EF3461 Lecture 7
China’s Economic Policy

• Effects of Budget Deficits:
  • Push effect - the deficit accelerates economic development, rapid economic results can be achieved in the short run.
  • Burden effect - the enlarged purchasing power leads to excess demand and inflation, leads to a larger deficit in the following year. Deficit breeds deficit.
Feature of Budget Policy

• Coexistence of budgetary and extra-budgetary expenditures and revenues.
• Outside govt budget include localities from different sources & purposes.
• Prolonged subsidies given to agriculture, SOEs and households.
Soft Budget Constraint

- Budget deficit since early 1980s, the “soft budget constraint”: govt bails out loss-making SOEs.
- A high cost of liquidation when there are strong interdependent relationship.
- Rent seeking activities of SOEs to exploit the softness of govt.
- The incentive to remain passive, hide bad loans.
Why SBC Possible?

• The initial investment is considered as sunk.
• Govt exhibits paternalism, i.e. the bailing out of firms go beyond the pure monetary return and include the welfare of its employees.
• Low level of collateral reduces financial discipline.
Harden SBC?

- Revenue to GDP ratio is very low. Govt has a weak revenue base. Improvement needed.
- Fiscal policy is a weak instrument in macro control.
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<th>1980</th>
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<th>1995</th>
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<td>South Korea</td>
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Theory of Financial Deepening

- Is money helping economic development?
- Shallow finance: money is used, but not growth, heavy state intervention with fund allocation, distorted interest rate.
- Financial liberalization: market rate, comprehensive commercial banks, open competition for loans.
Money and Banking

- $M_1 = M_0$ (cash) + demand deposits of enterprise and rural collectives & other institutions.
- $M_2 = M_1 +$ time deposits of enterprises + deposits if self-financed funds of capital construction + household savings deposits + other deposits.
- Large % growth, exceeding GDP growth.
Monetary Policy

• Quantity control include: credit restriction, raising interest rate, call back loans.
• When output fall, credit expansion again.
• M supply: state and credit creation through banks.
Feature of Banks

• Banks are accounting offices of govt.
• Bail out loss-making SOEs by a loose credit policy.
• Ill liquidity of banks, support inter-enterprise debts.
Bank Reform in 1995

- People’s Bank of China
- Policy Banks: 3 newly established
- State Commercial Banks: 4
- Nationwide Commercial Banks: 5
- Other Commercial Banks: corporate or regional
- Non-bank Financial Institutions.
Features of 1995 Bank Law

- Institutional reform, lacked explicit reform in operational & managerial level, prudential control and risk management.
- Sector-oriented vs comprehensive banks: portfolio coverage by banks.
Aspects of Financial Reform

• Reform of institutional structure of the PBC: independence of PBC, cut to become 12 regional branches.
• Reform credit allocation system: based on borrower’s ability to pay.
• Trim the size of state banks, promote local banks.
• Strengthen urban cooperatives, merge smaller banks.
Continues

• Reform the supervisory and responsibility system: the Bank of International Settlement (BIS) has laid down the minimum requirement in 25 core principles on supervision in November 1997.
TICs and ITICs

- Theory: share the burden of banks, become efficient.
- Many are subsidiaries (window companies) of banks and provincial govts.
- Expanded rapidly, achieved good results, but many engage in real estate, speculative activities, end up in debts.
Non-Performing Loans

• About 20-25% of total loan outstanding, bad debt about 6-7% of all loans.
• Underestimation is common, could be as high as 50-75%.
• 3 types of NPLs: overdue (unpaid for less than 2 yrs), idle (unpaid for more than 2 yrs); bad (unable to recover).
• Criteria not same as market economies.
Disclosure

• Poor disclosure of accounts and unavailability of financial data.
• Lacks a systematic reporting process, especially remote branches.
• Since 1998, banks regularly audit their branches.
• Electronic reporting is needed eventually.
Foreign Banks

• Needs a strict application procedure.
• Prefer to strengthen local banks before allowing foreign competition.
• Major businesses are syndicated lending and trade finance in designated cities.
• Restriction in Renminbi business.
• Also limited in insurance business.
WTO Conditions

• After 3 years of accession, foreign banks can operate open branches without limit.
• After 5 years of accession, all foreign banks can conduct Rmb businesses.
• Can China cope?