ABSTRACT

FACTIONAL POLITICS AND ECONOMIC REGULATION IN CHINA:

THE BALANCE BETWEEN ADMINISTRATIVE MEASURES AND MARKET MEASURES IN CONTROLLING INFLATION

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The evolution of administrative measures in regulating economic activities in China did not happen spontaneously with the transition from a planned economy to a market economy. This study provides a perspective on factional politics in explaining the dynamic of shifting from administrative measures to market measures in regulating investment activities in China. I specifically answer the question of under what kind of situations are the technocrats more willing to adopt administrative measures in controlling the growth of investment activities instead of market measures. Conventional wisdom explains this dynamic as in correspondence with the stability of economic situation, or as a gradual learning process of the central government in adopting fiscal or monetary tools. My study reveals that an alternative explanation for the shift of policy instruments is the tension of factional politics between technocrats and the generalist leaders in the expansion of discretional powers of local officials in economic issues. I studied six periods' economic cycles since the initiation of market reform in 1979. My conclusion is that when the technocrats were marginalized in their political agenda of centralizing economic policy-making power, they tended to adopt administrative measures in regulating economic activities in order to regain control.

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FACTIONAL POLITICS AND ECONOMIC REGULATION IN CHINA: THE BALANCE BETWEEN ADMINISTRATIVE MEASURES AND MARKET MEASURES IN CONTROLLING INFLATION

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CHAPTER 1

INTRODUCTION

This study explains why sometimes the central government in China adopts market measures in the regulation of an overheated economy, while in other times the central government adopts administrative measures in economic regulation. The occasionally occurring overheated economy in China has been closely related to the increased investment activities under the motivation of local governments. Two factions among the political elites at the central level possess contrasting attitudes toward the regulation of investment growth at the local level. The technocrats are a group of leaders who are promoted from a relatively narrow bureaucratic system. They dominate the bureaucratic system and implement the economic regulation policy. The technocrats advocate the centralization of investment approval power. The generalists are a group of leaders who are supported by a broad scope of party membership, including the local provincial leaders. They dominate the party apparatus and possess ultimate control over the ideological routes of the party, which directly influence the policy making of the bureaucratic system. Because of their broad political support from the provincial leaders based on a patronage relationship, the generalists advocate the expansion of discretional power of the local officials in the approval of investment projects. When inflation rises significantly, the generalists designate the technocrats in implementing investment control policies. I argue that sometimes the generalists try to marginalize the technocrats in order to protect local officials' discretional power. Once this situation occurs, the technocrats will prioritize the policy goal of regaining political authority from the local officials. They will adopt direct administrative intervention policies to regain political authority within a short time. In contrast, if the generalists do not initiate any actions to marginalize the technocrats, the technocrats will prioritize the policy goal of maintaining long-term macroeconomic equilibrium. They will not adhere to the adoption of administrative measures in controlling investment growth. As a result, the adoption of market measures becomes a possible solution.

In regulating the increasing investment, administrative measures and market measures exhibit different characteristics in the policy effectiveness and the implementation process. Administrative measures are direct executive orders in cutting the budget for, or ceasing the permission for certain investment projects. This type of measures is easily adopted without the need of adopting complicated fiscal or monetary leverages. If policy makers possess an urgent agenda in controlling investment growth within a short time, administrative measures are usually convenient to adopt. In contrast, more subtle changes of investment control occur under the adoption of market measures, which impose long-term fiscal or monetary regulations over the economy. As the development of market economy improves, fiscal and monetary policy become increasingly necessary in maintaining macroeconomic equilibrium. The central government has gradually improved their capability in adopting market measures in economic regulation over the past three decades. However, this effort has been inconsistent and administrative measures are occasionally readopted. This occasional adoption of administrative measures is the phenomenon I explain in this paper. I adopt the logic that elite politics influence the policy agenda of central bureaucrats, which further determines the policy instruments adopted in constraining the mass growth of local investment.

This study extends previous literature on elite politics and the dynamic of economic policy-making in contemporary China. Scholars studied how fissures between different factional groups within the central government influence the inflation cycles in China.[1] However, previous studies paid attention to the financial policy preferences of central elites without substantial discussion on the policy instrument they adopt in implementing these policies. My study fills in this gap through an examination of how elite politics influence the specific policy instruments adopted by the technocratic leaders, including the administrative intervening measures and fiscal or monetary measures. This study also makes an attempt to improve the measurement of different levels of political tension between the two factional groups, respectively the technocratic leaders and the generalist leaders. I generate specific indicators to indicate the level of domination by the generalist leaders in marginalizing the technocratic leaders. These two aspects are original contributions I make in this study.

[1] See Victor Shih, *Factions and Finance in China: Elite Conflict and Inflation* (Cambridge University Press, 2007)

In the following part of the introduction, I first elaborate on the hypothesis I made through an introduction of the incentive of local governments' mobilization for investment growth, the fissure between two factional groups among political elites upon the curbing of local investment activity expansion, and the different policy instruments (administrative measures and market measures) that will be adopted under different circumstances. In the second section of this chapter, I explain the relevance of this study and discuss the contribution of this work to the literature of market economy transformation. The third section introduces the study scope and the study method of this work. The last section provides an overview of the organization of the following chapters.

Investment Growth and Economic Cycles

Scholars believe that the periodic investment growth was driven by local officials who were against the willingness of central leadership, especially of the technocrats. The theory of shortage economics argues that market reform in socialist economies will bring an increased investment, because of the long-term accumulated "investment hunger."[2] A socialist economy generates limitation of production and insufficiency of consumer goods, because the economy planners are constrained with providing maximized social welfare instead of pursuing maximum economic efficiency. The market demand on consumer goods and the situation of "soft budget

[2] See Janos Kornai, *Economics of Shortage* (North-Holland Publishing Co., 1980).

constraint"[3] motivates local entrepreneurs to continuously increase investment activities.

In China, excess investment can be attributed to the investment hunger by local entrepreneurs and further augmented by the local officials' eagerness to achieve higher growth rates.[4] The motivation of local officials in increasing economic profit comes from two aspects: respectively, the economic incentive of increasing self-reliance on economic revenue and the political incentive of being promoted through indicating good economic performances. Local economic growth can always bring improved tax revenues and support local governments' developmental projects. From a perspective of economic security, economic growth enhances the economic security of local governments by lowering economic deficit, avoiding shortages, and increasing self-reliance.[5] Increased economic profit can also bring political credit to local officials as the evaluation system within the Communist Party determines that economic growth occupies a significant part in the promotion of local governors.[6] Thus, local provinces compete with each other in constructing new projects in order to increase local revenue. Superfluous construction projects were implemented by local governments in

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[3] It is well known that in socialist economies state banks or other financial institutions are usually ready to provide financing, subsidies, and bailouts for bad projects and unprofitable firms survive indefinitely.

[4] See Yasheng Huang, Investment and Inflation Controls in China: The Political Economy of Central-Local Relations During the Reform Era (Cambridge University Press, 1999) 63-88, 135-151.

[5] Ibid., 71.

[6] See Jiwei Lou, "On the Division of Economic Power between Central and Local Levels," *Chinese Economic Studies* 25 (Summer, 1992): 25-34; Liguo Wang, "Xingwei Maodun de Difang Zhengfu: Lilun de Kunhuo Yu Xianshi de Xuanze" (Local governments in behavioral contradictions: theoretical confusions and real choices), *Jingji Tizhi Gaige (Economic System Reform)*, no. 2: 64-68.

order to realize short-term economic profit and as a result, infrastructural industries were weakened under the imbalanced economic structure.

Whenever the excess investment by local officials occurs, the central government possesses a fundamental interest in curbing this trend. On the one hand, excess investment increases inflationary pressures, leading to economic and political instability. Increased investment leads to the rising of raw material prices, which will lead to inflationary pressure.[7] Another explanation of the inflation links the increased investment with the increased money supply from financial sectors since most of the investment activities in China are carried out by state-owned enterprises (SOE) which have access to bank credits.[8] Increased inflation brings higher pressure for the living expenses of citizens, which was believed to be the cause of economic and political instability by the central government. On the other hand, local officials compete with the central bureaucrats in the decision-making power on which type of investment projects are to be supported. Motivated by short-term economic profit, local officials always increase investment in processing industries,[9] rather than basic infrastructural

[7] See Gang Fan, "Dangqian Hongguan Jingji de Jiaodian Wenti yu Zhengce Fenxi" (Policy Analysis of the Current Focal Problems in Macroeconomic Management), *Jingji Yanjiu (Economic Research Journal)*, 1995 (2).

[8] See Zhiyong, Fan, "Zhongguo Tonghuo Pengzhang shi Gongzi Chengben Tuidong Xing ma? Jiyu Chao'e Gongzi Zengzhanglv de Shizheng Yanjiu" (Is Chinese Inflation Pushed by Wages: An Empirical Research Based on Excess Wage), *Jingji Yanjiu (Economic Research Journal)*, 2008 (8).

[9] Processing industries refer to those industries involve in the manufacturing and processing of items and indulge in either creation of new commodities or in value addition. The processing industries here are in contrast to the basic infrastructural industries, including energy industry and raw material industries, such as mining industry, steel industry, and petrochemical industry. The basic industries require high level of technological equipment and always require long construction period and strong financial support. They often provide crucial supporting service for the development of processing industries.

industries. In contrast, the central bureaucrats stress the development of those priority sectors, including the infrastructure and energy industries. Thus, the central government, out of its own interest, implements retrenchment policies to curb the increase of local investment.

Administrative Measures vs. Market Measures

In regulating the increased investment, the central government always adopts traditionally administrative measures; however, this regulatory measure is being reformed by the central government and market measures were increasingly adopted in recent years. The traditional administrative measures were a legacy of the planned economy and involved direct intervention in the investment project decision-makings. They include the elimination or postponing of the current construction of investment projects, the strengthening of licensing new investment projects, and the tightening of financial resources for local investment projects. These measures were easy to adopt as the central bureaucrats could easily implement these measures through the previously consolidated bureaucratic hierarchies. These measures were also effective in reducing the number of investment projects to an acceptable level within a short time. However, administrative measures cause discriminative policy outcomes for the development of private economy. Bureaucratic orders in eliminating production capacities target more at smaller private sectors, rather than large-scale state-owned enterprises (SOEs). Policy outcomes of administrative orders are always discriminative among different economic sectors. Meanwhile, the efficiency of bureaucratic decision in market regulation has been scrutinized by scholars. Lacking the mechanisms of hard budget constraint, which can be achieved through the building of market institutions, bureaucratically coordinated economy fails to make the most efficient response toward market changes (Lipton, Sachs, Fischer, & Kornai, 1990). Administrative intervention also weakens the ability of market mechanism in adjusting economic behaviors. Largely dependent on direct orders in eliminating investment projects did not allow the financial sector to develop independent capacity in evaluating investment projects. After administrative order expires, investment activities will become rampant again.[10]

Having realized the limitations of administrative measures, in the early 1980s, the central government attempted to reform these measures and adopt market measures instead, including fiscal and monetary policies. These methods include, but not exclusively, the adjustment of interest rates, the increase or decrease of the deposit-reserve ratio, the regulation over interbank borrowing and lending. The market measures adjust investment activities in a rationalized way, which means that the adoption of financial leverages establishes a systematic and stabilized way of regulating economic behaviors. This strengthened market system will enhance economic growth[11] and will repay the central bureaucrats with increased tax revenue

[10] Other flaws of the administrative measures include the limitation in adjusting economic structure among different sectors, and the damaging of relationship between the government and enterprises.

[11] About the relationship between a well-developed financial sector and economic growth, relevant mechanisms involve the increase of information searching efficiency in facilitating transactions, see Ross Levine (1997), Financial development and economic growth: Views and agenda," *Journal of Economic Literature*, *35*(2), 688-726.

from a long-term perspective. However, the implementation of these market measures was not cost free. The adoption of market measures in regulating investment behavior has been far from mature in China as the financial system was not comprehensively established. The adoption of market measures always involves the reform of the financial system, such as the reform of the capital funds[12] system in 1996 and the reform of the investment and finance system in 2004. These financial reforms consume both time and political resources.[13]

Technocrats vs. Generalists

In arguing that the central government possesses a fundamental interest in curbing the increased investment at the local level, the interest of the central government actually is not unitary toward this issue. Fissures occur on the side of generalist leaders who advocated the increase of local investment and the devolution of decision-making power to local officials upon investment projects. Generalist leaders are a political faction composed of "senior party functionaries" including local provincial officials.[14] This faction possesses crucial control over party apparatus as they are supported by a broader scope of membership. For most of the crucial policy issues, the generalist faction has the ultimate power in decision-making; however, they

[12] Also referred to as capital standard or capital requirement, it establishes a minimum level of funds required to initiate an investment project.

[13] Reforms on financial system always have significant distributional consequences, which might elicit opposition from those parties being affected, see Alberto Alesina and Allan Drazen (1991), Why are stabilizations delayed? *American Economic Review*, 1170-88.

[14] About the existence of two political factions within the communist party and their distinct political interests, see Victor Shih (2007).

also rely largely on the technocrats' expertise in certain policy areas, such as economic policies. When the vexing problem of inflation occurs, the generalist leaders are more willing to delegate their policy-making power to the technocrats in order to stabilize the situation.

In contrast to the generalists' support for local investment, the technocrats are pro-centralization and advocate that the central bureaucrats dominate economic policy-making, rather than local officials. Unlike the broad membership owned by the generalists, the technocrats receive promotion from a relatively narrower political career, often within a certain bureaucratic system (*xitong*) (Shih, 2007). They do not need to cultivate a broad scope of patronage of local supporters as the generalists do. What their political careers depend on is their expertise in the policy area within which they are involved and the bureaucratic resources they can control.

The grant of power to the technocrats in implementing contractionary policies from the generalist leaders is influential on the mechanisms technocrats adopt in curbing the investment activities, because the time technocrats possess and the political resources technocrats can maneuver are crucial constraints on the policy tools they can adopt. If the generalist leaders did not grant technocrats with sufficient time and allowed the local officials to expand investment to a level that exceeds technocrats' acceptable scope, the technocrats would consider first to realize their short-term policy goal of regaining investment approval power from local officials, and second to realize their long-term policy goal to improve future tax revenue through establishing stable financial institutions. Thus, the tension between generalist leaders and technocrats, and the tension between local officials and technocrats in investment decision-making power influences the adoption of short-term executive measures or the adoption of long-term monetary measures.

Several studies about the adoption of administrative measures in controlling investments claim that with the improved capacity of the Chinese government in adopting monetary measures to control investment, the adoption of administrative measures has been reduced during recent decades.[15] This argument of the learning process by the central government provides plausible explanation for the gradual rationalization of regulatory behavior by the government. However, it does not explain the inconsistency during this process. After making improvements in adopting market measures during a certain period, the central government sometimes readopts the administrative measure, such as the situation between 2003 and 2006. Another explanation links the adoption of administrative measures with the significance of the economic situation at a certain period. If the inflation increases significantly, which leads to economic and political instability, the central government is more likely to adopt direct administrative orders in controlling investment activities in order to achieve economic stability within a short time. In the following chapters, the economic indicators, including the inflation rate, the amount of the money supply, and the CPI, during six periods' retrenchment policy will be examined. These economic stability indicators provide certain explanations for the adoption of policy tools as the

[15] About the improvement of Chinese government in adopting market measures in regulatory policies, see Dali Yang (2004).

adoption of administrative measures mostly occurs at the period with high inflation rate. However, again, inconsistency appears during certain periods with higher inflation rates than previous periods, while the government adopted mild market measures.

This study explains the inconsistency of central government's improvement in adopting market measures in regulating investment activities from the perspective of timing of policy response toward increased investment activities by the technocratic leaders. From the six periods' inflation-retrenchment cycles I examine, if the technocrats were granted with regulatory power from the generalist leaders after the technocrats' authority in policy-making were eroded by either of the following two factors: 1) generalist leaders' efforts in marginalizing the technocrat group in order to implement the expansionary policy; 2) the local officials' breaching of the central principle in not intervening in the banking sector in order to support the local investment activities which was publicly criticized by the technocrats in central bureaucracies' meetings. These two factors explain some of the inconsistencies in the adoption of administrative measures and the economic stability indicators.

Relevance of Study

This study first contributes to the discussion of whether state intervention in guiding investment activities is efficient and what are the limitations of bureaucracy-led economic development. It then makes an attempt to contribute to the understanding of the political dynamics behind the rationalization of bureaucratic intervention behavior. By reaching these two goals, this study also links the understanding of policy dynamics with factional politics in China.

Regarding the problem of the efficiency of state-led economy, two groups of scholars, respectively the developmental school and the distorted market school, hold different arguments. The first group of scholars perceives state intervention as crucial at the initial stages of industrialization. Wade (1990) studied the state-led economies in the Newly Industrialized Countries (NIC) in Asia, including Japan, Taiwan, Korea, Hong Kong, and Singapore, and revealed the importance of state guidance in the development of the national economies in these countries. The author recognized the market inefficiency caused by market failure in certain aspects and rationalized state intervention in economic activities through strong economic bureaucracies. In the cases of Taiwan and Korea, investment activities by enterprises were largely funded by bank loans, rather than self-raised funds. With the majority banks as publicly-owned banks, the central government controlled the "amount and composition of investment" and directed financial resources to those crucial sectors for national development.

A similar situation happened in China during the pre-reform period. Justin Yifu Lin, Fang, and Zhou (1996) gave a high evaluation to the state-led economic development since 1960s in China. He perceived the central government's strategic policy in accelerating the development of heavy industries through suppressing the prices of raw materials and labor forces and through direct involvement in heavy industry investment decision-making as successful. Due to the nature of scarce capital in China's market endowment structure, the intervention of central government was necessary under this specific situation. Bureaucratic orders and investment control during this period played a significant role in guaranteeing the supply of financial resources and raw materials for strategic sectors.

A contrasting view comes from a group of scholars who argue that state-intervention has distorted market mechanisms and imposed negative effect on market efficiency. Okimoto (1989) studied the inefficiency in industrial policies in Japan caused by bureaucratic intervention. Unlike conventional wisdom, which perceives Japan's bureaucracy-led industrial development as successful,[16] Okimoto argued that economic bureaucracies in Japan lack coherence in industrial policies. The repression of market forces and the regulation over excess competition caused over-reliance on the government in trade conflict mediation, and "a vicious circle of deepening government involvement is thus triggered by industrial policy" (p. 8). The essential problem embedded in this situation is that economic bureaucracy as an information collector and analysis failed to make "responses to the special circumstances and needs of miscellaneous economic sectors" (p. 4).

Reliance on state authorities in the coordination of economic activities, according to scholars who advocate the establishment of market economy, has always led to suboptimal outcomes in the distribution of economic resources. Bureaucratic coordination of economic activities does not rely on a capital market to allocate economic resources. Investment spending is typically negotiated between enterprises,

[16] Besides Wade (1990), see also Chalmers Johnson (1982).

the relevant government ministries, and the central planning commissions. Centrally allocated investment funds seldom require an adequate assessment of cost and benefits. Thus the efficiency of the distribution of economic resources could hardly be achieved (Lipton et al., 1990). This is one major aspect of flaws in centrally coordinated state development.

This study responds to the topic of developmental states through an examination of the policy efficiency by economic bureaucracies in China in maintaining macroeconomic equilibrium. Similar to Okimoto's observation of Japan's case, this study reveals that administrative intervention in controlling investment activities to achieve macroeconomic equilibrium caused reliance on government's mediation in investment growth balance. Lacking mediation from independent banking sector, investment controls were largely dependent on administrative orders in China. Strengthening the licensing procedure and tightening the money supply to specific economic sectors merely make the financial resources physically inaccessible, rather than making them accessible with higher cost. These administrative measures are not beneficial for the long-term economic development, as they weaken the ability of the market mechanism in adjusting macroeconomic equilibrium. It also weakens the financial sector as an independent market participant and does not cultivate a healthy financial sector in making impartial evaluations of investment projects. Administrative measures control the rising inflation rate at a temporary period, but leave problems, such as the adjustment of macroeconomic structure, for afterward economic policies.

Another relevant contribution of this study refers to the policy dynamics behind the transferring of administrative measures in controlling investment activities to market measures. Previous studies always link the reform of administrative measures in economic regulation with the central leaders' awareness in improving market efficiency. Dali Yang (2004) argued that bureaucratic reform in China was to improve governance efficiency which was believed to better accommodate the market economy. Yang identified several initiatives by the central government in rationalizing bureaucratic behaviors, including the separation of direct leadership from bureaucracy-enterprise relationship, the reduction of bureaucratic approvals and licensing requirements[17] with increased autonomy in business decision-making. Another important reform involved the improved independence of the central bank (People's Bank of China, PBOC) which aimed at strengthening market mechanisms in regulating investment behavior. The banking law, promulgated in 1995, stipulates that the PBOC conducts and independent monetary policy under the leadership of the State Council and that the PBOC's operation shall be free from interference by local authorities. Strengthening the independent regulators further separated governmental authorities from intervening in market activities.

Yang and other scholars[18] treated the central government as a unitary performer with non-diverged political interests in rationalizing bureaucratic behavior.

[17] Central planning bureaus, including the SPC (State Planning Commission) and the SEC (State Economic Commission), gradually replaced their complicated investment approval system with a simplified registration system (Yang, 2003).

[18] For similar studies, see Barry Naughton, *Growing out of the plan: Chinese economic reform, 1978-1993* (Cambridge: Cambridge University Press, 1996)

However, this study indicates that fissure exists among political elites toward the regulation of investment activities and this tension influences the mechanism adopted in economic regulation. Technocrats are usually the group of elites who advocated reform of banking sectors which constrains the predator behavior of local officials. However, the prerequisite condition for the technocrats to undertake these long-term reforms is the consolidation of their authority in implementing economic policies. Another group of elites, the generalist leaders, possess broader political base than technocrats and advocated the increased discretionary power by local officials in making investment decisions which challenge the authority of technocrats. Reform on market measures will be postponed when this tension occurs and technocrats will adopt administrative measures to regain domination over investment decision-making.

Previous studies on the role of technocrats in market institutional reforms usually depict technocrats as active participants in initiating institutional changes. Mark Williams (2002) studied institutional innovations within the bureaucratic system in facilitating the market reform in deregulation and privatization in several Latin American countries, including Mexico and Argentina. Williams argued that technocrats played a "proactive role" in innovating the institutional arrangements within governmental system which helped "engineer their own autonomy, gain a decided advantage over reform opponents inside the state, and acquire enormous leverage over the reform process itself" (p. 396). One illustrative case would be that the Ministry of Commerce (SECOFI) managed to establish a new division within its bureaucracy which is insulated from political opponents. The sufficient legal authority this new division possessed prevented it from political disputes in carrying out market reforms, such as privatization.

This study also reveals that technocrats struggled for political flexibility in implementing financial reform in the regulation of investment activities. When the tension between generalist leaders and technocrats did not provide the latter with sufficient political flexibility, technocrats tend to adopt short-term measures in order to regain control over economic policies from local authorities who were patronized by the generalist leaders. In arguing that the technocratic leaders differ from the generalist leaders in advocating for centralized investment coordination, I owe an intellectual debt to Victor Shih's (2007) work on factional politics in China. Shih established an intellectual framework in analyzing China's financial policies through distinguishing two elite factions with contrasting policy agenda. He argues that the dynamic of the financial policy shift from expansionary monetary policy to contractionary monetary policy was a result of the shift of policy making power from the generalist leaders to technocratic leaders. The generalist leaders, according to his definition, are promoted from local party branches and are inclined to promote the expansion of the scope of local investment. In contrast, technocratic leaders are promoted from local bureaucratic branches and possess less interest in yielding their decision-making power in licensing investment projects to the local governments. This tension between the generalist leaders and the technocratic leaders influenced decision making in expansionary or contractionary policies. My study builds on this intellectual framework and extends the study to relationship between factional politics and specific policy instruments.

Study Scope and Method

This study examines six periods' macroeconomic control by the Chinese government over investment activities since market reform in 1978.[19] Previous studies consider these six periods as economic cycles in which macroeconomic policies functioned in maintaining economic equilibrium.[20] Investment activities become heated (or dampened) at the initial period of each economic cycle which led to the fluctuation in economic indicators, such as the amount of currency in circulation and the retail price index (RPI). Once these economic indicators suggest fluctuations exceeding the normal scope of economic volatility, the central government would intervene and impose macroeconomic policies.

I adopt a time series study and make comparison of each period of macroeconomic policies in investment control. I distinguish administrative measures from market measures. Information about the macroeconomic policy comes from official documents on the laws and regulations promulgated during the retrenchment period, stipulations on investment control, and the semi-official secondary accounts authored either by government officials or by Chinese scholars employed in

[19] The six periods include 1980-81, 1984-86, 1988-91, 1994-96, 1997-98, and 2004-06.

[20] For a review of the six periods' fluctuation in economic indicators, see Liqun Zhang (2008), Woguo jingji de zhouqixing bodong yu hongguan tiaokong: Gaige kaifang sanshi nian de huigu (Thirty Years of Reform and Opening- up: Review and Reflection on China's Economic Fluctuation and Macroeconomic Management), *Zhongguo Fazhan Guancha (China Development Observation)*, Vol. 8.

government research offices. Data will be collected on whether the central government implements the retrenchment policy through eliminating current construction projects and tightening bank loans for investment projects or through the adjustment of interest rates, deposit-reserve ratio, interbank borrowing and lending rate, monetary aggregates, and various other financial mechanisms.[21] I count the number of administrative mechanisms adopted in each period of economic cycle, including two categories: 1) the elimination of currently constructing or in plan investment projects. I will firstly examine whether the elimination of investment projects occurred, and then consider the significance and scope of the project elimination. 2) Tightening of bank loans through administrative orders. If administrative orders from the State Council, or the State Planning Commission (SPC), stipulated retrenchment of bank loans to certain economic sectors, I count this as occurrence of administrative orders in tightening bank loans.

I count the number of financial and monetary mechanisms in adjusting investment activities also based on two categories: 1) basic financial and monetary mechanisms, including the adjustment of interest rates and monetary aggregates. These two basic mechanisms are usually adopted in each period of economic cycle, so the number of times they were adopted during a certain year and the different levels of adjustment rate have different significances. 2) Improvement in financial and

[21] Other financial mechanisms include the reform on finance and investment system, which diversifies the resources of financing for investment projects. It allows the participation of private capitals in investment projects and stipulates specific information that was required to be exposed to investors. This reform aims at innovating the investment and finance system and encouraging the self-adjusting function of the market forces in eliminating low-quality investment projects.

monetary mechanisms (e.g. further differentiation of money supply criteria based on different levels of money liquidity) and the improvement of bank sector independency (e.g. removal of provincial leaders from banking sector leadership positions). The second category of measures is not direct implementation of monetary or fiscal policies; rather, it improves the policy environment for the market's self-adjustment. More importantly, these reforms constrain the governmental domination of decision-making power regarding investment promotion. I consider these reform measures as the technocratic leaders' effort in improving the policy environment for market measures and I include them in my dependent variable.

Qualitative interpretations are the main method in determining whether administrative measures or market measures are the dominating measures during specific economic cycle. If both two categories of administrative measures were adopted and the proportion of capital investment eliminated through administrative measures exceeds certain level, I consider this period as administrative measure dominant investment control (or "hard-landing investment control" in the traditional description by Chinese economic scholars). If more than one category of fiscal or monetary mechanisms were adopted, it offsets the significance of administrative domination. If both categories of fiscal and monetary mechanisms were adopted and the proportion of capital investment eliminated through administrative measures were below certain level, I consider this period as market measure dominant investment control (or "soft-landing investment control"). The reason for the strengthening or weakening of administrative measures in macroeconomic control could be influenced by the political agenda of the technocrats as I hypothesized in this study, or it could be influenced by other economic factors as well. Specific economic situations and political tensions will be discussed in detail in Chapters 3 and 4.

Another important variable in this study is the political agenda of the technocrats which will be influenced by the tension between the technocrats and the generalist leaders. The conceptualization of these two political factions, technocrats and generalist leaders, come from previous studies on the economic policy agenda in contemporary China.[22] The policy interest of each of these two factions will be discussed in Chapter 2. In this study, intervention from generalist leaders in the short-term policy agenda of the technocrats can be indicated from two aspects: 1) generalist leaders' effort in marginalizing the technocrat group in order to implement the expansionary policy. This marginalization can be indicated through the elimination of technocrats from crucial bureaucratic positions within economic sectors. 2) Local officials' breaching of the technocratic leaders' principle under the endorsement of generalist leaders in not to intervene in the banking sector in order to support the local investment activities. Considering the situation that local officials' breaching of the technocratic leaders' principle was a relatively common phenomenon in contemporary China, I count only those cases of breaching economic principles that roused the attention from central technocrats. The significance of attention can be revealed from the castigation of central technocrats on local predation behavior in certain central

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[22] See Victor Shih, *Factions and Finance in China: Elite Conflict and Inflation*, (Cambridge University Press, 2007).

meetings, such as the panel discussion with provincial deputies in the meeting of the National People's Congress (NPC). In obtaining this information, I rely largely on the description of previous studies on the political tension surrounding economic policies between liberals (largely composed of generalist leaders) and the conservatives (mainly technocrats) within the communist party.[23]

In order to test other influencing factors on the policy mechanisms in controlling investment, I also introduce several economic indicators, including 1) the inflation rate, 2) the Retail Price Index (RPI), and 3) the increase of money supply. In industrialized countries, the indicator selected to reflect economic stability is usually Consumer Price Index (CPI), rather than RPI. However, before the service industry was well developed in China, the central government usually adopted RPI in reflecting economic stability. This study adopts this indicator to be in accordance with the policy makers' concern with economic stability. The amount of money supply is another important indicator of economic stability. Also, since the investment activities at local level were mostly supported by bank loans, the increase in money supply gives the central leaders a direct signal in the increase of local investment.[24] I include these three economic indicators as alternative influential factors in the adoption of administrative measures or market measures in the control of investment increase. The result indicates that for most of the time, these economic indicators are consistent with

[23] These studies firstly include Victor Shih's (2007) study on factional politics and financial policy in China, and then include studies on liberalists vs. conservatives on economic policies, such as Joseph Fewsmith. (1994).

[24] Jian Lu (2007) built a regression model and tested that there is causal relationship between the increase of money supply from banking sectors and the increase of investment from 1978 to 2003.

the adoption of investment control mechanisms. Higher economic instability was more likely to lead to the adoption of administrative measures. However, inconsistency existed during certain periods. These inconsistencies will be discussed in Chapter 5.

In obtaining these economic data, I rely on resources from official reports by the National Statistics Bureau (NBS), the PBOC national report, and online research reports of some economic institutes.[25] Since no regression model will be built in this study to test the relationship between economic stability and the adoption of investment control mechanisms, the analysis of these economic indicators is mainly based on line charts, which have limitation in statistical predictions. I also do not deny any further studies that would be based on regression models in analyzing these economic data.

Chapter Organization

Chapter2 provides a background review of the central-local relationship. It focuses on the political tension over the issue of expansion of discretional power by the local governments. Two considerations of the technocrats will be mentioned, the strengthening of policy-making authority and the tightening of the central government's budgetary control. This chapter also further explains the two different policy instruments by the technocrats: the administrative measure and the market measure. The mechanisms and the effectiveness of these two policy instruments will

[25] Such as the Beijing Unbank Consultant Institute [Beijing Yinlianxin Xinxi Zixun Zhongxin].

be discussed. The last part of this chapter explains the fissure between the generalists and the technocrats on the issue of expansion of local investment approval power, and how this is connected with the adoption of different policy instruments.

Chaptesr 3 and 4 respectively review the investment control before and after the establishment of the socialist market economy. Chapter 3 studies the three time periods' investment control during 1978-1992. Both the first time period (1980-81) and the third time period (1988-89) adopted direct administrative control over investment growth. During the second time period (1984-85), even though the central government still largely relied upon administrative measures, they started the strengthening the role of the central bank. I will explain how the adoption of different policy instrument was connected with factional politics during each period. Similarly, Chapter 4 reviews the time period of 1993-2006. Both in the first time period (1994-95) and the second time period (1997-98), the central government succeeded in adopting market measures in adjusting economic activities. For the third time (2003), even though the monetary tools improved after decades of development, the central government directly intervened in investment activities through administrative orders. Explanations will be provided on the technocrats' adoption of these specific policy instruments.

Chapter 5 examines the relationship between the adoption of different policy instruments and the level of economic stability during the six economic cycles. In order to provide an alternative perspective to the changes in policy instruments, I look at the influence of economic factors, including the level of inflation rate, the level of

Retail Price Index (RPI), and the amount of money supply from 1978 to 2006. I also provide an overview of the complex economic factors that are imposing substantial influence on regulation policies during recent years, including the strengthening of the private sector, the integration into the global economy, and the financial sector reform. The conclusion from this chapter is that the interpretation of factional politics and the interpretation of other economic factors are not mutually exclusive with each other in explaining the adoption of policy instruments in investment control.

Chapter 6 provides a summary of the study and discusses the limitation of the study. A crucial limitation of the study is the measurement of political tension between the two factions. In the last part of this chapter, I also suggest directions for future study.

CHAPTER 2

BACKGROUND AND CONCEPTUAL PERSPECTIVES

The maintenance of macroeconomic equilibrium explains only one of the two layers of the policy goal by the central government in controlling investment during each economic cycle. The other layer of the policy goal is related to the competition between the central and local governments in dominating investment approval power. In this chapter, I will first explain why the competition over economic power between central and local governments comes as a policy priority rather than the improvement of market mechanisms in adjusting economic behavior. This involves a discussion of three issues: the tension between the central government and the local government on economic issues; the practical concerns of central government officials on political interest; and the central officials' reluctance in initiating substantial financial reform to strengthen the independence of the banking sector. Second, I explain how this policy priority of competition with the local government will be translated into specific policy mechanisms. Here I include a discussion on the different distributional effects of the administrative measure and the market measure. The former is proved to be more effective in the short-term and has more concentrated target groups. The latter requires a longer period of time to show policy effectiveness and the target group of this policy mechanism is more diffused. Third, I explain how the political tension between the technocrats and the generalist leaders will influence the "prioritazation" of policy mechanisms when it comes to investment control. I will explain the different political interests of the technocrats and the generalist leaders, and how the patronage relationship between the generalist leaders and local officials influence the policy implementation of technocrats. In the last section, I will explain why I consider technocrats, rather than the generalist leaders, as the political group that possesses ultimate power in policy-making regarding the investment control issue.

Central-Local Relations and Investment Policy Goals

Increase in investment activities is usually understood as an economic phenomenon, which is motivated by relevant economic incentives; however, in contemporary China, the increase in investment is related to the political tension between the local and the central governments. As discussed in the introduction section, investment growth is largely driven by local officials' eagerness in pursuing economic and political security. Local economic growth can always bring improved tax revenues and support local governments' developmental projects. From a perspective of economic security, economic growth enhances local governments' economic security by lowering economic deficit, avoiding shortages, and increasing self-reliance. If the local governments improve their economic performances, local officials will be promoted by the central government. Thus, local provinces compete with each other in constructing new projects.

Scholars have noticed the phenomenon that fiscal and political decentralization has brought changes to the relationship between the central government and the local governments. Montinola, Qian and Weingast (1996) adopted the concept of a "federalism of Chinese style" to describe the shifted dynamic between the central and local governments in China's contemporary economy. They have argued that fiscal and political decentralization in China granted local governments with relative authority in promoting the local economy. With a hard budget constraint,[1] local governments become active in promoting township-village enterprises (TVEs), which increased significantly the local governmental revenue. However, this incentive for economic growth from the local level also imposed challenges on the coordination of the economy at the national level. Local governments acquired increased autonomy in economic, political, and judicial power, which is "irreversible" institutional change. Discrepancies in economic development policy between the central government and local governments become difficult to address.

According to Huang (1996), economic reforms have "considerably weakened control by the central government over economic activities in the localities" (p. 655). The reform has weakened administrative control over many aspects of the economic activities, including the loosening of administrative approval of investment projects, the decentralization of tax collection, and the gradual detachment of administrative

[1] The hard budget here refers to the hard constraint on governmental budget. It does not necessarily extend to a hard budget constraint on local enterprises. State-owned enterprises (SOEs) at local level still face the problem of soft-budget constraint.

leadership from the banking sectors. Huang argues that even though this change happened, the central government always made attempts to regain administrative control over local provinces. Huang studied the tightening of leader appointment and promotion system by the central government and its influence on shifting the economic incentives of local provincial leaders. Frequent personnel changes and appointments by the central government tend to make local officials pursue an "objective function" closer to that of the central government on economic and financial issues. Even though not directly testing the strengthening of administrative control over provinces, Huang's study suggested that the central government is continuously making attempts to strengthen the centralization measures, including personnel control.

The incentive of central bureaucracies in centralizing economic control over local provinces has been recorded by previous scholars. Wang and Fewsmith (1995) studied the resistance of functional changes by the powerful central planning bureaus, such as the State Planning Commission (SPC), which was under the leadership of technocrats. Their study revealed that the central planning bureaus possessed intrinsic political interests in advocating the conservative economic policies and the central planning bureaus took advantage of their information collection and policy-implementing powers to "resist, deflect, and enervate the market-oriented reform policies" (p. 51). As the decentralization reform was implemented and the central planning bureaus' decision-making power in capital construction investment was diluted, these organizations still managed to take advantage of the periodically overheated economy to recentralize their control in the name of "restoring economic order" (p. 61). Even though the study by Wang and Fewsmith focused on the early period of market economy reform, we still believe that the central planning bureaus and technocrats' political interest in centralizing economic policy power is still logically plausible.

Besides the basic consideration in maintaining bureaucratic authority, central technocrats also possess certain higher level consideration on the "state capacity,"[2] which can be revealed from the policy recommendation reports that the central technocrats accepted. Wang Shaoguang and Hu Angang (1993) revealed the vulnerability of China's taxing system, which provided local governments with a bigger share of the tax revenue and left the central government with a smaller portion of tax revenue. The authors consider this as eroding the state's capacity in organizing large scope economic production activities, especially during this market transforming period. They opposed the reform policy in granting local officials with increased fiscal power to stimulate local economic development and advocated the strengthening of central fiscal power through an effective reform of the tax system. This study aroused great attention from the central government and some even say that this study led to the tax reform in 1994.

Previous studies indicated the policy tension between the central government and the local government on regulating investment growth. The intensified signal transmitted to the central government through several rounds of investment growth

[2] State capacity refers to the state's capacity in extracting economic resources.

was that overheated economy does not only represent a macroeconomic management problem, but more importantly, indicates the necessity in dampening the local authority in economic policy-making. To effectively achieve this policy-goal within a short time, administrative orders in controlling investment growth is usually the policy mechanism to choose. I will explain the different effectiveness and political cost of both administrative measures and market measures in the second section.

Maintaining macroeconomic equilibrium comes only after the central technocrats stabilize their political and economic authority. Improving long-term macroeconomic equilibrium involves effort in establishing market mechanisms in regulating economic activities. A famous Chinese economic scholar, Xue Muqiao, advocated for the establishment of a comprehensive fiscal and monetary system in adjusting macroeconomic equilibrium. He pointed out that macroeconomic equilibrium involves the reasonable distribution of economic resources among different economic sectors. Ultimately solving the problem of macroeconomic equilibrium depends on the establishment of a comprehensive tax system, well-functioning central bank system, and a regulated financial market (Xue, 2006). As discussed in the introduction chapter, improvement in macroeconomic equilibrium will repay the central bureaucrats with increased tax revenue from a long-term perspective. Central technocrats still possess the incentive to carry out these financial reforms; however, this incentive was much weaker than the concerns on maintaining political and economic authority. This prioritization of policy goals directly influences the policy mechanisms technocrats adopted in controlling investment growth, which will be discussed in detail in the third section.

Administrative Measures vs. Market Measures in Investment Control

In controlling investment growth, administrative measures have immediate effects. Meanwhile, administrative measures are implemented through a hierarchical bureaucratic investment scrutinizing system, which the technocrats are familiar with. In contrast, the market measures involve the adoption of fiscal or monetary measures in leveraging investment activities which requires a much longer period to reveal policy effectiveness and more complicated economic tools for the technocrats.

Administrative Measures and Policy Effectiveness

The adoption of administrative measures usually relies on the hierarchical bureaucratic structure, which was strengthened during the planning economy. The policy effectiveness of this category of measures in controlling investment growth can be witnessed within a short time since it directly eliminates the investment projects. Also, this category of measures does not involve complicated fiscal or monetary mechanisms which require extra time and political resources to implement. When the technocrats set the regaining of political and economic authority as policy priority, rather than improving long-term macroeconomic equilibrium, they will adopt administrative measures to control investment growth.

Retrenchment policies through administrative orders are implemented through the central planning bureaus, including the State Planning Commission (SPC), the State Economic Commission (SEC),[3] and their local branches. The State Council promulgates the general target for the retrenchment policy. The SPC and the SEC separately revise the five-year and one-year production plan. The revised production plan eliminates those investment projects with low profitability, with small production scale, or with laggard technology. Local branches of the SPC and the SEC receive orders from the central planning authorities, and implement the production plan accordingly (Wang & Fewsmith, 1995). Thus, a network of economic planning bureaucracies was organized under the leadership of the State Council. Retrenchment plans are implemented to each level of government through this bureaucratic network.

This category of measures evolved with the rationalization of the bureaucratic system since market reform was initiated; however, the administrative nature of this policy tool remains throughout different time periods. Previously, most of the investment projects were directly funded by the central budget. The retrenchment program could merely retract the budget from unnecessary projects. In 1985, the central government reformed the budget-funding system, and transformed government appropriations to bank loans. This reform involved the banking sector as a financial resource provider. However, this did not substantially increase the difficulty for the central planning bureaus to intervene in local investment activities. They supervised

[3] The SPC was transformed into the State Development and Planning Commission (SDPC) in 1998 and the SEC was transformed into the State Economic and Trade Commission (SETC) in 1995. The SDPC and the SETC was combined and a new central planning bureau, the National Development and Reform Commission (NDRC), was established in 2003.

the investment activities through a central approval system. Projects with production capacity above a certain level needed to be approved by the SPC. If retrenchment plans were initiated, the central planning bureaus simply tightened the scope of administrative restrictions for new investment projects to be approved.

Another perspective of administrative orders intervenes in the decision-making of the banking sector on tightening the credit scales. The banking sector was under strong influence by administrative orders in financing activities. During the period of investment retrenchment, the central government ordered the banking sector to reduce the ceiling of the credit scale to specific enterprises, or specific economic sectors. The banking sector did not make this decision of reducing loans based on impartial evaluation of certain investment projects, but based on abeyance to administrative orders. Both direct administrative order in eliminating investment projects and administrative intervention in loan provision can be considered as administrative measures. These two measures were effective in quickly reducing the speed of investment growth.

Market Measures and Policy Effectiveness

In adjusting investment activities, market measures include, but not limited to, the adjustment of interest rates, the increase or decrease of the deposit-reserve ratio, and the regulation over interbank borrowing and lending. In China, the market measures in adjusting investment activities have not developed into a comprehensive system. Some efforts in improving the comprehensiveness of the financial system also enhance the mechanisms of investment adjustment, such as the differentiation of money supply criteria based on different levels of money liquidity. This study only considers those financial reforms that aim to improve the filtration function of the market in financing good quality investment projects as market measures.

Market measures leverage investment activities indirectly and require a longer period to show effectiveness. Take the adjustment of interest rates as an example. Rising interest rates will bring a higher operating cost of business. New investments will be reduced by this rising cost. However, this process does not happen within a short period. According to a study by Shi, Deng, and Liu (2004), the time lag between investment activities' response to the retrenchment policy and the implementation of retrenchment policy is usually 2-4 seasons (six to twelve months). Similarly, the time lag for the interbank loan interest rates is usually 2-3 seasons (six to nine months) (Sun, 2006). If technocrats have a short-term policy goal, such as regaining economic authority within a short time, market measures are not proper policy mechanisms for them.

Generalists' Intervention and Technocrats' Policy Prioritization

As discussed previously, central government officials do not have unitary political interests toward investment regulation. Generalists' intervention into technocrats' policy agenda of centralizing investment control always led to the prioritization of policy goals in regaining economic authority. I will first explain the different political interests of the generalists and the technocrats toward investment regulation. Then I illustrate how generalists' intervention into technocrats' centralization policy agenda led to the changes in prioritizing policy goals by the technocrats. Finally, I reiterate my hypothesis and introduce the plan for the following chapters.

Generalist leaders, also known as the reformist leaders, advocate the expansion of local discretional powers on investment decision-making. The generalists were promoted from local party branches. They receive political support from local provincial leaders as a patronage to support local economic development. Based on the broad membership from local party branches, the generalist faction dominates the crucial party apparatus. They usually possess the ultimate power in policy making, unless they would substitute their policy-making power to the technocrats during difficult economic periods.

Compared to the generalist faction, which possess broad political support, the technocrat faction is composed of a relatively smaller scope of elites who were promoted within certain bureaucratic groups (*xitong*). Rather than pursuing a political goal of ultimate domination of the political power within the CCP, technocrats usually aim at getting a promotion in a vertical bureaucratic system. Their preference over financial centralization relies on the expansion of their jurisdictional domination over the financial resources for national projects, such as the Three Gorges Dam and the development of western China. Centralized financial resources allow them to expand the scope of domination over bureaucratic agendas. When the expansionary policy became out of control, the technocrats took the advantage of this economic situation and bargained with the generalists for the implementation of retrenchment policies according to their plans. Because of the limited scope of patronage for the technocrats, the generalists have little concern about the ultimate domination of political power by the technocrats. Thus, the generalists temporarily grant the policy-making power to technocrats and let them combat the rising inflation.

In this study, I argue that once the generalists intervened into the technocrats' policy agenda of recentralizing the investment policy-making authority, the latter adopts administrative measures in regaining control. The intervention from generalist leaders in the short-term policy agenda of the technocrats can be indicated from two aspects: 1) generalist leaders' effort in marginalizing the technocrat group in order to implement the expansionary policy and 2) Local officials' breaching of the central principle under the endorsement of generalist leaders in not to intervene in the banking sector in order to support the local investment activities that aroused the attention from central technocrats.

CHAPTER 3

1978-1991: TRANSITIONAL PERIOD

Market reform during 1978-1991 can be considered as a transitional period. The market mechanism was not maturely established. There was a combination between socialist planning economy and market economy. There were three periods' macroeconomic adjustments during this transitional period. The first period was 1978-1981, in which the central government adopted administrative measures in controlling investment growth. Political fissures between the reformist leaders and the technocrats led to the technocrats' failure in adopting market measures in macroeconomic management. The second period was 1982-1986, in which the attempt of "soft-landing" through market measures was initiated by the technocrats. Temporary political stability for the technocrats provided them with flexibility in attempting long-term macroeconomic management reforms. The third period was 1987-1991, in which the "hard-landing" policy through administrative measures was adopted. This period's policy mechanism can be explained by both the economic situation and the factional politics between the two groups of elites.

In each of these three periods, I will firstly explain the tension between two political factions. I pay special attention to whether the technocrats' political or economic authority was significantly constrained. Then I discuss how the marginalization of technocrats could lead to the prioritization of recentralizing economic control as short-term policy goal. After introducing these political contentions, I examine the administrative measures or market measures that were adopted during each period of retrenchment. I will discuss whether the prioritization of recentralizing economic control by the technocrats could explain the adoption of administrative measures. In the last, I look at economic factors during each period and explore whether economic stability could explain the policy mechanisms in controlling investment growth.

1978-1981: Hard Landing and Contention Over Political Agenda

Since the establishment of market economy reform in late 1978, two groups of political elites in China held different opinions on economic policies. The generalist leaders, also known as the reformists, advocated fast speed of reform and higher economic growth through encouraging investment. This group of leaders was represented by Deng Xiaoping,[1] Hua Guofeng,[2] and Hu Yaobang.[3] During this period, the generalist leaders managed to marginalize the technocrats, represented by Chen Yun,[4] Li Xiannian,[5] and Yao Yilin.[6] Several crucial political positions, including the

[1] Deng was the Chairman of the Chinese People's Political Consultative (PPC) (1978-83). He was considered the designer of the market economy system in China, and was politically influential until mid-1990s.

[2] Hua was the Chairman of the Chinese Communist Party (CCP) (1976-81), but under Deng’s leadership upon economic policies.

[3] Hu was the successor of Hua as the Chairman of the CCP (1981-82).

[4] Chen was the 1st Vice Premier of the PRC (1954-75, 1979-80). He was also the director of the Finance and Economic Commission (FEC) and was in charge of the economic policies.

deputy director of the Central Finance and Economic Leading Group (CFELG), were replaced with generalists' coteries.

Fissures Between the Technocrats and the Generalists

Deng's reform policy encouraged local autonomy in developing economy. Deng considers the initiative spirit by the local officials and entrepreneurs as a beneficial dynamic to improve economic profit. He urged the bureaucratic system and its subordinate banking sectors to loosen their doctrinal principles on planning economy. He opened green lights for local investment projects that were considered as profitable by local officials. In contrast with this reformist view, Chen Yun and his followers advocated the "comprehensive balance (*zonghe pingheng*)" in economic development. By emphasizing "comprehensive balance," they mean that there should be a balance between financial revenue and expenditure, between bank loans and repayment of credit, and between the supply and demand of goods and materials. It also emphasized the linkage among different economic sectors. The key to maintain these balances was through planning and coordination. Chen Yun opposed the overheated development of certain economic sectors under the mobilization of local officials which would lead to "big rise and fall (*daqi daluo*)" of the economy.

[5] Li was also Vice Premier at this period (1954-80). He presided over the economic work together with Chen. He also possessed conservative economic views, and pro-centralization policies.

[6] Yao was the successor of Chen as the Vice Premier of the PRC (1988-93), and he was a coterie member of Chen.

Deng was not satisfied with the conservatives' over-emphasis on economic balances and the tightened coordination over economic resources.[7] In order to support the development of the local economy, he successfully changed the "tones (*diaozi*)" within the communist party and demoted several conservative leaders, including Chen Yun, from crucial economic bureaucratic positions. Deng firstly castigated bureaucratic control over economic resources. He complained that "now, there are numerous reports on the budget and the banks. There are now many good projects that only require several hundred thousand yuan to make them work. But the budgetary and the banking system would not approve (the funds), so they languish" (Deng, 2000). He urged the bureaucratic system to support local investment projects, "… projects in the tens of millions range can work very quickly, so the budget and the banks should support them" (Deng, 2000). Deng directly accused Chen's coterie of state planners of blocking resources in the budget and in the banking system, stifling local economic programs.

Not only on economic policies did Deng reach triumph over the technocratic faction, but also on political influence. In 1980, Deng organized the Central Finance and Economic Leading Group (CFELG) to replace the Finance and Economic Committee that was previous under the leadership of Chen Yun (Shih, 2007). Zhao

[7] What Deng suggested here was the economic coordination of the central planning bureaus, including the SPC and the SEC. These planning bureaus were under the leadership of Chen Yun and his followers. The planning bureaus established specific production plans for the enterprises, coordinated among different ministries to arrange the supply of raw materials, and made decisions about raw materials that needed to be imported. Local enterprises would not be able to start investment projects unless the planning bureaus coordinate financial resources and raw materials for them. The coordination was usually based on the consideration of "comprehensive balances."

Ziyang was appointed the Deputy Director, and Chen Yun's protégé Yao Yilin became the vice deputy director of this organization. Although Chen still had great influence in the vast planning bureaucracy, his power was for the moment eclipsed by the newly promoted Premier, Zhao Ziyang. Through these institutional arrangements, Deng further dominated the political and economic agenda and weakened the technocrats' influence.[8]

After countermanding of Chen's earlier reduction orders, the discipline over fixed asset investment collapsed in the last quarter of 1979. Investment reached 52.3 billion yuan by the end of 1979, over 2 billion yuan above Chen's earlier goal of reducing investment to below 50 billion yuan (National Statistics Bureau, 1979). As we discussed previously, increased investment activities at the local level was a major reason for the rising inflation rate in China. Since the last quarter of 1980, the major cities witnessed rapid increasing of consumer products prices. Average inflation in cities rose to 8 percent, a level not seen after the Great Leap Forward. State Council bureaucrats immediately drafted emergency notices to the Premier (Xue, 2006, p. 363). The level of inflation reached highest level in the most recent ten years and Deng and his coterie took this situation seriously. If the crisis grew out of control, he and his generalist faction would face a threat to their political authority. Deng decided to

[8] The appointment of deputy directors of the Central Leading Small Groups (CLSG), including the CFELG, reflects the political agenda from political elites in the Politburo. For a review of the importance of appointment in these central leading groups, see Zonghai Shao (2005), "Zhonggong Zhongyang Gongzuo Lingdao Xiaozu de Zuzhi Dingwei" (The CLSG: Its Definition and Status in the CCP), *Mainland China Studies*, *48*(3), 1-23.

delegate the economic policy-making power to technocrats and let them carry out the austerity plan they advocated.

Economic instability provided the technocrats with an opportunity to regain power. Because of the limited scope of patronage for the technocrats, the generalists have little concern about the ultimate domination of political power by the technocrats. Thus, they temporarily grant the policy-making power to technocrats and let them combat the rising inflation.[9] At this time, many of the technocrats' economic policy suggestions were dampened by the generalist leaders. Their previous proposals of reducing the scale of investment growth at local level were opposed by the generalists.[10] Once the generalists approved their retrenchment policy, the technocrats did not hesitate in tightening the investment approval within a short time.

Policy Mechanisms in Controlling Investment

Chen Yun and his faction carried out strict reform over the expanding investment activities. Administrative measures were adopted in combating the rising inflation, mainly through the planning bureaus like the State Planning Commission (SPC). Rather than an investment ceiling in the 50 billion yuan range at the present

[9] For a discussion on the political tension between the generalist leaders and the technocrats on economic issues, see Victor Shih (2007), *Factions and Finance in China: Elite Conflict and Inflation*. Cambridge University Press.

[10] Early in 1979, Li Xiannian had ever made the suggestion at a central meeting that "economic adjustment should be put forward as the priority of economic works currently; … local large- and medium-size investment projects should be cut off at hundreds level; … 22 technology imported projects should be postponed with no hesitation." See Donglian Xiao, "1979 zhi 1980 Nian: Jingji Tiaozheng zai Zhenglun zhong Tuijin" (1979-1980: The Process of Economic Adjustment under Contention), *Dangshi Bolan* (General Review of the Communist Party of China), 2006, Vol. 2.

level, Chen called for fixing investment at 32 billion yuan and maintain a moderate growth rate of 4-5 percent for the next three years (Document Research Center of the CCP CC as cited in Shih, 2007, p. 100). Budget financed investment was cut from 24.2 billion yuan in 1980 to 17 billion yuan in 1981, and the investment target for 1981 was set at 30 billion yuan, an 86 percent cutback from the actual investment level in 1980. Eight billion yuan was transferred to central coffers from the provinces via "central borrowing," and 5 billion yuan of treasury bonds were issued. Measures were also taken to augment the administrative authority and the vertical control of the PBOC, by prohibiting local officials from authorizing loans. There is no evidence, however, that an adjustment of interest rates was used to curb credit demand. The State Planning Commission (SPC) drew up detailed guidelines for investment approval criteria, banning investment projects in ten categories (SPC as cited in Huang, 1999, p. 159).

The result of the 1981 retrenchment was quite impressive. Realized capital investment was 44.3 billion yuan, about 16 percent above the planned retrenchment target. The budget deficit was cut to 2.55 billion yuan, an 80 percent reduction from the level of the previous year. Price rises were contained. Retail prices and the cost of living rose by 2.5 percent in 1981, comparing with the 6.0 percent and the 7.5 percent rise, respectively, in 1979 and 1980 (State Statistical Bureau, 1987, pp. 558-60).

Scholars say that the central planners were not aware of the financial tools they could adopt in macroeconomic management and this was the reason for the dependency on administrative measures.[11] However, this might not be the case. Xue Muqiao, a famous economist,[12] had made suggestions to the central government since 1979 emphasizing the improvement of the fiscal and monetary system in adjusting macroeconomic equilibrium. He mentioned that the administrative measures were mostly "being pushed by the urgent economic situation." These measures seemed to have legitimacy at that specific time period; however, policy makers have to reexamine about the adoption of these imprudent measures. More efforts should be put in the establishment of a comprehensive tax system, well-functioning central bank system, and a regulated financial market (Xue, 2006).[13] He also mentioned that he was constrained of talking about adopting market measures in adjusting economic activities during 1980-81 as the policy-makers were not trustful in the policy effectiveness in these measures. Thus, government consultants had suggested about adopting more reasonable measures (even though not specifically as "fiscal or monetary measures") in adjusting economic activities; however, these reform suggestions were not accepted and discussed until 1984. The technocrats were constrained by the short-term policy goal of controlling investment growth. In the next

[11] See Jianing Wei (2008), "Gaige Kaifang 30 Nian Zhi Hongguan Tiaokong: Huigu yu Fansi (Macroscopic Regulation and Control During 30 Years Market Economy Reform: Review and Reflection)," a research paper of the Development Research Center of the State Council, available online: http://www.chinareform.org.cn/explore/history/201007/t20100727_38035.htm

[12] Xue was an academician of Chinese Academy of Science and former minister of the National Bureau of Statistics (NBS). He was also the chief consultant for several governmental research institutes, including the Development Research Center of the State Council, and the Economic Research Institute of the State Planning Commission (SPC).

[13] 2006 was the year that Xue published his memoir; however, the memoir reviewed many of his experiences as government consultant since 1950s.

section, I will discuss how the situation changed and the political flexibility allowed technocrats to consider long-term macroeconomic adjustment measures.

1982-1986: Attempt of Soft Landing with Immature Economic Mechanisms

During this period, the technocrats were not harshly undermined by the generalist leaders. Even though the economy became heated again and the increase of inflation rate even surpassed the level in the previous period, technocrats did not set the combat against rising inflation as an urgent policy agenda to be achieved within a short time. Another reason for the loosening of technocrats' political agenda in the competition for economic authority through retrenchment policies was their triumph over the investigation of corruption cases in the Special Economic Zones (SEZ), an economic reform program by the generalist leaders. Based on a long-term economic adjustment goal, the technocrats adopted both administrative measures and market measures in controlling investment growth.

Domination of Technocrats in Political Agenda

After the 1981 decline of inflation rate, in 1982, investment activities quickly recovered and climbed to 55.5 billion yuan. Deng's faction did not give up in initiating countermeasures against the retrenchment policy. They convened meetings with leaders from the central planning bureaus, including the SPC, the SEC, and the Ministry of Agriculture, to push for an increase in the planned growth rate for the coming year of 1983. However, their domination over economic reform agenda was meddled by the technocrats on a crucial aspect, the Special Economic Zones (SEZ), a pet program by Deng.

Since 1980, Deng had been trying to implement the reform of the Special Economic Zones (SEZ) which was a crucial reform in promoting local economic development by providing local governments with increased autonomy. Gu Mu, the head of the SEZ Office of the State Council, told cadres at the Hainan SEZ in Guangdong that "in the past few years, there was economic adjustment, but now we can put the acceleration of Hainan's development on the agenda" (Gu, 1986). At the end of January 1984, Deng took a trip to the prosperous provinces of Guangdong, Fujian, and Shanghai, where he exhorted local officials to "speed up growth and relax regulation a bit" (Document Research Center of the CCP CC, as cited in Shih, 2007). Deng was impressed with Shenzhen's progress and wanted to devolve investment approval power for projects below 30 million yuan to all the SEZs. Also, Deng wanted to expand the SEZ experiment to several other coastal cities, including Qingdao and Dalian (Deng, 1998).

Meanwhile, Chen Yun managed to undermine Deng's program of SEZ through the Central Discipline and Inspection Commission (CDIC). The CDIC was a crucial central bureaucracy which investigates the corruption behaviors of party members. The investigation of the CDIC usually reflects the political attitude within the communist party toward economic activities.[14] Chen Yun was the secretary of the

[14] Zhao (1993) studied the role of the CDIC in reflecting the inner political tension between Deng and Chen upon the SEZ issue. He concludes that both the two sides considered the CDIC as a crucial political base which could shape the media agenda.

CDIC in 1978-87. He initiated several investigations on local governors' corruption cases in SEZs. In 1985, the CDIC conducted an investigation over one special economic zone, Hainan Province, on importing luxury products and reselling them for much higher profits to inland provinces (Renmin Ribao, 1985). The investigation revealed the defects in the SEZ reform and revealed to other members within the party that Deng and his coteries' reform had wasted great economic resources of the country. During this period, even though Deng still managed to promote local autonomy in economic development, the technocrat faction under Chen's leadership could still maneuver political resources to maintain the domination status of bureaucratic system in economy policy making.

Absence of contentious debates over the economic development issues between the technocrats and the generalists and the triumph over the SEZ program loosened the technocratic leaders' policy agenda in competition for economic authority. When the inflation became obvious since 1984, they did not merely adopt administrative measures in controlling investment growth.

Policy Mechanisms in Controlling Investment

At the end of 1984, currency in circulation increased by over 26 billion yuan, much higher than the planned increase of 13 billion yuan (Xue, 2006, p. 403). At the same time, inflation rate rose to 2.8%, almost double times of that in 1983 (1.5%). The economic growth rate in 1984 was 25.1 percent over the previous year, and this number reached even higher in 1985, 44.5 percent, one of the highest in PRC history

(State Statistical Bureau, 1986, p. 446). The signs of macroeconomic instability began to surface. Retail prices rose 2.8 percent in 1984, and in 1985 they rose by another 8.8 percent. Central leaders under Deng, again, reluctantly endorsed Chen's retrenchment plan in order to maintain macroeconomic equilibrium.

Even though the inflation rate was higher than the level in 1980, the retrenchment measures were more flexible than the previous period, and several long-term adjustment measures were adopted. The regulatory power of the PBOC was strengthened. Within 1985, the PBOC raised interest rates twice, once in April and another time in August (see Table1), which had not been observed in previous adjustments. Fiscal policy was also adopted in the economic adjustment. In April 1985, the PBOC promulgated a stipulation on controlling the credit scale, "Several Regulations on Controlling the 1985 Credit Scale." This regulation stipulated a maximum level of credit increase of 71 billion yuan in 1985. The Agricultural Bank of China (ABC) was also imposed with a maximum level of credit increase of 14.1 billion.

Other measures through the PBOC were also adopted, such as the control over trust loans, establishment of a minimum deposit reserve rate for rural credit unions. These measures, even though still with strong character of administrative orders, were operated through banking sectors. Compared with the administrative measures of directly shutting down investment projects by bureaucratic authorities during 1980-81, this period's adjustment measures possessed certain level of flexibility.

Table 1

Interest Rate, 1979-2006

	Demand deposit interest rate	Time Deposit Rate		
		1 year	3 years	5 years
1979	2.16	3.96	4.50	5.04
1980	2.16	5.76	6.84	7.92
1982	2.88	6.84	7.92	8.28
1985	2.88	6.84	7.92	8.28
1985	2.88	7.20	8.28	9.36
1988	2.88	8.64	9.72	10.80
1989	2.88	11.34	13.14	14.94
1990	2.88	10.08	11.88	13.68
1990	2.16	8.64	10.08	11.52
1991	1.80	7.56	8.28	9.00
1993	2.16	9.18	10.80	12.06
1993	3.15	10.98	12.24	13.86
1996	2.97	9.18	10.80	12.06
1996	1.98	7.47	8.28	9.00
1997	1.71	5.67	6.21	6.66
1998	1.71	5.22	6.21	6.66
1998	1.44	4.77	4.95	5.22
1998	1.44	3.78	4.14	4.50
1999	0.99	2.25	2.70	2.88
2002	0.72	1.98	2.52	2.79
2004	0.72	2.25	3.24	3.60
2006	0.72	2.52	3.69	4.14

Source: National Statistics Bureau (2007).

1987-1991: Hard Landing and Political Crisis

The retrenchment policies during 1987-91 were believed to be the harshest among the six times' macroeconomic adjustments. People tend to connect the harsh retrenchment policies with the economic and political crisis during 1989. This explanation is not totally reasonable. It is reasonable to argue that the economic situation during 1987-88 led to a significant austerity plan in late 1988. However, the political crisis happened in 1989 which was actually after the austerity plan was initiated. In this section, I will explain how the economic situation and the political tension between the technocrats and generalists together led to the adoption of administrative measures in controlling investment.

Fissures Between the Technocrats and the Generalists

Contentions between the two factions over economic policies during this period focused on the proper level of inflation. A newly rising generalist leader, Zhao Ziyang, was the major actor who pushed the technocrats' policy agenda of centralization to marginal area. Zhao mobilized a group of young economists under him to reexamine the implications of inflation. They made an effort to reinterpret the economic inflation and tried to prove that it was within normal level. This group of economists was organized under the Economic Reform Institute (ERI) to generate economic policies separately from those economists who were supported by the technocratic leaders (Fewsmith, 1994). Zhu Jiaming, one economist from this group, authored an article arguing that high growth required a rapid expansion of money supply and relatively increased inflation. Throughout the years between 1986-87, this group of economists kept producing works to rationalize the quick expansion of economy, and to contend that the inflation was temporary phenomenon that would disappear after ownership transformation. Zhao himself also preferred to hear these theories and the stories of Latin American countries. He argued that his previous travels to Latin American countries told him that these countries could maintain economic prosperity with a huge inflation rate.

Contentions over the proper level of inflation escalated in 1987 when State Council economists tried to report the danger of the continuously rising inflation rate. Ma Hong, the director of the Development Research Center of the State Council, wrote a report on the exceeding distribution of national income (*guomin shouru chaofenpei*) warning Zhao of inflationary pressure on the economy caused by several quarters of rapid increase in lending. Zhao became furious about this report and castigated Ma in a Politburo meeting for having a "pessimistic attitude that caused unnecessary panic" (Wei, 2008). Zhao's firm attitude against any attempt to implement retrenchment policy during this period led to another round of relaxation of money supply. The PBOC decree ordered local branches to provide an adequate amount of liquidity to commercial banks to support working capital loans (PBOC, 1987 as cited in Shih, 2007).

Besides debates on economic policies with technocrats, the generalist faction also tried to regain the political height from the hands of technocrats. Deng was not satisfied with Chen's domination over the CDIC to investigate local governors' corruption cases. In 1986 he managed to shift the main anticorruption effort to the Central Secretariat headed by Qiao Shi, a junior member of Deng's faction. A shared power between the Central Secretariat and the CDIC ended the monopoly power by the CDIC in corruption investigations. The first case the Central Secretariat investigated was the subsidiary of the Ministry of Aviation Industry, a heavy industrial ministry directly under the leadership of the SPC (Document Research Center of the CCP CC 2004 as cited in Shih, 2007).

Temporarily under disadvantages on economic and political agendas, technocrats could only wait for economic situation to allow them to regain control over the combat toward inflation. In late 1987, signs of overheating began to appear. In a February 1988 CFELG meeting, Yao suggested that the Chinese economy was on the verge of collapse and that retrenchment was urgently needed. Zhao, at this moment, was still trying to rationalize the expansionary policy, and refuted technocrats' comments by arguing that "in Brazil, prices increase 15 to 70 percent; how can people live there? Why can't we live [with similar price increase]" (Fewsmith, 1994, p. 223). As a result of generalist faction's strong resistance toward retrenchment policy, the technocrats' still had to wait for proper opportunities to regain political agenda.

Situation shifted in late 1988 when the central government initiated the price reform. In May 1988, Deng began to call for comprehensive price reform to remove many consumer goods from the list of commodities controlled by the State Planning Commission (SPC). When Deng raised this issue at a Politburo meeting in the middle of May, the planners strenuously objected and insisted on a five-year timeline (Chen, 1995). Deng and Zhao still pushed for the realization of this reform agenda. Deng said, "the reform of price has to be implemented, no matter what kind of risk we will face, and no matter what kind of difficulties we have to overcome" (Hua, 2008). In August, Zhao had the *People's Daily* announced the price reform. After the official decision was made, residents realized that the price was going to rise soon. Panic purchasing started in several big cities and quickly spread to other cities around the country. Meanwhile, the inflation rate entered the double-digit range; retail prices rose by 18.5 percent and the climb in the urban cost of living was even steeper, around 20 percent. By the third quarter of 1988, price rises reached an annualized rate of 50 percent (Naughton as cited in Huang, 1996, p. 164).

Deng, after hearing the reports from Premier Li Peng, was aware of the urgency of this situation and had to acquiesce with the retrenchment plan by technocrats. Zhao also admitted that he had misestimated the situation of high inflation and had over-pushed the steps of reform. With consensus from the generalist faction, the State Council meeting on August 30, 1988, passed a resolution to freeze prices and limit investment and lending for the remainder of the year (State Council as cited in Shih, 2007). Under the pushing by technocrats, another round of administrative orders of retrenchment started.

Policy Mechanisms in Controlling Investment

Price controls were reimposed on some of the industrial goods whose prices had been liberalized. The State Council specifically mentioned that there were to be no exceptions for those SEZ regions, including Guangdong, Fujian, and Hainan (State Council, 1989b). The state monopoly over the marketing of a number of key raw materials was reimposed, and many of the trade corporations were ordered to shut down (Renmin Ribao [People's Daily] as cited in Huang, 1999). In a move to centralize the investment approval procedure, a “regulatory committee” was established to review project applications and to remove approval authority from individual government officials (Renmin Ribao [People’s Daily] as cited in Huang, 1999). Li Peng, as a member of the technocrats, headed the interagency leadership group within the State Council to preside over investment reduction work. The investment reduction target was quite drastic.

Yao Yilin (1991) announced that the capital investment target for 1989 would be 22 percent lower than the 1988 level, and in an attempt to preempt any anticipation of a more relaxed macroeconomic policy course later in the years, he strongly reproached those regions that had a “wait-and-see” attitude and were delaying in implementing central investment reduction measures. The State Council also drew up a long, extremely detailed, list of projects that were to be suspended. The list contained five general categories of projects, and within each category between twenty and thirty products were banned categorically (State Council, 1989a).

To curtail local investment, the State Council in essence abolished the authority of the localities below the provincial level to approve new project application for 1989 and 1990. Approval authority at the provincial level was reduced. Projects in excess of 10 million yuan were still approved by the provincial governments, but the decisions had to be reported to the SPC for record keeping. The investment control approach was overwhelmingly administrative in nature, even though some indirect macroeconomic measures were also adopted. The central government raised interest rates on deposits (see Table 1) and indexed them to inflation to stop the flight from financial assets. Lending rates on fixed-asset loans were raised sharply. Explicit quotas were assigned to local banks for investment-lending. This practice is separate from quotas for other lendings in order to minimize slippage in the use of funds.

Some may argue that the drastic administrative measure adopted during this retrenchment period was because of the political crisis; however, this saying was not the whole truth. Administrative measures were adopted by the technocrat because they had been waiting for the opportunity to recentralize the economic power that had been decentralized during 1986-87. The countervailing forces from the generalists in protecting local investment growth forged the technocrats' antagonistic attitude toward expansionary policy. According to Huang (1996), the contention over macroeconomic policies was "engulfed in a power struggle between the reformist wing of the leadership (headed by Zhao Ziyang) and the more cautious, central planning wing headed by Li Peng." The drastic shifts between the two political agendas dampened the effectiveness of a long-term macroeconomic adjustment.

Summary

This early period of market economy reform was considered as lacking mature financial mechanisms in adjusting economic activities. Scholars argue that the large dependency on administrative measures in controlling investment growth was a result of shortage of financial knowledge. However, during the three periods studied, we observed that the attempt of adopting market measures was not totally absent. This attempt occurred during the period that technocrats possessed relative political flexibility (1984-86) to implement long-term financial reform. A more clear view of political tension among elites and the policy mechanisms across the three time periods is indicated in Table 2.

The retrenchment policy in 1980-81 was mainly through administrative orders. Some scholars argue that the central planners were not aware of alternative macroeconomic management measures (Wei, 2008); however, this might not be true. From 1980 onward, Xue Muqiao, a famous economist, had proposed the reform of macroeconomic management measures (Xue, 2006). Technocrats were constrained by their short-term policy goals in regaining economic policy-making authority. The technocratic faction under the leadership of Chen Yun was marginalized by the generalist leaders, represented by Deng Xiaoping. Chen was deprived of the deputy director position in the traditionally powerful Central Finance and Economic Leading Group (CFELG) in 1980. Deng and his coterie, including Zhao Ziyang and Hu Yaobang, were pushing for the expansion of local discretional powers in starting investment projects. When Chen controlled the economic work after the inflation rose significantly in the last quarter of 1980, he adopted strict administrative measures to manage investment growth.

Table 2

1978-1991: Factional Politics, Policy Priority and Policy Mechanisms

	Political Elites		Factional Politics	Policy Priority of Technocrats	Policy Mechanisms
1978-82	Technocrats Generalists	Chen Yun Deng Xiaoping Zhao Ziyang	Generalists established new bureaucracy, the Central Finance and Economic Leading Group (CFELG) under the leadership of Zhao Ziyang and replaced Chen Yun's Finance and Economic Commission (FEC).	To regain policy authority on economic issues.	<u>Administrative measures:</u> Investment ceiling was reduced; Budget-financed investment cut; Central borrowing from provincial banks; Treasury bonds were issued.
1983-86	Technocrats Generalists	Chen Yun Deng Xiaoping	Technocrats investigated several corruption cases of the Special Economic Zones (SEZ) through the Central Discipline and Inspection Commission (CDIC).	To control investment growth and to maintain long-term macroeconomic equilibrium.	<u>Administrative measures:</u> Budget-financed investment cut; <u>Market measures:</u> PBOC raised interest rate twice; Fiscal policy of controlling credit scale; Control over trust loans; Establishment of a minimum deposit reserve rate for rural credit unions.
1987-91	Technocrats Generalists	Chen Yun Deng Xiaoping	Generalists organized a group of economists to form the Economic Reform Institute (ERI) and tried to rationalize the high inflation rate.	To regain policy authority on economic issues.	<u>Administrative measures:</u> Price control; State monopoly of marketing; Tightened approval authority; Investment projects cut; "Regulatory Committee" formed; <u>Market measures:</u> PBOC raised interest rate; Explicit quotas were assigned to local banks for investment lending.

Political tensions between the technocrats and the generalists changed slightly during the second economic cycle in 1984-86. The technocrats consolidated their authority in making economic policy. Also, they defeated the local authorities in deliberately expanding their economic activities. Chen Yun, through the Central Discipline and Inspection Commission (CDIC), investigated several corruption cases of the Special Economic Zones (SEZ). Local authorities became more cautious in expanding business operations to make sure they were compliant with the central disciplines. When the signal of rising inflation occurred in 1984, the technocrats became more flexible in controlling investment growth. The administrative measures, including the elimination of investment projects through central orders, were still adopted. However, several long-term macroeconomic management methods were also considered by the central government. The PBOC raised interest rates twice, once in April and another time in August, which had not been observed in previous adjustments. Other measures through the PBOC were also adopted, such as the control over trust loans, and the establishment of a minimum deposit reserve rate for rural credit unions.

The last economic cycle during this period (1987-91) adopted significant administrative measures to manage the investment growth. This measure can be explained by both the economic crisis and the elite political tensions during this period. However, through observing the timeline of the occurrence of events, we can notice that the fissure between technocratic leaders and generalist leaders on the continuously rising inflation have existed long before the burst of the political unrest in 1989. The technocrats had been in strong opposition to the high level of inflation rate. The newly raised generalist leader, Zhao Ziyang, tried to marginalize the technocrats by organizing a group of economists under the Economic Reform Institute (ERI). Zhao and this group of leaders made every of their efforts to rationalize the high level of inflation rate and kept pushing for increased investments. The technocrats did not find a proper opportunity to regain their authority in economic controls until the inflation became out of control in 1988. The shock therapy of the price reform under the pushing of the generalists in 1988 brought a large scale of panic purchasing in many big cities. Technocrats regained their policy-making power on economic issues and they adopted administrative measures in controlling inflation. Severe measures through administrative orders in eliminating the investment project could partly be explained by this long-term accumulated fissure between the two factions. Technocratic leaders represented by Chen Yun regained their authority in policy agenda through the severe contractionary policies. Meanwhile, the political unrest in 1989 further intensified the objective urgency of the situation which finally led to the implementation of administrative controls. Partly, these measures were to combat the serious economic crisis during this period, including the price control and the freezing of circulation of commodities. However, the technocratic leaders also took advantage of this economic situation to regain their authority in economic area. The investment project approval power was recentralized and a regulatory committee was established to supervise the implementation of retrenchment policy. These measures can be explained by the technocrats' urgent policy goal in regaining policy authority in economic area.

CHAPTER 4

1992-2006: ESTABLISHMENT OF THE SOCIALIST MARKET ECONOMY

Investment activities during this period involved more diversified types of ownership. In substitution of the bureaucratic coordination, the establishment of socialist market economy in 1992 allowed the market forces to adjust economic activities. However, a market economy required no fewer institutional constraints than a planned economy did. The Chinese government was not fully prepared to adopt market mechanisms to adjust economic activities. In this section, I review three periods' macroeconomic control over investment activities. Some of them succeeded in adopting market mechanisms, while the others were less successful. Again, the successful adoption of market measures was always accompanied by a constrained political tension between the technocrats and the generalists.

1992-1996: Soft Landing Under the Domination of Technocrats

The relationship between the technocrats and the generalists experienced subtle changes after a new generation of leaders rose in 1992. Jiang Zemin was selected by Deng as the next president of the PRC in 1993 and became the successor of the generalist faction. Even though he had the background of being a bureaucrat,[1] Jiang

[1] Jiang was the ministerial leader of the machine-building industry and the electronics industry for more than twenty years before getting promoted as the mayor of Shanghai.

possessed broad provincial support, especially from eastern and southern provinces, including Jiangsu, Shanghai, and Guangdong (Shih, 2007). In the early years of his presidency, he relied largely upon the support from technocratic leaders, especially Zhu Rongji,[2] for the consolidation of his political bases. Zhu was then the Vice Premier entrusted with the oversight of the country's economic and finance policy-making. Jiang relied largely on the cooperative relationship with Zhu during the early years of presidency. Jiang faced political vulnerability from an unstable political environment. Several political peers, including Qiao Shi and Li Ruihuan, challenged his political base and his leadership style under different occasions (Shih, 2007). Nathan and Gilley (2003) also mentioned Jiang's unstable situation during his first few years of rule and indicated that he was "constrained by several equal power centers" (p. 185). Jiang had been relying largely on Zhu's solid support since Zhu had a consolidated status within the party. Several times when Jiang's proposal was attacked by others, Zhu stood at his side and expressed his support.

Cooperation Between the Technocrats and the Generalists

In 1994, when Zhu initiated retrenchment policies toward the gradually heated investment activities, he did not encounter significant political obstacles from the generalists. This was also due to his own capability in maintaining a good cooperative relationship with the generalists, which provided him with sufficient political

[2] Zhu consolidated his political status as a capable technocrat through his impressive performance in solving the triangular debt problem of the State Owned Enterprises (SOE) during 1992.

flexibility in implementing long-term financial reform. The economic cycle during this period started from Deng's south tour[3] in 1992. This tour further encouraged local provinces' eagerness in developing the local economy. Even though Deng was still influential during this period, the south tour was considered his last push in market economy development. After 1993, because of his health, Deng did not intervene much in Zhu's centralization reforms.[4] Thus, the political tension between the two factions during this period mainly came from Jiang Zemin and Zhu Rongji.[5]

As the economy became heated, in 1994, Jiang Zemin, Zhu Rongji and Li Peng, convened a provincial leaders meeting and affirmed that the central government's foremost task in the coming year was inflation control. Jiang first set the direction of the discussion (*ding diaozi*) at the beginning of the meeting. He castigated the local provincial governors by checking about the price control at the local level. He asked, "How much can a citizen buy one kilo of eggs now?" Local governors answered, "a little more than 3 yuan." Then Zhu Rongji continued the conversation by refuting the local officials' report by arguing, "I have inspected several days ago, it was much more expensive than this price." Zhu had previously drafted a report on

[3] The south tour was a travel to Guangdong Province by Deng Xiaoping in 1992. It is believed that this tour further encouraged the development of market economy in China. Deng mobilized local provinces to speed up in importing foreign technologies, and involve diverse ownership enterprises.

[4] Official comments also said that Zhu's centralization reform in 1994 was under the consensus of Deng, see a comment from Kang Jia, director of the Research Institute for Fiscal Science, Ministry of Finance (MOF), "Dui Zhongguo Difang Caizheng Xianshi Wenti de Renshi (Some thoughts on the practical problems in the local financial system)," available from author's blog: http://blog.caijing.com.cn/expert_article-151563-19269.shtml

[5] Li Peng, as the Premier during this period (1988-98), was also a member of the technocrat faction. However, his political status was vulnerable and his political influence as a premier was almost a superficially symbolized figure (Shih, 2007).

implementing Sixteen Measures (*Shiliu dian jihua*), containing specific requirements on raising the deposit and loan interest, retracting the exceeded bank loans, reforming the foreign currency retention system, cutting the infrastructure investment scales, etc. These measures had been reemphasized. Also, Jiang supported these measures by sternly denouncing those local officials who breached central measures contracting investment activities. He published an editorial in Renmin Ribao (People's Daily) firmly requesting that local officials obey the requirements established by the central government and stop their irresponsible behavior of expanding non-performance loans (Kuhn, 2005). Instead of spreading conflicting signals on economic policies, leadership at this period exhibited a unified stand of points against inflation (Shih, 2007).

Policy Mechanisms in Controlling Investment

Political flexibility provided Zhu and the technocrat faction sufficient time in implementing the adjustment measures. Zhu designed several long-term economic reform measures in combating rising inflation. In order to implement reforms of the financial sector, Zhu designated himself as the President of the PBOC. He implemented strict regulations over the bank loans dispatched to local enterprises and adopted rigorous monetary policies on controlling investment scale. The PBOC gave priority to monitoring money supply and deposit and loan interest rates as two major indicators for the promulgation of monetary policies. For the first time, the PBOC adopted measures of monetary aggregates and differentiated various levels of money liquidities in order to provide an analysis of money supply. This differentiation improved PBOC's monetary leverages in supervising the macroeconomic equilibrium and providing strategies in adjusting money supply (Luo, 1999). Emphasis on monetary policies had been a main reason for the success of the "soft landing" during this period. Retrenchment policies during this period were well known in Chinese economic history as successfully controlling rising inflation without significant damage on the private economy.

1997-2003: Asian Crisis and Expansionary Policies

The 1997 Asian economic crisis led to the second significant financial reform during Jiang and Zhu's term of office as the president and the premier. They continued their cooperative relationship and Zhu carried out multiple long-term financial reforms during this period.

After the previous period of retrenchment policies, the recovery of economic development was still in process when the Asian economic crisis hit the surrounding countries of China in autumn 1997. The quick spreading credit crisis in the banking sectors in Asian countries aroused caution for the Chinese bureaucrats about the risk control of commercial banks. The banking system in China was far from being maturely commercialized at this period. Commercial banks did not have full autonomy in making independent decisions on whether to provide certain enterprises with loans. If those enterprises were state-owned, usually local governments possessed influential power in the provision of loans to certain investment projects (Cheng, 2008). The banking sector could not be independent from the local intervention and impartial evaluation of investment projects could not be conducted. Not being able to guarantee the quality of investment projects they supported, the banking sector was not eager to change the situation as we might expect, since they could always turn to local governments or higher level banking agencies for financial support (Wang & Wang, 2006). This soft-budget constraint on both the enterprises and on commercial banks generated a great number of non-performing loans (NPL). Under a decentralized economy, this situation became deteriorated since the central bureaucracy became incapable of supervising the funding activities by local banks with strong intervention from local governments.

When the financial crisis came, the central bureaucracy had several paths to recentralize the financial control, including administrative measures and economic measures. On the one hand, the central bureaucracy could tighten the money control through prohibiting local officials from authorizing loans, issuing government bonds, and transferring money from local banks to central banks through "central borrowing." These administrative measures could have frozen local funds temporarily and provided investors with a certain level of confidence in the stabilization of the financial sector in China; however, it could not solve the problem of soft-budget constraints within China's banking system and could not eliminate the non-performing loans (NPL). On the other hand, the central government could implement long-term financial reform and other economic measures[6] in reducing the credit risks. Institutional changes could be implemented to improve the efficiency of the banking sector through separating local governments' influence from funding decisions.

Cooperation Between the Technocrats and the Generalists

Political flexibility during this period provided technocrats with enough time and resources in adopting economic measures and implementing financial reforms. Jiang, instead of insisting on the protection of local governors' interests, advocated the tightening of financial control. He realized that "the prevention and resolution of financial risk is an important and urgent task" (Zhu, 1998). Actually, early in 1996, Jiang started paying attention to the huge number of non-performing loans (NPL) in the banking sector. In August 1996, Jiang convened a ministerial level meeting at Beidaihe, discussing the current financial risk caused by the high level NPL and some possible corresponding strategies. The four major commercial banks[7] totally possessed a balance of loans of 3.4 trillion yuan with 840 billion yuan non-performing loans (NPL), occupying 24.75% of the total amount of bank loans (Dai, 2010). In this meeting they discussed the current situation of high risks embedded in the financial sector, but did not implement concrete policy dealing with this problem.

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[6] Economic measures here are not constrained with the adoption of interest rate or fiscal measures in adjusting economic activities, but broadly involve financial sector reform which will improve the efficiency of macroeconomic management in a long-term perspective.

[7] The four commercial banks refer to the Bank of China (BOC), the People's Construction Bank of China (CBC), the Industrial and Commercial Bank of China (ICBC), and the Agricultural Bank of China (ABC).

In February 1997, before the burst of the Asian financial crisis, Jiang convened another meeting with the leaders from the Ministry of Finance and the PBOC to discuss the prevention of a deteriorated situation of financial crisis. This meeting aimed at arousing the awareness of various levels of party leaders about the serious consequences of illegal government appropriation for local investment projects. In May 1997, Jiang met the leader of the Ministry of Supervision,[8] and listened to the report about the local governor in Enping, Guangdong Province, who illegally ordered local banks to collect money at much higher interest rate and improperly provided loans to local cement enterprises. This behavior by local governors in Enping caused the credit crisis in local banks and rural credit unions twice within one year, and almost led to bankruptcy of local banks. The total financial loss in Enping was estimated to be 10 billion yuan. This event caught the attention from central leaders, including Jiang. Even though Guangdong Province was believed to be one of Jiang's political bases, he ordered stern investigation and severe punishment of this case (Dai, 2010).

Policy Mechanisms in Controlling Investment

When the financial crisis came, Jiang had realized the seriousness of the crisis and stood at Zhu's side in recentralizing the financial control. In October 1997, the Central Committee and the State Council jointly issued the "Notice Concerning Deepening Financial Reform, Rectifying Financial Order, and Preventing Financial

[8] Previously the Central Commission for Discipline Inspection (CCDI) until 1993.

Risk" (Guanyu shenhua jinrong gaige, zhengdun jinrong zhixu, fangfan jinrong fengxian de tongzhi). This document firmly transmitted the signal of the central government's determination in dealing with the NPL problem and the trend of recentralization of financial control. In November 1997, Zhu presided an emergency Central Finance Conference and spread the central government's decision of reducing local intervention in the funding decision of the banking sector. He also promised that institutional changes would be implemented in ultimately separating the local government from intervening in the banking sector. After the meeting, 12 working groups were established and chaired by central bureaucratic leaders to draft the institutional reform plans. By the following year's Central Finance Conference, a concrete reform plan was completed, which eliminated all the provincial PBOC branches and established 9 grand cross-province branches under the direct leadership of the central PBOC office. In order to strengthen the central control over these branches, a vertical party committee system within the financial system that was isolated from local intervention was established. The leading group of this system was the Central Finance Work Commission (CFWC), headed by the Vice Premier Wen Jiabao. Even though this reform was more about centralization, rather than the commercialization of the banking sector, it was an attempt to make institutional changes in constraining local governmental erosion in the banking sector. As Wen concluded, "this institutional change involved redistribution of power among different interest groups, and required a great amount of intellectual and diplomatic work from the central government" (Wen, 1998).

Besides institutional changes within the banking sector, other economic measures, including the reform of the exchange rate system, were also adopted in combating the financial crisis. Actually the reform of the exchange system was a heritage from Zhu's 1994 economic reform, as part of the Sixteen Measures (*Shiliu dian jihua*). Before 1994, China implemented the dual exchange rate system. In order to encourage enterprises in earning foreign exchanges, in 1986, the central government stipulated that enterprises could hold certain proportions of the foreign exchanges it earned from trade business,[9] and sell these foreign exchanges at a market price at some assigned foreign exchange swap centers. This led to the formation of a dual exchange rate system, with the coexistence of an official transaction market with a fixed rate and a free trade market with a floating rate. Rent-seeking behavior was significant during this period because the powerful officials who took control over the foreign exchange transactions within the official system could always get a certain amount of foreign exchanges for much higher prices at a free market. Zhu's reform in 1994 eliminated the officially fixed exchange rate and unified the dual exchange rate into one market exchange rate. This reform deprived the privilages of those powerful local officials and improved the performance of trade business. The flexibility of the trading businesses was strengthened. This prepared in advance for the adjustment of management strategies during the Asian financial crisis.

[9] Before 1980, foreign exchange management in China was under unified collection and allocation. All the foreign exchanges earned by enterprises should be sold to the central government. After 1980, enterprises could retain certain proportion of foreign exchanges and bring them to the swap center for the adjustment of surplus and deficiency; however, this transaction was at fixed rate stipulated by the government. In 1986, the price control of the retained part foreign exchanges were released.

During the post-crisis period, in order to encourage investment, the central government implemented expansionary policies for the following four years (1998-2002). These expansionary policies were mainly through economic measures, rather than administrative measures. Zhu's government issued 100 billion yuan special government bonds[10] and borrowed 100 billion yuan loans from commercial banks in support of the construction of infrastructural facilities. The PBOC also implemented expasionary monetary policies, including the lowering of the deposit reserve ratio from 13% to 8% and the lowering of interest rates for three times within 1998. Besides these expansionary policies to encourage investment, other measures were also generated to expand the domestic demand, including the generation of the consumption credit. In 1999, the PBOC promulgated the "Development of Individual Consumer Credit Guiding Opinion," in order to develop the consumption credit services for individuals. One year after the implementation of this consumption credit service, the total credit loans for individual consumption reached 135.8 billion yuan compared to 42.6 billion yuan in 1998. These policies stipulated domestic consumptions[11] and improved economic performance after the Asian financial crisis.

[10] Special government bonds differs slightly from ordinary government bonds. It was not issued to balance the governmental budgetary deficit, but to specifically support the development of certain industry or to support the economic development during certain period.

[11] Mainly in the real estate consumption.

2003-06: Fissure Over Economic Policies Under New Leadership

Fissures Between the Technocrats and the Generalists

During this period, Jiang[12] was still influential over economic policy-making, especially on the expansion of investment funds for eastern and southern provinces where his political base stood, including Jiangsu, Shanghai, and Guangdong. Unlike his cooperative relationship with Zhu Rongji, Jiang's relationship with the new generation of leadership, Hu Jintao[13] and Wen Jiabao,[14] was relatively confrontational rather than cooperative. Jiang insisted in supporting these coastal provinces' economic development with the central budget. His insistence substantially influenced the central-local relationship upon economic issues. Meanwhile the aggrandized authority[15] by local officials in economic policy-making strengthened their negotiating power with the central government. During 2004, the growth of money supply by the PBOC reached 19 percent and the lending growth reached 21%. According to Victor Shih (2007), most of the growth of loans happened in Jiang's supporting provinces,

[12] Jiang was relieved of his office as the president in 2002; however, he remained as the Chairman of the Central Military Commission (CMC) until 2005. He was still relatively powerful in protecting his provincial patronage's economic interests.

[13] Hu Jintao became the President of the PRC in 2002.

[14] Wen Jiabao became the Premier in 2002.

[15] The uncontrolled local officials' authority in investment project approval can be reflected from the case of Jiangsu Province Jiangsu Tieben Iron and Steel Company. On April 29th, 2004, the People's Daily published an editorial with extraordinarily firm tone announcing the State Council's investigation and prosecution of the illegal approval of the construction of Jiangsu Teiben Iron and Steel Company. Castigation over the provincial leaders in "blindly expanding the scope of project construction without taking into consideration the central macroeconomic management principles" appeared in the editorial. This editorial was transferred by many media and was considered as a firm response by the central government in regulating local investment behavior.

including Jiangsu, Zhejiang, Guangdong, Shanghai, and Shandong. Both Hu and Wen realized the urgency in constraining local authority's economic power in approving investment projects.

Policy Mechanisms in Controlling Investment

Retrenchment policies under the leadership of technocrats represented by Wen Jiabao were aiming at controlling the increasing investment activities in these provinces with effective measures. Wen Jiabao, at the Tenth National People's Congress, indicated that certain provinces needed to "start from reality, conduct affairs according to objective laws, combine enthusiasm to move forward with a knowledge of one's actual strength" (Xinhua News Agency, 2004). The motivation of local provincial leaders to promote investment projects was considered as the accumulation of higher political credits by increasing the local GDP (Liu, 2004; Xia, 2004). According to Xia, the political credit evaluation system in China encourages local officials to promote GDP growth without a comprehensive consideration of the overall economic efficiency of investment projects. Several industries, including steel, iron, cement, electrolytic aluminium, and flat glass, became the most attractive for investors because of the high profit generated by the increased market demand in these raw materials since 2003 (China Economic Times, 2006). At the provincial level, the constructions of these projects were in great redundancy with low technology efficiency. The amount of production was exceeding the amount of market demand in these industries (Beijing Unbank Consultant Institute, 2010).

The new round of retrenchment policies started under the name of controlling blind investment and over-capacity production in certain industries. At the executive meeting of the state council in 2003, Wen Jiabao explicitly listed several focuses for the next year's economic adjustments that were "the control of investment expansion, the regulation over certain industries that blindly increase investment in low technology efficiency and redundant projects" (Xinhua News Agency, 2003). A series of ministerial regulations were issued following this meeting in order to control the overheated investment projects. The National Development and Reform Commission (NDRC) issued "Several Opinions on Curbing Irrational Investment in Steel, Electrolytic Aluminium and Cement Industries" (State Council, 2003). Regulations over these industries strengthened the project approval system and explicitly specified the criteria to get permission. These criteria include the specific facilities certain plant should be equipped with, the specific production capacity the plant should reach, the level of energy consumption of the facilities, and the pollution that were estimated to be produced. Other criteria might even include the requirement on the specific characteristics of the facilities, including the area, volume, and height.

Administrative measures through ministerial approval of new investment projects and the elimination of certain backward production capacities had become the major strategy by the central government throughout 2004-2006. In 2004, the central government eliminated 23 large or medium-size projects in the electrolytic aluminium industry and stopped or postponed the construction of new projects with the total production capacity of 2.47 million tons (China Building Materials Information, 2006).

This round of retrenchment also adopted financial measures, including the reform of the investment and financing system. One essential problem of the continuous cycle of heated investment was considered as the flaw of the investment regulation system. Previously, under the mobilization of local governments, a large amount of financial resources were devoted into the construction projects which were believed to bring profits to the local budget. Local banks, as the major resources for financial funds, were under the domination of local officials. In order to change this situation, the central government promulgated the “Decision of the State Council on Reforming the Investment System” aiming at establishing a “new structure of multi-investors, multi-channels of capital resources, and diversification of ways of investment, as well as market-oriented project construction” (State Council, 2004). This decision has increased the opportunity of private capitals to participate in local investment projects and diversified the resources of financing. The local government had been dominating the investment in irrigation, transportation, natural gas, water supply, heat supply, and other infrastructural industries. These industries now allow investment by private capitals (National Development and Reform Commission, 2005).

Summary

In the first half of this decade, we witnessed relatively cooperative relationships between the generalist leaders and the technocrats. This political flexibility provided the technocrats with extra energy in implementing long-term macroeconomic management reforms, especially in improving the financial system.

Thus, even the inflation rate in 1994 (24.1%) was much higher than that in 1988 (18.8%), the central government still carried out several crucial financial reforms to adjust economic activities from a long-term perspective (see Table 3). However, in the second half of the decade, when a new generation of technocrats rose, political tension between the two sides became tightened again. We observed a readoption of administrative measures in controlling investment growth.

In 1992-93, Jiang Zemin became the newly selected president. Unlike the broad political base of Deng, Jiang faced vulnerable political situation when he came into power. Vice Premier, Zhu Rongji, a well-trusted technocrat who consolidated his political based through the solving of the triangular debt problem of the State Owned Enterprises (SOE) provided Jiang with political support. The cooperative relationship between Jiang and Zhu provided the technocrats with sufficient time and political resources in conducting long-term financial reforms during 1994-96. As the economy became heated in 1994, Zhu strengthened the leadership of the PBOC and adopted monetary policies in controlling investment growth. The monitoring of money supply and deposit and loan interest rate became two major indicators for the promulgation of monetary policies. For the first time, the PBOC differentiated different level of money liquidities in order to provide of money supply according to different level of liquidities.

Table 3

1992-2006: Factional Politics, Policy Priority and Policy Mechanisms

	Political Elites		Factional Politics	Policy Priority of Technocrats	Policy Mechanisms
1992-1896	Technocrats: Generalists:	Zhu Rongji Li Peng Deng Xiaoping Jiang Zemin	Generalists relied on the technocrats' support to consolidate their political base. The relationship during this period was more cooperative than confrontational.	To control investment growth and to maintain long-term macroeconomic equilibrium.	<u>Administrative measures:</u> Investment project cut; Retracting exceeded bank loans; <u>Market measures:</u> PBOC gave priority to the monitoring of money supply and deposit and loan interest rate in adopting monetary policies; PBOC differentiated different levels of money liquidities in money supply; Reform of foreign currency retention system.
1997-2002	Technocrats: Generalists:	Zhu Rongji Jiang Zemin	Continued cooperation between the two sides was observed throughout the whole economic crisis.	To stabilize economic situation from both short- and long-term perspective.	<u>Administrative measures:</u> Elimination of all provincial PBOC branches and establishment of 9 grand cross-provinces branches; A vertical leadership system was established within the banking sector under the leading of the Central Finance Work Commission (CFWC); <u>Market measures:</u> Dual exchange rate reform; PBOC lowered the deposit reserve ratio; PBOC developed individual consumer credit.
2003-2006	Technocrats: Generalists:	Hu Jintao Wen Jiabao Jiang Zemin	New leadership of techno-crats failed to maintain cooperative relationship with the generalist and the latter group expanded local investment activities, especially in Jiangsu, Zhejiang, and Shanghai.	To regain policy authority on economic issues.	<u>Administrative measures:</u> Strengthened investment approval in several industries, including cement, electrolytic aluminum, and flat glass; Elimination of investment projects; <u>Market measures:</u> Reform of the investment and financing system

The cooperative relationship between the technocrats and the generalists continued in the second economic cycle in this decade (1997-2002). The occurrence of the Asian economic crisis brought challenges to the central government in tightening its control over financial resources. Even though administrative measures were adopted in restructuring the managing system of the banking sector, these administrative reforms were considered as beneficial institutional changes in constraining local governmental erosion in the banking sector. Zhu eliminated all provincial PBOC branches and established 9 grand cross-provinces branches. A vertical leadership system was established within the banking sector under the leading of the Central Finance Work Commission (CFWC). Tightening control of the banking sector assisted in the rebuilding of confidence toward banking system, and helped with the combat against financial crisis. After the economic crisis, Zhu also adopted market measures in encouraging the increase of investment, including the lowering of the deposit reserve ratio and the implementing of individual consumer credit.

The cooperative relationship between the technocrats and the generalists did not continue in the fourth generation of leadership when Hu Jintao and Wen Jiabao became technocratic leaders. After Jiang was relieved of his office as the president in 2002; however, he remained as the Chairman of the Central Military Commission (CMC) until 2005. He was still relatively powerful in protecting his provincial patronage's economic interests. Unlike the moderate attitude during his cooperation with Zhu, Jiang became more aggressive in providing his patronage provinces with banking loans. Hu and Wen has ever publicly investigated and prosecuted Jiangsu

Province leaders, a political base of Jiang, in illegally approving an investment project of Jiangsu Tieben Iron and Steel Company. The tension between the two sides became escalated. When Wen Jiabao was granted with power to regulate the overheated economy in 2003, he readopted administrative measures. He strengthened investment approval in several industries, including cement, electrolytic aluminium, and flat glass. The NDRC also eliminated thousands of investment projects in these industries. However, Wen did not totally rely on administrative measures in adjusting investment activities as in early 1980s. He also initiated investment and financing reforms to improve multi-channels of capital resources, and diversification of ways of investment.

CHAPTER 5

ECONOMIC CONDITIONS AND INVESTMENT CONTROL MECHANISMS

The adoption of macroeconomic policies in adjusting economic activities is a policy response toward economic fluctuations. Policy instruments, including administrative measures and market measures, should reflect the policy goals. According to classic economic theories, the policy goal of macroeconomic adjustment firstly involves the maintenance of macroeconomic equilibrium. Administrative measures can be considered as short-term "shock therapies" to stabilize the economic situation within a short period, but it does not ultimately improve the macroeconomic equilibrium from a long-term perspective.[1] Based on this understanding, the adoption of administrative measures in macroeconomic management should be connected with emergent economic fluctuations which require stabilizing methods immediately. In this chapter, I will examine several economic indicators, including 1) the inflation rate, 2) the retail price index (RPI), and 3) the amount of money supply, to reveal the relationship between economic stability and the adoption of different policy instruments. In the last section of this chapter, I also provide an overview of the complex economic factors that are imposing substantial influence on regulation

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[1] For a review of the different policy effectiveness of various macroeconomic policy instruments, see S. Haggard & S. Webb, *Voting for reform: Democracy, political liberalization, and economic adjustment* (Oxford: Oxford University Press, 1994).

policies during recent years, including the strengthening of the private sector, the integration into global economy, and the financial sector reform.

Inflation Rate and Policy Instruments

Inflation rate has become one important indicator for the stability of the economy. Fluctuation in the inflation rate has also been the reason for the central government to adopt macroeconomic policies. We expect that the significance of the fluctuation in inflation rate will predict the adoption of different policy instruments, including short-term "shock therapy" method and long-term macroeconomic adjustment method. During the economic cycles that inflation rate rose significantly, we expect that the central government would adopt short-term effective methods to control investment growth. In order to control the rising inflation and maintain the macroeconomic equilibrium effectively, the central government would adopt administrative measures. During the economic cycles that inflation rate rose mildly, we expect that the central government would not adopt the severe methods as it did during the significant fluctuation period. As the "shock therapy" methods do not ultimately improve the macroeconomic equilibrium from a long-term perspective, the central government would avoid adopting these methods when the increase of inflation rate was mild. Instead, they will adopt market measures, including the fiscal and monetary measures, to adjust economic activities. In this section, I will firstly review the several economic cycles that indicated serious fluctuation in inflation rate. Then I will examine the inconsistency in the significance of inflation rising and the policy instruments by the central government. In the last, I connect these inconsistencies with the discussion in previous chapters to show its connection with elite politics.

Since 1978, there were totally six periods' economic fluctuations which were accompanied by obvious inflation rate rising (see Figure 1). Among the six periods' economic cycle, generally speaking, the significance of the inflation rising was in accordance with the policy instruments. However, for certain economic cycles, the significance of the inflation rising did not predict the severance of policy instruments. I mainly discuss three economic cycles. The first inconsistency was in 1984-86. The inflation rate during 1985 was 9.3%, higher than any other economic cycles except two peaks in the PRC history, the 1988-89 inflation and the 1994-95 inflation. However, compared with the severe administrative control in 1980-81, the central government, for the only time during 1980s, made an attempt in adopting market measures in adjusting the overheated economy. The PBOC raised interest rate twice and implemented other financial reforms, including the further specification of the scope of operation of the trust companies and the sources of funds for these trust companies. These long-term financial adjustment measures could hardly match the high level inflation rate during this period.

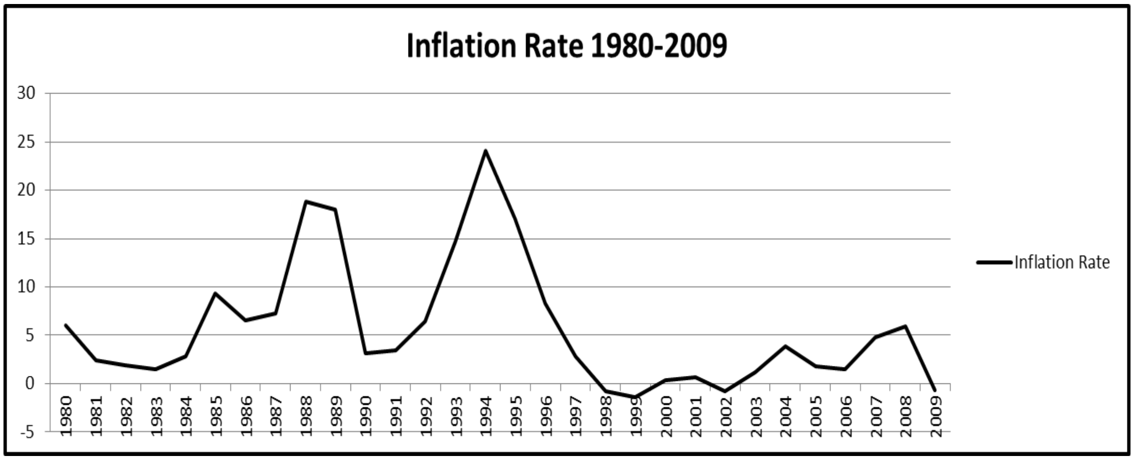

Figure 1. Inflation Rate, 1980-2009.

The high inflation rate in 1984 was a result of the reform of "delegation of power and transfer of profits (*fangquan rangli*)."[2] The central government promulgated the "Decision on the Reform of Economic System" in October, 1984. This reform delegated the enterprises with ten categories of management rights.[3] These reforms stimulated the activeness of enterprises to increase investment as they possessed greater power in management decision-making. The technocrats were not fundamentally against the delegation of management power to enterprises, like they did to the delegation of power to local officials. Chen Yun has for many times expressed his support in expanding the discretional power of the enterprises to bring

[2] See Min Ji, Chaoming Wu, "Gaige Kaifang Yilai Woguo Jici Wujia Shangzhang Fenxi (Analysis of the Several Times' Rising of CPI since the Market Reform)," *Zhongguo Jinrong (China Finance)*, 2010, Vol. 23.

[3] The ten categories include the right to establish production and marketing plan, to manage sales of product, to price the product, to import raw materials, to make decisions on fund using, to dispose assets, to change organizational structures, to arrange human resources, to arrange salaries, and to jointly use its land with other enterprises.

dynamic to the planning economy.[4] Inflation caused by increased investment at the discretion of enterprises did not arouse significant response from technocrats as the deliberate expansion of investment by local officials did. Most of the measures aimed at guiding the enterprise investment rather than controlling enterprise investment, such as the raising of interest rate, the further specification of the scope of operation of the trust companies and the sources of funds for these trust companies.

Another period aroused our attention is 1993-94 when the inflation rate reached the highest level since 1978. Under the leadership of Zhu Rongji, the central government adopted multiple measures in controlling investment growth, including extensive market measures. Conventional wisdom considers this period's success in implementing financial reforms as a result of Zhu's absolute governance character[5] and his expertise in finance and economic works. However, the support from generalists in sweeping away the obstacles from local officials also contributed greatly to the successful implementation of financial reform during this period. Jiang' support in initiating centralization reforms imposed local officials with a clear signal that the central government would not hesitate in tightening the financial resources for new projects. Zhu and his technocratic coterie did not need to wait until the last minute when the local investment became out of control to eliminate large amount of projects

[4] See an article Chen Yun wrote in 1979, "Jihua yu Shichang Wenti (The Problem of Planning and Market)," in *Selected Works of Chen Yun, Vol. III (1956-1994)* (People's Publishing House, 2005).

[5] See a commentary in Nanfang Zhoumo (Southern Weekly), an influential independent-mind news media in China, "Zhu Rongji Ling Zhongguo Jingji Chenggong Shixian Ruanzhuolu, Zhengce Quanmian Zhuanxiang (Successful leadership of Zhu Rongji in the Soft Landing of Chinese Economy)," *Nanfang Zhoumo (Southern Weekly)*, March 6, 2003.

through administrative measures. Even though this time the inflation was caused by the large amount of investment projects by local governments, especially the coastline provinces, the early intervention of the central government provided technocrats with flexible policy agenda. Zhu did not merely rely on administrative measures in eliminating investment projects; instead, several extensive financial reforms and the strengthening of the PBOC were successfully implemented.

Significance of inflation in 2003-06 weakly explains the readoption of administrative measures in investment control. Even though the inflation rate did not become exceptionally high,[6] administrative orders have already been issued to control the growth in several industries, including steel and iron, cement, electrolytic aluminium, and flat glass.[7] In this round of inflation, increase of investment in infrastructure construction in several provinces was considered as the reason for the momentum for the rising price. These provinces include Jiangsu, Zhejiang, Shandong, and Shanghai, all of which were the generalists' political bases. Unlike the early intervention during the last round of economic cycle, the generalists were not supportive in the centralization policies by the technocrats in this round of inflation control. Jiang and his coteries in local provinces resisted the early warning of centralization policies. This tension between the technocrats and the provincial leaders

[6] Scholars consider this round of inflation as within the scope of light inflation and it has imposed mild influence on the price of consumer goods. See Chen Yanbin, "Zhongguo Dangqian Tonghuo Pengzhang Xingcheng Yuanyin Yanjiu: 2003-2007 Nian (The Empirical Study of China Current Inflation's Causes: 2003-2007)," *Jingji Lilun yu Jingji Guanli (Economic Theory and Business Management)*, 2008, Vol. 2.

[7] See the NDRC document, "Several Opinions on Curbing Irrational Investment in Steel, Electrolytic Aluminium and Cement Industries" (State Council, 2003).

supported by the generalists can be indicated from the well-reported case of Jiangsu Tieben Iron and Steel Company. Technocrats' adoption of administrative measures was obvious in this round of economic adjustment, including the tightening of approval authority, and the elimination of laggard production capacity projects.

Retail Price Index (RPI) and Policy Instruments

The RPI has been adopted as an indicator for the stability of product price in China for longer time than the Consumer Price Index (CPI) did. Compared with the generally adopted CPI, the RPI is less effective in reflecting the price changes in service industries. However, the Chinese government adopted RPI in indexing the level of inflation several years after the establishment of the PRC (in 1956). The CPI was not officially adopted until 1994 and the record of more than ten years before this time cannot be achieved. In this section, I examine the fluctuation of the RPI[8] rate since 1979 and compare the fluctuation with the severity of policy instruments in investment control.

The curve of the RPI since 1979 has been in much accordance with the curve of inflation rate (see Figure 2). Since the RPI measures many of the products' prices that are also in the measurement of inflation rate,[9] the trend of RPI has been consistent

[8] RPI has been considered as a commonly adopted indicator for the central government in evaluating the fluctuation of economy, see Liqun Zhang, "Woguo Jingji de Zhouqixing Bodong yu Hongguan Tiaokong: Gaige Kaifang Sanshi Nian de Huigu (Thirty Years of Reform and Opening- up: Review and Reflection on China's Economic Fluctuation and Macroeconomic Management)," *Zhongguo Fazhan Guancha (China Development Observation)*, 2008, Vol. 11, 8-11.

[9] Both the measurement of RPI and inflation rate covers the price change of commodities, including food, clothes, etc. See Fan Yuejin and Feng Weijiang, "Hexin Tonghuo Pengzhang Celiang ji

with the fluctuation of inflation rate. Thus, some of the inconsistencies in the significance of fluctuation in RPI and the severity of policy instrument in controlling investment have been explained in the previous section.

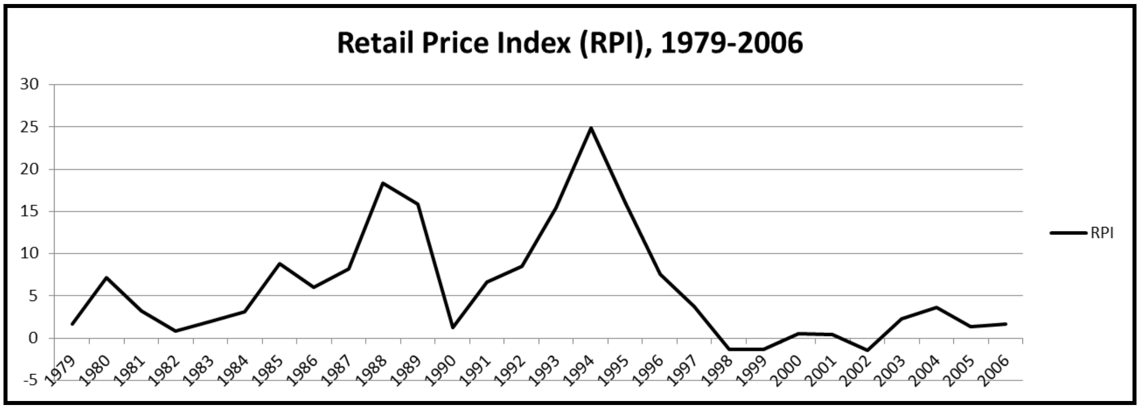

Figure 2. Retail Price Index (RPI), 1979-2006.

One important period that the RPI has become an important indicator for the policy instruments was 1988-90. In March 1988, the central government implemented reform on the dual-price system and allowed the float of commodity prices according to market demands. For long time, people have been accustomed to the quota system which provided citizens with commodities with specific amount and fixed price. Most of the commodities, including rice, soap, TV set, and refrigerator, were provided with quota. Immediately after the release of quota system and the floating of commodity prices, panic buying started to spread in several big cities. RPI significantly rose by

Hongguan Tiaokong de Youxiaoxing: dui Zhongguo 1995-2004 de Shizheng Fenxi" (Method of Measurement for Core Inflation and the Effectiveness of Macroeconomic Policy: Empirical Analysis of China's Case during 1995-2004), *Guanli Shijie (Management World)*, 2005, Vol. 5.

18.8% during 1988, but actually many products, including agricultural products, rose by almost 30%. The significantly rose retail prices aroused attention of the central government. Price stabilization measures were adopted and product prices became fixed again. In order to control the capital liquidity, the central government froze most of the financial floats through administrative measures. RPI explains this period's policy instruments better than other economic cycles, as discussed in previous section.

Money Supply and Policy Instruments

The curve of money supply since 1979 better indicates the dynamic of central government in expanding or controlling the scope of money supply and the dynamic of local commercial banks in producing the "multiplier effect" of money supply under the pressure of local government. In this section, I examine three levels of money supply, *M0* (currency in circulation),[10] *M1* (M0 plus demand deposits of enterprises, organizations and institutions, government agencies, social groups, army units, and rural cooperatives, plus collective owned demand deposits in rural areas, and other demand deposits), and *M2* (M1 plus time deposits of enterprises, organizations and institutions, and government agencies, plus time deposits of self-raised funds for infrastructure [*ji ben jian she*] investment, saving deposits of individuals, and other time deposits).

[10] The definition of the three levels of money supply was according to the definition by the People's Bank of China (1997).

The growth rate of the three levels of money supply (M0, M1, and M2) indicated different elasticity during the past three decades (see Figure 3). In 1984, a significant increase in M0 (currency in circulation) was a result of the increased money supply by the PBOC in order to meet the rapidly developing demands for expansion of investment projects (Dai, 2000). In order to make up the financial deficit of local commercial banks which was caused by excess loan to investment projects, the PBOC provides overdraft loans to local banks.[11] The policy instrument of money supply control in 1984 was quite severe, as indicated from the curve. The level of increase rate of money supply dropped over twenty percent during one year. This result was a surprising result according to our hypothesis in this study. We consider the policy instrument in 1984 was relatively mild compared with that in 1988. This can be explained by the limitation of this money supply curve in reflecting the severity of policy instrument. In previous discussion, we considered investment control policies not only about control on credit scale, but also about the tightening of approval authority and the clearance of business of multiple financial intermediaries (such as the trust loan companies). These administrative measures were not observed to be strong in 1984 retrenchment policy. Thus, the credit scale control reflected from this curve indicated partly about the severity of policy instrument in investment control.

[11] This function is called a "reversed transmission of the pressure for easing monetary condition (Daobi Jizhi)." It is a distinguished transmission system in China in which the local commercial bank's deficit crisis imposes pressure on the PBOC to increase money supply.

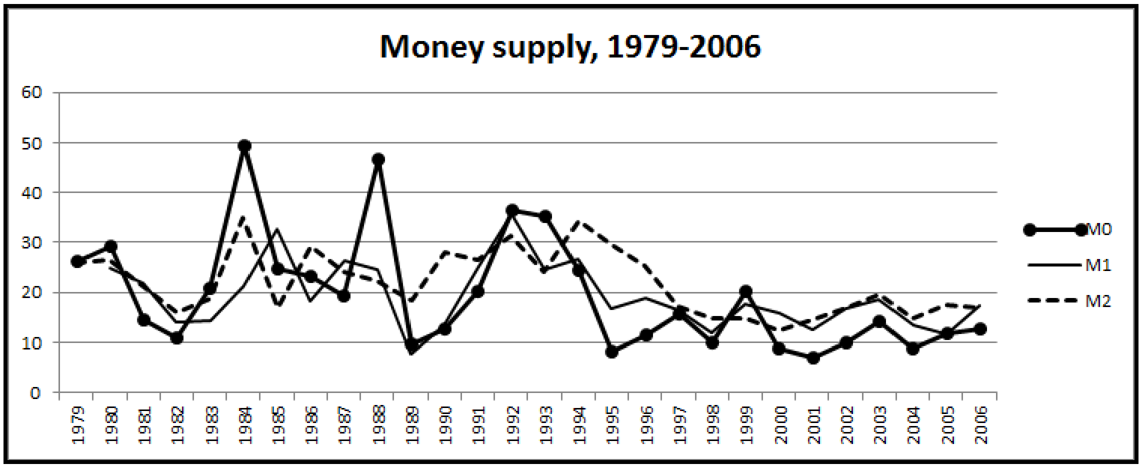

Figure 3. Money supply, 1979-2006.

Since 1994, from the fluctuation of the three levels of money supply, we can observe the fact that the increase rates of M1 and M2 were generally higher than that of M0. This can be explained by the different growth elasticity and the "multiplier effect" of money supply. As M1 includes the demand deposits from various social groups, it calculates certain proportion of the circulating money multiple times. The multiplier effect depends on the required reserve ratio[12] of the commercial banks imposed by the PBOC. Reform in 1994 changed policy instruments by the PBOC in regulating money supply from direct intervention in credit scale to indirect adjustment of the reserve ratio. Previously, we observe a sharp decline of M0 and not significant fluctuation in M1 or M2 in each round of retrenchment policy (including 1980, 1984, 1988). Under the strict credit scale control of the central government, money supply to

[12] The reserved ratio sets the minimum reserves each commercial bank must hold (rather than lend out) of customer deposits and notes. It is normally in the form of cash stored physically in a bank vault or deposits in the PBOC.

enterprises through bank loans was stabilized at a fixed level. After the introduction of policy instrument in adjusting the required reserve ratio, the response of M1 and M2 in stabilizing the amount of money supply always had a time lag with the implementation of the retrenchment policy. Also, under the multiplier effect and the lacking of physical constraint on credit scale, the commercial banks possessed higher flexibility in the continuation of provision of loans which led to the excess supply of M1 and M2 (higher than the level of M0).

The multiplier effect was more obvious in those time periods when local commercial banks were motivated to increase loans to investment projects, such as in 2003. During the 1990s, in addition to the domination of the central bank, a few smaller commercial banks, many city cooperative banks, and non-banking financial intermediaries on the joint-stock basis were established. The frequency of transaction among commercial banks and other financial intermediaries increased significantly. The commercial banks may borrow funds from the PBOC and engage in overnight lending activities in inter-bank fund markets. Thus, money supply becomes a multiple expansion of the central bank's net monetary liabilities. In this respect, the PBOC is capable of indirectly adjusting fund sources through establishing the required reserve ratio of commercial banks.[13] This can be indicated from the curve since 1994 when the supply of M0 became more and more stable and the supply of M1 and M2 were generally above the level of M0 through a multiplier effect.

[13] See G. Yi, (1991), The monetization process in China during the economic reform. *China Economic Review, 2*(1), 75-95.

Based on this understanding, we observe the fluctuation of M0, M1 and M2 for the economic cycle in 2003-06, rather than merely observing M0. We find out that money supply control during this period was mild. The central bank did not rely on the regulation of credit scale in macroeconomic management. Indirect measures, including the adjustment of required reserve ratio and interbank loan interest rates, became major policy instruments. This indicates that learning process of policy-makers in adopting indirect market measures in the macroeconomic management process. However, again, this curve of money supply neglected several subtle administrative measures adopted by the central government, including the tightening of project approval authority.

Deepening of Market Reform and the Complexity of Policy Instruments

This study focuses on the tension between local governments and central technocratic leaders on the expansion of local investment activities. The assumption brought up by this study is that local governments' behavior in pushing for increased investment is the major momentum of periodical inflation. Based on this assumption we assumed and tested central technocrats' selection of policy instrument targeting at curbing local governments' investment behavior. However, as the deepening of the market reform and the integration of Chinese market into the international market, the factors that influence the dynamic of local enterprises' investment behavior have become more and more complex. This section discusses how the diversification of domestic market and the integration into international market influenced the analysis model in this study. I will firstly discuss how the strengthening of private sector within the domestic market has brought challenge to the implementation of macroeconomic policies. Then I explore the reform of finance and investment system and discuss how this institutional change has shifted the domination of local governments in generating periodically overheated investment activities. In the last section, I investigate the influence of integration into global economic community on the macroeconomic equilibrium of China's economy. I achieve the conclusion that even though the deepening of market reform has, to certain extent, shifted the institutional arrangements that influence the growth and regulation of investment activities, local governments' domination over investment activities is still one of the major factors that influence the dynamic within this process. The analysis model of central-local governments' competition over economic power will still possess strong explanatory function as long as local governments dominate the investment activities of large state-owned enterprises (SOEs) which still occupies the largest amount of local economy.

Private Economy and Macroeconomic Equilibrium

Economic cycles in China have been driven by more and more diverse factors with the development of market economy, such as the strengthening of the private sector. The investment tide that was previously propelled by local state-owned enterprises under the pressure of local governments has nowadays been diversified by multiple types of enterprises, including private businesses. Private enterprises investment constituted only 34.4% in the total amount of national investment in fixed assets in 1990.[14] This number increased to 70.0% in 2006, which almost doubled during the past fifteen years (see Table 4). The increase rate of private enterprise investment during 2006 was 30.3%. According to a report on the development of non-state-owned economy in China, privately owned economy contributed to almost 65% of GDP growth in 2005 (The Development Report of Non-State-Owned Economy in China, 2006). The private sector has been imposing greater influence upon national economy, especially in the most recent decade.

Table 4

Total Amount and Percentage of Private Enterprise Investment

	State-Owned Enterprise Investment		Private Enterprise Investment	
	Investment	Percentage	Investment	Percentage
1985	1689.51	66.43	853.68	33.57
1990	2918.64	65.60	1530.65	34.40
1995	10898.24	54.44	9121.02	45.56
2000	16504.4	50.13	16413.3	49.87
2006	32963.4	29.97	77034.8	70.03

Source: National Statistics Bureau, 2007.

[14] According to the National Statistics Bureau (1991), private enterprises include individual-owned enterprises, collective-owned enterprises, joint-owned enterprises, share-holding economic units, foreign-funded economic units, and economic units funded by entrepreneurs from Hong Kong, Macao and Taiwan, in contrasting with state-owned enterprises (SOEs).

Private economy, unlike the state-owned economy that has been largely influenced by the local governments' investment agenda, is driven by more diverse economic factors. Compared with state-owned enterprises, the private enterprises are more sensitive toward changes in market demands. Without a promising bale out plan from local governments when facing bankruptcy, private enterprises have been more cautious in making the decision of investment. According to Yuan and He (2004), macroeconomic cycle that started from 2003 exhibited a notably new character that was an investment growth driven not only by the expanded scope of infrastructure construction but also by the increased individual consumption. Increased consumption, especially on housing and automobiles, gave impetus to investment in certain intermediate input products, such as iron, steel, electricity, and transportation (Yuan & He, 2004). Scholars have reached consensus that the private sector has been more responsive toward these changes in market demands. Niu (2004) pointed out that private enterprises contributed a large proportion in the newly increased investment in automobile industry and iron and steel industry.

Besides being responsive to the increase of market demands, the private sector is also sensitive toward changes in foreign trade situations. Large proportion of the private economy is composed of medium and small-sized enterprises. Many of these enterprises, especially those located in east coast line provinces, rely on exporting their products to foreign countries. With China's entry into the WTO since 2001, situations of global economy influences greatly on China's private sectors' export. This topic will be elaborated in the third part of this section. To sum up, with the growth of private economy, investment cycles in China are no longer merely driven by the willingness to increase investment by local or central governments, but instead by more diverse factors within the market. Thus, regulatory policy on investment growth can be influenced by multiple factors as well, rather than merely by the tension between bureaucrats and local officials.

However, the presence of a growing private sector does not totally deny the usefulness of the analysis model provided in this paper. Relationship between central bureaucratic elites and local officials still explains the policy instruments on regulating investment growth. The tension between local officials and central technocrats in maintaining a relatively balanced scope of investment can still effectively explain the policy agenda of central bureaucrats based on two reasons. First, even though the private enterprises investments were driven by multiple economic factors, they were still under direct influence of local government. Whenever local governments raised their expectation on the revenue that will be brought by investment, they encourage local investment through provision of extra loans and licensing of land use. Distorted financial system (part two of this section will discuss this topic in detail) and loosened regulation over land use substituted market signals. Investment in iron, steel, cement, flat glass, and other mediate input products follow the agenda of local government economic agendas rather than the market signals. Second, state-owned enterprises still compose a substantial proportion of the national economy and occupy the most crucial economic sectors. Infrastructural construction investment not only composes a crucial proportion of GDP growth, but also has multiplier effect in relation to other economic sectors (Liu, 2005; Zhu, 2009). These investments of infrastructural construction projects, such as the building of railways, dams, or bridges, are largely controlled by the state-owned enterprises, which are under the direct leadership of central or local governments. As long as these two transmission mechanisms between local governmental investment agenda and the actual increase of investment in national economy exist, the analysis model of central-local tension is plausible in understanding policy instrument in investment regulation.

Financial Sector Reform and Investment Growth Cycle

Recent financial reform in China was initiated by central bureaucrats with an attempt to detach local governments' involvement into local financial sectors. In 1998, provincial branches of the People's Bank of China (PBOC) were eliminated and 9 grand cross-provinces branches under the direct leadership of the central PBOC office were established instead. Meanwhile, a vertical party committee system within the financial system that was isolated from local intervention was established. The leading group of this system was the Central Finance Work Commission (CFWC), headed by the vice premier Wen Jiabao. In 2003, the central government promulgated the "Decision of the State Council on Reforming the Investment System" aiming at establishing a "new structure of multi-investors, multi-channels of capital resources, and diversification of ways of investment, as well as market-oriented project construction" (State Council, 2004, pp. 2-3). This decision has increased the opportunity of private capitals to participate in local investment projects and diversified the resources of financing. These reform measures weakened local governments' influence on the financial sector and brought diversified players on the stage of investment project financing.

Financial sector reform in China has not successfully detached local government from interference into the financing of local investment projects. Financial market in contemporary China was largely occupied by the four major commercial banks, the Bank of China (BOC), the People's Construction Bank of China (CBC), the Industrial and Commercial Bank of China (ICBC), and the Agricultural Bank of China (ABC). These four major state-owned commercial banks are inclined to provide investment loans for large-scale state-owned enterprises. According to Yang (2003), since the market reform in China, the fiscal capacity of the state declined and was not able to support the growth of state-owned enterprises as it used to do in the 1970s. Under this circumstance, the four major state-owned commercial banks substituted the Ministry of Finance in providing financial support for the development of nationally owned economy. Thus, investment loans are not dominated by the evaluation over the risk and profit of the financial resources, but instead influenced by the developmental policies at both central and local governments.

The structure of the financial sector and the provision of investment loans for nationally owned economy in contemporary China determine that government developmental agenda substantially influences the growth or decline of the total amount of social investment. Local branches of the commercial banks were under the influence of local government. If there is conflict between the central government and local governments or within central government toward the issue of local investment growth, this fissure of development philosophy will transfer into oscillation in local governments' developmental agenda as discussed in previous chapters. To claim that the tension between local and central governments on the issue of investment growth influence the economic cycle in China is not an exaggerated assertion, unless the economic structure among different types of economy (private- and state-owned economy) and the financial structure in providing investment loans have major changes, which is not promising to occur in the forthcoming years. These two factors discussed above, the growth of private sector and the reform of financial sector in China, are domestic economic factors. In the last part of this section, I will review the increasing influence of foreign trade on policy instrument of investment regulation.

Integration into the Global Economy and Challenges for Macroeconomic Policy

Global economy influence Chinese macroeconomic equilibrium through two mechanisms: the fluctuation of the price of exporting and importing products and the excess liquidity caused by increased foreign exchange reserve. Both of these two mechanisms influenced the domestic economic situations, especially since China's enter into the WTO in 2001. Global economic factors have become an important aspect that draws attention from the central bureaucrats in implementing economic regulation policies.

Since late 1990s, Chinese economy has been more and more influenced by the international economy through foreign trade. In 1980, China's gross export value was only 18.12 billion dollars. This number increased to 969.07 billion dollars in 2006, almost 54 times more than twenty-six years ago. The growth rate of gross export value during 2006 was 35.4% compared with the previous year. The expanded foreign trade promoted the increase of investment in domestic economy, especially in the manufacturing industry and the apparel industry. Being more dependent on foreign trade, domestic industries increase or decrease their production according to the changes in foreign market demands. Meanwhile, as many of the products China exported to foreign countries were processed products which require raw materials imported from other countries, global price of raw materials influence the domestic consumer price index (CPI) indirectly. Since 2002, global price of raw materials, including the iron ore, nonferrous metal, and petroleum crude oil, continued to rise, which led to the increased cost for domestic processing industries. According to a most recent statistics by the Institute of Economic Research of Renmin University of China (Feng, 2011), the level of import dependence of raw materials of China's processing industry reached 44% in 2010. With the large dependence on international trade for raw materials, volatility in global commodity price largely influences the domestic CPI level. Under this situation, the central government maintained the contractionary fiscal policy in order to control the rising CPI.

Another mechanism that global economy influence domestic CPI is through the excess liquidity that is caused by the monetary policies of foreign countries. With the growth of foreign trade in the recent decade, China also accumulated large amount of foreign exchange reserve. Meanwhile, the depreciation of dollar increased the outflow of capital from the U.S. International investors inclined to transfer their capital to newly emerged markets, such as China, as a harbor. This international capital flow increased the inflow of “hot money”[15] in China. Increased foreign exchange reserve and the inflow of foreign capitals lead to excess liquidity in domestic capital market.[16] Excess liquidity increases the pressure of rising CPI. In reaction to the changes in global capital market, the Chinese central government, again, needs to implement contractionary fiscal policy.

With the integration into global economy, international economic factors will more and more influence Chinese domestic economic situation. Changes in global economy will become another crucial factor that needs to be included in the discussion of macroeconomic policy instruments in China. However, this perspective is not mutually exclusive with the analysis of domestic elite politics in explaining the dynamics of changes in macroeconomic policy instruments. These perspectives mutually supplement each other.

Summary

Economic indicators explain well the policy instrument in controlling investment growth as we expected. The inflation rate and the growth rate of the Retail Price Index (RPI) exhibit almost the same curve as their measurement of products’

[15] “Hot money” refers to funds that are controlled by investors who actively seek short-term returns.

[16] The excess liquidity is caused by the increase of funds outstanding for foreign exchange, which refers to the domestic currency supplied by the central bank when foreign capital inflows. Because RMB is non-convertible currency, foreign capital needs to be converted into RMB before it can be circulated in China.

prices overlaps with each other. During the economic cycle that inflation rate and RPI rose significantly (such as in 1988), severe administrative measures were adopted to control the price and to control the investment growth. However, the curve did not explain another inflation peak (in 1994) and the flexibility of policy instruments during this period very well. The technocrats implemented several long-term financial reforms and structural changes in the banking sector in 1994 which does not seem to be in coincidence with the high level of inflation rate during this period. The political flexibility earned by the technocrats allowed them to implement long-term macroeconomic policies which does not have “shock therapy” function at temporary period but benefits the macroeconomic equilibrium from a long-term perspective.

The inflation rate curve and the RPI curve also failed to indicate the subtle policy instrument changes in 2003-04. According to the statistics, the inflation rate growth was not significant during this period (1.2% in 2003 and 3.9% in 2004). However, the discretionary power of the local officials aggrandized and they challenged the authority of central bureaucrats in expanding local investment blindly. Several cases, including the illegal construction of the Jiangsu Tieben Iron and Steel Company, indicated this tension. Subtle policy instrument changes were observed since 2003, including the tightening of investment project approval power and the eliminating of over 700 thousand investment projects nationwide through administrative orders. These policy instrument changes were better explained by the political tension between central technocrats and the local authorities (as well as the generalists supporting them), rather than by the economic stability indicators.

The money supply curve indicated the improvement of the central government in adopting more flexible market measures in adjusting money supply to combat inflation growth. However, still, this reflects only partially the improvement of policy instruments of macroeconomic management by the central government. Before 1994, we observe an obvious trend of fluctuation in the supply of M0 during each economic cycle (including 1984, 1988, and 1994). This can be explained by the direct intervention of central government in controlling the credit scale of commercial banks. After 1994, we observe an obvious change in the dynamic of M1 and M2, which can be explained by the advancement of the financial market in generating the "multiplier effect." Transactions among commercial banks and between commercial banks and other financial intermediaries were improved. The central bank relied more and more on indirect monetary instruments, including the adjustment of required reserve ratio and interbank lending interest, to control the amount of money supply. This is an evidence for the learning process of the policy-makers in improving monetary instruments in adjusting financial activities.

However, similarly with the conclusion from analyzing the inflation rate and RPI curves, economic indicators explains only partially the improvement of policy instrument. Several subtle policy instrument changes in 2003-04 were neglected in the analysis of improvement of monetary policy instrument, such as the tightening of investment project approval power and the eliminating of over thousands of investment projects in crucial economic sectors. Political tensions between the central technocrats and the local authorities (as well as the generalists supporting them) explain these subtle changes better than economic indicators.

I also discussed the evolving market institutions and how it shifted the dynamic between central government and local governments in economic policy making. I reviewed the strengthening of private sector and its influence on local governments' domination over investment projects. Currently, investment growth in China was still mainly caused by the expansion of production of state-owned enterprises. Within the forthcoming years, tension between local governments and central government will still provide an illustrative framework for the understanding of investment regulation policies. Similar discussions are conducted upon the financial reform in contemporary China and the integration of Chinese economy into global economy. In this study, I do not argue that elite political tension explains the adoption of policy instruments in adjusting investment activities better than alternative economic factors. Instead, I consider these two perspectives of explanations supplementing each other.

CHAPTER 6

DISCUSSION AND CONCLUSION

Improvement of market measures in regulating investment activities during each economic cycle has not been a consistent process in China. This study revealed that once the technocrats were marginalized on their centralization policy agenda, either by the deprivation of critical economic positions by the generalists at central level or by the competition of economic policy-making power from the aggrandized local authority, they will prioritize the regaining of economic policy-making power as policy goals. This prioritized policy goal will lead the technocrats to adopt direct administrative measures in controlling investment.

Investment control in China always involves the tension between central technocrats and local officials, as well as the generalist leaders who support the discretional power of local officials. The technocrats have been reluctant in granting economic policy-making powers to local officials, especially on the approval power of investment projects and the intervention power in the provision of bank loans. There has been a dilemma for the central government to decentralize economic power to local governments. On the one side, decentralization promotes local economy through providing local authorities with higher autonomy and increased profits. Local governments became more willing to take risks and make innovation in the promotion of diversified economy. On the other hand, a situation of investment competition was formed among different provinces. Motivated by the increased economic profits, as well as out of the consideration of political credit, local governments compete with each other in constructing infrastructural projects. Most of these projects were short-term profitable; however, they are not necessarily economically effective.[1] Scholars argue that the economic growth under the pressure of provincial competition will not be beneficial for the transition of Chinese economy from extensive to intensive[2] growth mode.[3]

Technocrats' intention of centralization can be explained by their preference in dominating the fiscal power of organizing nationwide construction projects, as well as their concern of structuring economic development in support of certain crucial basic industries. Central technocrats have continuously made attempt in recentralizing the authority of economic policy-making, especially during the overheated development period. The policy instruments adopted by the technocrats in controlling investment growth at local level tend to interact with their political agenda in consolidating their

[1] Local governments' focus on short-term profit projects led to an inefficient allocation and distribution of economic resources. Many projects were not economically competitive; however, they brought short-term profits to local governors within their period of office. See OECD report, "China in the Global Economy: Challenges for China's Public Spending toward Greater Effectiveness and Equity," OECD Publishing, 2006.

[2] Extensive Growth is based on the expansion of the quantity of inputs in order to increase the quantity of outputs. Thus, extensive growth is likely to be subject to diminishing returns. Intensive growth is mainly driven by productivity growth and technological progress.

[3] See Jinhai Zhao, and Angang Hu, (2005). "Zhongguo Gaige Shiqi Shengji Shengchanlv Zengzhang Bianhua de Shizheng Fenxi (1979-2001)" (An Empirical Analysis of Provincial Productivity in China [1979-2001]), *Jingjixue (China Economic Quarterly)*, *4*(2), 263-296.

authority in policy-making. Marginalization of technocrats always leads to direct administrative controls.

This study examines six periods' of economic cycles in China since 1979. During 1980s, China has just experienced a transition from central planned economy to market economy. Because of the poorly established market institution, the adjustment of economic activities was largely dependent on administrative measures. However, we still observed certain period when the technocrats were willing to implement long-term macroeconomic management reform, such as in 1984-85. High inflation rate during 1984 did not result in technocrats' adoption of significant administrative measures in combating investment growth, as they did in 1980 and 1988. The technocrats managed to control the abuse of discretionary power in the provision of subsidies to short-term profitable projects through several investigations by the Central Discipline Inspection Commission (CDIC). Inflation in 1984 was largely caused by the delegation of power and transfer of profits to enterprises. Central technocrats adopted several reforms to guide the efficient investment projects rather than control through administrative measures.

Compared with the situation in 198os, the market economy institutions were improved in 1990s. The central government learned to adopt market measures in regulating economic activities, such as through fiscal or monetary measures. However, in 2003, the readoption of administrative measures in eliminating investment projects and tightening project approval system seemed hard to explain. Closer examination would reveal an intensified tension between the central government and local authorities in the expansion of investment projects. Provinces that were supported by the generalists deliberately violate the central regulation over the quality of investment projects, such as the construction of Jiangsu Tieben Iron and Steel Company. Administrative measures were adopted, such as the elimination of over 700 thousand projects, in order to control the expansion of local investment within a short time.

This study does not claim that political tension between the technocrats and the local governments, as well as the generalists, is the only explanation, or the most important explanation of policy instruments in investment control. An examination of economic indicators tells us that economic stability also explains the adoption of different policy instruments. When inflation rate or the retail price index (RPI) became exceptionally high, the central government tended to adopt more severe measures, including administrative orders, to control investment growth. However, the situation of inflation rising needs to be further differentiated according to different causes. Sometimes the inflation growth was caused by deliberate expansion of investment growth at the local provincial level and the technocrats tended to respond with stricter control with administrative measures (such as in 2003). In some other period, the inflation growth was caused by individual enterprises' incentive to increase economic benefit through increasing investment and the technocrats tended to respond with guidance policies rather than administrative controls (such as in 1984). I would argue that political tension provides a supplemental perspective to the explanation of economic stability in viewing the different policy instruments by the central government.

Limitation of Study

One crucial limitation of this study is the measurement of the level of political tension between the technocrats and the local government, as well as the generalist leaders who support the discretional powers of local government. This study connects the technocrats' political agenda, which is determined by their interaction with the local governments and generalist leaders, with the policy instrument they adopt in control investment growth. However, it is hard to precisely interpret to what extent were the technocrats "marginalized" by the local authorities, as well as the generalist leaders.

An important assumption this study has made is that the technocrats were conscious about their disadvantage in putting forward their political agenda of centralization of economic policy-making power and they responded with direct administrative intervention to regain authority. I rely on the generalists' and technocrats' speeches and articles, as well as news reports, to determine the political tension between different political groups. This method has been justified by previous studies in the factional politics in China (see Shih, 2007). However, it has the limitation of being subjective in certain judgements. This problem can only be solved through conducting interviews to the political figures who involved which is difficult to be achieved. In this study, I still rely on the interpretation of large amount of news reports to analyze the political tension among different factions.

Future Study

This study made an attempt in explaining the adoption of administrative measures in the control of investment activities from the perspective of central-local relationship. This study stops at explaining the motivation of policy goals. It will be a meaningful study in the future to conduct empirical analysis on the policy effect of direct administrative intervention in reshaping the central-local relationship. Elimination of investment projects and the tightening of investment approval would bring negative effects to local governments' budgeting system. Local officials would either make attempt to reschedule their developmental plans in the coming years, or try to negotiate with the central government. It will be an interesting study to conduct empirical analysis on these possible changes.

Another meaningful study would be to examine how the diversification of monetary measures in contemporary financial system complicated the process of the central government to intervene in the banking sector through administrative orders. As we can see from Chapter 5, the multiplier effect of the commercial banks became more and more obvious nowadays. Monetary policies through the PBOC could hardly rely on simple adjustment of the credit scale of local commercial banks. What kind of changes has the diversification of monetary tools brought to central financial regulation is a potentially interesting subject to study.

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