Formulating theory on dual-subject currency regulation

FINANCE

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A roundtable forum themed on "new development of RMB internationalization under new circumstances" was held as part of the 2022 Financial Street Forum Annual Conference on November 22, 2022. Photo: CFP

From a global perspective, the formation and development of modern financial systems are closely intertwined with fiscal policies. However, mainstream theories in both fiscal and monetary domains have failed to thoroughly study the linkages between the two. China's unique fiscal-financial system exerts a powerful influence on the market's monetary circulation. As a result, existing fiscal and monetary theories can neither explain nor guide the deep-level interaction between the central bank and fiscal authorities in the broad-based regulation of currency. Therefore, it is imperative to establish a currency regulation theory rooted in China's economic practices and exhibits Chinese characteristics.

Financial system with Chinese features

First, the Communist Party's centralized and unified leadership over China's financial work helps coordinate fiscal and monetary policies. This is a notable feature and serves as a crucial institutional guarantee for the effective coordination of fiscal and monetary policies. China consistently upholds the leadership of the Party, while continuously exploring the right path of financial support for economic and social development. Hence, it is less susceptible to external influences and disruptions caused by short-term political objectives.

In terms of strengthening the top-level design of financial policies, the establishment of the Central Financial Commission has fostered a working pattern where the decisions and deployments of the commission are implemented through collaborative efforts of various executive agencies. In terms of consolidating the central authority of the financial system, the establishment of the Central Financial Work Commission has realized unified leadership over the Party organizations and cadres of financial institutions.

Additionally, by establishing a Monetary Policy Committee within the central bank, China ensures that fiscal policy reactions are fully considered in the formulation and assessment of monetary policies, thereby avoiding misalignments and conflicts between fiscal and monetary policies and creating synergy between them.

Second, the key link in the transmission of monetary policy lies in the hands of major state-owned financial enterprises. Monetary policy tools ultimately influence social investment and consumption through the intermediation of the financial market. In China, state-owned financial enterprises are the main players within the financial system both in terms of asset size and in crucial aspects of financial transactions. When it comes to indirect financing, the eight banks that dominate the banking industry are either centrally owned financial enterprises or controlled by them. Regarding direct financing, as of July 2021, 102 of a total of 140 securities companies in China are controlled by state-owned capital. Moreover, state-owned financial enterprises dominate as providers of financial infrastructure in China.

Third, the Ministry of Finance and local finance departments play a crucial role as sponsors in state-owned financial enterprises. This arrangement is a key feature of the attribution of financial rights to state-owned financial capital, and an important institutional guarantee for the policy transmission mechanism through which the fiscal authorities in China influence monetary policy. State-owned financial capital is owned by all Chinese people, with the State Council representing the state in exercising ownership rights. The State Council and local governments respectively authorize the Ministry of Finance and local finance departments to fulfill the responsibilities of shareholders in state-owned financial capital.

At the micro level, these responsibilities include guiding institutional reforms, optimizing capital allocation, and improving supervision systems. At the micro level, while adhering to market principles, the MOF emphasizes its "shareholder" role by strengthening corporate governance, scrutinizing major issues, and overseeing personnel appointments and dismissals. The monetary policy tools of the central bank influence the transaction behavior of financial institutions, such as commercial banks, by altering their reserve requirements and financing costs.

However, under the institutional arrangement where the MOF and local finance departments represent the state in exercising shareholder rights over state-owned financial enterprises, the fiscal authorities, as shareholders, can directly influence the specific operational transactions of financial enterprises from a legal perspective. This influence has implications for regulating and impacting currency circulation.

Fourth, the centralized national treasury collection and payment system empowers fiscal revenues and expenditures to impact currency circulation. In China, the national treasury's single account is held at the central bank, independent of the currency circulation system. The funds within this account are non-circulating and are not included in the monetary statistics, allowing them to serve as a centralized repository for fiscal funds included in government budget management, thereby facilitating the function of "centralization."

Additionally, when the government finance department deposits fiscal funds into the national treasury's single account, forming treasury deposits, the account adopts a centralized payment and settlement mode for fiscal funds. This institutional arrangement isolates fiscal funds from the currency circulation system. This system enables the government finance department to influence currency circulation through fiscal revenue and expenditure activities and treasury cash management, thus achieving the desired effects of monetary regulation.

Mainstream monetary theories

Mainstream monetary theories often perceive the central bank as the sole regulatory authority in a country's currency circulation, while overlooking the actual regulatory role of government finance departments. The understanding of money creation in mainstream monetary theories has evolved from the monetary intermediation theory to the money multiplier theory, and later to the money credit theory.

However, their exploration of money creation methods remains confined to the internal institutions of the banking system, including central and commercial banks. Meanwhile, the scope of theoretical discussions is limited to the roles and divisions of labor between the central bank and commercial banks, as well as whether commercial banks are the main agents of money creation. This disregard for the regulatory role of finance departments results in a lack of explanatory power in mainstream monetary theories, when it comes to the relationship between fiscal policy and monetary policy.

On one hand, financial departments exert substantial monetary regulatory functions through fiscal revenue and expenditure activities. In the process of legally organizing fiscal revenues and arranging fiscal expenditures, China's financial departments facilitate the flow of fiscal funds, between the centralized payment and collection system and the market's currency circulation system, and thus possesses the ability to regulate currency circulation.

On the other hand, the issuance of banknotes, coins (minor currency), and digital currency, whether carried out by the central bank or government finance departments, is a clear manifestation of national credit. It is fully based on national sovereignty and government financial credibility, aiming to meet the common social need for convenient transactions and wealth preservation. This reflects the fundamental objective of finance in satisfying society's common needs.

In China, the formation and development of the modern financial system are closely intertwined with government finance, as the unique fiscal-financial system arrangement in China enables government financial departments to influence the money supply. Under the banking credit money system, the creation of broad money primarily relies on commercial banks.

However, under China's institutional arrangement where the MOF and local finance departments fulfill the responsibilities of shareholders in state-owned financial capital, government finance departments possess the prerequisite conditions for providing credit guidance to commercial banks from a legal standpoint. This differs from Western countries, where the commercial banking system is predominantly driven by private capital while government financial departments have limited influence.

Additionally, government bonds have a significant impact on the broad money supply. Undersubscription or failures to raise funds, common in some countries, is unlikely to happen in China's institutional design. The considerable overlap between state-owned financial enterprises funded and managed by finance departments and primary dealers responsible for underwriting government bonds means that, when the finance departments plan to issue government bonds for fundraising and face the risk of unsuccessful issuance due to a sluggish economy, they can influence the behavior of state-owned financial enterprises, by fulfilling the responsibilities of shareholders in state-owned financial capital. This ensures that state-owned financial enterprises, with their identity as primary dealers, purchase and underwrite government bonds, thereby guaranteeing the smooth issuance of government bonds.

Dual-subject currency regulation

In the practice of a socialist market economy, China has developed a fiscal-financial system arrangement that differs from Western countries, giving the fiscal authorities substantial influence and regulatory power over the market's currency circulation system.

Professor Huang Da's theory of "comprehensive balance theory of fiscal credit" elucidates the viewpoint that government finance departments can impact currency circulation through their revenues and expenditures. This theory represents an important theoretical exploration in China's academic community during the early stages of transitioning from a planned economy to a market economy. However, with the formation of China's unique fiscal-financial system, there is an urgent need to construct and refine a currency regulation theory that aligns with the existing institutional foundation.

The theory of dual-subject currency regulation by the central bank and finance departments is based on China's distinctive institutional foundation and follows the research paradigm of new market finance. It explores the regulatory capacity of government finance departments over the broad money circulation and its formation mechanism.

Additionally, it investigates the relationship between finance and banks within the framework of this currency regulation system, both in theory and practice. This theory can be seen as a further development of the comprehensive balance theory of fiscal credit, which explains the influence of fiscal revenues and expenditures on the circulation of real money during the transition from a planned economy to a market economy. It not only conforms to the historical development trend of the inseparable relationship between modern financial systems and finance, but also responds to the current macroeconomic policy's emphasis on the monetary and fiscal effects of finance.

Research conducted by Li Junsheng and others also demonstrates that government fiscal activities have monetary effects. In the market currency circulation system between 2000 and 2018, approximately 44.31% of the money supply was influenced by government finance departments, and this proportion keeps growing. Studies on the monetary effects and channels of government debt show that between 2015 and 2020, up to 25.31% of credit scale in the monetary market was influenced by the entire process of local government bonds.

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