4

## Monetary and Exchange System Reforms in China An Experiment in Gradualism

į,

A star

ß

ø

` { Hassanali Mehran, Marc Quintyn, Tom Nordman, and Bernard Laurens



INTERNATIONAL MONETARY FUND Washington DC September 1996



## Contents

÷

.

		Page
Prefa	Preface	
Glossary Of Abbreviations		
ł	Introduction	ł
11	China's Financial Reforms Since 1978: An Overview	3
·	Three Components of Financial Sector Development Institutions Instruments Markets Characteristics of the Overall Reform Process Laboratory Approach and Selectivity Intermediate Control Mechanisms	3 6 6 8 8 9
ш	Financial'Sector Development	10
	The Role of Banks and Banking Before Economic Reform Re-Establishment of Banking System (1978–84) Diversification and Innovation (1984–88) Rectification and Recentralization (1988–91) Commercialization and Expansion (1992–Present) Present Characteristics	10 10 11 13 14 15
١V	Legal Underpinning for a Market-Based Financial System	18
	Establishment of a Legal Framework for the Central Bank Autonomy of the Central Bank The Central Bank as Legal Entity Primary Objective of the Central Bank Responsibility for Formulating and Implementing Monetary Policy Functions of the Central Bank Instruments of Monetary Policy Regional Participation in Monetary Policy Summary: How Much Autonomy for the PBC? The Commercial Bank Law A Two-Tier Commercial Banking System Reinforcement of the PBC's Authority Separation of Banking and Nonbanking Activities Enhancing Financial Discipline Summary	<ul> <li>18</li> <li>19</li> <li>19</li> <li>20</li> <li>20</li> <li>21</li> <li>21</li> <li>22</li> <li>22</li> <li>23</li> <li>23</li> <li>23</li> <li>23</li> </ul>

•

V	Development of Money and Capital Markets	24
	Money Markets	24
	Primary Securities Markets	27
	Government Securities	27
	Nongovernment Securities	31
	Secondary Markets for Securities and Equity	32
	Initial Developments	32
	Building the Infrastructure	32
VI	Payments, Clearing, and Settlement System	37
	Payments System	37
	Clearing and Settlement System	38
VII	Instruments of Monetary Policy and Monetary Developments	40
	The Operating Framework	40
	The Credit Plan	41
	PBC Lending Facilities	42
	Reserve Requirements	43
	Interest Rates	45
	Open Market Operations	47
	Monetary Developments	48
	The First Cycle (1979–82)	48
	The Second Cycle (1984–Early 1986)	48
	The Third Cycle (Mid–1986–Late 1989)	48
	The Fourth Cycle (1992–Present)	52
	Overview: Monetary Developments Versus the Instrument Framework	54
VIII	Developments in the Exchange System	55
	Early Stages: Regulated Exchange Rates and the Foreign Exchange Plan	55
	Swap Centers and Retention Quotas: First Step Toward	
	Market-Determined Rates	55
	Settlement Procedures	58
	Regulation of Swap Center Trading	58
	Reform Plans and Reforms Since 1993	58
	Reform Plans	58
	Implementation	60
	The Present Exchange System	61
	Domestic and Foreign-Funded Enterprises (FFEs)	61
	Domestic and Foreign Banks Interventions by the PBC	61 62
I	Prudential Regulation	62 62
( 	T.	
IX	The Agenda for Developing a Market-Based Monetary and Exchange System	64
	,	04
•	Assessment of Achievements and Directions for Future Reform	64
	Assessment	64
	Some General Principles	66
	Directions for the Future	66
	Interest Rate Liberalization	67
	Reasons for Liberalizing Interest Rates	67
	Structural Impediments	68
	Plans for Interest Rate Liberalization	69

2

The Shift to Indirect Monetary Policy	72	
The Target-Instrument Framework	73	
The Supporting Infrastructure	75	
Next Steps in Foreign Exchange Reform	79	
Alternatives for Developing Exchange Markets	79	
Supervising and Regulating Banks' Foreign Exchange Operations	79	
Financial Institutions' Operational and Managerial Capabilities	79	
Forward Operations	80	
Leveling the Playing Field and Strengthening the Environment		
for Competition	80	
X Assessment and Conclusions	18	
Main Characteristics of Financial Sector Development	81	
Diversification of Financial Sector	81	
Accessibility of Financial Sector	82	
Interplay of Government Plans and Market Forces	82	
Capital Markets and Money Markets	82	
Role of the PBC and Underlying Legal Framework	82	
Transition to Indirect Monetary Policy Instruments	83	
Interest Rate Liberalization	83	
Exchange System	83	
The Challenges Ahead	83	
Commercialization of State Banks and Level Playing Field	84	
Foreign Exchange Market Development	84	
Coordination of Monetary and Exchange Rate Policy	84	
Real Sector Reform	84	
Appendix Chronology of Financial and Exchange System Reforms	85	
Bibliography		

5

٠

•