation doubled from 7.4 percent to 14 percent annually (4). Attempting to combat inflation and increase the government investment stimulus on the economy at the same time, the state investment of 1 Trillion Yuan overcommitted state funds to
investment projects. The allocation of state funds was consequently scaled back, halting projects where money which the state did not have was pumped in and causing many projects to be abandoned half-completed. In response to the need to combat inflation Communist Party general secretary, Zhao Ziyang, delivered a report on September 26, 1988 stating that China would cut investment in fixed assets by 50 billion yuan in 1989, approximately 20 percent of the actual 1988 investment (5).

Monetary policy represents the strongest source of inflationary pressure.

While state budgets have a strong impact on the economic stability of China, the rapid growth of the Chinese money supply represents the real culprit of inflation. While a steady growth in the money supply is important to the stimulation of consumer purchasing, it must be constrained to reflect the growth of real production in the economy. In the United States for example, the Federal Reserve has generally targeted the growth in M1 at 3-7 percent, while GNP has grown at roughly 3-4 percent annually. In China, the money supply for the period of 1986-1987 shot up 18.5 percent, while GNP increased less than 6 percent (6). The Beijing Review reported that the money supply of China had increased at an average of 20 percent per year since 1979 while GNP increased at an average of only 9.4 percent per year. In a 1988 visit to China, Milton Friedman pointed to the financing of government spending and the granting of credit by state banks to
state-owned enterprises as the major reasons behind China's recent monetary growth. "Under any price system," Friedman stated, "there is only one way to control inflation, and that is to curb the rate of monetary growth" (7).

The increase in circulated currency initially helped to find consumers for the new goods in the economy, as the money supply continued to rise, however, the purchasing power of the Renminbi began to be undermined. As Wu JingLian stated in 1985,

"the high purchasing power on the market now is to a large extent the result of stimulation by the excessive issuing of currency in the latter half of last year, particularly in December. Excessive issuing of currency results in the rise of social purchasing power surpassing the increase in supply, and when this reaches a certain point the consumer will rush to by and hoard goods without giving consideration to whether the commodity is suitable for use or whether the price is too high" (8).

As Wu suggests, the stimulation of social consumption through the increase of the money supply leads to an imbalance in supply and demand. As the ratio of currency to available goods increases, price increases and inflation occur. One of the main channels through which the Chinese government has allowed the money supply to increase has been through the banking industry.

Banking reform and growth increases volatility and instability in the Chinese financial system.

Control of the banking industry has always been government's main form of control over the monetary policy of the country. In efforts to support the expanding economy, Chinese officials have allowed for an increase in the number of state banks as well as
the establishment of several private banks. By expanding the banking industry, Chinese officials have indirectly increased the number of loans in the economy and consequently the velocity of money in the system.

The central bank of China, the People's Bank, was created in 1948 (9). The People's Bank originally exercised very tight central control over all financial transactions in China. In addition to the People's Bank there are three major banking institutions: the Bank of China, playing a major role in international finance; the Agricultural Bank of China, later merged with the People's Bank; and the People's Construction Bank of China (10).

In 1979 China began a series of major reforms in the banking industry (11). In 1980 individual banks were given greater power to individually regulate their own decisions (12). In 1986 the Chinese government allowed for the establishment of private banks with minimal supervision over private loans.

An example of the new non-governmental banks in China is the Huitong Urban Cooperative Bank in Chengdu. The bank is owned by stockholders and managed by a board of directors. The local People's Bank has no jurisdiction over the private bank apart from central financial regulation. According to the Beijing Review:

"The bank has 3 million yuan of capital, 50 million yuan in savings deposits and 30 million yuan available for lending. So far, 2000 enterprises have opened accounts with the bank. The bank's predecessor was the Huitong Financial Company, established in February 1985 by Zhang Wei and a few other young economic theoreticians and educationalists. Zhong's aim was to push for
reform of the financial system and collect funds for theoretical research. The company offered loans to private businessmen who could not open accounts with the state banks, and generally helped to supplement state banking activities. In October 1986, the company was reorganized into the Cooperative Bank with support from the provincial government and financial institutions" (13).

Bank loans represent probably the single largest source of pressure for continued rapid expansion of the Chinese economy. As Wu JingLian points out,

"Stimulated by the desire to seek high targets, investment is increased through financial allocation and bank loans; greater investment gives rise to increments in the national income and revenue; with increased revenue, the scale of investment is further expanded with the support of loans; as this cycle goes on, both the construction and the national income rapidly expand until the growth reaches a limit imposed by shortage of supply. At this juncture, the development of the national economy oscillates between the peaks and troughs at an accelerated negative rate. Of course, under the socialist system, we can overcome difficulties by conscious readjustment of the national economy and enable the economy to return to normal. But the steep rise and fall in the form of "leap forward-readjustment" causes too many losses. It is better to adopt necessary preventive measures when the signs begin to show that the economy is "overheated" so as to enable the national economy to maintain stable and appropriate growth rather than launch a major readjustment whenever there is an imbalance" (14).

Wu’s comments regarding the ability of the socialist economy to readjust and correct imbalances is probably overoptimistic. His assertion that growth must be slowed to reasonable levels in order to control reform and continued growth more accurately reflects historical economic data.

The deputy governor of the People’s Bank of China, Liu Hongru, recently reported "that from August 1 to 15, about 7.314 billion yuan were put into circulation, 2.675 billion yuan more than in the same period last year. In the first seven months this year total bank loans increased by 69.64 billion yuan, 44.85
billion yuan more than in the year earlier period. If the sharp increases in currency and credit continue unchecked, they will cause added difficulties for China’s reform next year and it will be hard for the economy to stabilize” (15).

Lower interest rates has a strong inflationary impact on the economy, the demand for money and goods and leading to more shortages and inflation. In August 1988 it was reported that currency in circulation had reached 170 billion yuan, 40 percent greater than in August 1987 (16). As a consequence of the need to combat inflation, "the People's Bank of China, the country's central bank, announced on August 16, 1988 that it would raise both deposit and loan interest rates from September 1 as part of the nation's efforts to stop price rise spiral and attract more savings” (17).

Conclusion: Successful management of reform presents fantastic potential for the future economic presence of China.

The size and growth potential of the Chinese economy indicate that China will become a powerful player in the future of the world economy. While it is difficult to estimate exactly the current or future economic strength of China’s economy, the potential is staggering.

A recent study conducted by RAND Inc. of the United States produced unheard of projections of China’s economic strength. "It also estimated that given an average annual growth rate of 4.6 percent, China's GNP will have surpassed Japan by 2010 to
make it the world's second largest, just behind the United States. Henry Kissinger, Caspar Weinberger and 11 colleagues from America's long-term comprehensive strategy committee showed great interest in this conclusion. Most China experts in America believe it a little too optimistic" (18).

It will be interesting to see how close either the successful or unsuccessful management of new reforms will bring us to the estimates for future Chinese economic power.
Footnotes


3 Wu Jinglian, Hold Down the Growth Rate of the National Economy within an Appropriate Range, Chinese Economic Studies, Volume 19, No. 1, M.E. Sharpe, Inc. Armonk, New York, 1985, p59-60.


8 Wu Jinglian, Hold Down the Growth Rate of the National Economy within an Appropriate Range, Chinese Economic Studies, Volume 19, No. 1, M.E. Sharpe, Inc. Armonk, New York, 1985, p56.


Bibliography


