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# Reforming China's financial system and monetary policies: a sovereign remedy for locally initiated investment expansion?

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**Abstract**

This paper studies the efficacy of China's financial reforms in helping the central monetary authority to achieve its goals of macroeconomic stabilization. A local–local monetary game is presented which examines the investment competition between local governments in different hypothetical financial settings. It is shown that direct means of credit control and indirect instruments of monetary policy have both strengths and weaknesses, suggesting that their combination would be desirable in macroeconomic management under the new financial arrangement. © 2000 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

In 1994 the Chinese government initiated further restructuring of the financial sector. The four key features of this program are as follows. First, the central bank's powers were to be greatly strengthened by various measures. This aims to

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lessen the influence and interference of local governments in its macro-financial control. Second, the state-specialized banks began the transformation into state commercial banks (SCBs). Third, state policy banks (SPBs) were to be created to provide finance for policy-based activities. The fourth feature is the gradual shift to the use of indirect monetary instruments from that of the traditional credit quotas in macroeconomic management. Macroeconomic instability was believed to have been caused by chronic locally initiated investment expansion. So the changes to the Chinese financial sector and monetary policy were intended to reduce this instability.

Prior studies of China's financial reforms have concentrated on a few issues. These include the manner of the institutional restructuring of the banking sector, the disadvantages of the old means of control such as the credit quota, the relationship between banks and enterprises, central–local relations under the old financial arrangement and so on.[1] However, the following questions have not yet been properly addressed: What would be the effect of the reforms on local government interactions when there is a shift to the use of new instruments of monetary policy and to the new mix of financing avenues? How might alternative policy instruments be compared to each other in terms of their regulatory power? These two questions are especially important given that the reforms are aimed at restraining the activities of local governments and helping maintain macroeconomic stability.

Regarding the first question, the emphasis of this paper is placed on the local–local relations, contrary to Ma (1995a,b, 1996). A central–local monetary game can be used to explain *how* local governments force the central bank to change and increase the predetermined credit lines thus creating inflation (Ma, 1996), but not *why*. If local governments were all happy with pre-announced policies by the center in the first place, then it would not matter that much whether the center lacks its commitment to them. So the root cause of inflation may be further tracked down in the local–local relations to find out why local governments are not happy. Another justification for this lies in the following observed facts: (a) the new central bank system is becoming increasingly independent of governments at various levels (e.g., the central government's deficits can no longer be covered by borrowing from the central bank); and (b) the central government is able to resist demands from localities, such as rescuing state-owned enterprises (SOEs) etc., with recent massive labor shedding by SOEs being a good example. These imply that the central bank is more and more likely to commit itself to prudent monetary policies. Therefore, a theory of local–local monetary game is an appropriate framework. It is intriguing to find out the way this game is

[1] Major studies on China's financial reforms and monetary policy include, among others, Bonin (1998), Lu and Yu (1998), Ma (1996, 1995b), Bowles and Gordon (1989), Wei and Wang (1997), Tseng et al. (1994), and Qian (1994).

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