INERTIA, RESISTENCE AND FORCED INNOVATION: A LONGER VIEW OF CHINA'S RECENT FINANCIAL REFORMS

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ABSTRACT

Gradualist in nature, China's economic reform has been criticized as being wrongly sequenced. Serious problems of inertia and delayed changes, particularly in the macroeconomic and financial spheres have built up since 1979. To rectify the situation, the Chinese government launched in 1994 major reform initiatives covering taxation, central and commercial banking, and the foreign exchange system. This paper looks at the historical background to these financial reforms from the perspective of sequencing and examines the factors behind their partial and uneven successes.

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INTRODUCTION

China launched in 1994 a comprehensive economic reform program that covered the fiscal system, central and commercial banking, foreign exchange, trade, and investment. Against the background of economic overheating at the time, it was a bold step taken by the government to build a more market-oriented economy with effective macroeconomic control mechanisms. One major objective was to restructure the operation of the economy, particularly its financial aspects, and transform the ways through the authorities could exert influence on it. The urgency with which the macroeconomic reforms, which formed the core of the program, were carried out pointed to the problems of inertia and delayed changes that had built up since 1979.

A crucial question about the Chinese economic reform has been that of the proper sequencing of its various facets, given the "gradualist" strategy which is quite distinct from the "shock therapy" approach adopted by Russia and a number of East European countries. A view which is gaining currency is that the Chinese sequencing has been "wrong" and over-decentralization has led to macroeconomic ineffectiveness. It is therefore important that the recent financial reforms be analyzed from the proper historical perspective.

In their review of China's economic reform, Chen, Jefferson and Singh (1992) identify "six key lessons": (1) the importance of having leading sectors; (2) the efficacy of gradual and partial reform; (3) the usefulness of introducing kindred models through the open door policy; (4) the critical distinction between centrally managed reform and bottom-up (or spontaneous) reform; (5) the tendency for flawed macroeconomic institutions and bad policies to obstruct reform; and (6) the need for checks and balances on economic power. China is judged to have performed well in the first four counts, but relatively poorly in the last two.[1]

The Chinese authorities appear to be quite aware of the merits and pitfalls of the country's economic experiments. As if to address the criticisms of Chen *et al.*, important steps relating to lessons (5) and (6) above were taken in the past few years. In 1993, Jiang Zemin, the President and party chief, started an anti-corruption campaign, whose most noted "achievement" up to 1995 was the house arrest of the party boss of Beijing and an overhaul of the ruling body in the capital city. On the other hand, the comprehensive economic reform program was launched in 1994. The intention to significantly change the economic institutional framework was quite obvious.

The partial success of the 1994 reforms has been a vindication to the Chinese government. In any case, such a courageous attempt at transforming the macroeconomic framework came into conflict with several different sets of factors: (1) resistance by parties of vested interests; (2) the lack of commensurate progress at the microeconomic level, e.g., stagnating reform of state enterprises; and (3) economic cyclicality which put pressure on measures that might aggravate inflation or illiquidity and insolvency in the state sector. Some compromises had to be, and were, made.

An analysis of the background to the financial reform initiatives and the results obtained so far, including the twists and turns in the process of decision and implementation as well as the relative success and setbacks of different facets of the program, would generate useful insight on the institutional dynamics and the interaction between politics and economics in the rapidly evolving Chinese economy. I will start by looking at China's overall reform strategy from a historical perspective.

ADMINISTRATIVE DECENTRALIZATION VERSUS ECONOMIC REORGANIZATION

It is well known that China's socialist system has been less monolithic and more decentralized in comparison with the former Soviet Union for various environmental and political reasons. Even before the economic reform, there were two major bouts of "administrative decentralization": in the Great Leap Forward of 1957-58 and in the Cultural Revolution which began in 1966. It therefore came as no surprise that in the economic reform launched in 1978, Beijing was tempted to resort again to administrative decentralization as a mode. The motto was vividly presented as ***fangquan rangli*** ("decentralization of power and transfer of benefits").[2] The major difference with the pre-1978 context was that instead of aiming at revolutionary goals motivated by extremist ideology, Deng Xiaoping was concerned with compensating the masses through increased material incentives.

In any case, the fact that Deng Xiaoping resorted to ***fangquan rangli*** as the key mode of reform reflected an important political dimension. As I have analyzed elsewhere, in launching the economic reform in 1978, the dominant objective of the Chinese Communist Party was to survive and revive after the turmoil of the Cultural Revolution.[3] Top leader Deng Xiaoping viewed the reform as a means to quickly raise the living standard of the masses and to recoup some credibility for the Communist Party. Therefore Beijing was eager to achieve observable results as soon as possible. What could be more gratifying to the Party and the masses to see abundant supplies in the market place and that urban and rural residents became better fed and dressed. Increased work motivation through administrative decentralization seemed able to deliver that result quickly.

In contrast, the reform of macroeconomic control mechanisms and microeconomic organization is a very different story. Such reform is by nature time-consuming and resource consuming, and results are not easily observable, at least in the short run. Few would realize the importance of establishing a strong Finance Ministry or an effective central bank until severe imbalances emerge in the economy, i.e. these macro institutions get their worthy attention by default.[4] As to microeconomic re-organization, the problems are equally, if not more, haunting, as it involves changing people's mode of behavior, rather than just giving them power and material incentives to reduce "X-inefficiency". It also requires the transformation of the way through which economic agents relate to each other.

In economics, the concept of the "production possibility frontier" (PPF) is traditionally used to describe the theoretical output level given a bundle of inputs (capital, land, raw material, management, labor etc.). It assumes that all the input elements, particularly managers and laborers, put forth their "best efforts". In reality, various disincentives exist and "shirking" by managers and workers may prevail, creating "X-inefficiency", i.e. resulting in an output inside rather than on the theoretical PPF. The concept of "X-inefficiency" was pioneered by Leibenstein.[5] It is similar to the concept of "role distance" in sociology, although the latter does not necessarily carry a negative connotation. X-inefficiency can presumably be eliminated through suitable motivation and incentive, bringing the output level back on the PPF.

For the case of China's economic reform, or the reform of any former centrally planned economies, what is at stake is however more than the elimination of "shirking". It involves systematic changes in the behavioral mode of inputs as well as the way economic activities are organized. Metaphorically, it aims at expanding the PPF, pushing it outward (even given the same bundle of inputs). Hence the mere re-gaining of motivation on the part of the managers and the workers is not enough, and there lies the limitation of administrative decentralization and the necessity of economic reorganization.

THE MERITS AND CONSEQUENCES OF *FANGQUAN RANGLI*

While economic reorganization is necessary for systemic transformation, it is costly and requires not only breakthrough but also persistence. Vertical decentralization of administrative power, on the other hand, could generate enhanced incentives in a centrally planned system relatively quickly, but may create unintended long-term problems. The experience in the former Soviet Union and China has pointed to the importance of establishing an optimal mixture and sequencing of these two aspects of economic transition.

In the Chinese reform, administrative decentralization has largely taken the form of the "responsibility system" or "contract system". The typical example of the former is the "household responsibility system" in agriculture, under which the communes were disbanded and peasant households were given back power to make input-output and pricing decisions, provided they fulfill some "responsibilities" first, which consisted largely of production quotas, mandatory or voluntary in nature.[6] Contractual arrangements, on the other hand, were mainly used to define the relations between the state and the enterprises, as well as those between the central government and local authorities. A contract essentially specifies the amount of profits or revenues that the subordinate has to remit to the center (or conversely, the amount that the subordinate can retain), plus some other obligations.[7]

Some have argued that a certain form of vertical division of power, or even "federalist" arrangement, is inevitable in a large economy like China's.[8] Administrative decentralization also has the merit that it is easy to implement because it attacks ***the line of least resistance***. Few, other than ultra-conservatives in the center, would fail to welcome it. Moreover, the results from enhanced incentives may be easily observed. It was particularly useful in spheres where economic restructuring, in terms of behavioral and organization modes, is not so important, and where the key problem is the over-centralization of power rather than a "wrong" or "distorted" mode of operation. Agriculture is a classic example, where labor intensity is usually a crucial factor, out-weighing other considerations (such as investment and technology) which could only be significant in the longer run. China's success in agricultural reforms has been widely noted: agricultural growth doubled in 1978-84, the first phase of reform, compared with the preceding two decades. Chen, Jefferson and Singh (1992) also agree that the "initial success of the agricultural reforms is beyond doubt".[9]

Nevertheless troubles emerged as the same formula of administrative decentralization was applied to urban reforms after 1984. The basic reason is that these spheres require more than just local autonomy, because of the intrinsic inter-relatedness of their operations. In a farming field, increased efforts by peasants as a result of material incentives arising from decentralization can already push up output markedly. After all, peasantry is a relatively "self-sufficient" activity at many levels. However, industrial output cannot be raised so easily, as it requires inputs from many sources (raw materials, energy, semi-processed materials, "intellectual input" in the form of designs and packaging etc.). The demand for its output is also often structural. In the terminology of input-output economists, the ***backward and forward linkage effects*** of industry are much stronger than agriculture. Hence, increased work effort alone would not perform the magic as in agriculture. It requires at least two other complimentary forms of economic re-organization:

(1) Microeconomic changes in ***de jure*** and ***de facto*** ownership, management, and operational behavior.

(2) Macroeconomic changes such as the liberalization of the price system and effective fiscal and monetary control to offset the negative externalities of purely self-interested microeconomic behavior.

The Chinese were aware of these problems even in the 1980s, but the top economists were embroiled in a heated debate of whether enterprise reform or price reform should be implemented first. The government, meanwhile, was cautious on both fronts. The Chinese government did try some financial re-organization at both the micro and macro levels, but without much success. The ***li gui shui*** (tax for profit) reforms of 1983-85 aimed at changing the profit remission system of the state enterprises into a genuine taxation system, while since 1984 the authorities have been struggling to establish a genuine central and commercial banking system along western lines. The former failed quite dismally,[10] and the latter has been facing a lot of difficulties, even up to now.[11]

In the end, both microeconomic and macroeconomic reorganizations were quite limited, while administrative decentralization became the dominant mode of stimulating economic growth. As a result, serious problems existed alongside phenomenal growth momentum. First, acute structural imbalances emerged. To make use of their newly acquired power, local units rushed to build their "small empires". Because of the lack of market discipline or macro coordination, their action led to the "lightening" and "structural duplication" of industries,[12] as they concentrated on the same profitable activities at the same time, albeit each on a relatively small scale. They also indulged in "short-term behavior": seeking maximum immediate profit rather than investing for long-term benefits. Hence, infrastructure, basic industries and the capital goods sector tended to be neglected. Aggravated by unequal profitability due to the uneven pace of the price reforms, which favor the processing and consumer goods sectors, the resource flows were lopsided, creating serious bottlenecks and structural disequilibria in the macro economy.[13]

Second, the unbalanced reform pattern has given rise to the so-called ***zhuhou jingji*** ("economic warlordism"). Wu and Reynolds have warned of the consequence of failing to set up a framework of effective discipline and control before groups of vested interest become powerful.[14] In the pre-1978 system, local authorities and enterprises served largely as passive agents of the center, with little self-identity and self-interest. Therefore, at least in the earlier stages of the economic reform there should have been enough time for the center to re-organize and modernize the control mechanism, without having to face much resistance. In the literature of economic transition, many analysts have stressed the importance of transforming the fiscal and monetary systems before launching the enterprise reform.[15] Unfortunately, for reasons we discussed above, China has not heeded such advice. In other words, the problem has been the wrong sequence of various pieces of "gradual" economic reforms.[16]

FAVORABLE FACTORS: LEARNING BY DOING, HIGH GROWTH, AND PARALLELISM

It is however not wise to exaggerate the adverse legacy of the reforms of the 1980s. Otherwise it would be difficult to adequately explain some of the economic reversals in the first half of the 1990s and the partial success of the financial reforms of 1994.

While short-term behavior led to a relative neglect of infrastructure and the basic sectors under administrative decentralization in the decade after 1979, causing bottlenecks and structural disequilibria, the same cannot be said of the situation in the last few years of the 1990s, when euphoria over infrastructural and capital construction swept the country. Local authorities rushed to build airports, railways, highways, ports and energy plants; turn out grand blueprints on "economic development zones"; and engage in ambitious property projects. This is a very different mode of growth compared with the preceding decade where resources concentrated in light industries.[17]

On the other hand, the problem of excess demand in the consumer goods market, dramatically evidenced by bank run and panic buying in the overheating of 1988, has surprisingly given way to a situation of "market weakness" (***shichang peiruan***), or lackluster sales. The "shortage economy" seems to have been turned into a "surplus economy". This has led to the paradoxical situation of the coexistence of very high inflationary pressure and yet rising saving rate in the 1990s. The retail inflation rate was 13.2% and 21.7% in 1993 and 1994 respectively, but saving deposits rose by 27.9% and 41.5%, representing a real growth of 13.0% and 16.3% during the same periods. These compared with the real GDP growth of 13.5% and 11.8%, and the expansion of retail sales volume of 11.4% and 7.8% in the two years respectively. According to the International Monetary Fund, China's saving rate now is among the highest in the world.

How do we unravel these paradoxical reversals? So far there has not been any systematic, rigorous analysis. I would venture a few hypotheses here. First, administrative decentralization gave local units the chance to make decisions. While they might have been myopic in the initial stages, indulging in "short-term behavior" which maximized their own immediate benefits, they have discovered gradually through "learning by doing" that bottlenecks and structural disequilibria would work against them in the longer run unless they change their behavior. In other words, over a lengthy process of reforms, it is possible for local units with decentralized power to acquire experience and adjust their behavioral norm. Second, the high real growth in the 1980s, averaging 9.3% per year, plus the trend of decentralization which transferred material benefits to localities, means that the latter would have the physical and financial means to modify their behavior and shift investment to long-term projects, reversing to a certain extent the myopia of the previous decade. Indeed, ***chaoqian guihua*** (forward planning) has become the motto in many local regions, from Zhuhai to Chengdu, Dalian to Hainan.

Third, with the high growth of the 1980s, the basic needs of most residents have been satisfied, and the average saving ratio has passed a threshold. Moreover, the observed supply capacity seems adequate and inflationary pressure arises largely from reform measures, market imperfection, as well as short-term factors such as natural disasters and speculation. Hence consumer expectations have been relatively stable, particularly as average incomes have persistently grown faster than the inflation rate. Upgrading of consumption pattern, e.g. towards durables and imported brands, have on the other hand been facing two sets of constraints: (1) income disparity constraints; and (2) infrastructure constraints.[18]

Four, another very important factor affecting domestic behavior has been what I would call "parallelism", whose external counterpart is the open policy. Internally, Beijing has allowed, alongside the state sector, the parallel development of the "collective" and the "individual" sectors, whose aggregate contribution to GDP began to overtake that of the state sector in the 1990s. Relatively less hindered by bureaucratic planning, these sectors have generated useful pressure on the state sector, forcing it to change. The importance of the foreign sector also needs little emphasis. In 1979-93, China's total trade valued in U.S. dollars increased by 567.3%, and the total values of committed and actually utilized foreign funds amounted to 314.373 and 137.79 billion U.S. dollars respectively. In 1994, foreign investments in China reached 33.7 billion U.S. dollars, against a total fixed asset investment of Renminbi 1592.6 billion. At the average of about Rmb8.55/US$ for the newly unified exchange rate, the share of foreign investments would be as high as 18%. On the other hand, gross output by foreign-invested enterprises (FIEs) was estimated to be 11% of the national total (***Guoji Shangbao***, 1 April 1995). These "parallel models" have created significant competitive pressure and demonstration effect on the state-owned sectors. Hence the latter's behavior has not remained intact.

DELAYED CHANGES AND FORCED INNOVATION

In any case, genuine problems and difficulties existed before the reforms of 1994, and they were related to the lack of economic re-organization and the perceived weakening of effective control from the center. The favorable factors analyzed in Section 4 also created some adverse side effects, e.g. the drive to invest in infrastructure and "forward planning" by localities has led to serious competition for and diversion of funds, which has further undermined the center's fiscal and monetary resources.

In other words, while learning by doing and the benign effects of both high growth and parallelism have led to some appropriate changes at the microeconomic level, the contradictions at the macro level have continued to accumulate. Such an unbalanced development has given rise to serious tensions, and there is no doubt an urgent need to rectify it. The financial reforms of 1994 were undoubtedly a bold attempt. Its mixed success points to an important conclusion: the achievements of the past 15 years of reforms are both a blessing and a curse. Let us start with the most impressive reform: the foreign exchange reform, before looking at the fiscal reform and, lastly, the least successful one---the banking reform. The criteria for success are of course debatable. I shall have more to say later.

FOREIGN EXCHANGE REFORM

The foreign exchange reform was the most progressive among the reforms of 1994, in both conception and practice. The pledge to unify the dual (official and swap) exchange rates within five years was made by top officials in early 1993, apparently as concession to speed up GATT re-entry. In the second half of the year, however, a much more radical proposal---to merge in 1994---rapidly gained currency. Then in late 1993, the government unveiled a reform package, whose major features included the unification of rates, the enhancement of the degree of current-account convertibility, and the transformation of the foreign currency trading system into a bank-based market.[19]

Although it did not constitute a "shock therapy" like that adopted by Poland, Russia or Bulgaria, this "three-in-one" reform package was more advanced than most had recommended or expected. Before its actual implementation, there were worries as to whether China had sufficient foreign exchange reserves and possessed the necessary macroeconomic instruments to stabilize a unified and liberalized Renminbi in a bank-based trading system, particularly as inflation remained unabated. Whether there were sufficient bank employees with adequate knowledge and expertise to operate the new system and prevent leakage at the branch level also posed as a question. Nevertheless, while some "watering-down" did occur, the new regime turned out to be surprisingly stable and the Renminbi actually strengthened in the course of 1994, in contrast to pessimistic forecasts. Overall, the reform combined three important separate moves into one single package:

(1) The unification of the dual exchange rates by abandoning the official rate.

(2) The abolition of the foreign exchange retention arrangements and the institution of a forced settlement system, compensated by the enhancement of the degree of current-account convertibility of the Renminbi through the elimination of foreign exchange

authorization and rationing for domestic enterprises and units.

(3) The transformation of currency trading system into a bank-based market: the swap centers were replaced by a network of designated foreign exchange bank branches which became mini-trading centers authorized to offer quotes within the limits set by the central bank: the People's Bank of China (PBC).

In essence, each of these three measures was an ***independent*** policy choice. The dual rates could be unified without any impact on convertibility. After all, China had a unified exchange rate before 1980 and in 1985-86, when convertibility was low. If convertibility should be enhanced, it was not necessary to abolish the swap centers and opt for bank-based currency trading. In fact, the mainstream recommendations in the few years preceding 1994 focused on the unification of the dual rates plus the enhancement of convertibility through liberalizing the monitoring procedures in the swap centers as well as expanding their scope and functions.[20] The establishment of a system of bank-based currency trading to replace the swap centers has been the most important step forward. It was not widely advocated at all in 1992-93, as the task of monitoring thousands of bank branches looked very demanding compared with the job of taking care of 100-odd swap centers.

The new system came into full operation on 1 April 1994 after a 3-month transition. The extent of liberalization turned out to be less than that proclaimed by some officials and their advisors before actual launching. In the first quarter of 1994, for example, officials gave the impression that trading in all swap centers would be terminated on 1 April 1994. It turned out that they were reserved for foreign-invested enterprises (FIEs), while domestic enterprises and units had to turn to the banks. Those who wrongly expected "free floating and convertibility" also faced an anti-climax.[21] The range of "float" around the "middle rate" fixed by the PBC was fixed at only 0.25% on either side---very narrow indeed. However, one very important point to note is that such "watering down" was not a result of strong resistance by any major parties. It rather reflected technical caution on the part of the monetary authority and the FIEs.[22]

Defying all pessimistic forecasts, the Renminbi showed remarkable strength under the new system. On 4 April 1994, the first trading day, the Chinese currency was sold at Rmb 8.6967/US$. It later continued to strengthen and ended 1994 at 8.4462 and was quoted around the 8.320 level by the end of August 1995. The rates offered by banks and financial companies in Hong Kong were very close to these prices, showing that the Chinese rates were at least regarded as reasonable by the offshore free market, which was legitimized by the decision of the Chinese government in March 1993 to allow Chinese citizens to bring each an amount of Rmb 6,000 out of the country.

The stability of the Chinese currency in the new system is a testimony to the success of the reform. The major reasons include: (1) the large depreciation preceding the reform and implied by the unification; (2) relatively tight monetary policy; (3) the fact that the exchange rate has not been out of tune with the average foreign exchange cost of exports (***huanhuai chengben***) for Chinese enterprises; and (4) the very impressive rise in the foreign exchange reserve of China, which went up from about US$200 billion to US$51.6 billion in 1994, representing an increase of US$30.4 billion within a short time span of twelve months.[23] By the end of June 1995, it even rose to US$62.66 billion.

Such a satisfactory result has apparently encouraged the financial authorities in China. They seem to be increasingly optimistic about the prospect of full convertibility for the Renminbi. In early 1993 Vice Premier Zhu Rongji said that the Renminbi could become fully convertible only when China's foreign exchange reserve reached the US$100 billion level. Many economists held the view that a 10-year transition was probably needed. However, in an interview with the Xinhua News Agency in March 1994,[24] the Director of the State Administration for Exchange Control (SAEC), Zhu Xiaohua, said that "China will strive to achieve the full convertibility of the Renminbi in the current account within six years". Then reports in late 1994 had it that a Vice President of the PBC, Chen Yuan, "optimistically estimated" that the Renminbi could be turned into a "convertible" currency by 1998, "two years ahead of the schedule".[25]

FISCAL REFORM

In comparison, the fiscal reform has faced more problems. The pre-1979 fiscal system was very centralized and provided little motivation for local governments and enterprises to enhance efficiency. Unfortunately, reform attempts in the 1980s produced little results. The failure of the ***li gai shui*** (tax for profit) reform of 1983-85 to establish an effective direct tax scheme for enterprises was especially noteworthy. Overall, the fiscal system remained arbitrary in design, inefficient and inequitable in functioning, as taxes and charges payable were often open to negotiations between the enterprises, local governments and the central government. Authorities often resorted to various kinds of ***ad hoc*** measures and administrative arrangements in the form of "contracts" to cater for the lack of economic reorganization, the uneven pace of reform, as well as the diversity in the country. In the worse case, the fiscal system degenerated into a situation of ***yihu yilui*** ("one tax rate for one enterprise").[26]

Another outstanding issue relating to our discussion of the relative merit of China's peculiar reform strategy has been that of "fiscal decline". The pre-reform taxation system was heavily dependent on the revenue of the industrial sector, which was mostly state-owned and whose profit artificially boosted through price control. Yet, in the age of "parallelism" when non-state-owned enterprises flourished and the monopoly of state industries was significantly weakened, the state's tax base has been progressively eroded. Even within the state sector, reforms have been implemented to decentralize financial resources to the enterprises, particularly through "extrabudgetary" funds, which grew to almost the same size as total budgetary revenue by 1992. Local authorities, on the other hand, were often eager to provide tax exemptions and holiday to enterprises and overseas investors to boost economic activities under its control. The result was a marked decline in the ratio of budgetary revenue to GNP, which according to our calculation went down from 31.6% in 1978 to 14.1% in 1993 on an adjusted basis.[27] The share of the central government in total fiscal revenue also showed a secular down trend: from about 70% in the 1950s, to 60% in the 1960, and to 40% in the early 1990s.[28] These are often quoted as the most vivid pieces of evidence of ***zhuhou jingji***.

To give a more balanced picture, I have to point out that there are some doubts as to whether the Chinese government's "fiscal health" has been so poor, particularly on the part of the central authority. Despite the decline in the ratio to GNP, both fiscal revenue and expenditure showed substantial real growth in 1978-91, at an average annual rate of 3.2% and 4.8% respectively. The World Bank also argues in a report that among the extrabudgetary funds, the revenues of local finance bureaus and administrative and nonprofit units, which averaged 20% to 30% of the extrabudgetary total in recent years, should be considered fiscal revenue. In its adjusted figures, the government's revenue share fell from 36.8% in 1978 to 26% in 1990. The Bank goes on to argue that a 26% share of GNP is comparable with the share of other Asian developing countries which averaged 27.0% in 1988.[29] Concurrent with the decline in revenue, there has also been a consistent trend of delegating expenditure responsibilities to the local governments and the enterprises, which have had to shoulder an increasing economic and social burden.

In any case, a simple comparison of revenue ratios might not fully reveal the full problem of declining fiscal control. China is after all still a "socialist" country, unlike most of the Asian countries. Equally troublesome for the government has been the widening budget deficit. Since 1979, a deficit has been registered in every year. While financial resources and major expenditure responsibilities have been continuously decentralized, the need to spend more in specific areas and to facilitate the reform process has been increasing, e.g. the huge amount of price subsidies which were mostly related to food items. In 1993, the budget deficit was as large as 12.7% of total revenue. Moreover, the deficits have basically been incurred by the central government. According to recently released official statistics, the cumulative deficit for the central government in 1979-1991 was 114.795 billion yuan, while a cumulative surplus of 6.521 billion yuan was recorded for local governments.[30] Another source has it that the cumulative deficit for the central government in 1979-93 reached 180 billion yuan.[31]

Hence, Beijing felt an urgent need to rectify the situation. In paragraph 18 of the ***Decision*** document of the Third Plenum of the 14th Party Congress in November 1993, the overall thinking on fiscal reform was summarized. Due to the limitation of space, we will discuss here one of the most important aspects of the reform: central-local fiscal arrangements.[32]

Up to 1993, central-local revenue arrangements in China were supposedly dominated by the fiscal contract (***baogan***) system, which could be classified into two major subsystems: (1) a fixed or adjusted quota scheme applied to provinces such as Guangdong and Fujian, under which the local government remitted to (or received from) the central government a fixed amount of revenue (subsidy) which could be adjusted upwards by a rate of acceleration; and (2) a proportional sharing arrangement under which the central and local authorities divided revenue according to a pre-set ratio. By mid-1980s, the proportional sharing scheme was applied to most localities. Yet a few of them, most notably Shanghai, shifted to the fixed or adjusted quota arrangement in the late 1980s after they had consistently protested of getting too little fiscal resources compared with Guangdong. In any case, both systems have been criticized by economists as generating distorting economic effects because they induce strategic behavior on the part of the local governments, which may run counter to national interests.[33]

In 1994, a ***fen shui zhi*** (tax assignment system) was implemented and it divided taxes into three categories: central taxes, local taxes, and shared taxes between central and local governments. At the same time, a tax collection system for the central government was established at the localities.. A manifest goal was to move from the central-local tax revenue ratio of about 40:60 in 1993 to that of 60:40, which is more in line with the pattern in most other countries.[34] In fact, a "tax division system" existed as early as 1980 for the majority of provinces and was revived in the reform of 1985. However, the division between "central fixed revenues" and "local fixed revenues" was somewhat arbitrary and subject to bargaining. The "baogan" and the "proportional sharing" systems of contracted revenue sharing therefore became the key to settle central-local interests.[35] The 1994 reform was intended to rectify the situation and rationalize intergovernmental fiscal relations.

To enforce a genuine tax assignment system in the era of ***zhuhou jingji*** when local authorities were becoming increasingly powerful and vocal was a relatively bold attempt, although the strains on the fiscal position of the central government left it with few alternatives. It appears though that in the actual bargaining on the detailed formula of the assignment and sharing of taxes, Beijing was forced to make compromises. Right after the Plenum in November 1993, the Finance Minister, Liu Zhongli, told reporters that the "tax assignment system" would be implemented in a "slow-moving, step by step manner" (***huanhuan er xing, fenbu tuijin***). "Local interests" would be "guaranteed" as "the increase in the share of central fiscal revenue would only be gradually obtained from the growth in taxes from now on."[36]

The "guarantee" of local interests was to be effected through a complicated scheme of tax rebates to local governments, under which increased taxes for the central authority would come only from additional revenue. The basic motivation was to reduce local resistance. 1993 was fixed as the "base year" for the rebate. The new assignment system implied that the taxes collected by local and central tax authorities would be re-accrued according to the agreed divisions of specified tax types and the central-local ratios of the shared taxes. A net transfer of revenue by the local authorities to the central government was likely for most if not all cases in the collection-accrual adjustment process. The amount of such a warranted transfer for the final accounts of 1993 was called the ***jishu*** (base amount). To safeguard vested interests, it was rebated to the local authority in total. In other words, as far as 1993 was concerned, the local authority fared the same under the new arrangements, compared with old the baogan system. In other words, the central government obtained no benefit at all in 1993 for the tax changes.

For 1994 and beyond, the sum of rebate would be adjusted by a coefficient of 1:0.3 on the basis of the national average growth rate of two taxes: consumption tax (a central tax) and value added tax (a shared tax). If the revenue from those two taxes goes up by a national average of 1%, the rebate would be increased by 0.3% on top of the ***jishu***. Should the calculated net remittance to the central government in any year from 1994 onwards fall below the ***jishu*** of the preceding year, the rebate to the local authority would simply be the actual net amount so calculated.[37]

The reform of central-local fiscal arrangements has thus turned out to be a compromise solution. The "double-track" arrangements involving rebates would ensure that the shift in central-local ratio is achieved through the growth in tax revenue, while the stock of revenue distribution is kept intact. It is unclear when the target ratio of 60:40 for central-local tax revenue would be realized and the rebate arrangement abolished under such a program although some mentioned the possibility of year 2000. A World Bank projection however estimates that only 52% of fiscal revenue would be accrued to the center in that year.[38] Moreover, in its rush to push through tax assignments to alleviate its fiscal problems, Beijing has sidestepped the long-term objective of rationalizing rights and responsibilities. The system has not been augmented by any clear demarcation of the responsibilities of the central and the local governments.[39] Such an asymmetry between rights (tax assignments) and (expenditure) responsibilities may lead to instability in the system, as different parties would contest about the tax assignments in the future, when problems and arguments arise on the expenditure side.

On the surface, the central leadership also made a curious move on the determination of tax rebates. Bargaining on the formula apparently went on throughout the summer of 1993 and was concluded around September. When it emerged that 1993 would be used as the base year, local authorities used all kinds of methods to increase revenue to push up the ***jishu***, in order to secure a larger amount of tax rebate in 1994 and beyond. Guangdong was a dramatic example. In January - July 1993, total budgetary revenue in the province rose 31% over the same period in 1992. In the remaining months, the growth rate climbed rapidly and reached 146% in December.[40] A more rational step by Beijing seems to be to use 1992 as the base year, so that no such strategic behavior could occur. However, one could also interpret the apparently "irrational" move as a deliberate one, which allowed local authorities some room to maneuver, hence reducing their resistance to the new system. In actual implementation, the government also made another compromise to placate local interests. Instead of using the ***national*** average growth rate of both the consumption and value-added taxes in the adjustment coefficient of 1:0.3 in the rebate system, as previously announced, the ***provincial*** growth rate of the consumption tax was used, which varied from province to province.[41]

BANKING REFORM

Compared with the foreign exchange and fiscal reforms, the banking reform of 1994 was obviously the least ambitious and has so far achieved the least. China had been struggling to build an modernized central and commercial banking system since 1984, but to little avail up to 1993. A key problem was what I have called the "financial fragility" of the Chinese banking system.[42] Elsewhere, I presented a comparison of the aggregate balance sheet of the four specialized banks in 1988 and 1993, which showed fundamental weakness in their operation.[43] Above all, they depended too heavily on the central bank, the People's Bank of China (PBC), for funding. In 1988, their net liabilities to the PBC amounted to Rmb 217.61 billion, or 17.95% of their total assets, and were vital in bridging the huge loan-deposit gap of Rmb 355.96 billion, which represented 29.36% of total liabilities. The situation improved somewhat by the end of 1993. Net liabilities to the PBC equaled 13.87% of total assets while the loan-deposit gap was 13.0% of total liabilities. Nevertheless, the aggregate balance sheet still looked precarious.

Moreover, unlike the commercial banks in a market economy, over 70% of the specialized banks' funds were lent out as loans, rather than diversified into a portfolio of assets with different degrees of liquidity, risk, and returns. A related problem was that a substantial portion of the loans was "policy loans"[44] with very low liquidity and, if any, low returns, and many "commercial" loans extended to ambitious investment projects and speculative activities also faced repayment difficulties. According to some estimates, as much as 30% of the total outstanding loans of the banking system could be regarded as at risk in 1993.[45]

The fact that such a muddled financial state could exist is a testimony to the lack of economic reorganization that clearly defines rights and responsibilities, backed by genuine sanctions. Chinese banks and their clients were not particularly bothered by the implications of credit risks, because they knew that the consequences of any failure or default would not bite. Facing such a fragile financial structure of the banking system, the PBC has been caught in a dilemma. The evolution from the initial "gap control" in 1984-85 to the later system of reserve requirement and relending did not markedly change the situation. Any serious tightening by the PBC would have severe impact as there were very little liquid assets out of which the banks could switch. To return to equilibrium, the banks had few alternatives other than cutting new lending and demanding enterprises to repay outstanding loans. This would generate drastic knock-on effects in the economy as a whole. It was one of the key reasons why the PBC was reluctant to clamp down unless things were really out of control. To get out of the dilemma, it has become obvious that real reforms in the central and commercial banking systems must be implemented.

The 1994 banking reforms were also related to the problems in the financial scene in the preceding two years. Financial disorder had become rampant by the first half of 1993 as the "Deng whirlwind" of 1992 ignited local expansionism and euphoria. Huge amounts of funds were irregularly channeled to long-term projects such as the economic development zones (EDZs) and property developments, as well as short-run speculation in the stock and futures markets (together constituting the so called "three new fevers"---***xin san re***). At the same time, there was an upsurge of the activities of non-bank financial institutions (NBFIs). Unauthorized borrowing and lending, involving NBFIs, had become widespread since 1992, and many of these NBFIs were established by local branches of specialized banks as a vehicle to bypass central scrutiny. The frantic scramble for funds reached a climax in 1993. On the one hand, there was a rapid expansion of direct fund-raising by enterprises. On the other, a massive decline of bank deposits was observed, as many NBFIs illegally raised interest rates to attract deposits, and underground banks and funds operators charged exorbitant lending rates, some even on a daily basis. The liquidity position of many local branches of the specialized banks was heading for crisis.[46]

Hence Beijing felt a strong need to do something to restore financial order. A 16-point program was launched in late June 1993, and over half of the measures were administrative in nature. With hindsight, it appears that the Chinese authorities had made up their mind then that some banking reforms must also be pushed through, otherwise the problems would simply recur in the future. An economist from PBC has confirmed that in the National Finance Working Conference chaired by Vice Premier Zhu Rongji in July 1993 a consensus was reached that the problems of financial disorder could only be solved by the deepening of institutional reforms. After the conference, other than implementing measures to clamp down on malpractice, the formulation of the proposals on financial reforms also passed from a stage of "nurturing" into one of substantial drafting and revision.[47]

As to the blueprint to follow, a series of reports by the World Bank on options of monetary reforms[48] were well echoed within China. A popular view was to address the problems of balance-sheet fragility and the lack of autonomy of the specialized banks by shifting the "policy loans" in their portfolio to newly established, non-profit-seeking financial institutions. Having shed the burdens of loans of low viability and returns, the truly "commercialized" banks would behave more rationally, while the "policy banks" could get on with their specific functions. An alternative transitional measure was to have two separate balance sheets for the two types of loans extended by the specialized bank.[49] Competition might be promoted by allowing a larger number of banks to be set up, particularly at local levels, while more markets should be established to widen and deepen the financial system. Moreover, the effectiveness of the PBC ought to be strengthened through the enhancement of its status and autonomy in the political hierarchy, the development of more monetary instruments, and the liberalization of interest rates.

The resolution of the Third Plenum of the Fourteenth Central Committee of the Communist Party of China in November 1993 turned out to be relatively cautious in tone. In paragraph 19, the ***Decision*** summarized the financial reforms to be implemented, which had few surprises, looked vague, and refrained from giving a specific timetable. It emphasized the need to establish an effective central banking system which adopted modern measures such as reserve ratio on deposits, the PBC's lending rate, and open market operations to replace administrative credit control. It talked about the setting up of a "monetary policy committee" for the timely adjustment of monetary and credit policies, but gave no clues on its structure and functions.

Contrary to the suggestion of some commentators, the ***Decision*** did not stipulate the closure of all provincial and district branches of the PBC. That was a radical proposal intended to sever the link between the PBC branches and parties of vested interests at the local level.[50] Instead, the document said that "the branches of the People's Bank of China are clarified as agencies of the head office, and active efforts should be made to create conditions for setting up trans-regional branches". While "policy banks" were to be formed, the "specialized banks should gradually change into commercial banks, and, when necessary, rural and urban cooperative banks should be set up step by step". No significant liberalization of interest rates was proposed, but the "central bank should make timely readjustments of the benchmark interest rate and allow the deposit and loan interest rates of commercial banks to float freely within a specified range." All in all, despite the desire for breakthrough, the Chinese authority was careful not to become adventurist.

The cautious stance was reinforced by the overheating of the Chinese economy, stirred by the "Deng whirlwind". In the course of 1994, the PBC had to walk the tightrope of putting a lid on rising inflation on the one hand, and injecting funds to help ailing state enterprises and to pacify grunting farmers on the other. It should not be surprising that marked progress in the reform of the banking system and the establishment of modernized, flexible, but effective monetary control would be difficult. In any case, some steps were taken, including those at the top layer of the hierarchy. The internal control mechanism of the central bank was re-centralized, with the abolition of the credit granting power of its branches[51] as well as the profit-retention system. The link between fiscal deficit and monetary expansion was severed, as the Finance Ministry had to issue bonds to cover its revenue shortfall instead of borrowing from the PBC.[52]

Three "policy banks" were established, as promised. They were: (1) The China State Development Bank (SDB); (2) The China Import and Export Bank (IEB); and (3) The China Agricultural Development Bank (ADB); which officially started functioning in April, July and November of 1994 respectively. As I have commented elsewhere,[53] several points should be noted. First, the initially planned equity of the three policy banks, at Rmb 73.4 billion, was less than half of the combined capital of the four specialized banks at the end of 1993, which stood at Rmb 154.33 billion. Second, other than the ADB, the SDB and IEB could only top up their capital by issuing bonds and borrowing from domestic and financial institutions, rather than collecting deposits. Their funding sources were therefore limited. Third, the total lending of the policy banks, at least for the immediate future, looked small compared with the outstanding loan balance of the specialized banks.

Given such operational sizes of the policy banks, the commercialization of the specialized banks would face major constraints. While the classification of "policy loans" and "non-policy" or "commercial" loans met few theoretical barriers, and, according to a source of the author, was completed by June 1994, the transfer of ***existing*** policy loans form the specialized to the policy banks was an different story. Assuming a 20% overall ratio, they would exceed Rmb 520 billion in 1994. Not all of these policy loans were "bad" or "doubtful", but it is likely that a substantial portion of them could be "non-performing", at least in the short run. How to apportion the burden is clearly a political as well as economic issue.[54]

All in all, the problem is one of absorbing bad-quality loans in a banking system with low liquidity and facing problems of solvency. A Vice President of the PBC, Chen Yuan, recently disclosed that the ratio of problematic debts in the four specialized banks was about 20%, but actual bad debts constituted only 3%. On the other hand, another survey published by ***Guangming Ribao*** put the ratio of loans in arrear in the banking system as more than one-third.[55] Unless huge amounts of new capital and funds can be raised or massive write-offs are acceptable, the only choice is go slowly, in the hope that high growth could provide the cushion and costs might be distributed in an agreeable manner among various parties of vested interests. Another possibility is to establish cross-shareholding between the policy and the specialized banks to even out the costs and benefits of the transition, but the evaluation of their asset values and share prices presents serious technical and political problems.[56] The Chinese authority has not taken that course. One of the reasons might have been that it would be very troublesome to engage in such a bargaining process in 1994 when so many things were happening.

As for the "commercialization of the state banks", the only major step taken in 1994 was the implementation of an "asset and liability ratio management system", as summarized in Table 1, which was regarded as temporary and transitional given "the specific situations" in China.[57]

Table 1

Stipulated Asset and Liability Ratios for Commercial banks

Loan/deposit ratios		
1.	Loan/deposit ratio	≤ 75%
2.	Incremental loan/deposit ratio	≤ 75%
3.	Long and medium-term loan/deposit ratio (of maturity of one year or more)	≤ 120%
Liquidity ratios		
4.	Liquid asset/liability ratio (of maturity of one month or less)	≥ 25%
5.	Excess reserve ratio	≥ 5-7%
Concentration ratios		
6.	Single customer loan ratio	≤ 15%
7.	Ten largest customers loan ratio	≤ 50%
8.	Shareholder loan ratio	≤ 100%
Interbank ratios		
9.	Interbank borrowing ratio	≤ 4%
10.	Interbank lending ratio	≤ 8%
Loan quality indicators		
11.	Overdue loan ratio	≤ 8%
12.	Non-performing loan ratio	≤ 4%
13.	Bad loan ratio	≤ 2%
Capital adequacy ratios		
14.	Capital adequacy ratio	≥ 8%
15.	Core capital adequacy ratio	≥ 4%

Sources: Adapted from Mao Hungjun, ***Zhongguo Jinrong Tizhi Gaige Xin Juicuo*** (New Measures in the Financial System Reform in China), Beijing University Press, July 1994, pp.109-125; and HongkongBank China Services Limited, ***China Monthly Report***, November 1994, pp.15-16.

The incremental loan/deposit ratio (i.e. the increase in loans divided by the increase in deposits) was applicable only to the four state banks, while the loan-deposit ratio (i.e. the outstanding balance in loans as a percentage of the outstanding balance in deposits) was to be followed the Bank of Communications and other commercial and joint venture banks (totally nine). Such a differential treatment was a concession to the problem of financial fragility of the specialist banks. The aggregate loan-deposit ratio of the four banks was 120.9% at the end of 1993. It would almost be impossible to bring their ratio down to 75% any time soon. On the other hand, the range of the excess reserve ratios (≥ 5-7%) would give the PBC some flexibility to cater for the different banking situations.

Ratio restrictions on interbank borrowing and lending are seldom seen in the West. They were supposed to constrain the practice by banks to borrow short from the interbank market and lend long to customers, neglecting the risks of illiquidity---a practice which threw the financial system in chaos in 1992-93. As to the loan quality indicators, they were fixed "after considering the average quality levels of existing loans in the country" and might be tightened with the improvement of the operation of the commercial banks.[58] Lastly, it was recognized that it would be difficult for the banks to fulfill the capital adequacy ratios in a short time. Improvement by stages was explicitly allowed, but a deadline by the end of 1996 was stipulated.[59]

In sum, there was a high degree of "softness" in the asset and liability ratio management system, whose "Chinese characteristics" were quite outstanding. At the same time, due to the need to dampen inflation and the poor operational situation of the specialized banks, the PBC was concerned not to give the banks too much freedom immediately. Administrative instructions on loans (e.g. working capital loans for the ailing state sector) were frequently resorted to. Moreover, loans for fixed asset investments were put explicitly under mandatory plans in 1994.[60]

CONCLUSION

China's special mode of economic reform, in comparison with the "big bang" or "shock therapy" practiced by Russia and Eastern Europe, has been a subject of intense scrutiny and considerable controversy. While few would deny its relative success so far, the peculiar form of gradualism or partial reforms is also widely viewed as beset with the problems of "wrong sequencing" and the lack of genuine economic reorganization which effectively transform behavioral norms and social relationship. Administrative decentralization has allegedly given rise to a situation of "economic warlordism" (***zhuhou jingji***), under which parties of newly formed or vested interests vie for more power and other concessions from the central government, but resist the latter's command. The central government finds itself caught in a vicious circle of decentralization and decline in authority and resource. Worst still, since any economic boom has been, on the surface at least, the result of decentralization, the only contribution of the central government is perceived to be negative in nature, i.e. by letting go its power and keeping its hands off the localities. In the extreme, Beijing could be viewed as an increasingly irrelevant obstacle.[61]

Judging on the basis of the financial reforms of 1994 and their aftermath, one could fairly say that China has not reached that stage of irrelevance. The favorable factors that we discussed in Section 4, including learning by doing, high growth, and parallelism, may have contributed to the formation of a more positive atmosphere, under which major attempts at economic reorganization become possible even at a "late" stage, if the central authorities pursue them with tact. The cumulative problems in China are no doubt serious, but have not reached a crisis. They could still be solved, although a drawn out process of hard bargaining would be necessary and in the actual implementation, compromises seem inevitable.

The doomsday scenario of "economic warlordism" and regional breakup of China looks overplayed. While no one can rule out such a possibility, particularly in the present era of post-Deng transition and increasing tension with Taiwan and the U.S., it nevertheless does not appear very likely. A key factor is that after more than a decade of high growth, the "warlords" or various parties of vested interests in China now are basically fighting ***not*** for survival, but for a ***better*** life. At the same time, unlike the situation in the some parts of the former Soviet Union and Eastern Europe, there are no fundamental ideological, ethnic or religious conflicts among the ***zhuhou's***. Overall, their propensity to act compulsively or desperately should not be unduly high. To use an analogy: if one wants to have a color television set to replace one's antiquated black-and-white model, one would not resort to killing to attain one's goal. High growth rates are therefore an effective buffer against political disintegration. This is not say that localized disturbances in some of the poorer regions and various forms of local misbehavior, social dissent and political jittery would not occur. But they are probably manageable.

While the doomsday prophecy seems too pessimistic, the fact that only partial success has been achieved in the reforms of 1994 also points to the seriousness of the cumulative problems of inertia and delayed changes. Most commentators would agree that among the three major facets of the program, the foreign exchange reform has been the most successful, followed by the fiscal reform, and lastly the banking reform. Such a judgment, though accurate, may however be unfair, as each reform has to deal with different hurdles and difficulties and is affected by dissimilar factors.

In any case, the degree of success seems to have been negatively correlated with the level of resistance that the reform produced. The achievements of the foreign exchange reform pleasantly exceeded the mainstream recommendations in the pre-1994 period and defied pessimistic forecasts about its viability in a period of double-digit inflation. The reasons are multiple and I have analyzed them above. But the fact that the experiment could be pushed through with relative ease despite explicit worries in many quarters might be because opposition to it was diffused and unorganized. The exchange rate is no more than a price of the home currency against foreign monies. Transforming its formation and trading mechanisms would meet less resistance as it intrudes less into specific interests, a point which Lal emphasizes in advocating the priority of price reform in China.[62] Few would say that the reform was targeted at them.

The same cannot be said about the fiscal reform, particularly the tax assignment system, as redistribution of financial resource was a manifest objective. The government was forced to adopt (or wisely enough to initiate) "sweeteners" in its attempt to transform the status quo, at the expense of a quicker resolution of the center's fiscal problems. Some key issues have also been sidetracked. The adopted system is half-baked but to a certain extent innovative, full of "Chinese characteristics". Finally, the operation of the banking sector is even more fundamentally interwoven with that of the whole economy, particularly the state sector. Its financial fragility is almost a mirror image of that of the enterprises that it has been sustaining. Resistance to changes that imply short-term erosion of interests is therefore very widely spread. Both practical and sociopolitical considerations dictate that a relatively long process is needed to sort out the financial mess, which is an indication of the lack of economic reorganization in the crucial aspects. This is not to mention the fact that the Chinese government was forced to resort to administrative means to keep inflation from bursting through the seam in its stop-go monetary policy, whose effectiveness was of course far from perfect. Against this background, though, one cannot simply brush aside the banking reform measures actually implemented in 1994 as totally insignificant.

Taking a longer view, one has to come to the conclusion that the reform program of 1994 was of a significantly different kind compared with past attempts, in that much greater emphasis was placed on achieving breakthrough in key areas, on top of macroeconomic balancing. It represented a major shift in government strategy and policy, partly as a result of greater confidence after a decade of relatively successful reforms, and partly because the problems arising from procrastination had become too pressing.

The timing of the reform package---in the third year of overheating since the "Deng whirlwind" of 1992---was apparently ill conceived, as an earlier launch seems more rational. It should therefore not be surprising that there have been twists and turns in the government's position along the way, when bold proclamations were later offset by explicit or tacit backtracking in response to protestations by powerful parties or unexpected hurdles in reality. This kind of institutional uncertainty will probably persist for some time, as China enters a crucial stage in her reform history. In any case, the government seems quite determined to pursue reforms whenever the situation allows, even at the expense of higher inflation. In a way, Beijing is attempting a "triangular trade-off" between growth, reform and inflation, in contrast to the bivariate trade-off between growth and inflation in a typical market economy.

All in all, through the reforms of 1994, a number of useful building blocks for a modernized financial system has been put in place in China despite observable imperfections. As there are still many tasks to be achieved, if the macroeconomic atmosphere and the external environment improve in the future, the possibility of more rounds of bold attempts cannot be ruled out.

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8. See for example Zhao Renwei, "The Target of Reform Should be the Combination of Economic and Administrative Decentralization" (in Chinese), ***Jingji Yanjiu***, No.4, April, pp.31-32.

9. Further down the road, though, China's agriculture has faced a number of difficulties, evidenced by lower growth and other anomalies, which could be attributed to the lack of long-term investments and effective coordination policies by the government. We have discussed this elsewhere. See Cheng Yuk-shing and Tsang Shu-ki, "The Changing Grain Marketing System in China," ***The China Quarterly*** 140 (December 1994): 1080-1104; and Tsang, Shu-ki and Cheng, Yuk-shing, "Investment versus Production Incentives: Reform and Growth in China's Grain Economy", ***BRC Papers on China*** CP94011 (July 1994), Business

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18. For more detailed analysis, see Tsang Shu-ki, "Current Problems in the Chinese Economy" (in Chinese), ***Wide Angle***, December 1992.

19. For a detailed discussion of the evolution of the Chinese foreign exchange system up to reform package of 1994, see Tsang Shu-ki, "Towards Full Convertibility? China's Foreign Exchange Reforms", ***China Information***, The Netherlands: Leiden University, Vol.IX, No.1, Summer 1994, pp.1-41.

20. See The World Bank, ***China, Foreign Trade Reform: Meeting the Challenge of the 1990s***, Washington D.C., 1994; and Tsang Shu-ki, "Towards Full Convertibility...", ***op. cit.***, pp.19-21.

21. In the first quarter of 1994, many analysts outside China talked about a "shock therapy" in China's macroeconomic reforms. Even after the implementation of the full system in April, a major news service still opined that "China...on January 1 launched a `big bang' of financial reforms". See "Beijing to limit exchange rates", ***South China Morning Post***, Hong Kong, 3 April 1994. It seems however to have been a problem of their own misunderstanding.

22. It is well known for analysts following the reform that the Chinese government wanted to integrate the FIEs into the bank-based market from the beginning, but the representatives of the latter expressed reservations in the consultation process and opted to stay on the sideline. After witnessing the success of the system, they quickly reversed their position and asked to join the market. By mid-1995, according to a Vice President of the central bank, Chen Yuan, plans were in place to let them in. See ***Wen Wei Po***, Hong Kong, 21 June 1995.

23. Tsang Shu-ki, "Financial Restructuring", in Lo Chi-kin, Tsui Kai-yuen and Suzanne Pepper (eds.), ***The China Review 1995***, (Hong Kong: The Chinese University Press, 1995), chapter 21.

24. See ***Wen Wei Po***, Hong Kong, 6 March 1994.

25. See the report on ***China Economic News***, 26 December 1994, p.3.

26. Chai, Joseph C.H., "Incentive and Profit Sharing.....", ***op. cit.***

27. For details, see Table 1 in Tsang Shu-ki and Cheng Yuk-shing (1994), "China's Tax Reforms of 1994: Breakthrough or Compromise?", ***Asian Survey***, Vol. XXXIV, No.9, September, pp.769-788. The fiscal figures were adjusted for debts and subsidies, following international convention.

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34. See "Finance Vice Minister on Central-Local Tax Assignment", ***China Economic News***, Beijing, Vol.XV, no.1 (3 January 1994), pp.7-8.

35. A recent World Bank report however uses unpublished data from China's Ministry of Finance to show that the dependence on the revenue sharing through contracts actually declined over the course of the economic reform as the central government expanded its fixed revenue base. It shows a sharp decline in *net* transfers through the revenue-sharing system, which fell from 9.3% of GNP in 1981 to 1.9% in 1990. See World Bank, ***China: Budgetary Policy and Intergovernmental Fiscal Relations, op. cit.*** This view contrasts with the conventional view about a key aspect of central-local fiscal relations in China. If it is accurate, then the "tax assignment system" of 1994 should probably be called "tax re-assignment system" as the major objective would be to increase the central share through re-division of old taxes and imposition of new ones rather than to eliminating an already shrinking contract system.

36. See ***Wen Wei Po***, Hong Kong, 18 November 1993, p.3.

37. See Jiang Yonghua and Zhao Huaitan (eds.), ***Caizheng shuishou xinzhidu xiangjie*** (Detailed Explanations of the New Fiscal and Taxation Systems), Qiye Guanli Chubanshe (Enterprise Management Publishing House), 1994, section 1, chapter 3.

38. The World Bank, ***China: Country Economic Memorandum***, Washington D.C., 1994.

39. A critical comment on this aspect of the reform is raised in Jiang Yonghua and Zhao Huaitan (eds.), ***Caizheng shuishou xinzhidu xiangjie***, p.35. Since "no action has been taken", the demarcation of expenditure responsibilities is regarded as one of the "outstanding issues" of the tax assignment system. The same view is also expressed by The World Bank, ***China: Country Economic Memorandum, op. cit.***

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44. According to a report, the shares of policy loans in the outstanding loan balances of the four specialized banks were estimated as follows: 20% for the Industrial and Commercial Bank, 30% for the Agricultural Bank, 15% for the Bank of China, and 45% for the Construction Bank. See ***United Daily***, Hong Kong, 13 November 1993.

45. See Tsang Shu-ki, "Financial Disorder and Macroeconomic Reforms in China", ***Hong Kong Economic Papers***, Hong Kong: Hong Kong Economic Association, No.23, 1994, pp.1-13.

46. State Statistical Bureau of China, "Financial and Monetary Developments in China in the First half of 1993 and Its Implications for the Second Half of the Year", ***Current Chinese Economic and Financial Reports***, No.6, CERD Consultants Ltd., Hong Kong, 1993.

47. See Mao Hungjun, ***Zhongguo Jinrong Tizhi Gaige Xin Juicuo*** (New Measures in the Financial System Reform in China), Beijing University Press, 1994, p.8.

48. See the World Bank, ***China: Financial Sector Policies and Institutional Development***, 1990; and ***China: Reform and the Role of the Plan in the 1990s***, 1992.

49. For the latter, less ambitious proposal, see The World Bank, ***China: Financial Sector Policies and Institutional Development, op.cit.*** However, in early 1993 top leaders already seemed to be in favor of the more radical approach of setting up "policy banks". See ***Jingrong shibao*** (Financial News), March 21, 1993, p.1.

50. See for example the interview of Guo Shuqing, a top economist in the Planning Commission, by Peter Seidlitz of ***Handelsblatt*** before the Third Plenum. It was reprinted on ***Sunday Post***, Hong Kong, 14 November 1993, under the title "China bites the bullet on reform". Guo reportedly made the suggestion of disbanding all local branches of the PBC and said that the reform package would be "the beginning of changes that will alter totally China's system".

51. See the People's Bank of China, ***China Financial Outlook '94***, p.34-35.

52. See Wu Jinglian, "1994 nian gaige shiji pingjia yu 1995 nian gaige zhongdian shexiang" (Assessment of the Results of the 1994 Reforms and Thoughts on the Foci of the 1995 Reforms), ***Gaige*** (Reform), No.6, November 1994, pp.5-10.

53. Tsang Shu-ki (1995b), "Financial Restructuring", in Lo Chi-kin, Suzanne Pepper, and Tsui Kai-yuen (eds.), ***The China Review 1995***, (Hong Kong: The Chinese University Press, 1995), chapter 21.

54. From one source, I am given to understand that actually some ***existing*** policy loans have been transferred from the specialized banks to the policy banks, but details are still not available.

55. For Chen Yuan's figures, see ***Hong Kong Economic Times***, 21 June 1995. For the report on ***Guangming Ribao***, see the extract on ***Ta Kung Pao***, Hong Kong, 30 June 1995. According to the author's source, Chen's figures were from the reporting statistics of the PBC and actually covered all financial institutions, not just banks, while the latter report was from a sample survey on the four specialized banks and the nine smaller commercial banks.

56. See Tsang Shu-ki, "Financial Disorder and Macroeconomic Reforms in China", ***op. cit.*** See also Liu Zunyi and Qian Yingyi, "Guanyu Zhongguo de yinhang yu qiye caiwu de chongzu wenti" (On the Recommendations on the Financial Re-organization of Banks and Enterprises in China), ***Gaige*** (Reform), No.6, November 1994, pp.25-38.

57. See Mao Hungjun, ***Zhongguo Jinrong Tizhi Gaige Xin Juicuo*** (New Measures in the Financial System Reform in China), Beijing University Press, 1994, pp.109-125.

58. ***ibid.***, p.116.

59. ***ibid.***, pp.120-121.

60. ***ibid.***, p.114.

61. For more detailed discussion of the vicious circle, see Tsang Shu-ki, "China Faces the Danger of the Loss of Control?" (in Chinese), ***Wide Angle***, Hong Kong, July 1993.

62. Deepak Lai, "The Fable of the Three Envelopes: The Analytics and Political Economy of Reform of Chinese State Owned Enterprises", ***European Economic Review***, Vol. 34, September 1990.