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Paradigm Shifts and Time-lags? The Politics of Financial Reform in the People's Republic of China

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This paper assesses the political implications of financial reform in the People's Republic of China from the key reforms of 1994 to China's entry into the World Trade Organisation. It argues that the reforms implemented after 1994 in China shows a watershed in the evolution of economic reform. While the period before 1994 was dominated by dismantling the old system, subsequent reforms represent the attempt to build a new structure. But while the incomplete nature of reform provides the rationale for reform, it also provides the main obstacle to successful reform. Financial reform provides a case study of how the old and new economic systems are clashing with each other — and how the political interests associated with the old economic system are conflicting with those interests associated with the emerging new system.
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This paper focuses on the politics of financial reform between 1994 and China's entry into the World Trade Organization (WTO). An important area for study in its own right, financial reform also provides an excellent case study of the political consequences of economic reform, and the relationship between political and economic paradigms. The reforms implemented since 1994 represent a deliberate attempt to make a final break with the old state-planned political economy. They were also designed to deal with two almost defining features of the post-Mao Chinese political economy — the growth of local economic autonomy and government support for the residual state-owned sector. But in effect, I argue that there is a lag between the introduction of new economic paradigms, and the adoption of new political paradigms by key political actors. Thus, while economic reforms might create a more market-oriented system, many political leaders, particularly at the local level, continue to operate under an old paradigm more associated with a state-planned system. In short, many political leaders use the new financial system to fulfil the old functions of the plan such as providing subsidies for key producers in an

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attempt to maintain social stability through employment. As a result, while the reforms have had some success in meeting their targets, this success has only been partial, and large sections of the financial system are effectively bankrupt. In this respect, Chinese policy represents a compromise between the embedded residual socialist system, and the dictates of economic reform.

In many ways, the technical financial reforms are less significant for the financial system than wider political and economic choices and strategies. Financial reform is intended to reduce the financial burdens of supporting the state-owned sector, but cannot be successful until abandoning the state-owned sector becomes acceptable to all within the leadership. However, we should not simply explain the politics of financial reform in domestic terms, and neglect the importance of indirect and direct pressures emanating from China's transition from (relative) international isolation to (partial) integration with the global economy. On a very basic level, re-engaging with the global economy requires supporting policy changes in order to attract investment and facilitate trade.[1] On another level, external actors have at times placed more direct pressure on the Chinese authorities to reform and to conform with international standards and norms — to play by the rules of the international economy.

Perhaps, the clearest example of this direct pressure is the financial liberalization concessions to the United States that the Chinese authorities made in their attempts to join the WTO. It is particularly notable that if implemented in full, these concessions will strip away some of those mechanisms that allowed China to survive the East Asian financial crises relatively unscathed. Indeed, many in China believed that the key lesson from the crises was that China had been entirely correct in maintaining a relatively closed and controlled financial system. As such, debates over the short-term wisdom and even the underlying logic of financial reform emerged as major lines of cleavage within the Chinese party-state elites. And the way in which elements within the Chinese leadership have sought affirmation and political support for their policy preferences from external actors goes a long way to explaining the political dynamics behind the 1999 deal with the US, and the final WTO protocol on Chinese accession. It also provides an excellent example of how shifting political alliances are a key element of economic reform.

The Second Phase of Reform: Replacing the Plan

In some ways, calling the period after 1994 phase two of reform gives an impression that there was some sort of plan or model for future developments in 1984. While this was not the case, policy reforms after 1994 do mark a distinct shift from what came before. If we can characterize the period after

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1984 as the abandonment of the plan, the period after 1994 represents the (as yet) incomplete attempt to build a new financial system.

Indeed, this failure to construct a new financial system to replace the old planned system in recognition of the changing nature of the Chinese economy is often cited by Chinese researchers as a major cause of financial instability. For example, Zhou Shaohua (1987) argues that "The central government's comprehensive management system has been dismantled while new economic pillars have not yet been erected". Similarly, Gao Zhanjuri and Liu Fei (1999: 55) argue that:

> China is now in an important historical period during which an old financial system is shifting to a new one and the two are hitting each other… . New financial institutions and business lines are constantly emerging, whereas the old financial system has not been broken up completely, nor has a brand new financial system taken shape

Zhou's analysis was made in 1987, just 3 years after the central party-state leadership started to dismantle the old state-planned financial system. Gao and Liu were commenting some 12 years later, and 5 years after Zhu Rongji began to build a new integrated financial system. The similarity of these two assessments is testament to the size of the challenge to reformer and the strength of political constraints on economic reform. It is also a consequence of the assessment of some Chinese leaders that the CCP should not abandon the state-owned working class — either from ideological or more pragmatic considerations.

You Ji (1991) argues that reform-minded leaders essentially ducked the decision to push ahead with real fundamental reform in 1984 as they were unable or unwilling to push through market reforms in the face of opposition from more conservative leaders. Indeed, policy changes in the 1980s were frequently shaped by the shifting balance of power between different groups of leaders with different visions of China's future. The death of key conservative leaders, and the general success of reform (in generating growth at least) reduced the intensity of those debates and conflicts in the second half of the 1990s. Nevertheless, we should acknowledge that there is considerable suspicion, scepticism and at times downright opposition to the post-1994 reforms.

The key reforms implemented after 1994 are most closely identified with Zhu Rongji. First as Vice-Premier with specific responsibility for banking reform, and subsequently as Premier, Zhu has been the most visible proponent of reform. And even though Zhu has overseen the appointment of a number of his followers into key ministerial positions, Zhu's policies have faced considerable opposition from within the broadly defined Chinese party-state leadership itself.

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In particular, Zhu was accused of over-zealously attacking inflation after 1994 at the cost of urban employment. He had set a target that through its secondary consequences placed price stability as a more urgent priority than job creation. It is notable that the loudest voices of criticism came from those areas of China where the residual state-owned system still dominated the economy. These areas had most to lose (in the short term at least) from the liberalization of the Chinese economy; they faced the prospect of increased urban unemployment if loss-making state-owned enterprises (SOEs) went bust; they faced a decrease in local control over local revenues; and they faced increased competition from outside China in the wake of the agreement signed to join the WTO. As Solinger (1982: 71) put it in a very early period of reform in 1982:

> The most obvious bases determining which point of view a particular group or institution is prone to support are the province in which it is located and the branch of industry with which it is connected.

Notwithstanding China's acceptance of liberalizing reforms as part of the WTO accession protocol, the case for liberalization does not have the full support of Chinese elites. On the contrary, there is no shortage of people who think that China should not liberalize its economy too early or too quickly — not least senior figures within the Chinese financial institutions themselves.[2] There is also a strand of opinion that resents external pressures to reform— irrespective of what they say, it is the fact that they are external actors that is the problem. There remains, then, a lack of consensus over the timing and pace of reform, if not the ultimate direction. As such, many of the post-1994 reforms were implemented in the face of considerable opposition from the very groups whose interests could be damaged by the reforms.

Zhu's initiatives are often referred to as a process of 'recentralization' (Lam, 1999).[3] While they are indeed intended to increase the power of the central authorities, we should be careful not to associate these processes with previous attempts to recentralize the economy in the 1980s. The intention was not to return to draw back from the market as was the case with the last serious attempt at recentralization in 1988–89. At that time, then Premier Li Peng (1988) did try and restore planning control through the reintroduction of price controls, and by strengthening central planners' control over investment capital (*Renmin Ribao*, 1988: 17). It is notable that Li Peng himself argued that financial problems existed because "the old structure coexists with the new, we are faced with many new contradictions". While Li Peng saw the solution to financial instability in returning to the plan (the failings of which had led to the decision to introduce economic reform in the first place), Zhu Rongji's solution was to create new mechanisms of macro-economic control over the Chinese economy. Zhu's attempts to 'recentralise' the economy in the 1990s was

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intended as one step on the way to greater economic liberalization, not a retreat from it.

In many respects, isolating different areas of policy change misses the point that the post-1994 reforms were intended to finally replace the plan with a new integrated and holistic system. It was a direct response to economic fragmentation and built on the premise that financial reform, fiscal reform, enterprises reform and international liberalization had to be coordinated. Nevertheless, for the sake of simplicity, the following analysis is divided into two sections. The first deals with the growth of local economic control, and the second with the subsidization of employment and the growing debt crisis.

Power to the Provinces?

Decentralization of economic authority to the provinces did not begin with the post-Mao reforms. Considerable power over local economic affairs was devolved to provincial level units in 1956 and 1957, and again during the Cultural Revolution. However, in these early periods of decentralization, local initiative was constrained by both the maintenance of planning restrictions and targets, and the lack of local financial independence. Locally collected revenues were remitted to the central authorities, which then used these funds to cover national projects and towards redistributing wealth across the country. Thus, Lardy (1975: 57) argued that the key to — perhaps the defining characteristic of — the old financial system was that there was no correlation between collecting and controlling finances.

In dismantling the planned financial system in the 1980s, the central leadership deliberately and consciously created a link between local collection and control of finances. Indeed, as the central authorities consciously devolved considerable financial authority to local governments, it might seem strange that they have subsequently spent so much time and effort in attempting to regain this power. This is, in part, due to the fact that in its hurry to find a strategy that would maximize economic development, the central authorities did not think through the consequences of reform, or coordinate policy in different areas. While individual policy changes might have had their own internal logic, they were not planned in conjunction with reforms in other areas. The planned consequence of reform in one area was frequently undermined by reform in another related area. It was not unheard of for reforms in different areas to totally contradict each other (Breslin, 1996).

The growth of local financial autonomy, then, results from a combination of changes in the fiscal system and the banking system in combination with the impact of the introduction of more market mechanisms. So while a loss of central revenues relative to the provinces was perhaps inevitable, as Wong

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(1991: 690) noted, "the magnitude and rapidity of this decline appear to have caught officials in China by surprise".

Revenue Sharing Reforms

As noted above, under the plan, there was no correlation between collecting revenues from any specific territory and controlling the use of those revenues. This system began to change with the introduction of new budgetary arrangements in Jiangsu province in 1976. Rather than setting targets for the collection and remittance of local incomes to the centre, the new system allowed the provincial authorities to keep any surplus revenues collected over and above the agreed amount to be remitted to the centre. A 3-year negotiation cycle also replaced annual negotiations. A slightly different method was employed in Sichuan Province where different categories of income were subject to different sharing rates, and 5-year targets were used instead of the 3-year cycle in the Fujian model. This latter model — what became known as the 'Sichuan model' — became the basis for national strategy in February 1980, although different arrangements were in place for different provinces. For example, the three municipal provinces of Beijing, Shanghai and Tianjin remained under much tighter central control, while Guangdong and Fujian were deliberately granted much greater local control in order to boost local development (Donnithorne, 1981; Tong, 1989).

But what happened next indicates the almost haphazard uncoordinated nature of the Chinese reform process in the 1980s. The amount of revenue to be remitted to the central authorities was based on an understanding that the local government would collect all local finances. However, this basic understanding was over-ridden by the introduction of a new fiscal system, by which enterprises were to be taxed on profits. Thus, most provinces faced a decrease in revenue — but their income collection targets were not changed accordingly. As a result of the problems facing provinces in meeting their revenue targets after the introduction of taxes on profits, most provinces turned to the arrangements outlined above for Jiangsu Province in 1982 (Yun and Li, 1983; Guo, 1984).

We should note here that the revenue-sharing reforms were deliberately uneven, and gave some provinces much more financial autonomy than others. While Shanghai's financial responsibilities to the state remained largely unaltered by the reforms, other provinces were given special treatment. For example Shanghai continued to send around 70 per cent of its income to the central authorities, but Guangdong Province remitted only 15 per cent (Wang, 1988). As such, the first stage of financial reforms not only resulted in an increase in local revenues *vis-à-vis* central funds, but also resulted in

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inter-provincial tension (Breslin, 1996) and intense political lobbying to be given the same treatment as the apparently favoured 'Gold Coast' (Hamrin, 1990: 83).

Redressing the balance: the 1994 reforms and centre-local relations

The transition from the plan was (and remains) incomplete. It is clearly the case that market mechanisms now exert a much greater influence on the Chinese economy than at any time since 1949, and are likely to increase in the wake of WTO entry. Nevertheless, local governments remain crucial actors and determinants of economic activity. The old vertical dictatorship of the state plan where orders flowed directly down through ministerial and government agencies has been removed. But in many cases, this has been accompanied by the growth of a form of horizontal dictatorship (*kuaikuai zhuanzheng*) whereby the local government becomes the focal point for economic authority (Unger, 1987).

The 1994 Fiscal Reforms and Centre–Local Relations

This growth of provincial autonomy and the loss of central macroeconomic control over the economy was a key impulse behind new financial reforms after 1994. The reform of the taxation system is particularly important here. The reforms were intended to redress the balance of fiscal power between centre and provinces by creating three categories — central taxes, local taxes and shared taxes. Importantly, the central government established its own national tax service to collect both central taxes, and also those taxes that are subsequently shared with the local governments (Zheng, 1999: 1168–1169). Under the old system, the central authorities entrusted local authorities with the task of collecting and reporting fiscal revenues. The creation of the new national tax service was a sign that the centre no longer trusted the localities.

At first sight, the fiscal reforms were simply an attempt at recentralization. And in some respects, this was clearly the case. But the reforms also partially strengthened provincial autonomy in that they almost represent the creation of a quasi-federal system. At the very least, it represents another attempt to formalize an institutional relationship between centre and province that acknowledges the pivotal role of local authorities and local interests within this structure. Nevertheless, the immediate result of the fiscal reforms was to increase both the total amount of tax revenue, and also the proportion accruing to the central authorities, which rose from around 30 per cent to around 50 per cent of all fiscal revenues. The increase in the total revenue base can only be explained by either previous lax tax collection, or the deliberate underreporting of local fiscal revenues to avoid making remittances to the central authorities.

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It is notable that the tax revenue continued to increase in the 1990s despite the slide into deflation. This was partly due to increased customs duties resulting from a surge in imports, but it was also partly due to campaigns against corruption and smuggling (particularly in Guangdong Province). China's tax revenues reached the RMB 1 trillion mark (US$ 124.54 billion) in 1999 — up 13 per cent on the previous year. It is also notable that central tax revenue increased faster than local tax revenue — by 15 per cent as opposed to 11.5 per cent. By the end of the decade, the balance of centre-province shares of total tax revenue had reached 58–42 per cent (Xinhua, 11 January 2000).

Fees and Taxes

On the face of it, then, the fiscal reforms were successful in that they increased the total volume of fiscal resources. More important, they partially redressed what the central leadership perceived to be a structural imbalance in the division of finances between centre and locality. However, tax revenues are only part of government income in China — indeed, only 40 per cent of all government revenue. The majority of government income is termed 'extra-system' revenue, which Gao Peiyong (1999: 41, 45) defines as:

> revenues whose regulations are formulated independently by various departments and localities and which are collected and disposed of by them as well… . If this state of affairs lasts for a long time, it will inevitably jeopardise the unification of national administrative orders and China's long-term stability.

Complaints about impositions of *ad hoc* fees by local authorities rank high in the list of problems faced by foreign companies operating within China. But while foreign companies might feel that they are being treated unfairly, they are effectively being treated in the same way as many Chinese companies. Essentially, anyone or anything that makes a profit is likely to face new fee charges.

Local Control of Financial Institutions

The importance of fees as a source of local revenue is just one example of how the Chinese financial system has proved difficult for the central authorities to control; a example of how the financial systems are moulded to serve specific interests.

Another example — perhaps more important for an understanding of financial reform — is the way in which banking reforms altered the relationship between central and local authorities. In 1984 the People's Bank of China was designated as the Central Bank, and four large specialist banks were

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introduced, each channelling capital for different sectors of the economy. Thus, the Industrial and Commercial Bank was responsible for channelling finances into SOEs; The Construction Bank of China was responsible for new investment projects; The Agricultural Bank of China was responsible for agricultural procurement, and rural investment (including rural industry); and the Bank of China took control of foreign exchange business.

This was followed in 1985 by a key transition from the plan, in that China switched from a grant-based to a loan-based investment system. In order to facilitate the transition from central grants to bank loans, the power of specialized banks in the localities was increased in 1985. But in setting the investment quota for the new banks, the central authorities announced that the 1985 investment quota would depend on the amount of loans extended in 1984. This move coincided with the extension of managerial responsibility in urban industrial sectors, which included lifting ceilings on staff wages and bonuses. As with the banking reforms, the amount of money allocated for wages in 1985 was based on the size of the 1984 wage bill and according to You Ji (1991: 71), "Many enterprises, as a matter of urgency, distributed extra money to the workers".

The move to bank loans sponsored a huge boom in investment in capital construction by local governments (Hung Da, 1985). While investment in state-planned projects recorded a 1.6 per cent year on year increase in 1985, investment in unplanned projects by local governments increased by 87 per cent. Crucially, while state planning agencies and financial authorities controlled the provision of 76.6 per cent of internal national investment capital at the start of the reform process, this proportion fell to 33.2 per cent in 1986 as a result of the new banking reforms (Zhu Li, 1987).

Despite exhortations from central leaders calling for restraint and a cutback in investment, local authorities continued to make the most of the banking reforms. It was not until Li Peng replaced Zhao Ziyang as Premier (in 1987) and implemented an economic retrenchment campaign in the autumn of 1988 that investment spending began to come under control. As a World Bank (1990: 24–25) report commented:

> It has taken the People's Bank of China nearly four years, since its designation as a central bank in 1984, to gain *a measure* of control over credit expansion and deflect the demands of local government authorities on its provincial branches. Earlier episodes of credit tightening in 1985, 1986 and 1987 could not be sustained in the face of provincial opposition. [emphasis added]

Here we need to focus on the notion of dual control of local-level organisation in China. Administrative organisation is built on twin and simultaneous functional and geographic channels. Thus, a provincial branch of a bank is

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vertically responsible to the bank's central offices, and ultimately to the Ministry of Finance. But at the same time, it is also responsible to the provincial finance bureau and the provincial government. The latter has the advantage of hands-on contact with the branch, since it is in direct day-to-day contact with bank officials. Furthermore, it possesses considerable power in terms of allocating goods, services and personnel to the banks. Thus, while not formally an agency of the local government, local branches of banks often act as if they are part of the local government structure.

The power of local authorities[4] to collect and impose fees and local influence (if not control) of local banks contribute to the characterization of many local governments as running 'dukedom economies' (*zhuhou jingji*) (Shen Liren and Tai Yuanchen, 1990). The notion of dukedom economy is not just that the local government is in control of finances, etc, but also controls the judicial system as well; "Since courts and judiciary departments are subject to local Governments, justice cannot be brought along in many fields" (Xie Ping, 1999).

While fiscal reform went some way to restoring the central authorities' ability to control the national economy, it was, in itself, not enough. As we have seen, both the levying of fees and control of local branches of central financial institutions shifted the balance away from the centre to the provinces. Furthermore, there is financial 'chaos and mismanagement' resulting from the expansion of local financial institutions (Gao Zhanjun and Liu Fei, 1999: 53). For example, despite a policy of encouraging mergers in the light of the failure of the Guangdong International Trust and Investment Corporation (ITICs), and the decision to cut the number of central ITICs to three in September 2000, there were still around 240 locally controlled ITICs operating in China in 2002.

In addition to the ITICs, there are over 50,000 small-scale locally controlled rural and urban credit cooperatives in China today. By the end of 2001, outstanding deposits from all rural credit cooperatives stood at about RMB 1.73 trillion, accounting for 12 per cent of total deposits in financial institutions, while outstanding loans by rural credit cooperatives were about 11 per cent of the national total (*Renmin Ribao*, 2002). As a result of local control and horizontal dictatorship, many of these essentially exist beyond the reach of the central macro-economic control and central financial regulatory institutions. Indeed, this quote from Xie Ping (1999: 13) provides a succint assessment of the impact of localism on the financial system:

> a considerable number of financial institutions to be restructured are jointly invested by local Governments and controlled by them. It is local government's interventions in senior management and business that cause the losses and difficulties of these financial institutions. Consequently, upon merger, restructuring and closure or even bankruptcy of these financial

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> institutions, on the one hand local governments are only responsible for liabilities up to the amount of their investment, but on the other hand for the local interest their interventions in the described processes are severe. Even judicial justice cannot be guaranteed since local judicial departments have to obey the orders of local governments.

It is this concern with local control over local financial institutions that led the PBC to undertake a major structural reform in August 1998. The central bank abolished its 49 provincial branches and replaced them with nine multi-provincial regional offices.

> The purpose of these reforms were to put an end to local government (mainly provincial government) disturbance in monetary policies and financial supervision of the Central Bank; and to set free state-owned commercial banks from the intervention of local government. (Xie Ping, 1999: 4)

In addition to the general issue of local financial autonomy, the PBC reforms were aimed at facilitating fundamental reform of the banking structure in an attempt to deal with the technical insolvency of China's major banks — a problem that results from the leadership's strategy of providing a soft-landing on the transition from socialism.

Safety-net socialism and financial reform

If the decentralization of economic power is one defining characteristic of the Chinese reform process, a second is what we might call 'safety-net socialism'. The leadership's desire for rapid economic growth has been tempered by a recognition that rapid growth can be as politically destabilizing as no growth at all. The issue of decentralized control is also relevant here, in that the central authorities have faced constant pressure from representatives of those areas that have not developed as fast as the coastal areas. But the main emphasis in this section is on the perceived relationship between unemployment (particularly urban unemployment) and social stability.

Government Debt and the Subsidy Cycle in the 1980s

In the initial period of reform, one of the major political tasks associated with reform was assuring key sectors that the new era would not harm their interests. Thus, for example, rather than liberalize grain production and supply, the government retained central pricing and allocation to ensure relatively equable supplies of basic foodstuffs. With the price of other produce increasingly set by the market, the government essentially controlled incentives for grain production by increasing the procurement price. In most cases, an

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increase in the grain procurement price subsequently led to an increase in urban subsidies to offset the impact on urban purchasing power.

By the end of the 1980s, official Chinese figures showed that subsidies constituted almost a quarter of total central government expenditure. The political logic of reform was creating a subsidy cycle that was proving difficult to overcome. And while subsidies to maintain purchasing power were an important component of this subsidy cycle in the 1980s, debt to maintain employment became a characteristic of the 1990s.

It is difficult to overestimate the importance that the Chinese leadership ascribes to maintaining employment. Particularly in urban centres, maintaining employment is seen as the pre-requisite for the maintenance of social stability, and perhaps even the CCP's continued grip on power. A quick survey of China's employment statistics gives some indication of why employment comes so high on the list of the leadership's concerns. We should also bear in mind that China does not have a national system of social security. China developed a system of workplace socialism after 1949, through which the *danwei* in urban centres and the collective in the countryside provided health, education and welfare.

> although China has been building socialism for nearly half a century, yet the unemployment insurance system, one of the basic systems of a socialist society, has remained in name only. It cannot play the role of a social safety net. Once a worker gets unemployed, he will lose everything. (Hu, 1999: 20)

With no national social welfare safety net,[5] the costs of maintaining employment can in some respects be considered to be disguized social welfare payments.

The PRC had a labour force in 2001 of roughly 718 million people — around a quarter of the world's total labour forces and around one and a half times the combined workforce of all developed states. In the countryside, mechanization and the replacement of collective socialist motivations with private and profit motivations resulted in the loss of an average of six million workers a year in the 1990s, and it is widely accepted that around 120 million rural workers are without work for most of the year.

One of the more notable consequences of this increased rural unemployment is the growth in migration — both state-sanctioned and supported, and illegal. Not surprisingly, China's poorest provinces are the major sources of migrant workers.[6] Neither is it surprising that many have made their way to the cities in search of jobs — to the extent that people with rural household registrations accounted for 29.85 per cent of the new urban workforce in 1996 (Hu, 1999). Rural unemployment is now very definitely an urban issue.

The extent of the unemployment problem in rural China is clearly significant. But for the purposes of this paper, we need to turn our emphasis

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to the issue of urban unemployment. As Solinger (2001: 671) has argued, it is all but impossible to get a truly accurate number for unemployment in China, and "No one, and certainly not the central government, knows how many once-state workers have been removed from their posts". Different accounting methods are used by different analysts, and official unemployment (*shiye*), figures do not include laid-off (*xia gang*) workers — and workers can be laid off for up to 3 years before they count as officially unemployed. While urban unemployment increased by about 8 per cent per annum in the 1990s, the number of laid-off workers increased by around 40 per cent a year. Thus, while in 1993, laid-off workers accounted for around 3 per cent of the total urban payroll, the figure had risen to 8 per cent by 1996.

Two-thirds of these laid-off workers are from SOEs, and, as with all things in contemporary China, there are large geographic variations. In essence, the old industrial bases have both the highest levels of unemployment and the highest levels of laid-off workers — 14.2 per cent of the pay-roll in Liaoning, 13.8 per cent in Heilongjiang, 11.2 per cent in Hunan and so on.

So while the official unemployment rate remains at around 4 per cent, the percentage of workers without jobs is at least double that, and maybe even as high as 14 per cent. And this is the situation before any potential impact on employment from WTO entry has kicked in.

Non-performing Loans and Institutional Debt

Throughout the reform period, the government has devoted a considerable amount of government spending on subsidies to keep loss-making enterprises in operation. Lateron, it has also relied on loans from the banks to serve the same function. As these loans are influenced by political considerations and often ordered by government officials, they are sometimes referred to as 'para-fiscal' investment (Wang Luolin *et al.*, 1999: 6) and can be considered to be quasi-government debt. While the government debt balance as a percentage of GDP was only 8 per cent in 1997, the figure rises to 33.12 per cent if you include non-performing loans as part of the calculation (Yu, 1999: 12). Even these figures do not give the full extent of the problem, as those unperforming loans that will not be paid off, but which are not yet due, are not counted as bad loans (Wang, 1999: 35).

The Chinese State Statistical Bureau announced that unpaid loans to various levels of government accounted for 10 per cent of Chinese GNP in 1995 (China News Digest, 15 December 1996), while a World Bank (1997) calculation suggested that non-performing loans accounted for 20 per cent of the assets of Chinese banks. Looked at from the enterprise side, debts equalled 71 per cent of the assets of non-financial SOEs capital structure in 1995. As non-productive loans in support of political stability increased in the 1980s,

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then the returns on assets of China's specialized banks dropped from around 1.4 per cent in 1986 to virtually nil by 1997 (Lardy, 1998: 100). And while the capital of state banks increased by 1.88 times between 1987 and 1996, the balance of loans provided by state banks increased 5.25 times (Wang, 1999).

It is difficult to come to an accurate assessment of the extent of bad loans in the four major state banks. The figures emanating from the People's Bank of China are widely regarded as being politically constructed to present a positive confidence-building image, rather than being based on firm accounting. Furthermore, the official figure of 25–30 percent does not include the RMB 1.4 trillion of non-performing loans that had been transferred from the banks to Asset Management Companies (AMCs) by May 2002. These AMCs take over portions of bank debts, and then try to sell them as equity in the open market. So until and unless the equity is sold, it is effectively 'debt' by another name. So the real extent of non-performing loans in the big four banks in 2002 ranges somewhere from the official figure of 25 per cent, to the most pessimistic calculations of 50 per cent (Chang, 2002). Perhaps, it is best not to concentrate on finding the exact figure, and just accept Harding's (1997: 3) assertion that "In short, China's banking system is insolvent: its bad debts exceed its capital".

Dealing with the Debt

Finding an effective answer to the debt crisis thus entails much more than technical reforms in the financial system. Rather, it entails a fundamental restructuring of the Chinese economy and a fundamental change in the basis of communist party rule. The national leadership has to find new ways of finding employment, new ways of providing social welfare, and has to accept and live with higher rates of unemployment. As reform of the financial system is inextricably linked with perceptions of the consequences of unemployment, processes of liberalization and integration with the global economy are also brought into the equation.

The initial reforms of 1994, however, simply dealt with the symptoms, rather than the ailment itself. The banking reforms saw the four policy banks replaced as policy-based lenders by three policy banks. The State Development Bank of China took responsibility for long-term projects, notably infrastructure and the development of strategic industries. The Agricultural Development Bank took responsibility for procurement of agricultural produce and agricultural development projects, and the Import–Export Bank was established primarily to provide credit to promote exports. Theoretically, at least the 1994 reform introduced effectively commercial banks for the first time, and also fostered the development of competition between banks at both central and local levels

The banking reforms highlight two key features of China's reform process. First, when new systems are introduced, they frequently, indeed, typically, do

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not replace the old systems, but are grafted on top of (or alongside) the existing system. Thus, when the new policy-based banks were introduced, the four old specialized banks continued to operate, and retained responsibility for all their previous debts.

Second, despite repeated commitments to the independence of the banks (not least in the Central Bank Law and Commercial Bank Law, of 1995), political interference remains a hallmark of lending decisions. Indeed, even the theoretical independence of the PBC is somewhat limited. Quite apart from the authority of Zhu Rongji over the bank while Vice Premier in the mid-1990s, the PBC remains a government department under the State Council, and the State Council is mandated to approve major policy initiatives (Xie, 1999: 5). The autonomy of specialized commercial banks is also strictly limited. As Chen Yixin (2000) puts it:

> With directed lending operations (especially those financing the working capital of SOEs) still ongoing, the specialised banks can hardly be said to be commercial in any real sense.

The 1994 reforms then essentially achieved little. They did nothing to deal with the existing bad debts of the now-commercial banks, nor did they put an end to the extension of more bad debts in pursuit of political objectives. In an attempt to partially resolve the former, the government issued an unprecedented RMB 270 billion special treasury bonds on 18 August 1998 to replenish the capital of the four major state-owned banks. The bonds allowed RMB 120 billion of bad loans to be written off, and were intended to keep capital adequacy at above 8 per cent for 5–8 years.

Debt-to-equity Swaps

Another solution lies in the extension of 'debt-to-equity' initiatives. As noted above, these initiatives simply convert some of the debt of selected SOE and financial institutions into equity which are then sold on to private and institutional investors. In the first instance, the equity is held and managed by four AMCs established to help clear the debts of the four big commercial banks. Thus, Huarong handles the bad debt of Industrial & Commercial Bank of China, Cinda those of the China Construction Bank, Great Wall those of the Agricultural Bank of China, and Dongfang those of the Bank of China.

One of the problems with the scheme, according to the Bank of International Settlements, is that the initial capitalization of RMB 10 billion each is too little for them to survive on the long run.[7] Furthermore, it is only really applicable to essentially healthy companies — those that took out loans before 1995 and whose deficits are 'mainly' results of the burden of interest payments.[8] Thus, it is an attractive option for those that are basically sound, but does nothing for

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the hopeless cases. Indeed, the scheme is so attractive that it has given rise to intense lobbying from government organizations that want to help revenue-generating firms in their own sector. And as Zeng Paiyan argues, if the same political pressure that frequently led to the creation of bad debt in the first place is placed on the asset management companies, then 'the whole process will increase and not reduce financial risks and expenditures for the state'.[9]

Bad Debts Revisited: The Politics of Employment in the PRC

Again, these initiatives deal with some of the problems that are still affecting the solvency of state banks, but do not deal with the fundamental problem. Bad loans as a proportion of all loans remained high, and have continued to increase. Effective reform is contingent on ending the strategy of using the banks as a means of subsidizing employment in keeping with the party-state leadership's political goals.

In this respect, the most important reforms for the creation of a modern financial system are related to the position of SOEs within the Chinese economy — perhaps, ultimately to the creation of a national social security system. As such, structural reforms, recapitalization, debt-to-equity swaps and so on are not as significant as two announcements made by Zhu Rongji in 1998). First, Zhu announced that politically directed lending would end in 1998. Second, at the March 1998 session of the National People's Congress, Zhu reaffirmed his commitment to accelerating reform of the SOEs.

The significance of SOEs cannot be underestimated for the reform of the financial sector. In 1996 four major state-owned commercial banks held more than 90 per cent of all credit funds and extended 90 per cent of them to SOEs (Gao and Liu, 1999: 54). Even after the implementation of reforms, at the end of 1998, SOEs accounted for 63.5 per cent of all manufacturing assets, utilized 70 per cent of the national budget, and employed around 55 per cent of all urban workers. By the middle of 1999, the state-owned sector had an estimated US$ 200 billion worth of bad debts (Hexun Caijing, 30 August 1999).

The move towards final and fundamental SOE reform was tempered and at times put on hold as the leadership considered the social impact of rising urban unemployment. For example, when concerns over social instability resurfaced, new reactive policies were introduced to provide a temporary palliative. Indeed, rather than decrease, bank loans continued growing, by over 10 per cent in 1999 (Zhengquan Shibao, 13 September 1999).

This hesitation was partly a result of the delayed impact of the Asian financial crises on Chinese export growth. Export growth had essentially been relied upon to provide the opportunity to deal with problems in the 'domestic'

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economy without jeopardizing overall growth rates. It was a means of providing at least some new jobs to replace those being lost in the state sector. But falling demand in South East Asia, South Korea and most importantly Japan, combined with increased competition from the South East Asian states, undermined Chinese export growth in 1998. Export growth for the year was 0.5 per cent in nominal terms — a decline of around 1 per cent in real terms (Breslin, 1999).

Chinese economists calculate that an 8 per cent increase in GDP equates to a 1 per cent increase in employment (Hu, 1999: 15). If export growth declined, as it did in 1998, then this reduced the window of opportunity for domestic restructuring. Furthermore, attempts to increase domestic consumption through interest rate policy were startlingly ineffective. There is little incentive for enterprises to invest and expand production as there is already overcapacity and oversupply in the economy. The prospect of increased competition from foreign enterprises in the wake of the November 1999 deal to join the WTO has not exactly increased confidence either. Even as prices continued to fall, fear of unemployment, and the prospect of increased expenditure from welfare and housing reform were typically provided as explanations for a lack of consumer spending.

In particular, the uneven geographic spread of development resulted in differential calls for special treatment. Those areas that had gained least from integrating with the global economy, and were still major centres of the 'old' economy, had most to lose from SOE reform. An expansionist policy thus allowed the central government to target those areas with large-scale urban unemployment, and/or (typically and) areas where resentment at the uneven geographic wave of modernization is highest. For example, in 1999, Jilin Province in the north-east received the biggest increase in central investment in capital construction projects (28.8 per cent), with Guangdong among the lowest (around 10 per cent) (China News Digest, 23 January 2000). Neither was it any coincidence that the 'look west' policy was reaffirmed (and Zhu Rongji charged to oversee it) as the national government tried to persuade representatives of China's perceived peripheries that it was now 'their turn' to develop.

In some respects, the post-1998 expansionary strategy created the worst of both worlds. On one level, unemployment continued to increase. Simple demographics alone mean that about 8 million people joined the workforce in 1999. In addition, the economic downturn led to around 20 million workers being laid off in 1998 (1.3 million in Shanghai alone), and a further 10 million were laid off in the first half of 1999 (Hu, 1999: 19). The added welfare burden[10] when added to the cost of the expansionary fiscal policy unsurprisingly resulted in a record budget deficit in fiscal 1999 of US$ 21.77 billion.

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Financial reform and opening to the global economy

The struggle to find a politically acceptable way of coping with unemployment provides the backdrop to an understanding of the relationship between the domestic and the external in financial reform. Viewed from within China (or by professional China watchers) there is a tendency to emphasize the relative openness of the Chinese economy. This is a valid view — China is relatively more open and liberalized than it was in the past. It is also arguable that the Chinese economy is more liberal than the South Korean or Japanese economies at similar stages of development (Economist, 1995).

This gradual and partial liberalization is clearly important and significant. On a very basic level, as China has re-engaged with the global economy, it has had to introduce mechanisms to facilitate international trade and inward investment. It has also developed policies in response to the demands of external actors, such as to attract and retain (rather than just facilitate) investment.

Nevertheless, while China is much more open than it was before, pre-WTO entry liberalization was limited in terms of geographic areas,[11] of economic sectors, and in degrees of openness to the global economy. Indeed, in the financial sector, foreign actors are heavily restricted in who can operate, where they can operate, and what they can do. For example, prior to WTO entry, only 25 foreign banks were allowed to conduct business in renminbi — six in Shenzhen and 19 in Shanghai (Zhejiang Ribao, 18 November 1999).

Viewed in comparison with other contemporary developing states (not least the crisis states of Asia), then China looks relatively closed. And the lessons of the Asian financial crises, particularly when taken in conjunction with the lessons of earlier financial crises in Latin America, seem to be that China has more or less got it right (although not always necessarily by design). As Yu (1999: 15) puts it:

> For many years, observers have criticised China's slowness in developing financial markets and liberalising its capital account. The Chinese government itself was also worried by the slow progress. Rather theatrically, the disadvantage has turned into advantage. Owing to capital controls and the underdevelopment of financial markets and the lack of sophisticated financial instruments, such as stock futures and foreign exchange forwards, RMB escaped the attack by international speculators.

In particular, the only partial and incremental process of opening resulted in a limited role for foreign capital. Strict capital controls, the lack of currency convertibility, and the underdeveloped nature of Chinese financial markets had helped create a situation where 90 per cent of all foreign capital in China in 1999 was in the form of FDI projects. And through a managed currency

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devaluation in 1994, the Chinese authorities massively increased the price competitiveness of exports compared to competing exports from the rest of Asia. The underdeveloped nature of Chinese capitalism allowed China to exploit its position as an 'even-later' developer and also provided a bulwark against the international economy when it was needed during the crises.

Furthermore, in responding to the impact of the financial crises, the relatively closed nature of the economy gave the leadership a degree of autonomy and leeway in developing a response that was not available in other states. Witness, for example, the extent to which export tax rebates were used after 1997 as a means of promoting export growth to the extent that China was accused of implementing a fiscal devaluation. Witness too the way in which the retention of capital and exchange controls allowed the Chinese authorities to reduce interest rates in an attempt to boost spending while maintaining the stability of the RMB.

In the wake of the Asian financial crises, then, the strength of the arguments for further liberalization seemed to have declined. Currency convertibility was delayed, export rebates increased, many institutions lost their rights to trade in foreign currency, and regulation and control of the stock exchanges was increased. As the Asian financial crises unfolded, and began to impact on China in 1998, then debates over liberalization and globalization were renewed. In fact, the crises were interpreted in two different ways. For liberalizers like Zhu Rongji, the crises confirmed the need to overhaul China's financial institutions. China's financial institutions were far less stable than those of pre-crisis South East Asian states, and it was essential to deal with this key and fundamental problem.

For opponents, the crises undermined the examples of other developing states as models for China's development.[12] In addition, as strikes and demonstrations against the closure of factories and unpaid welfare benefits increased through 1998, the social and political environment appeared less conducive for economic reform than in 1997. Zhu's position, and the political profile of the liberalizers, was further weakened by the failed negotiations to broker a deal to join the WTO in the Spring of 1999. One senior figure from China's financial system said that he did not know what was worse — that Zhu had offered as many concessions as he did, that he offered them without consulting with key figures in the financial structure, or the fact that having done all this, he still did not get a deal.

In the wake of this failure, Zhu's position as China's key reformer came under threat. On a number of occasions, Western news sources ran stories about Zhu's impending resignation. As such, the deal signed with the US authorities in November 1999 to pave the way for China's WTO entry marked a key political moment in China's post-Mao evolution. Here, a new alliance for reform seemed to appear — one in which the Chinese Premier, Zhu Rongji,

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entered into an alliance with external actors and promoters of neo-liberalism in opposition to domestic Chinese forces for conservatism. The WTO deal was used by Zhu as a means of boosting the reform agenda. At the same time, the US representatives used the deal as a means of boosting Zhu within China, and promoting both him and the reform process at a time when domestic considerations seemed to be pulling China back (or at least, maintaining the status quo). And this approach is enshrined in official US statements on the impact of WTO entry on China, summarized by an official White House (2000) statement of March 2000:

> China's accession agreement will deepen and help to lock in market reforms — and empower those in China's leadership who want their country to move further and faster toward economic freedom. In opening China's telecommunications market, including to Internet and satellite services, the agreement will expose the Chinese people to information, ideas, and debate from around the world. And China's accession to the WTO will help strengthen the rule of law in China and increase the likelihood that it will play by global rules.

Nor is it just an American approach, as the EU's trade commissioner, Lamy's (2000), speech in Beijing in October 2000 illustrates:

> It can only lock in and deepen market reforms, empowering those in the leadership who support further and faster moves towards economic freedom.

There is already a considerable literature considering what might happen in concrete terms, ranging from wider global perspectives to individual industry case studies.[13] Nevertheless, the impact of the WTO deal on financial reform in China remains far from clear — not least because officials across China have developed new means of protecting chosen producers once the WTO concessions have been implemented. Whether the concessions that were agreed on are finally and fully implemented by the Chinese is also a matter of some dispute. However, in general terms, we can identify both direct and indirect implications for financial reform.

In terms of the direct impact, The Standard Chartered Bank calculates that foreign banks in China can expect a 40 per cent annual growth in lending in China in the next decade, with the four major commercial banks receiving the most competition (China News Digest 2 January 2000). However, representatives of foreign financial institutions attempting to begin operations in China are much less optimistic. They fully expect new barriers to be put in the way of foreign interests — with one expecting to wait a further ten years after China joins the WTO before foreign institutions can effectively compete with Chinese financial institutions.

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The main indirect impact is on employment and in particular, employment in the state sector. Indeed, a research report from the Chinese Academy of Social Sciences argued "structural unemployment may be China's chief adjustment cost for WTO accession" (Yu *et al.*, 2000: 1–2). Should the reforms be implemented in full, it seems likely that China's textile industry will gain through the phasing out of US import quotas. But these gains could be dwarfed by the losses in steel, automotive, chemical machinery, computer and electronics industries, and in reduced incomes for China's farmers. Notably, there is an expectation that industries where private ownership and (in particular) joint ventures dominate will benefit most, while those sectors where the residual state sector still dominates will be the main losers. In effect, this represents a move towards the privatization of the Chinese economy by other means, and a further transfer of economic power and political relationships and alliances.

Conclusions

The start of the transition from socialism in China is usually dated as the third plenum of the 11th Central Committee in December 1978. At the third plenum of the 14th Central Committee in November 1993, the party leadership issued a decision that would theoretically and fundamentally alter the relationship between the state and the economy. The decision outlined the need to reform the residual state-owned sector, clarify the property rights of all enterprises, and establish financial and fiscal systems that could effectively manage the economy by economic, rather than political, means.

Joining the WTO should represent a key turning point — the beginning of the end of the protectionism that has been a key determinant of the manner in which Chinese reform has evolved. However, two key questions remain to be answered: First, whether the leadership have the political will, commitment, and perhaps even confidence in their own position, to see the reforms through. In this respect, the leadership have to come to terms with the reality that previous high levels of growth are not sustainable in the future; and second, whether key power-holders at the local level adhere to central policy rather than pursue their own local ends through licit, semi-licit and illicit manipulation of the financial, economic and judicial structure.

As China joined the WTO, the problem of debts in the financial system not only remained unresolved, but the debts themselves continued to grow. High growth rates had been maintained through a recovery in export growth after the first impacts of the Asian crises in 1998, and through massive government expenditure. But the domestic economy essentially remained in deflation. For example, in April 2002, the consumer and retail price indexes in China were 98.7 and 97.9 per cent of the previous year, respectively, while investment in

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fixed assets and capital construction were up by 127 and 21 per cent, respectively. Between 1996 and 2001, expenditure on capital construction rose from RMB 907.44 to 2517.9 (100 millions) while expenditure to support agricultural production rose from RMB 510.07 to 905.3 (100 millions). In addition new bank loans remained a major source of maintaining production, with a year on year rise of over 11 per cent in April 2002.

After more than two decades of reform, the key challenge remains — what to do with the state-owned sector during the transition from socialism. We should remember that the Chinese experiment has, by almost all criteria, been more successful than the shock therapy big-bang away from socialism deployed elsewhere, but China is now facing the task of paying for its relative success in three ways — paying in financial terms in the guise of an insolvent banking system; paying in terms of increased obligations, duties to and pressures from the international system; and paying in terms of the (delayed) growth in unemployment.

Financial systems and structures do not just emerge. They are constructed to serve specific ends. The case study of financial reform in China is a study of an attempt to build a new financial system to serve new ends, but constraints remain from the incomplete nature of reform and the residual importance of old political alliances. Financial reform, and so much else, remains shaped by and contingent on how the leadership manoeuvres between conflicting demands and conflicting imperatives — in effect, how the leadership faces up to the task of finally dealing with the transition from socialism and the long-term political consequences of economic reform.

Notes

1 Not just in banking, foreign exchange and so on, but also at a more basic level in simply legalizing joint ventures, foreign ownership and so on.
2 Personal interviews with officials who have asked for anonymity.
3 Zheng (1999) refers to these processes as 'selective recentralization'.
4 We should exercise care in assuming that there is a single local interest at work in each local authority. Duckett's (1998) investigation of Tianjin Municipality, for example, found that different departments within the local government were following their own independent policies which entailed independent strategies for raising capital.
5 Experiments in different forms of welfare systems are ongoing in a number of places across the country.
6 For example, in Gansu, over 21 per cent of registered peasants work elsewhere; in Ningxia 20.6 per cent; in Sichuan 18.4 per cent; 18 per cent in Anhui and so on.
7 All four received the same amount irrespective of the extent of bad debts in their area. See *China News Digest*, 7 November 1999. http://www.end.org
8 The idea was first put into practice on a large scale after the default of the China Everbright Trust and Investment Corporation in October 1996. The problem here was that as the TIC was not making any money, those who took up the equity soon faced financial losses. See Xie (1999: 11–13).

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9 Zeng was Chairman of the State Development Planning Commission. See *China News Digest*, 7 November 1999.
10 According to, China's Minister of Labour and Social Security, Zhang Zuoji, the government needed a total of RMB 24.5 billion (US$ 2.95 billion) to pay the basic costs of living of laid-off workers in 1999, and in August 1999 was still short of RMB 5 billion (US$ 603.8 million). *Hexun Caijing* (Homeway Financial News) (30 August 1999).
11 Even though virtually all of China has now been formally opened to the global economy, international economic relations remain dominated by nine coastal provinces. These provinces account for over 85 per cent of all exports and around 80 per cent of all foreign direct investment.
12 And in particular, proposals to build SOE reform on the model of the South Korean *chaebols* lost much of its appeal.
13 See, for example, the Special Issue of The China Quarterly (2001).

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