Reclaiming the Commanding Heights amid Political Succession
the Political Economy of Financial Reform in Post-Deng China

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ABSTRACT

Reclaiming the Commanding Heights Amid Political Succession:

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Yifeng Tao

In late 1993, the Chinese central policymakers launched a series of reforms to rationalize and resume central control over the fiscal and financial systems. The rationalization and recentralization reforms pose a challenge to our previous view that economic decentralization is an irreversible trend in China's transition toward market economy. It also puzzles us when we consider the importance of political support of an increasingly powerful provincial officialdom to any forthcoming Chinese leaders in the post-Deng succession competition. The contending successors, in order to increase their own share of power in the collective leadership, should have competed with each other to extend Deng's course of decentralization reforms to earn political support from provincial leaders.

This dissertation argues that the center's control over provincial leaders' appointment is an essential but rarely explored aspect of central-provincial relations in the Deng era. Without considering this unique feature of the Soviet-type political system, we only obtained a partial view of the evolution of central-provincial relations, and reached an oversimplified conclusion about the effects of succession politics on the balance of power between the center and provinces. The *nomenklatura* would provide the contending successors with the incentive to temporarily unite, rather than split, to exercise this power when they just assume the power and need assertive action to consolidate the new regime at this particularly uncertain moment. By reversing the long-term drain of funds and power from the center to the localities, and replacing the increasingly recalcitrant provincial leaders with a new generation of officials, the newly inaugurated central leaders can demonstrate to the public the effectiveness of the top authority on the one hand, and replace the old regime's supporters with their own loyalists on the other. This study combines qualitative research and statistical analysis to prove this argument. The findings suggest that, compared to other former socialist countries, China's preservation of the *nomenklatura* system allows central policymakers much higher autonomy in determining transition trajectories.

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To my father, Tao Tzi-Chiang

Chapter 1

Introduction

In Deng's China, economic decentralization seemed to be an irreversible trend in the economic transition. Centrifugal forces were argued to be the underlying drive of China's astonishing economic growth since 1978 and had gradually shifted 'the centers of economic power... to the localities' (Goodman 1994, p.5).[1] In the early 1990s, in the wake of sudden collapse of communism in the Soviet Union and Central and Eastern Europe, and deteriorating health of Deng Xiaoping and the members of his cohort, there was increasing doubt among China watchers whether the center could hold China together, especially after Deng Xiaoping's death.[2] However, precisely at this moment, the seemingly sacred theme of economic decentralization was halted by a new generation of Chinese central leaders in the Third Plenum of the Fourteenth Congress of the Communist Party of China (CPC) in November 1993. A series of fiscal and financial reforms were since introduced to rationalize and resume central control over the distribution of national financial resources. Observers of China see this Third Plenum as

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[1] For similar view, also see (Shirk 1993) (Wang and Hu 1993) and related articles in (Walder 1995b).

[2] 'China – Can the Centre Hold?' *The Economist*, 6 November 1993, p.32, also see (Shambaugh 1993).

'a watershed in central-local relations' (Yang 1994, p.59). Some even argue that '[this] Third Plenum Decision may prove to be equally or more important than the decisions made by the Third Plenum of the 11th Congress of the CPC held 15 years ago'(World Bank 1995, p.59).

The rationalization and recentralization efforts since 1993 not only pose a challenge to our early view that economic decentralization is an irreversible trend in China's transition toward market economy. It also puzzles us when we consider the importance of the political support of an increasingly powerful provincial officialdom to any upcoming Chinese leaders in the post-Deng succession competition. The new-generation central policymakers, still fragile and vulnerable, should presumably have competed with each other to extend Deng's decentralization reforms in favor of provincial leaders, arguably the most important political constituents nurtured during the Deng era. This study is designed to address these issues, with a specific focus on the reforms in the banking system since 1993. It is an attempt to pinpoint the characteristics of the economic reforms in post-Deng China, to explore the shifting nature of central-provincial relations under a new regime, and, in a broader sense, to examine the relations between political succession and economic policymaking in a Soviet-type political system.

It argues that the center's monopoly of provincial leaders' appointment rights is an essential, but rarely explored aspect of central-provincial relations in the Deng era.[3] Without considering this unique feature of the Soviet-type political system, we only

[3] Most students of central-provincial relations have pointed out the fact that, even after 15 years of economic decentralization, the Chinese central leaders still control the appointment of provincial officials, but few of them have really examined its effect on the development of economic relations between central and provincial governments. The most notable exceptions are James Tong's work on the relations between revenue remittance and provincial elite turnover (Tong 1989) and Yasheng Huang's work on its relations with the central policymakers'

obtain a partial view of the evolution of central-provincial relations, and reach an oversimplified conclusion of how succession politics would affect the balance of power between the center and provinces. The *nomenklatura* does more than provide a unified central leadership with the power to repress any potential resistance against its policies from below. It also plays a crucial role in helping the successors of the central collective leadership to consolidate their authority during the uncertain moment of power transition. With the provincial leaders' *nomenklatura* fully in their control, the newly inaugurated central leaders would utilize this power to consolidate their collective authority, rather than placate local officials by continuing Deng's decentralized reforms. It has long been recognized that assertive action of a unified central leadership is needed in the Soviet-type political system during a power transition because, in the absence of clear legal or procedural norms, the central authority at this uncertain moment could only be enforced by the fact of control. Thus, there has been a tendency of the top leaders in the Soviet-type system to temporarily overcome the inherent factionalism in the collective leadership and work together to earn the continuous acknowledgement of their authority from the bureaucracy as well as the society, when they have just assumed power from their predecessors. In the face of deteriorating macroeconomic stability and widening regional disparity, the post-Deng central leaders would utilize their monopoly over local personnel to reverse the long-term drain of power and resources from the center to localities, and replace the increasingly recalcitrant provincial leaders with their own men. By doing so, they could demonstrate to the bureaucracy and the society that the new central leadership was as effective as ever, if not more so. Nonetheless, once the collective leadership's authority has consolidated, the central leaders would not hesitate

effectiveness in inflation control during the Deng era (Huang 1996).

to re-engage in competition for outside support. Factionalism would therefore recur, resuming the politics as usual in the inherently unstable collective leadership.

The problem: explaining the political economy in post-Deng China

Since 1978 when Deng Xiaoping brought China onto the road of reform and opening, the general perception of the defining characteristics of China's economic transition has been gradual liberalization through devolving resources and decision-making power from central planners to the localities within the communist hierarchy. The particularistic distribution of power and resources down to the hands of local cadres at all levels enables China to enjoy the dynamism of economic liberalization on the one hand, and still preserve the communist monopoly of political power on the other. How effectively can this description serve as a guideline for us to understand the political economy in post-Deng China? Is it true that economic decentralization is an irreversible trend even after Deng? Or is it a policy platform that only reflects the characteristics of the Deng regime? Would the post-Deng leaders continue the trend, or set their own policy platform? If they would reverse the trend, do the post-Deng central policymakers have the political clout to do so?

Fiscal decentralization endowed more economic decision-making power as well as responsibility to the local governments and "hardened" their budget constraints. To generate more revenues to meet local development needs thus became the major factor behind local officials' endeavor to explore local economic potential since the late 1970s. They were given little choice but to engage in industrial expansion, duplicate investments, and regional protectionism regardless of their potential consequences, such as economic overheating and macroeconomic imbalance, at the aggregate level. As more and more investment decisions are made locally, the localities gradually developed their distinctive interests and identities from the central policymakers (Goodman and Segal 1994) (Goodman 1997) (Cheung, Chung, and Lin 1998).

Some scholars therefore assert that local officials with their distinctive interests and identities would also develop the political clout to bargain with the center. For example, Susan Shirk argues that economic decentralization was Deng's political strategy to nurture local officials as a political counterweight against the powerful central bureaucracy, which presumably had vested interests in perpetuating central planning. In comparison to its Soviet counterpart, the political structure Deng inherited was a fairly decentralized one with relatively strong local power and less entrenched central bureaucracy. Under this circumstance, Deng could "play into the provinces" rather than, like Gorbachev, opening up the political arena to mass participation to build a policy coalition against the central bureaucracy. As more and more production resources are controlled in the hands of provincial governments, the central leaders will have stronger incentive to make policies in favor of provincial officials to earn their support in succession competition (Shirk 1993). In the long run, the waning central state power can be expected as the economy is further decentralized (Walder 1995a) (Wang 1995).

The above analyses by and large captures the dynamic of economic reforms in Deng's China. Economic transition and rapid growth were achieved by the grant of flexibility from units at each administrative level of the political system to those at next lower level (Lieberthal 1997). However, the arguments still can be improved in at least three aspects: First, in assessing the evolution of central-provincial economic relations, the focus is usually centered around the fiscal relations between the center and the provinces, especially the extractive capacity of the central government. The declining extractive capacity of the central state has caused extensive worries and debates in China as well as international community in the early 1990s. Scholars who are worried about a fiscal decline of the central state argue that the declining extractive capacity of the central state has affected its capacity to govern the economy. They cited the deterioration in macroeconomic stability and growing regional disparities as evidence of the danger of a declining center. Nonetheless, more comprehensive studies of revenue distribution between central and provincial governments find that the argument for a fiscal decline of the central state is far from established. In comparison to the early 1980s, the extractive capacity of the center, examined from various aspects, has *not* suffered a decline due to economic reforms (Wong 1991) (Yang 1994) (Zhang 1999).[4]

In fact, the diminishing role of the center is much more significant in the redistribution of expenditure rather than revenue. While the center's role in government expenditure has sharply declined throughout the reform era, it was more an *intended* consequence of the central policymakers, rather than an unexpected result of the emergence of localism. In an effort to get rid of the center's heavy burden in public finance, starting in the late 1970s, central policymakers gradually had local governments as well as the banking take over the center's burden in financing public investment and expenditure system, through decentralization of investment decision-making power. It in turn resulted in a sharp increase in local extra-budgetary funds and bank credits.

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[4] For more detailed discussion of the debate, see Chapter 2, Section 1.

Table 1-1. CHANGING ROLE OF THE STATE

	1978	1984	1989	1993	1995	1997
Output of state-owned enterprises (SOEs)						
As % of total output	77.6	73.6	56.1	47	34	25.5
Gov't revenue as % of GDP	31.2	22.7	15.8	12.6	10.7	11.6
Gov't expenditure as % of GDP	30.9	23.7	16.7	13.4	11.7	12.4
Financing of SOEs Investment						
Budget	37.7	39.0	13.4		5.0	4.7
Loans	n.a.	15.4	20.9		23.7	23
Foreign Investment	n.a.	2.2	10.2		7.9	5.1
Self-raised funds	n.a.	43.4	55.5		63.4	67.2
Bank deposits as % of GDP						
Total	31.6	47.6	56.8	85.5	92	110.2
Enterprise	10.3	19.2	19.5	24.8	29.4	38.3
Urban savings	4.3	11.2	23.6	43.9	50.7	61.9
Rural savings	4.3	5.4	4.5	3	2	2
Treasury & government	9.7	7.1	5.8	3.5	3.2	3.2

Sources: World Bank, 1992, *China: Reform and the Role of the Plan in the 1990s*, p.54; China Statistical Bureau, 1998, *China Statistical Yearbook 1998*, p.55, p.187, p.190, p.269, and p.433; and People's Bank of China, 1998, *Almanac of China's Finance and Banking*, p.508.

Table 1-1 shows the changing role of the state in China's economy. At first, we find that as the output of the state-owned enterprises (SOEs) – the most important source of formal government budgetary revenue - sharply declined in the transition, so did government budgetary revenue, including both the central and local governments. The decline of formal budgetary revenue as a percentage of GDP does not show a decline of the central state as Wang and Hu assert. The figure only tells us that the Chinese economy has experienced such a transformation that the non-state sector, i.e. the economic sector outside the state planned system, has become the primary growth engine, and from which the formal budgetary system lacks institutional instruments to extract revenue. It is the expenditure side that tells a fading role of the central state. Since China launched SOE reforms in 1984, the financing of SOEs investment has been gradually taken over by bank loans and extra-budgetary funds (mostly the SOEs retention funds). As shown in the table, in 1984 government budget financed about 40 % of the SOEs investment, in the 1990s it fell to less than 5 percent while the majority of the funds came from the categories called loans and self-raised funds. They are bank credits, money raised from financial markets, and local extra-budgetary funds.[5]

As more and more money is circulating outside the formal government budget, the Chinese banking system gradually became the major channel for national financial flows and functioned more like banks in a market economy. From 1978 to 1997, bank deposit as a percentage of GDP increased from 31.6 percent to 110.2 percent, and most of the deposit was from household savings. While the growth in the vibrant non-state sector contributed the majority of funds deposited in the banks, the banking system was still tightly controlled by the state. Therefore, more than 90 percent of China's bank credits were used to finance SOE investments and government expenditures. In other words, through the banking system the fruits of the growth in non-state sector became the sustenance of the obsolete state sector. As the banking system has gradually become an important instrument for the Chinese government to finance its investments and expenditures, it would be misleading if we analyze the balance of economic power

[5] The official account of the bank loans does not include issuing bonds and borrowing from banks indirectly, such as through Trust and Investment Companies, or postponing payments to banks. According to a survey of the SOEs' self-raised funds in nine provinces, conducted by the headquarter of the People's Bank of China, 73.1 % of the self-raised funds in fact were debts. As a result, debts composed 74.2 % of the total investments in all the SOE projects covered by the survey (People's Bank of China, 1994).

between the central and local governments without mentioning the banks. From regulating macroeconomic stability to equalizing regional disparity, the Chinese central policymakers have increasingly relied upon the distribution of bank credits rather than budgetary funds to achieve these policy goals. As long as the economic transition continues, the central state's capacity in governing the economy would be determined by how well it is able to articulate monetary instruments, rather than how much revenue it can extract. Therefore, in assessing the evolution of the central-provincial economic relations and the capacity of the central state during the reform era, we cannot afford to ignore the banking system.

Secondly, in previous studies of the political economy of central-provincial relations, relatively few scholars have analyzed the interaction between politics and economics. For those who touch the issue, the causal direction is usually from economics to politics. That is, how economic decentralization will eventually lead to political liberalization. While the absence of political reforms naturally leads us to study economic reforms and their potential impact on the operation of the political system, Susan Shirk (1993) and Yasheng Huang (1996) are among the few whose studies focus on the effect of the political institutions on economic policymaking in China. But their work provides us with somehow opposing views of how the political factors are operating in economic policymaking. Inspired by new institutionalism, both of them set the focal point of their studies on the roles of delegation and accountability in the policymaking process. In Susan Shirk's model, it is the increasingly powerful provincial officials that, through their holding of a significant number of seats in the Party Central Committee, hold the top leaders "reciprocally accountable" in the policymaking process.

She argues that the top leaders in the face of succession competition would make policies in a particularistic manner to earn political support from their provincial constituents. In contrast, Yasheng Huang sees the provincial officials as the agent, rather than the principal, of the central leaders in their delegation relations, and examines how the central leaders, through their control over the appointment of local personnel, hold provincial leaders accountable in inflation control. Susan Shirk's model captures the *bargaining* aspect of the political system in which the Chinese central leaders no longer enjoy that high degree of discretion as Mao did in policymaking and should take care of the interests of their political constituents. Yasheng Huang's model reminds us of the *hierarchical* aspect of the political system in which the Chinese central leaders still hold firm control over the appointment of local leaders. After all, local officials have to implement central policies to the extent that the top leaders would retain them in office. A more comprehensive research design is needed to examine the two models simultaneously.

Thirdly, most of the theories about China's central-local relations were developed before 1993. Since the Third Plenum of the Fourteenth Party Congress in November 1993, the central-local relations have gradually changed in a manner that the concepts invented to describe the central-local relations in early years, such as "fiscal decentralization"(Oksenberg, 1991), "particularistic contracting" (Shirk 1993), and "devolution of the central power" (Wang 1995), are no longer adequate to capture the characteristics of the relations. In the new round of reforms, "macro-level adjustments and controls" (*hongguan tiaokong*) replaced "devolving powers and yielding benefits" (*fangquan rangli*) to be the primary policy platform. "National interests" instead of "local initiatives" are the aim of reforms. And "rationalization" rather than "particularistic bargaining" is the guideline to restructure the economic infrastructure.

To sum up, the gap between our early conceptions of the central-provincial relations in the reform era and the recent development following a series of reforms carried out since 1993 calls for reexamination of central-provincial relations. The reexamination ought to incorporate an assessment of the relations in banking aspect as well as an analysis of the effects of top leaders' monopoly over provincial personnel on the changing central-provincial relations.

The Argument of the Study

This study will address two research questions. One is what are the defining characteristics of the political economy in post-Deng China, i.e. whether it is appropriate for us to continue to use "economic decentralization" to characterize central-provincial economic relations after Deng. The second question is, if the post-Deng central policymakers really have set their own policy platform and somehow reversed the decentralization trend set by Deng, why do they have the incentive and how have they obtained the political power to do so, given that political succession should have presumably engaged them in severe competition for political support from the provincial leaders - the most important political constituency nurtured by the Deng regime.

To understand the characteristics of the central-provincial economic relations in post-Deng China, this study focuses on an important, but perennially neglected, aspect of the relations – the banking system. As discussed earlier, the banking system has replaced the government budget as the major channel for national financial flows since more and more money is circulating outside the government budget as a result of economic transition. Although the Decisions of the Third Plenum of the Fourteenth Party Congress – the keystone document to define the path of economic reforms in post-Deng China – cover areas including banking system, fiscal system, and state-owned enterprises (SOEs), the study chooses to only focus on the banking system for two reasons. First, distribution of national financial resources is always at the core of China's central-provincial economic relations. Although the SOE reforms are as important as the reforms in financial and fiscal systems, the later is more related to the issues we intend to address here. Secondly, as the role of banking system in the distribution of national financial resources became more important than the formal government budget, our research on this aspect seem far behind the development. Disproportional attention has been placed on the fiscal aspect in previous studies of central-provincial relations. Therefore, more research on the banking aspect is needed.[6]

Through in-depth qualitative research that combines a survey of government documents, official statistical data, and secondary resources, and 145 interviews with Chinese policymakers, bankers, as well as academic scholars in places including Beijing, Shanghai, Shenzhen, Zhengzhou, and Hong Kong,[7] the study finds that the banking reforms in this stage precisely reflected the general guidelines laid out in the Third Plenum of the Fourteen Party Congress. "Macro-level adjustments and controls" (*hong guan tiao kong*) is the central guideline of the banking reforms. Monetary stability and financial order replaced economic growth and local initiatives as the ultimate goals of

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[6] Research on the post-Deng fiscal reforms also find a similar trend of recentralization, see (Zhang 1999).

banking reforms in the post-Deng era. They were achieved by the resumption of central control over many aspects of the banking system. Through vertical integration of corporate governance and financial flows within the state banking system, the local branches of both the central bank and the "big four" state banks were made administratively and fiscally dependent upon their headquarters, and were stripped of the autonomy they had in the 1980s in the distribution of selective credits to local government units and state-owned enterprises. Through crackdowns on non-state and quasi-state financial intermediaries, the channels available to local branches of the state banks for diverting loanable funds from the planned system to assets with higher returns in the market were contained, and the competition to the state banking system from these newly emergent market players was largely undermined. Through the establishment of three new policy banks and a "main bank system" comprising the four state banks and 1,000 strategic SOEs, the role of the central planning agencies in controlling the allocation of bank credits was enhanced.

The second question of this study is how it was *politically* possible for the contending successors of the post-Deng top leadership to temporarily unify themselves to stop the drain of national financial resources from the center to the localities. One may argue that the deterioration of China's macroeconomic situation had reached such a dangerous level that unified the contending successors' opinions on the urgency of restructuring the distribution of national financial resources (Yang 1994, p.83). However, to accept this argument, one must assume that the Chinese central policymakers are unanimously public-good providers who would take good care of macroeconomic stability rather than distribute particularistic favors to earn political support from their

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[7] For the list of interviews, see Appendix A.

local constituencies. If contending successors of the top leadership can be unified by urgent economic problems, it is hard for us to understand why the economic situation before the Tiananmen incident in 1989 did not unify the contending successors then, but led to the most serious split in the central leadership since the Cultural Revolution. The answer to a political puzzle should be sorted out in politics.

Exogenous economic crisis may provide momentum for policy reorientation. It by itself, however, won't provide a solution to potential resistance from an important political constituencies. If one does not revisit the theories about the impact of political succession on economic policymaking, one could not find a satisfying answer as to why the contending successors of the Chinese top leadership in the early 1990s, unlike those who in the late 1980s, could launch a series of fiscal and financial reforms against provincial interests. This study proposes that the political institutions of the Soviet-type system create a distinctive dynamic of succession politics, in which the contending successors during *consolidation period* – when they have just assumed power and need assertive action to demonstrate the effectiveness of their collective authority – will *temporarily* unify themselves to enhance the general perception of the authority's effectiveness at this particularly uncertain moment. The top leadership of the Soviet-type hierarchy is particularly sensitive to populace's perception during regime transition because the top authority, lacking legitimation of clear legal and procedural norms, could only be enforced by the fact of control. The newly inaugurated central leaders, unlike those who are still under the protection of their predecessors, must exercise their newly acquired power in a very assertive way in order to earn the continuity of the general acknowledgement of their authority. It is in the interest of each individual successor in the collective leadership to maintain the survival of the regime. They would demonstrate the authority by reorienting their predecessors' policy platform and replacing the power elite left by the old regime with their own loyalists. The dynamic has been found in the succession consolidation of Khrushchev and Brezhnev's regimes in the former Soviet Union (Bunce 1980) (Hough 1980). In China, it was in this fashion that Deng and his colleagues initiated China's economic transition and consolidated their power in the late 1970s. The same political logic also set the post-Deng leaders in motion to do the same thing.[8]

This study employs qualitative data to explain how the political logic of succession consolidation has driven the post-Deng Chinese central leaders to simultaneously launch a series of financial reforms in an assertive manner and reshuffle the provincial officialdom in large scale. It also subjects the proposition, together with hypotheses derived from various theories of central-provincial relations, to a statistical test. Using more than one method to illuminate the causal mechanism of an argument has been widely accepted as a way to improve the reliability of research findings in political science (King, Keohane, and Verba 1994) (Levi 1997). If the mechanism identified in qualitative study is valid, it should hold up as well under statistical test. A statistical test will make our argument more convincing if the results confirm our findings from qualitative research.

The statistical test conducted here employs the *event history analysis* method to estimate the effect of succession consolidation on the political survival of provincial leaders. The effect is examined against several hypotheses derived from the theories of central-provincial relations. Our findings show that, in terms of provincial leaders'

[8] For detailed elaboration of the argument see Chapter 6 of this book.

turnover, the central leaders have not gradually lost control over the localities during the reform era as conventional theories propose. Nor were they able to maintain coherent policy goals and stringently monitor the provincial leaders' implementation. The central-provincial relations actually varied over time, and succession consolidation did lead to a higher turnover of provincial leaders. Therefore, the statistical results support our proposition that the contending successors in the Soviet-type political system, in order to demonstrate the credibility of their authority, would reshuffle high-ranking officials more often than usual when they are consolidating the new regime.

Although this study is limited to China, the findings have implications for comparative political economy in general. The effects of political institutions on economic policymaking have been the core concern of general political economy since Adam Smith began to ask how nations prosper and what is the relationship between polity and economy (Hall 1997). By exploring the relations between political succession and economic policymaking in China, this study can contribute to our general knowledge about how political institutions may affect the choices of economic policies. Moreover, the analysis of China's banking reforms also belongs to the grand tradition of comparative financial institutions that concerns how allocation of economic and political power affects the development of national financial institutions (Zysman 1983) (Haggard 1993) (Maxfield 1997) (Sylla, Tilly, and Tortella 1999). The continuous monopoly of political power at the apex of the communist hierarchy provides a unified central leadership with an extraordinarily high degree of discretion in policymaking. In comparison to other transition economies that have experienced political liberalization, the trajectory of China's economic transition is still by and large determined by a handful of top leaders today. While China's outstanding economic performance has led many to conclude that authoritarian policymaking process is necessary for successful economic transition (Huang 1996, Chapter 9), decision without deliberation has also caused problems in implementation and may actually hinder the transition in the long run. These issues are discussed in greater detail in the concluding chapter.

Organization of the Dissertation

This dissertation is organized into two parts. The first part, which consists of three chapters, and is devoted to pinpointing the characteristics of central-provincial economic relations in post-Deng China with a specific focus on the transformation of banking system. The second part uses two chapters to analyze the relations between political succession and economic policy reorientation since 1993.

Charpter 2, the first chapter of part one, portrays the role of the banking system in China's economic transition. It explains how the banking system has gradually helped finance government's expenditures and investments since the late 1970s when the Chinese central policymakers decided to gradually have local governments and the banking system shoulder heavier expenditure burdens, and how it led to tension between the central and provincial governments in terms of controlling monetary stability and credit distribution. The following two chapters analyze how the post-Deng leaders resolved the problems by resuming central control over the banking system beginning 1993. Chapter 3 discusses the restructuring of the central bank and the creation of the three policy banks. Chapter 4 analyzes the transformation of the whole banking system.

The second part, beginning with Chapter 5, examines the effects of political succession on economic policymaking in post-Deng China. Chapter 5 presents the theoretical framework and uses qualitative data to illuminate the causal mechanism. In chapter 6, the proposition is examined by a statistical analysis against hypotheses derived from various theories of central-provincial relations.

Chapter 7 briefly discusses the policy implications of this study's findings as the conclusion. The discussion is centered around a normative concern of the apparent positive relations between authoritarian policymaking and successful economic transition.

Part I

Reclaiming the Commanding Heights of the Financial System

Chapter 2

The Role of Financial System in China's Economic Transition

The financial system has long been an under-explored area in our studies of the political economy of China's economic transition. The under-exploration can be partially attributed to the relatively high entry barrier for researchers to enter this area. The high barrier is not only caused by all the technical terms involved in the operation of the financial system, but also due to the unavailability of data and documents to outside researchers, because the financial sector is still being considered by the Chinese authorities as one of the most sensitive areas. Moreover, reform in the financial system was far behind the progress of China's overall economic transition. Thus, relatively few scholars have chosen to study the financial sector in works on the political economy of the transition.[1]

Although it is among the least explored sectors, the financial system actually played an indispensable role in China's economic transition. Through its control over the financial system, the Chinese government has successfully mobilized the explosive

[1] Most of the works about China's financial reforms are done by economists. See (Byrd 1983) (Mundell 1996)and (Lardy 1998), besides numerous papers published by the World Bank and International Monetary Fund, for example. Only Yasheng Huang and Andrew Walder, in part of their works, have attempted to analyze financial reforms from the perspective of political economy. See (Walder 1992) and (Huang 1996). Recently, we have started to see more dissertations devoted to this issue, see (Sehrt, 1999) and (Tsai 1999).

expansion in household savings as a substitute for its dwindling budgetary revenue to maintain the survival of the obsolete planned system. Therefore, China could, unlike other transition economies, enjoy the luxury of continuing high investment in the planned system without suffering serious inflation throughout the transition. Nonetheless, using the outdated socialist financial system to control the flows of financial resources in an increasingly liberalized economy still caused problems to the Chinese central policymakers. On the one hand, as the financial system was shouldered more fiscal burdens by the government, the distribution of bank credits became more and more politicized. The local governments, driven by the impetus of "investment hunger" after economic decentralization, would compete with the center for control over the allocation and expansion of bank credits. On the other hand, as numerous non-state financial intermediaries emerged on the fringe of the formal state banking system to circumvent the constraint of the state plan as well as to serve the financial need of the booming non-state sector in the 'real' economy,[2] the formal state banking system was faced with unprecedented attraction and threat from these newly emerging market players. As a result, the central policymakers, increasingly losing control over the allocation and expansion of national financial resources, felt the urgency to restructure the financial system in a large scale.

This chapter provides a grand picture of the evolution of China's financial system prior to 1993. It argues that the financial system played a crucial role in smoothing China's economic transition by shouldering the fiscal burdens left by the declining state budgetary revenue. As the financial system became an important channel for the

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[2] Here, non-state sector means the sector outside the traditional state planned system. 'Real' economy usually refers to the production and transaction of 'real' goods and services. In this

distribution of national financial resources, control over the financial system has thus been another battleground between the center and the localities. However, the traditional studies of central-local economic relations have not given enough attention to this area. Thus, this chapter starts with a critical review of the traditional studies of the central-local economic relations. It is followed by an overview of the development of the financial system prior to the 1993 policy reorientation. The achievements of China's financial system are illuminated by a comparison with the experiences of other transition economies. The third section, nonetheless, analyzes the problems for Chinese central policymakers to continue to use the outdated socialist financial system to control financial flows in an increasingly liberalized economy. The analysis serves as an introduction to the following two chapters, in which the post-Deng financial reforms are analyzed in greater detail.[3]

Banking – an Neglected Aspect of the Central-Provincial Relations

Traditionally, the studies of Chinese central-provincial relations tend to put their focus on the fiscal aspect of the relations, especially the revenue extractive capacity of the central state. The most conspicuous example is the *Report on the Capacity of the Chinese State* made by Wang Shaoguang and Hu Angang in 1993, right before the Chinese central leaders launched a series of bold reforms to rationalize and recentralize the management of public finance (Wang and Hu 1993). In that *Report*, Wang and Hu's argument for a declining central state is based upon two findings. One is the declining

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sense, financial transaction is seen to mirror these activities.

[3] The specific problems in regard to central banking and managing the increasingly fragmented

ratio of government budgetary revenue to gross national production (GNP), indicating the declining extractive capacity of the state vis-à-vis the economy. According to official figures published by China's State Statistical Bureau, it had declined from 31.2 percent of GNP in 1978 to 14.7 percent in 1992, and was predicted to fall to 11.3 percent by 2000 (Wang and Hu 1993, p.6). The other evidence is the declining ratio of the central government's revenue collection to the total budgetary revenue, measuring the declining extractive capacity of the central government within the state. Comparing the center's shares in the total revenue collection between the periods of the "First Five-Year Plan" (1953-1957) and of the "Seventh Five-Year Plan" (1986-1990), they find the center's shares had declined from 45.4 percent in the 1950s to 39.5 percent in the late 1980s (Wang and Hu 1993, p.36). They therefore argue that, due to the declining extractive capacity, the Chinese central state has lost its capacity in maintaining macroeconomic stability and equalizing regional disparity. In the long run, the persistent situation of a "weak center, strong localities" may lead to the disintegration of the Chinese political system.

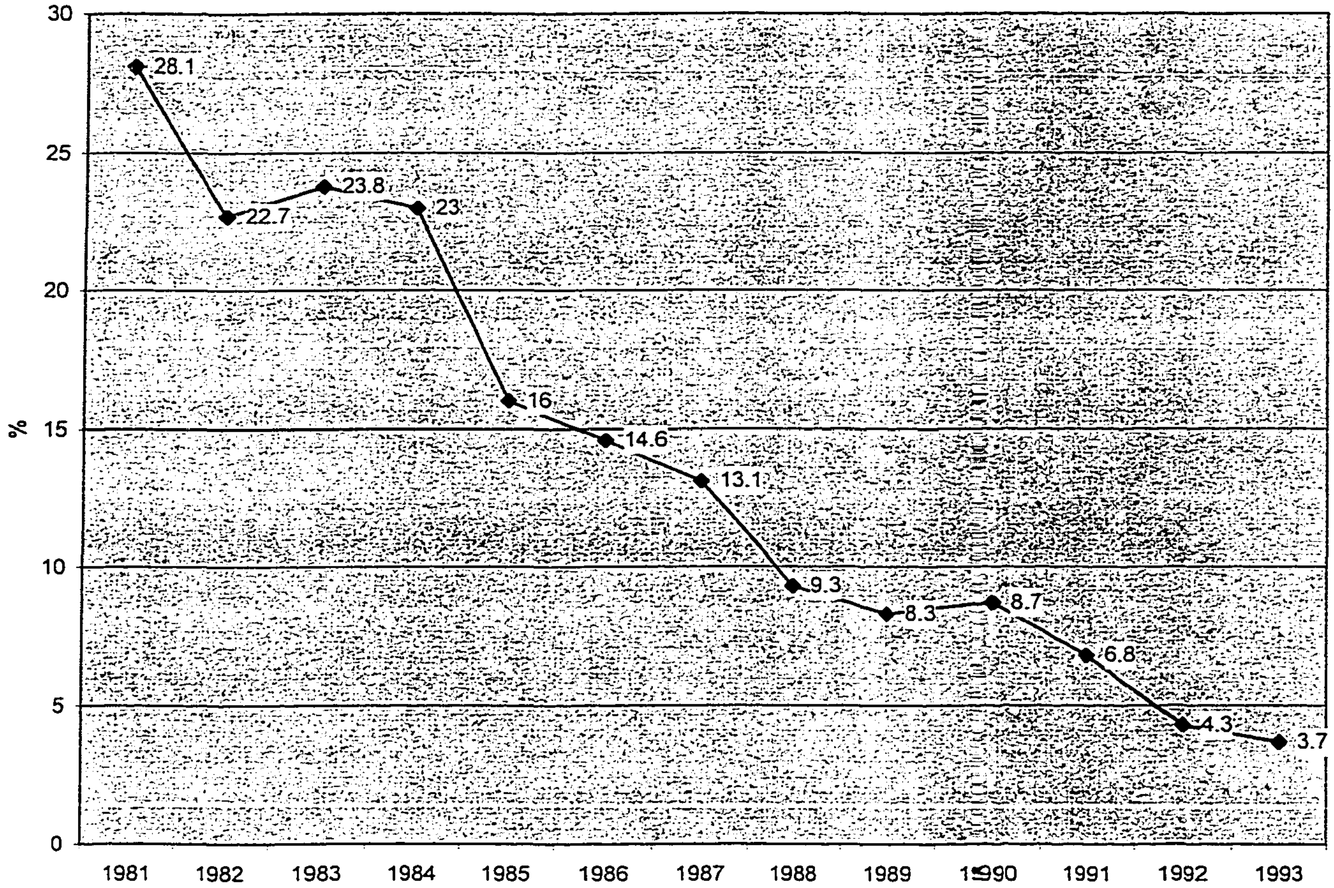
Wang and Hu's provocative argument, although momentarily providing a favorable epistemological foundation for the center's recentralization reforms, has proved to be overstated. First of all, their employment of the "two ratios" as the indicators for a declining central state has encountered serious challenges from scholars who conducted more comprehensive surveys of the evolution of the fiscal relations between the central and local governments. For example, Dali Yang argues that, since the state increasingly extracted resources from the economy through instruments beyond the formal taxation system, the first ratio, measuring the extractive capacity of the state vis-à-vis the

financial system will be discusses separately in Chapter 3 and Chapter 4.

economy, should include both formal budgetary revenue and extra-budgetary funds. By using this new indicator, he finds the ratio of government revenue to GNP has remained at its historical average at around 40 percent throughout the reform era. 'The extractive capacity of the Chinese state had not suffered a significant decline' (Yang 1994, p.61). In regard to the second ratio that measures the extractive capacity of the central state vis-à-vis the provinces, Yang finds that, although the 39 percent of the center's share in total revenue collection in the late 1980s was a decline from 45 percent in the heyday of the socialist planned economy in the 1950s, it was actually an *increase* from just around 20 percent in 1981 when the economic reforms started. Nonetheless, Yang further argues that the relative share of budget revenues say very *little* about the central-local fiscal relations because the figures only indicate 'who collected the revenues but not who had claims over the revenue collected.' (Yang 1994, p.61) In the meantime, as extra-budgetary funds played an increasingly important role in government expenditures, it is inappropriate to make an argument of a declining center simply based upon the distribution of formal budgetary revenue between the center and the localities. Moreover, the declining capacity of the central state in revenue collection is not a result of the tax-sharing arrangement between the center and provinces. It is rather because of the declining profitability of the state-owned enterprises, the most important source of the center's budgetary revenues (Wong 1991) (Zhang 1999).

Secondly, it is actually on the expenditure side of the budget that tells a story of a declining center. The declining central control over expenditure was evident in two areas. One was the declining role of the state budget in financing national investment. As shown in Figure 2-1, state budgetary investment as percentage of total investment declined from 28.1 percent in 1981 to only 3.7 percent in 1993. The decline was a natural result of the economic transition: on the one hand, investment from non-state sector grew rapidly; on the other hand, within the state, investment had gradually decentralized. In a socialist system, central planners control the economy through controlling the allocation of investment. As the state budget's role in financing national investment diminished, the central planners would become less able to control the economy.

Figure 2-1. State Budgetary Investment as Percentage of Total Investment, 1981-1993.



Sources: China's Statistical Yearbook, 1998, p.187.

The other evidence for a declining center in expenditure is the sharp increase in government's borrowing from the People's Bank of China, the central bank. In Chinese government's accounting practice, the borrowing is not shown in the government budget as a deficit. According to the World Bank's estimate, although China's official figures only show a budget deficit below 1 percent of GDP in the 1987-1993 time period, when including the "policy loans" extended by the central bank to finance government expenditure, the *consolidated government deficit* would be between 5.5 and 7 percent of GDP (See Table 2-1).[4] The increases in borrowing from the central bank indicated a central government that has increasingly relied upon currency issue of the central bank to finance its expenditure.

Table 2-1. China's Government Budget Deficit, 1987-1993.
(as Percent of GDP)

	1987	1988	1989	1990	1991	1992	1993	7-year average
Budget deficit (official figures)	0.7	0.6	0.6	0.8	1.0	1.0	-	
Budget deficit (IMF definition)	2.2	2.4	2.3	2.1	2.4	2.5	2.1	2.3
Consolidated budget deficit								
Lower bound	3.1	5.4	5.5	5.3	4.9	5.0	7.2	5.2
Upper bound	3.5	6.4	6.5	6.3	5.7	5.8	8.9	6.2

Sources: World Bank, 1995, *China: Macroeconomic Stability in a Decentralized Economy*, p. 25.

[4] The *consolidated budget deficit* is defined by the World Bank 'as the sum of the budget deficit and the part of central bank lending that is undertaken to serve the policy objectives of government' (World Bank 1995, p.xiii).

Thirdly, the declining capacity of the Chinese central state in managing macroeconomic stability and regional disparity is mostly caused by its lack of effective monetary instruments rather than revenue collection. As more and more money became circulated outside the state budget as a result of economic transition, the banking system became the major channel for national financial flows. Therefore, the Chinese central leaders, like most policymakers in market economies, have to rely upon monetary, rather than fiscal, instruments to regulate the economy. For example, in inflation control, the Chinese central government now cannot simply use reduction of its own budgetary expenditure to implement austerity program. It has to control the expansion of bank credits simultaneously since bank credits have become one of the major source of national investment, and they have strong effects on the expansion of investment from other sources. Thus, it is misleading to argue that the deterioration of the center's capacity in managing macroeconomic stability and regional disparity is due to its declining extractive capacity. In a market economy, government's capability in governing the economy is determined more by how well it articulates monetary policies than by how much revenue it collects.

Therefore, when discussing the evolution of central-provincial relations in reform China, or the changes in the central state's capacity, one should not only focus on the fiscal aspect of the relations. The development in banking system has to be incorporated into our discussion.

An Overview of the Development of China's Financial System since 1978

In the fifteen years from 1978 to 1993, the financial sector, despite the slowness in its transformation, was probably among the fastest growing sectors in China. The enduring economic boom in the non-state sector during the time created huge amounts of disposable income for Chinese households, which resulted in an unusual high growth of domestic savings. The mounting savings in turn led to the expansion of the financial sector as a whole and the proliferation of financial institutions in a variety of forms. In general, through their control over the state banking system, the Chinese central leaders had successfully utilized domestic savings as a substitute for the state budget to finance the expenditures of the old central planning system, and maintained a relatively stable macroeconomic environment throughout the transition. However, behind the overall financial success, as local governments developed their own distinctive preferences from the center's over the allocation and expansion of bank credits, and numerous newly-emerging financial institutions 'grew out of the plan'[5] and created the source of 'leakage' for funds to flow out of the state banking system, the central policymakers gradually found themselves unable to control the allocation of financial resources and macroeconomic stability as effectively as they intended to. Large-scale financial restructuring was thus needed to resume central control.

The Dual-track Reform Approach and the Development of the Non-state Sector

[5] The term is borrowed from Barry Naughton's book title (Naughton 1995). The definition will be provided later in this section.

In comparison to the experiences in other transition economies, what made China's transition so outstanding was its accomplishment of high economic growth and dramatic structural transformation at the same time. From 1979 to 1993, China maintained a GDP growth rate that averaged at 9.3 percent per year, while Russia's GDP declined at 9.6 percent per year from 1989 to 1995 (World Bank 1996, p.18). Economists tend to attribute this achievement to China's distinctive reform strategy of so-called *dual-track approach*, in which economic actors were engaged in both a plan track and a market track simultaneously, and economic transition gradually proceeds as the market track incrementally takes over the plan track (Naughton 1995) (Naughton 1997) (Sachs and Woo 1997).

The co-existence of a plan track and a market track is not itself sufficient to define China's reform strategy. A dual-track system exists in every socialist economy. Even the most strictly implemented socialist system can not totally eliminate the activities in black markets. What distinguished China's transition from others' was the way the market track replaced the plan track. Namely, without any dramatic restructuring of the plan system, China just let the market grow and kept the plan system fixed in absolute terms. In the long run, the plan would become proportionally less and less important as the economy gradually 'grew out of the plan' (Naughton 1995). This approach prevented China from the tremendous costs that must be paid when dramatic restructuring of the traditional plan system brought economic and social disruptions.

As Jeffrey Sachs and Wing Thye Woo point out, the pre-reform economic structure was essential to the success of this reform strategy (Sachs and Woo 1997).[6] In 1978, the

[6] They argue that it is the pre-reform economic structure (agriculture vis-à-vis industry), rather than reform policy (gradualism vis-à-vis shock therapy), led to the diverge transition experiences

agricultural sector was the biggest sector in China, accounting for 71 percent of employment and 37 percent of output. In Russia, the agricultural sector only employed 13 percent of the labor force and produced 18 percent of GNP. It is much easier to move labor from low-productivity agriculture to higher-productivity industry than to transfer workers from privileged jobs in state-owned enterprises (SOEs) to non-state sectors. The boom of China's non-state sector was for the most part achieved by the reallocation of underemployed labor from agriculture to industry (Woo 1994). As numerous labor force and individual resources released from the soil after agricultural reform, tons of collective and individual enterprises were set up for labor-intensive manufacturing in the countryside. The sharp rise of the township and village enterprises (TVEs) composed the bulk of China's non-state sector growth. TVE's share of industrial output has risen from 9 percent in 1978 to 31 percent in 1991, and their share of the industrial labor force from 29 to 47 percent. In the meantime, the SOE production within the planned system had never experienced any significant disruption. The SOE sector in fact kept hiring *more* labor. From 1978 to 1994, employment in the SOE sector increased by 40 million, and retained a steady 18 percent share of the total employment (Lardy 1998, p.3). However, as the economy grew out of the plan, the share of SOE's industrial output in GDP has shrunk from 78 percent in 1978 to 34 percent in 1994. The non-state sector thus took over the position of the heavy-industrial SOEs as the growth engine of the Chinese economy.

The Growth of the Non-state Sector Savings and Financial Deepening

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of China and countries in the Former Soviet Union and Central and Eastern Europe. The point has also been proved by Vietnam's experience – it has achieved economic growth even with big-

One significant consequence of the liberalization of surplus labor and the subsequent boom of the non-state sector was the sharp rise of domestic savings. The salience of the phenomenon is shown in the fact that household savings is 23 percent of disposable income in China while it is 21 percent in Japan, 18 percent for Taiwan, 13 percent for West Germany and 8 percent for the United States (World Bank 1990, Table 4.9). Since money was the only form of financial assets available to regular Chinese citizens, most of the household savings was held in the form of currency and deposited in the state banks. As show in Figure 2-2, while China's nominal GNP grew about 10 times during the reform era, bank deposits increased about 20 times with household deposits rising 40 times. Measured by the ratio of broad money holding (M2) to GNP, the cash in circulation and savings together rose from about 28 percent in 1978 to 100 percent in 1994 (Cheng, Fong, and Mayer 1997, p.205).

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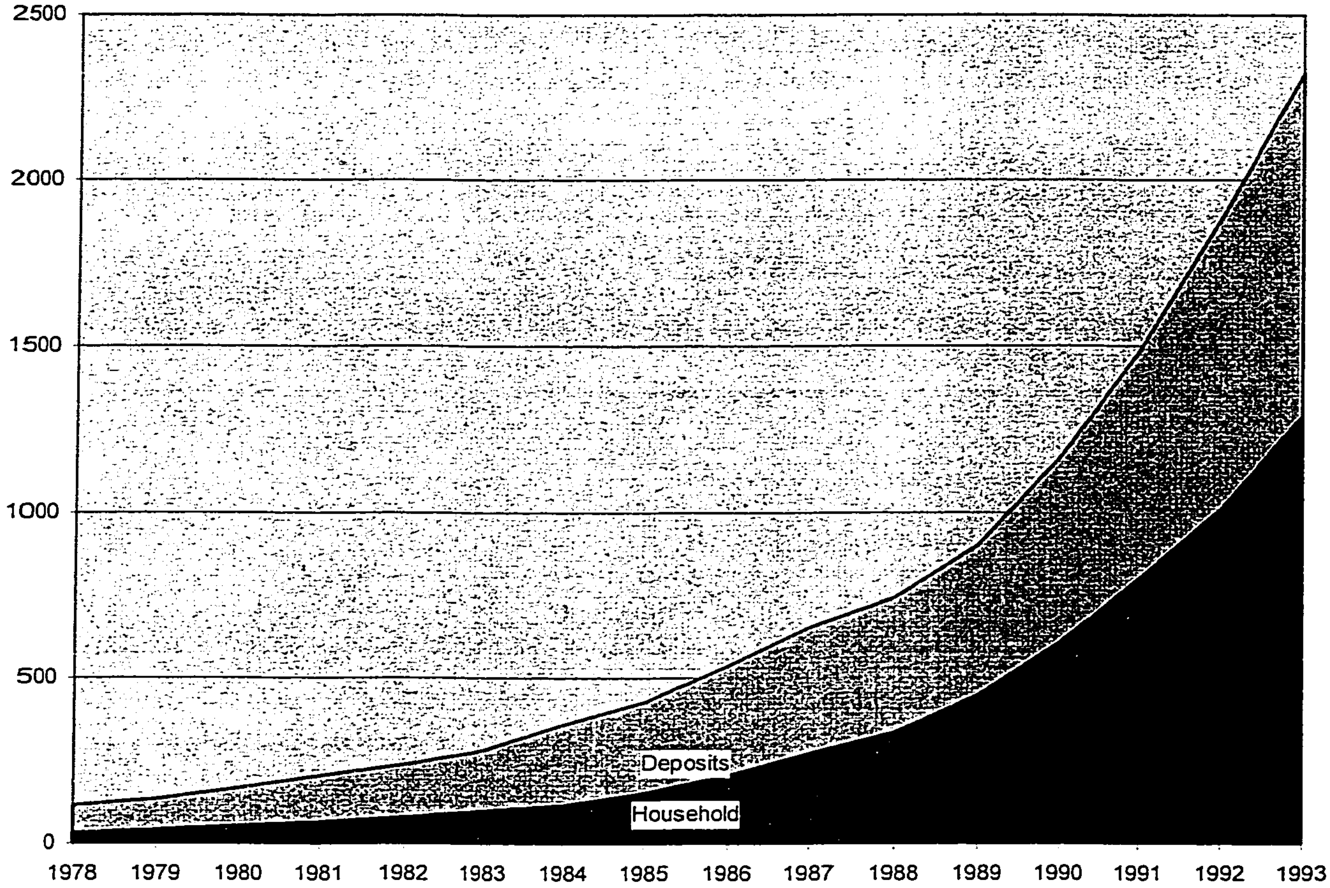
bang reform policy because their reform also started from agricultural sector.

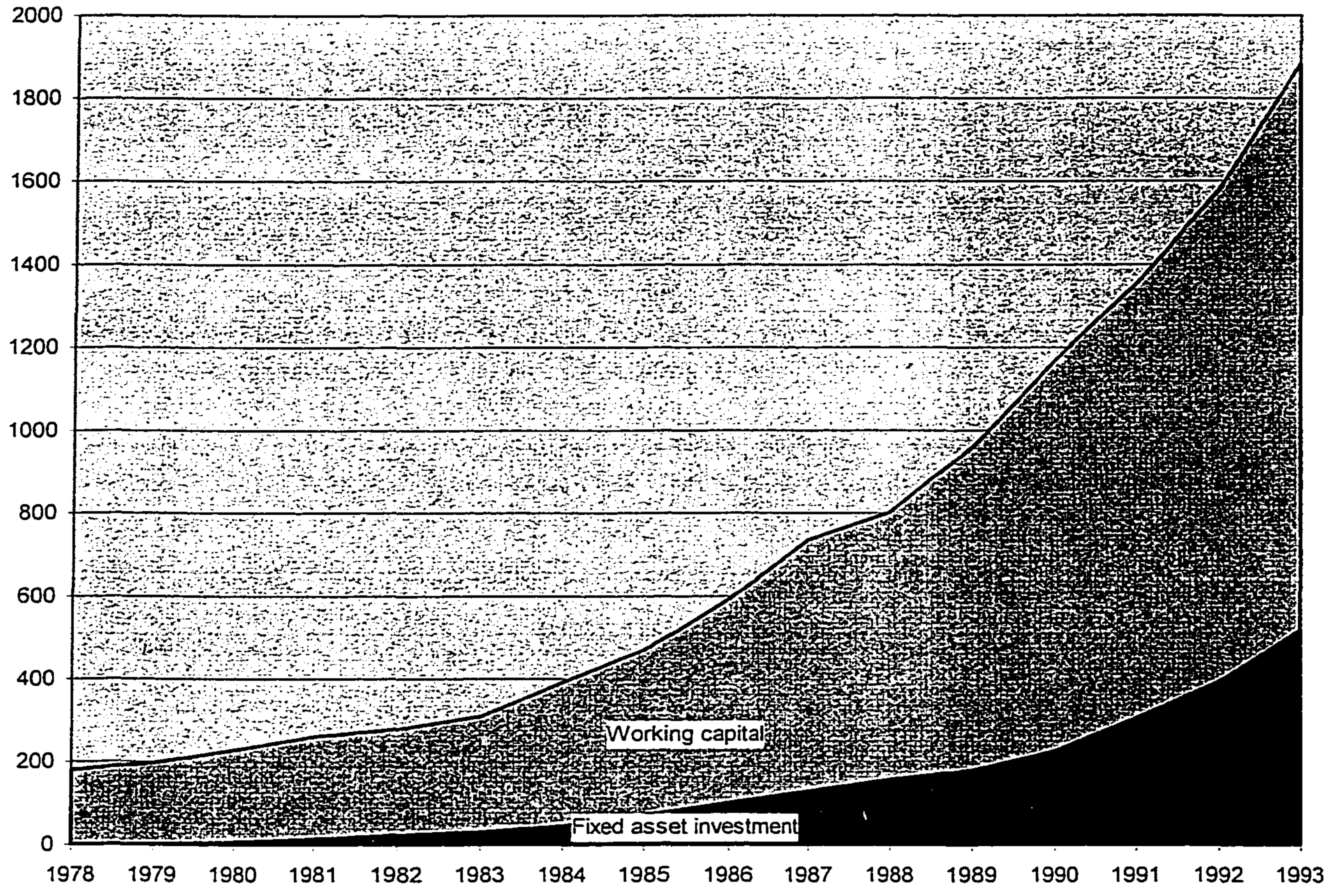
Figure 2-2. Growth of state banks' deposits, 1978-1993



Sources: Almanac of China's Finance and Banking, 1988, p. 58-59; 1993, p. 357; and 1998, p.509.

The "monetization" or "financial deepening" i.e. the increase in use of money as the means for transaction and accumulation, in the Chinese economy has been the precious keystone of China's smooth transition. First of all, the high demand for money dampened inflationary pressure even though the Chinese financial authorities have maintained a high growth rate of the money supply. While the growth of the money supply was maintained at a rate as high as 25 percent, the inflation rate averaged only 7 percent from 1978 to 1993. That is, when the nonstate sector kept a high demand for money to facilitate transactions and savings, the Chinese government would be allowed more leeway to print money (Lardy 1998, p.11-14).

Figure 2-3. China's state bank loans for investment in state units, 1978-1993.



Sources: Almanac of China's Finance and Banking, 1988, p. 58-59; 1993, p. 357; and 1998, p.509.

Secondly, the high domestic savings generated tremendous lending resources for the state banking system. Figure 2-3 depicts cash in circulation and household deposits as the share of bank loans for government expenditures and investments. We find that, while cash in circulation steadily contributed around 20 percent of the bank loans for government expenditures and investments, the share of household deposits grew from about 20 percent in 1978 to more than 50 percent in 1993. The sharp increases in household deposits relieved the central bank from printing as much money as it otherwise would have had to finance the obsolete socialist apparatus.

As a result, although China, like most of other transition economies, was faced with sharp decline in state revenue and consequent mounting budget deficits, it was able to maintain low inflation and high investment rate throughout the transition period. In the meantime, the nonstate sector became the biggest net lenders to the government through the state banking system.

"Loan for Grant" – Bank Deposits as a Substitute for State Budget

In 1979, in the midst of the war with Vietnam and the new leadership's economic policy reorientation toward the neglected sectors in the traditional planned system, the mounting budgetary expenditures resulted in an unprecedented large budget deficit of over 17 billion yuan.[7] The central policymakers therefore decided to gradually transfer

[7] According to earlier published data, the budget deficit in 1979 was more than 17 billion yuan, 12.75 billion in 1980, see (Byrd 1983) and (Pei 1995). But in the 1998 Chinese Statistical Yearbook, the figure is 13.5 billion for 1979 and 6.89 billion for 1980. The balance for the consecutive years around the time is 3.09 billion in 1977, 1.01 billion in 1978, -13.5 billion in

part of its budgetary burdens to local governments as well as the banking system. Both fiscal decentralization and banking reforms were initiated in this year. Under the policy of "loan for grant" (*bo gai dai*), government budgetary grants for the working capital and fixed asset investment of the SOEs were gradually taken over by bank loans. According to one estimate, in 1980, 44.5 percent of Chinese SOE fixed asset investment was financed by the state budgetary appropriation and 19 percent was financed by bank loans. By 1994, only 4.9 percent of the investment was financed by the state budget and 46.5 percent was financed by bank loans (Lo, Xu, and Xie 1998, p.32).

In order to mobilize savings from the grassroots to finance the "loan for grant" program, assorted decentralizing schemes were introduced to the banking system. In the early 1980s, a "difference contracting" (*chae baogan*) program was initiated to stimulate the enthusiasm of bank branches to mobilize savings. The central planners no longer handed down separate planned quotas for loans and deposits to local bank branches. Instead, they handed down a "difference" between the loans an individual branch was supposed to make, and the deposits the branch was supposed to absorb. After remitting the "difference" upward, the branch could lend out the retained deposits in their own discretion. Therefore, the more deposits the local branch absorbed, the more autonomy it obtained in its lending activities. The local branch would have stronger incentive to mobilize savings from the society.[8] From then on, the Chinese state banking system was brought onto the road of the dual-track transition. Through the introduction of a variety

1979, - 6.89 billion in 1980, -1.76 billion in 1981, and –4.26 billion in 1982 (State Statistical Bureau 1998, p.269). In either case, the salient increase in budget deficits was apparent.

[8] The "difference contracting," like production contracting for farmers (*baogan daohu*), fiscal contracting for local governments (*caizheng baogan*), and profit contracting for the SOEs (*liruen baogan*), engaged the local branches of the Chinese banking system into a dual-track system in which they operate in plan and market simultaneously.

of institutional changes, bank officials were encouraged to engage in market and plan economies simultaneously.

The monobank established in the socialist era was gradually broken down into a central bank and several specialized banks. They were encouraged to set up as many branches as possible to absorb savings. By 1993, the formal state banking system was a three-tier hierarchy with the People's Bank of China (PBC) at the top as the central bank, the four specialized banks – the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC), and the People's Construction Bank of China (PCBC) – at the second level, specialized in loans stipulated by the state credit plan, and nine newly-established universal or regional banks at the third level to finance regional investment projects.[9] In total, these banks set up about 200,000 branches and had 2.6 million employees throughout the country.[10]

Financial Institutions 'Growing out of the Plan'

Besides the formal state banking system, numerous financial institutions, legal or non-legal, were established at all levels of the government hierarchy to circumvent the constraints of the credit plan which still served as the guideline for financial flows within the state banking system. By the end of 1993, these 'growing out of the plan' financial institutions included hundreds of trust and investment companies (TICs) run by bank

[9] The formal state banking system should also include a network of rural credit cooperatives (RCCs). Since the late 1970s, the funds and operations of the RCCs were subordinate to the control of the Agricultural Bank of China (ABC). As a result, it became a saving mobilizer of the state banking system in the countryside. By 1994, its market share of domestic deposit was as high as 14 percent. The bulk of the funds were incorporated into the general arrangement of the PBC and ABC. The RCCs themselves engaged in few lending activities.

branches and governments at provincial and county levels, dozens of finance companies run by SOE groups, more than 5,000 urban credit cooperatives (UCCs) run by various urban collectives or private owners, more than 130,000 'rural cooperative funds' (*nongcun hezuo jijinhui*) run by township and village governments, and numerous informal financial institutions existing in a variety of forms. Most of their activities were not legally sanctioned by the central financial authorities. They were the major fund-raisers for the government and enterprise units they were subject to. These vibrant players of various non-legal financial markets were heavily engaged in the transaction of short-term loans, treasury bonds, foreign exchanges, and bonds and equities issued by various government and enterprise units without central permission. In comparison to the big state banks, these newly emerging financial intermediaries were engaged in high-profit, high-risk asset management that could automatically offer higher returns to investors. The emergence of these non-state financial intermediaries therefore caused serious concern to the central policymakers. The issue will be discussed in detail in the next section.

A Comparison to Financial Development in Other Transition Economies

In comparison to the financial development in other transition economies, the most significant feature of China's experience was the consistently high saving rates and the consequent "financial deepening" during the transition. As discussed earlier, the pre-transition economic structure and the reform strategy chosen therewith were the determining factors that differentiated China from other transition economies. The

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[10] *Almanac of China's Finance and Banking,* 1996, p. 542.

reallocation of underemployed labor and resources from agriculture to light industries provided strong incentives for the rural population to voluntarily move into the non-state manufacturing industries and contribute to the economic boom of these sectors. The sharp increase of household disposable income, mostly deposited in the state-monopolized banks, was used to finance government expenditures and investments in the old state sector. The Chinese central authorities thus obtained a great substitute for their dwindling revenues, besides printing money, to finance the inefficient state sectors and successfully managed to avoid the hyperinflation suffered by many other transition economies.

On the contrary, in the formal Soviet Union and some Eastern European countries, the highly industrialized economic structure provided them with little choice but focusing their transition on large-scale restructuring of the state-owned enterprises. Sudden price decontrol allowed the state-owned enterprises to bid for all goods, services or foreign exchange with still very soft budget constraints. The skyrocketing prices of various production factors and foreign exchange led to hyperinflation, constant financial crises, and finally, in Russia's case, collapse of confidence in the currency. The transition resulted in "de-monetarization" rather than "monetarization" of the economy. In extreme situation, in order to minimize the impact of volatile currency prices on regular production, economic actors in today's Russia would rather choose barter over ruble transaction (Woodruff 1999).

To prevent the price overbidding fueled by the state-owned enterprises (SOEs) with soft budget constraints, one needs not only the right reform strategy, but also the *political power* to enforce price control. In the case of China, the ability of the central authorities to enforce the dual-track price system for the SOEs was an important prerequisite for price stability (McKinnon 1994). The Chinese central planners effectively constrained the SOEs from price overbidding for crucial production factors and maintained price stability throughout the reform period. Given the political turmoil experienced by Russia, this might not be a feasible option for the Russian policymakers even if they had chosen to do so.

The pre-transition economic structure provided Chinese policymakers with a favorable environment to choose a dual-track approach to economic transition. The dual-track reform strategy had simultaneously achieved gradual structural changes, rapid economic growth, and overall macroeconomic stability in the Deng era. However, from the central policymakers' point of view, the dual-track reforms also created problems for them to keep the allocation and expansion of national financial resources in the direction and speed they preferred. On the one hand, local governments, driven by the impetus of local "investment hunger," would compete with the central policymakers in control over the allocation and expansion of bank credits. On the other hand, numerous newly emerging financial institutions not only created the source of 'leakage' at all levels of the formal banking hierarchy for the plan-stipulated funds to flow out of the system for higher returns in the market, but also posed severe competition to the inefficient state banks. The next section will analyze what problems Chinese central policymakers faced in the financial system prior to the 1993 reforms.

The Agency Problems of a Socialist Financial System in a Decentralized Economy

The problems of central control over the financial system can be formulated as agency problems in a hierarchical organization. In the neoinstitutional framework, a hierarchical organization is seen as a network of contractual relations in which the principal relies upon a set of formal and informal contracts to have the agents act in the principal's interests. Agency problems arise when the information the principal can obtain about the agents' behavior is always incomplete, and the agents would therefore behave opportunistically because the contracts, with the limitations of incomplete information, cannot specify ex ante all possible situations. Therefore, from the neoinstitutional perspective, the problem of control in an hierarchical organization is a problem for the principal to minimize agents' opportunistic behavior by setting clear working targets.[11]

The socialist planning system suffers particularly serious agency problems. In the absence of the market clearing price to reveal information about the demand and supply of production factors, central planners cannot set accurate planned targets for their subordinates to implement. They can only set the planned targets by *guessing* the implementers' future capacities according to their past performance. This approach, on the one hand, leads the planners to constantly adjust targets in the midst of plan implementation to reflect the performance of the implementers. On the other hand, it provides strong incentives for the plan implementers to hide information about their true potential in order to get easier output targets in the future. It is the so-called *ratchet problem* in the planned system (Litwack 1990) (Solnick 1996). The ratchet problem not

[11] For a more comprehensive introduction of the neoinstituional approach and the theory of agency, see (Eggerstsson 1990).

only leads to extensive investment in the planned system, but also undermines the credibility of the planned targets. Both planners and implementers understand well that the planned targets set by guessing are certainly subject to change.

As the planned system is under transition, the bargaining nature of the planned targets will be further deteriorated because too many factors beyond the implementers' control can fail to fulfill their targets. For instance, price reform on steel may prevent auto-makers from fulfilling the planned profit targets. The auto-makers thus have a very legitimate reason to demand a re-negotiation of the profit targets in the midst of implementation. As a result, no one will take the original profit targets seriously. Even if there is a dutiful subordinate who is willing to overcome all the uncertainties of economic transition and manage to meet the profit targets, his benign behavior will make no difference because no one else in the system has the incentive to follow him. This *prisoner dilemma* situation thus further strengthens the incentive for plan implementers to shirk. Therefore, the ratchet problem in the socialist planned system becomes especially serious when the system is under transition.

Despite rapid expansion and transformation of China's financial system over the transition period, the Chinese central policymakers continuously relied upon a traditional socialist instrument – the state credit plan – to control the financial system. The state credit plan naturally suffered serious agency problems during the transition.

The declining credibility of the state credit plan

As a practice inherited from the socialist era, the state credit plan was compiled every year to match the state investment plan. The Chinese central policymakers primarily relied upon this instrument to control the amount and direction of bank credit allocation.[12] Although the credit plan set mandatory credit quotas that bank branches were not allowed to exceed in implementation, no bank branch really met the targets. Like the auto-makers we used as an example to explain the ratchet problem during socialist economic transition, the bank branch officials would not take the credit plan seriously when the credit targets became easy to change during the transition. The financial authorities in the banking hierarchy knew this situation very well. Thus, they would not reveal the real credit ceilings to the subordinate branches in the beginning of every year. And the bank branches also knew very well that the credit ceilings assigned to them were not the real ceilings. As a result, the state credit plan became a repeated bargaining game between the superiors and subordinates in the banking hierarchy. In this game, the credit quotas became the minimum rather than maximum of the credit that the bank branches were allowed to extend. There was no credibility in the original credit plan.[13]

The credibility of the credit plan was further hurt by the central authorities themselves for their own abuse of the plan. In addition to the tasks regularly assigned for the state banks to write off government debts, the state banks often received orders from central planning agencies to make "hatted loans" (*daimao xiadai*), "designated loans" (*dian dai*), "special project loans" (*zhuanxiang daikuan*) etc. to finance extra central projects beyond the original credit plan.[14] Driven by the "investment hunger" after fiscal

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[12] The making and implementation of the state credit plan will be introduced in greater detail in chapter 3.
[13] Interviews, No. 62 and 70.
[14] Interview, No. 21 and 23.

decentralization, local governments would not hesitate to emulate the same practice by giving orders to bank branches in their jurisdictions to make extra loans for their own projects. The credibility of the credit plan was thus destroyed.

Local Intervention and the Problems of Multiple Principals

In fact, branch officials in China's state banking system had to take orders from more than one principal. Since the Mao era the bank branches' personnel has been included in the local *nomenklatura* – that is, they were appointed, monitored, and evaluated by the local Party committee. In Chinese terminology, the administrative leadership relations (*xingzheng lingdao guanxi*) of these local branches belonged to the localities although the PBC and the four specialized banks were administratively members of the central cabinet.[15] In other words, although the central bank and the state banks were part of the central government, their local branch officials were supervised by local governments. This institutional legacy of *dual leadership* (*shuangchong lingdao*) constituted an important Chinese departure from the Soviet model and had a profound impact on the behavior of China's local bankers. The dual leadership might work when the central and local governments have consistent preferences over the allocation and expansion of bank credits. Nonetheless, when economic decentralization led to the preference differentiation between the center and the localities, the local bank officials would be faced with the problem of *multiple principals*. In hierarchical organizations that have multiple principals, agency problems will deteriorate because the agents are

[15] The relations between the Beijing headquarters and the local branches are called professional leadership relations (*yewu lingdao guanxi*). See (Huang 1996, p.29).

faced with a confusing incentive structure (Moe 1984) (Kiewiet and McCubbins 1991). Nonetheless, as the orders from Beijing headquarters and local governments were in conflict, local bankers would choose to obey the latter. After all, their careers were controlled by the local Party committee and, therefore, determined by the extent of their contribution to local economic development.

The Exit Provided by the Market Economy

Another idiosyncratic institutional factor that provided incentives for local bankers to shirk from the orders of the central financial authorities was the *profit retention system* (*lirun liucheng zhidu*). Influenced by the agenda of the SOE reforms, a profit retention system was introduced to the local branches of both the PBC and the four state banks in the mid-1980s. The system allowed bank branches to retain a portion of their profits to finance branch expenditures and linked the branch employees' personal rewards to these profits. It was aimed at lifting the central government's budgetary burden on the one hand, and creating an incentive for bank branches to be more profit-oriented on the other. Since then, the local branches of both the central bank and the four state banks did become quite profit-oriented and self-reliant. In order to maximize their profits, they would divert funds from the state banking system toward assets with higher returns in the market, and thus increased the information costs for Beijing in monitoring the implementation of the state credit plan.

As the declining credibility of the state credit plan and the increasing intervention from the local governments provided greater incentives for bank officials in local branches to shirk from the planned targets set by the central authorities, the flourishing market economy outside the traditional planned system, on the other hand, provided an *exit* to facilitate their shirking behavior. As mentioned in last section, an army of "growing out of plan" financial intermediaries had emerged during the reform era. Although sporadic crackdowns by the central authorities resulted in a relatively small market share of these "growing out of plan" players (i.e., in comparison to their counterparts in the 'real' economy), they caused serious problems for the operation of the traditional planned scheme. On the one hand, operating outside the state credit plan, these financial intermediaries became the major channels for bank branches to bypass the constraints of the credit plan and funnel funds to local investment projects. On the other hand, the higher returns these market players could offer made them the fierce competitors to the state banking system. As a result, more and more funds were circulated through these financial intermediaries and, therefore, they remained beyond the control of the state credit plan.

As the central planners became less effective in using their limited monetary instruments to manage credit allocation and macroeconomic stability, cyclical inflation resulted. From 1978 to 1993, China had experienced four cycles of economic overheating, and each cycle came faster and was more dramatic.[16] On top of that, the central policymakers found that the increasingly diverse and fragmented financial system was not a good instrument for them to deliver preferential credits to the sectors and

[16] A discussion of how the operation of outdated monetary instruments led to cyclical inflation will be provided in greater detail in chapter 3.

regions they targeted. The "policy loans" ranging from funds for the center's investment in its own SOEs to money for grain procurement were constantly channeled out by the local branches of the state banks, in collaboration with the local governments, for other uses. The central policymakers were thus forced to have the central bank to print even more money to supplement this "leakage."

In the summer of 1993 China's economy had been brought to another peak of rapid growth in a new round of decentralization and liberalization. It was reinvigorated by Deng's famous 1992 Southern Tour, the intention of which was to break through the three-year impasse of reforms after the Tiananmen incident. The economy was growing at an annual rate of 14.2 percent, with consumer prices in most cities rising by 20 percent and production prices rising by more than 40 percent. Inflation drove blackmarket interest rates as high as four times the official rates. Individual depositors rushed to take out their now-in-negative-interest-rate bank deposits for higher returns offered by informal financial institutions as well as SOEs and TVEs. Even bank branches would divert loanable funds to more profitable assets outside the state banking system. Most of the disintermediated funds ultimately floated to puff up the real estate bubbles in coastal cities.[17] On top of that, in early June, the Chinese central authorities found that more than 80 percent of their policy loans, especially funds for the state grain procurement, had been diverted to other uses.[18] And the targeted annual quotas for the sale of treasury bonds, an important source of the central budgetary funds, were only fulfilled by 5

[17] "Disintermediation" means large-scale withdrawal from banks.
[18] The ABC local branches, the major channel for the distribution of these loans, diverted earmarked policy loans to other investments and issued IOUs to peasants for the state grain procurement. Peasants' grievance and fury towards this practice turned to protests and riots in certain areas and caused serious concerns of the central leaders.

percent. (Lin 1999, p. 316-324)

Table 2-2. The 16-Point Austerity Program
(issued by the Chinese Communist Party Center in June 1993)

Financial Measures
(1) Raising interest rates on bank deposits and loans, and on new treasuring issues, effective July 11, 1993.
(2) Mandating all specialized banks to recover their loans exceeding the lending ceilings set by PBC by August 15, 1993.
(3) Mandating all specialized banks to examine their interbank lending to nonfinancial institutions with the view to recovering illegal loans.
(4) Separating policy lending from commercial lending by specialized banks.
(5) Strengthening the authority of PBC headquarters.
(6) Listing shareholding companies in the stock market according to the state stipulations.
Fiscal Measures
(7) Cutting administrative fees by 20 percent.
(8) Mandating all regions to complete their sales of state treasury bonds before July 15.
Investment Planning Measures
(9) Reexamining all locally approved development zones.
(10) Cutting the investment in capital construction.
(11) Increasing investments on the transport sector.
Other Measures
(12) Reforming the foreign exchange retention system
(13) Stopping issuing IOUs to farmers to pay for grain purchases
(14) Stopping local authorities from collecting funds illegally from enterprises and farms.
(15) Dispatching inspection teams to 20 provinces and autonomous regions to examine financial probity.
(16) Discontinuing new price reform measures that would inflate prices for the rest of the year.

Source: World Bank, 1995, p. 19.

The State Council first responded by handing down two orders. One was to require immediate restitution of all policy loans to the targeted uses. The other was to call for sweeping fulfillment of the treasury bond sale nationwide. It was followed by a more comprehensive and mandatory order of serial measures, called the 16-point austerity program (Table 2-2), from the Chinese Communist Party Center. At first glance, the 16-point program was similar to all the ad hoc administrative measurements that the central policymakers had taken every time to "restore order" to an overheating economy before, such as cutting down overall investment in capital construction, mandating the recovery of all policy loans, imposing a deadline to all regions for the sales of the treasury bonds, and recentralizing the approval rights of local investment projects. But when looking into the details, the intention to re-allocate financial resources towards central policymakers' priority projects was clearer than before. For example, against the overall cutback of investment in capital construction, it stipulated *increasing* investment in priority sectors, such as transportation and infrastructure.[19] More profound structural reforms were also hinted in the 16-point program, such as separating policy lending from commercial lending, strengthening the authority of the PBC headquarters, and reforming the foreign exchange retention system. All of which required substantial institutional changes (World Bank 1995, p. 18-20).

The determination of the central leadership to set out comprehensive structural reforms to tackle the chronic problems of its control over macroeconomic stability and credit allocation was further demonstrated by Zhu Rongji's decision to sack the PBC governor, Li Guixian, and assume the title himself. Zhu was then a member of the standing committee of the Party Politburo and the vice-premier in charge of national

[19] Some would argue that the measures were to avoid the consequential "hard landing" whereby an indiscriminate cut of over all investment would have been ended.

economic affairs. It was the first time in the PRC history that a member of the Politburo standing committee directly took charge of the central bank.[20] In November 1993, a 50-point "Decision on Some Issues Concerning the Establishment of a Socialist Market Economic Structure" was issued in the Third Plenum of the Fourteenth Party Congress.[21] It was to serve as the guideline for structural reforms in areas ranging from taxation, financial system, to state-owned enterprises for the coming several years.

The "Decision" is seen as a watershed in China's economic transition (Yang 1994) (World Bank 1995). Before the "Decision," the economic transition primarily proceeded through gradual devolution of power and resources from the center to the localities. Since the "Decision," focus of the transition has been shifted to the institutional changes that could enhance the central policymakers' capacity in "macro-level adjustment and control" (*hong guan tiao kong*). That is, to enhance the central policymakers' capacity in maintaining overall economic order and directing economic development in an increasingly liberalized economy. The institutional changes in the financial system included a vertical integration of organizational structure and financial flows within the central bank and the state banks to reduce local governments' intervention to the bank branches; the creation of three policy banks and the establishment of the so-called "main bank system" between the four state banks and the 1,000 largest SOEs to enhance central planning agencies' role in allocating bank credits; and a series of crackdowns on non-state financial intermediaries to eliminate the channels for bank funds to flow out of the

[20] After holding that position for two years, the vice-premier Zhu Rongji had Dai Xianglong, a deputy governor then, who came to the PBC with Zhu in 1993, succeed him as the governor in July 1995. Zhu's influence over the PBC would be continued not only because he has been continuously holding the helm of the general direction of economic reforms even after he became the premier in March 1997, but also because Dai has been his protégé since both of them worked in Shanghai in the late 1980s. *Far Eastern Economic Review*, July 13, 1995, p. 82.

state banking system as well as to reduce competition from these market players. With these institutional changes, the central policymakers' control over the expansion and allocation of financial resources was largely enhanced.

Conclusion

This chapter provides an overview of the development of China's financial system prior to 1993. By comparing to the experiences in other transition economies, it has identified the achievements and problems that the post-Deng Chinese leaders inherited from previous reforms. During the Deng era, the dual track reform strategy resulted in explosive development of the non-state sectors and astonishingly high domestic savings. On the one hand, the central policymakers, through their control of the state banking system, had successfully channeled these funds to finance their investment in the state sectors and avoid the hyperinflation suffered by other transition economies. On the other hand, the increasingly diverse and fragmented financial system suffered serious agency problems in three areas: the declining credibility of the center's credit plan; the increasing intervention from local governments; and the proliferation of financial intermediaries outside the formal state banking system.

The central policymakers found this development threatening to their effective control over macroeconomic stability and the allocation of financial resources. Following a 16-point austerity program issued by the Party Center in the summer of 1993 and the Decisions issued by the Third Plenum of the Fourteenth Party Congress in late 1993, a series of institutional changes in the financial system were introduced to resume

[21] For the content of the 50 points, see FBIS-China, 17 November, 1993, p. 22-35.

central control over macroeconomic stability as well as the allocation of financial resources. The next two chapters will discuss these institutional changes in greater detail. Chapter three, focusing on the reforms of central banking, analyzes the reorganization of the central bank and the creation of the three policy banks. Chapter four discusses the transformation of the financial system as a whole, covering both the restructuring of the state banks and the crackdowns on the non-state financial intermediaries.

Chapter 3

The Reforms of Central Banking in Post-Deng Era

Since late 1993, a series of reform measures was carried out by the post-Deng Chinese central leaders to rationalize and recentralize the central banking system. With Zhu Rongji, China'economic tsar, temporarily heading the People's Bank of China (PBC) – the central bank - from 1993 to 1995, the right to the distribution of both credit quotas and relending quotas was centralized from the PBC provincial branches into the hands of the PBC headquarters in Beijing. And for the first time since it was transformed into China's central bank in 1984, the PBC local branches were made both administratively and fiscally dependent on the headquarters. With the enactment of the Budget Law in 1994 and the Central Bank Law in 1995, the PBC ceased to directly finance the budget deficit of both central and local governments. And a Monetary Policy Committee was set up in the PBC to conduct monetary policy in the future. In 1998, with the establishment of nine trans-regional branches, the PBC provincial branches were entirely discharged of their central banking functions and set to be phased out eventually.

Attention to the Chinese central leaders' efforts in reclaiming the commanding heights of central banking has often been put on its effects on the center's capacity to maintain macroeconomic stability and its achievement of a 'soft landing' in subsequent years (World Bank 1996) (World Bank 1999). Yet, little notice has been given to the fact that the PBC continuously plays the role of government financier through the practice of the central bank "relending"[1] – a function contradictory to its role as the provider of macroeconomic stability. The only difference is now, with the recentralization within the PBC organization and the establishment of the three policy banks, the relending is made to exclusively serve the policy goals of the central government. On top of that, close scrutiny of the current decision-making process for monetary and credit policies finds that the PBC still has to share its policy authority with the Ministry of Finance and other central planning agencies, and is far from obtaining central bank independence. In retrospect, the reforms of central banking were part of the post-Deng central leaders' efforts in establishing a financial system with greater central control that could channel funds to the center's priority sectors and regions more effectively.

Contemporary studies of central banking focus on the two main functions of central banks – the preservation of price stability at the macro level and the maintenance of financial order at the micro level. In this sense, central banking is in essence about how to conduct monetary policy, and how to regulate and supervise the financial system in normal times and to play the role of the lender of last resort during crises.[2] However, this textbook definition actually is a novel thing in the history of central banking. These practices first evolved in England in the nineteenth century and were not being widely

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[1] "Relending" is a practice of the banking system that the Chinese financial authorities use to redistribute financial resources. Through extremely high reserve requirement, the Chinese central bank forces banks to deposit certain amount of funds in the central bank and then "re-lends" them back to the banks in the form of earmarked policy loans. It will be discussed in greater detail in the first section of this chapter.
[2] For economics textbook definition of central banking, see (Mishkin 1998); for studies on the politics of central banking along this definition, see (King Banaian, 1986) (Cukierman, Webb, and Neyapti 1992) (Goodman 1992) (Lohmann 1998) (Maxfield, 1997) (Broz 1999).

adopted by most countries until about two decades ago (Goodman 1992) (Maxfield, 1997) (Capie 1999). Historically, no central bank, probably with the exception of the U.S. Federal Reserve System (established in 1913), was created to serve these functions. In most cases, they were created in the first place to be the financiers of the rulers when modern states were about to emerge in Europe in the seventeenth and eighteenth centuries. In late industrializing countries, apart from government financiers, the central banks were also obliged the function of industrialization promoters.

As a late developing country, the People's Republic of China chose the most radical strategy to promote industrialization – completely abolishing the market and financial system, and establishing a socialist economy in which the state directly commands the allocation of national resources according to a central plan. Since the late 1970s, the gradual transition toward a market economy resulted in more and more production resources being allocated by the market. The central planners therefore increasingly relied upon their control over the allocation of financial resources in a rapidly expanding financial system to steer the economy. However, the rapid expansion of the financial system resulted in serious agency problems in the socialist apparatus that the Chinese central planners employed to manage the system. The conflicting roles of the central bank in financing government expenditure and maintaining monetary stability further exaggerated the problems. Moreover, the local governments at all levels of the administrative hierarchy, driven by the impetus of local "investment hunger," would compete with the central planners in control over the financial system. As a result, cyclical capital outflows from the state banking system and inflation became chronic problems that endangered the Chinese central leaders' governance over the economy, and even the polity. Taking back the helm of the financial system thus became a priority task for any upcoming post-Deng leaders.

The next section provides a detailed discussion of the problems of central banking in China prior to 1993. As the economy in general and the financial system in particular became increasingly diverse and decentralized, the Chinese central policymakers found themselves increasingly unable to rely upon traditional socialist monetary instruments to control credit allocation and macroeconomic stability. The following three sections analyze how the post-Deng policymakers launched a series of reforms to resume central control over central banking. The second section discusses how the restructuring of the PBC organization stopped the PBC branches from being pressed by local governments to divert funds from central projects to local investments and increase aggregate money supply. The third section analyzes how the PBC, despite the reorganization, continuously plays the role of government financier. However, with the establishment of the three policy banks, the PBC now can exclusively serve the development goals of the central government. The last section evaluates how independent the Chinese central bank is today. It argues that, although the post-Deng reforms have successfully terminated the intervention of local governments in central banking, the PBC is by no means independent from the State Council, the Ministry of Finance, and other central planning agencies.

Problems of Central Banking before 1993

The People's Bank of China (PBC) was converted into China's central bank in 1984. As the financial system gradually replaced the state budget as the major conduit to channel national financial flows, it appeared increasingly necessary for China to establish a central bank to look after aggregate monetary growth and supervise the operation of the financial system. Serving as the monobank during the socialist era, the PBC had held the majority of deposits and loans in China. In order to focus itself on central banking, the PBC therefore created a new bank called the Industrial and Commercial Bank of China (ICBC) to take over all this part of operations. The PBC and ICBC together with the Agricultural Bank of China (ABC), the Bank of China (BOC), and the People's Construction Bank of China (PCBC), comprised a two-tier banking system of a central bank and four specialized banks.[3]

The two-tier banking system served as the skeleton to mobilize domestic savings to finance the expenditure and investment of the traditional state planned system. The PBC continuously relied upon the state credit plan to control financial flows in the system. The state credit plan was compiled annually by the PBC, Ministry of Finance, and State Planning Commission (SPC) on the basis of the overall development goals set by the State Council and the aggregation of sectoral and regional needs through repeated negotiations between the center and locale. Once the state credit plan was determined, credit quotas would be issued down through both the provincial branches of the PBC and the Beijing headquarters of the four specialized banks. The provincial PBC in turn handed down credit quotas to their subordinates as well as the local branches of the specialized banks. Traditionally, the credit plan was made to match the state investment

[3] The third tier of the nine comprehensive and regional banks were not established until 1987.

plan made by the SPC. As long as an investment project was listed on the state investment plan, credit quota was guaranteed for the project. As reforms proceeded, the state credit plan was divided into a 'mandatory plan' (*zhilingxing jihua*) for fixed asset investment funds (long-term loans) and an 'indicative plan' (*zhidaoxing jihua*) for working capital funds (short-term loans). The mandatory plan continuously set rigid restrictions on the amount and direction of long-term loans while the indicative plan allowed bank branches more leeway for short-term loans. The PBC continuously used its control of loan quantity in the credit plan as the major monetary instrument to control inflation. (World Bank 1995, Annex 2.6 and 3.1)

Since 1984, the PBC also used a reserve requirement/relending scheme to redistribute bank funds within the state banking system. The PBC required all bank branches to reserve a proportion of their deposits in their local PBC branches. The ratio of the reserves to their deposits was set as high as 30 percent during the 1980s. Ostensibly, the reserve requirement was a conventional monetary instrument for the central bank to control aggregate money supply.[4] In practice, the PBC used the extremely high reserve requirement to finance government investment projects. Bank branches were required to set up two accounts of reserves in the PBC branches – one was official (long-term) reserves, which was in fact forced lending to the central bank; the other was short-term reserves, which served for bank's regular payment. In 1993, the ratios for official reserves and short-term reserves were set at 13 percent and 5-7 percent respectively. The PBC paid interests for both accounts. Each year the PBC main office in Beijing collected

[4] The central bank usually does not pay interests to the reserve that banks hold in the central bank. By adjusting the reserve requirement ratio, the central bank can influence the costs of bank

all the official reserved funds and "relent" them back to the specialized banks as earmarked 'policy loans' for central government's priority projects. They included state priority infrastructure projects, state procurements of agricultural products, imports of technological equipment, important materials reserves, poverty relief, disaster relief, etc. (Wu 1992; Zhou 1992).

The implementation of the state credit plan and the 'relending' policy required the PBC to preserve the overall organizational framework inherited from the socialist era. The PBC kept a hierarchical organization of local branches parallel to the government administrative hierarchy down to the county level to allocate and coordinate the distribution of credit quotas and relending quotas among the local branches of the specialized banks. As of 1993, the PBC still had over 2,400 branches in provinces, municipalities, and counties, with 138,000 employees (World Bank 1995, p. 43). It certainly was the largest central bank in world history. The gigantic organization inherently suffered serious agency problems for its high monitoring costs. Moreover, the agency problems were exaggerated by the conflicting roles of the central bank as government financier on the one hand and monetary stability watcher on the other. The intervention from local governments as well as the proliferation of various financial institutions outside the credit plan system further aggravated this controdiction.

The Conflict between the Fiscal and Monetary Roles of the Central Bank

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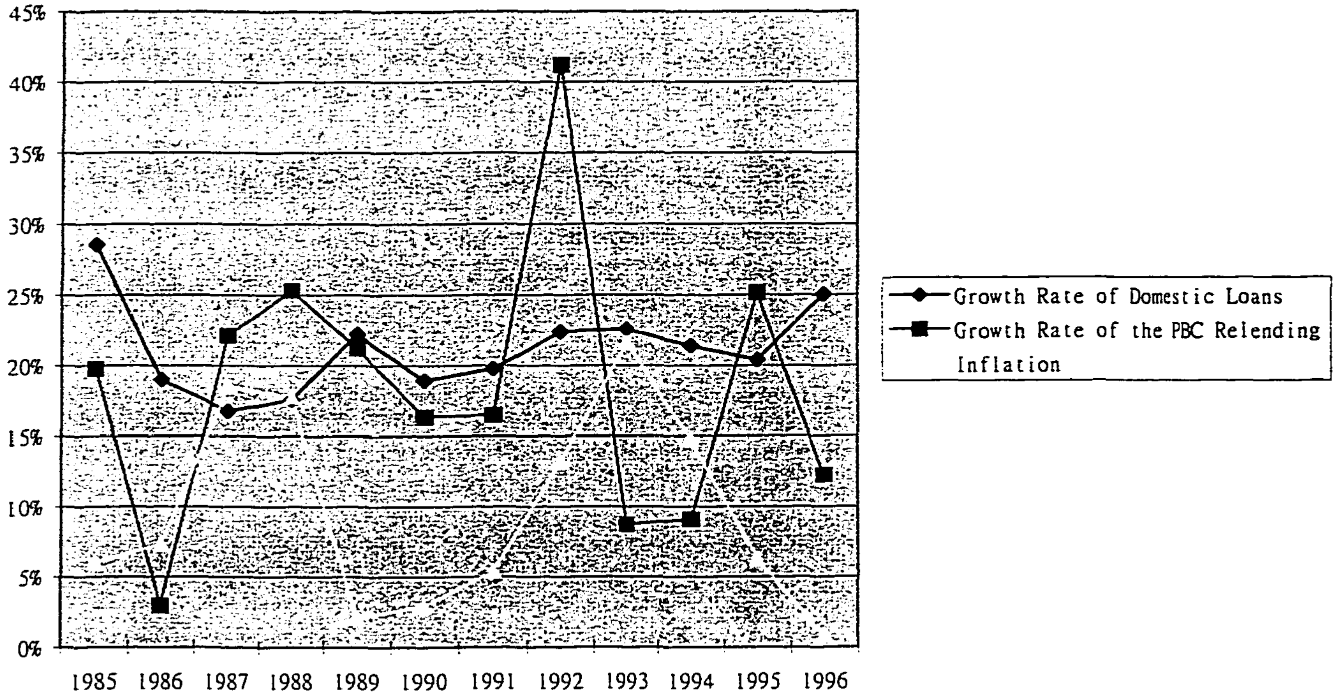
loans and thus the demand for credit in the financial market. The ratio is usually set at 8 % in advanced capitalist economies.

In implementing the "relending" programs, the PBC local branches were supposed to supervise their implementation by the local branches of the specialized banks. However, under the political pressures from the local governments, the PBC branches would choose to collaborate with the local branches of the state banks to shirk from the center's "relending" scheme. As mentioned in the last chapter, the credit quotas and "relending" quotas were often changed for the unpredictability of the economic situation in an increasingly marketized economy in the reform era. When the profit retention system provided strong incentives for the branches of specialized banks to make profits from their asset management, if they had extra deposits on hand, they would make loans to or invest in projects they found profitable rather than use the funds to cover the loans assigned by both central and local governments beyond the original plan. As a result, the PBC branches always allowed the state bank branches to use up their "relending" funds in the middle of year to cover these loans and forced the headquarters to issue more funds to finance the center's "policy loans."

Figure 3-1. The Relation between the Growth of Domestic Loans, Central Bank "Relending," and Inflation Rates, 1985-1996.



Sources: World Bank, 1995, *China's Macroeconomic Stability in a Decentralized Economy*, p. 191, 209; PBC, *Almanac of China's Finance and Banking*, 1989, p. 57; 1996, p. 124, 412, and 435; 1997, p.1; 1998, p. 98, 492, and 509.

Figure 3-1 presents the relationship between the growth of domestic loans, the growth of central bank relending, and inflation rates since the PBC started its relending operation in the mid 1980s. In 1986, 1988-1989, and 1992-1993 when the economy was growing rapidly and the total domestic loans were experiencing sharp expansion, the central bank's relending to the state banks also grew sharply. The increases in the central bank's relending were followed by inflation in the subsequent years. This picture tells us that, when the economy showed signs of overheating with rapid increases in credit demands, the PBC was not only unable to contract the aggregate demand, but was actually compelled to pump more money into the economy, because the PBC local branches would divert relending quotas to finance other investment projects and leave the hardest assignment of the policy loans for the headquarters to supplement. In consequence, the sharp increase of the central bank's relending in the form of creating base money, i.e. printing cash, became the major cause of inflation.[5]

Reserve requirements originally should have been a monetary instrument for the PBC to control inflation. But the redistributive scheme of reserve requirement/relending totally eliminated the monetary function of the reserve requirement. As shown in Figure 3-2, given the huge amount of annual relending funds, the central bank's claims on financial institutions were always larger than its liabilities to financial institutions. It, thus, became meaningless to adjust the reserve requirement ratio to control the growth of base money.[6]

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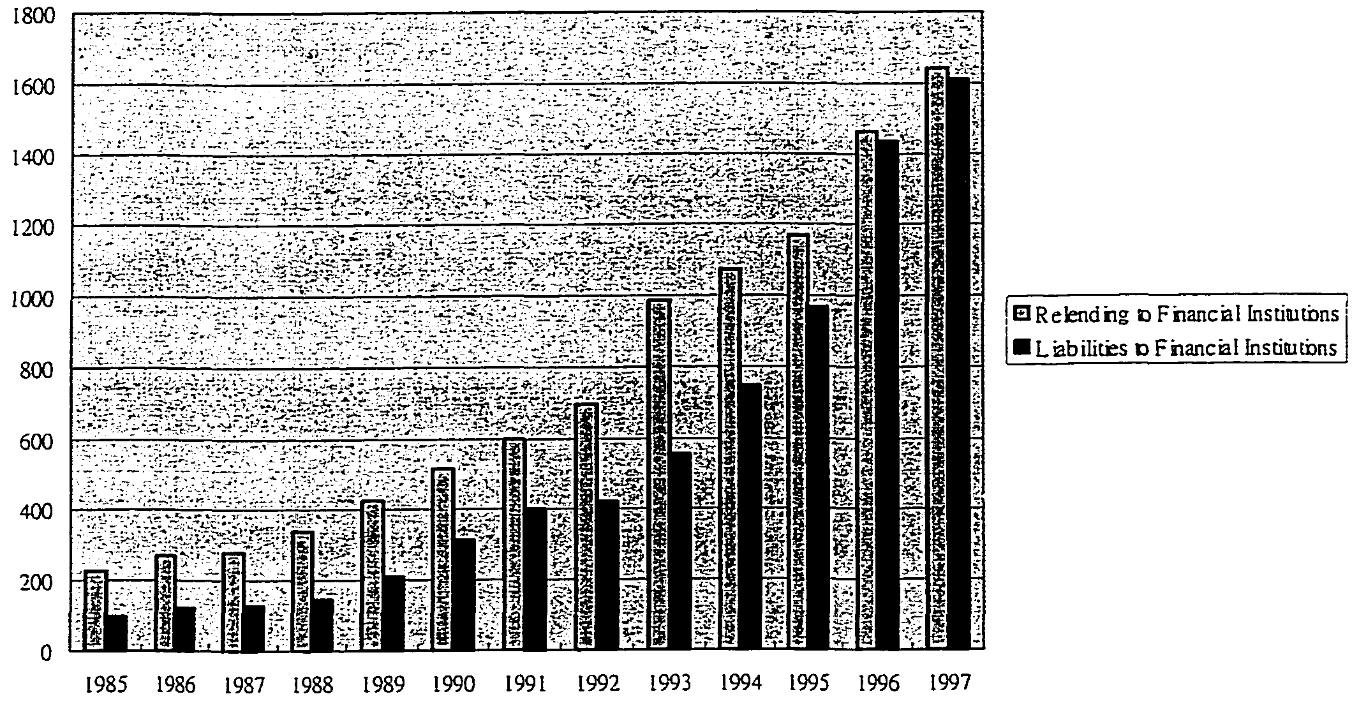
[5] A world bank study of China's inflation control holds the same view that the central bank relending was the major cause of inflation during the Deng era. See (World Bank 1995). Another study estimates that the ratio of base money creation to bank credit expansion is around 1:5 in China (Lou 1998, p.40).

[6] Interest rate is another policy instrument the PBC can use to control inflation. But given the fact that most SOEs were still running under soft budget constraints, they were insensitive to the

Figure 3-2. PBC's Claims and Liabilities to Financial Institutions, 1985-1997.



Sources: World Bank, 1995, *China's Macroeconomic Stability in a Decentralized Economy*, p. 191; PBC, *Almanac of China's Finance and Banking*, 1996, p. 412; 1998, p. 492.

From the above discussion, we find that the poor performance of the reserve requirement/relending scheme in an increasingly decentralized state banking system led the PBC to play the role of *fire-raiser*, instead of *firefighter*, when inflationary pressures

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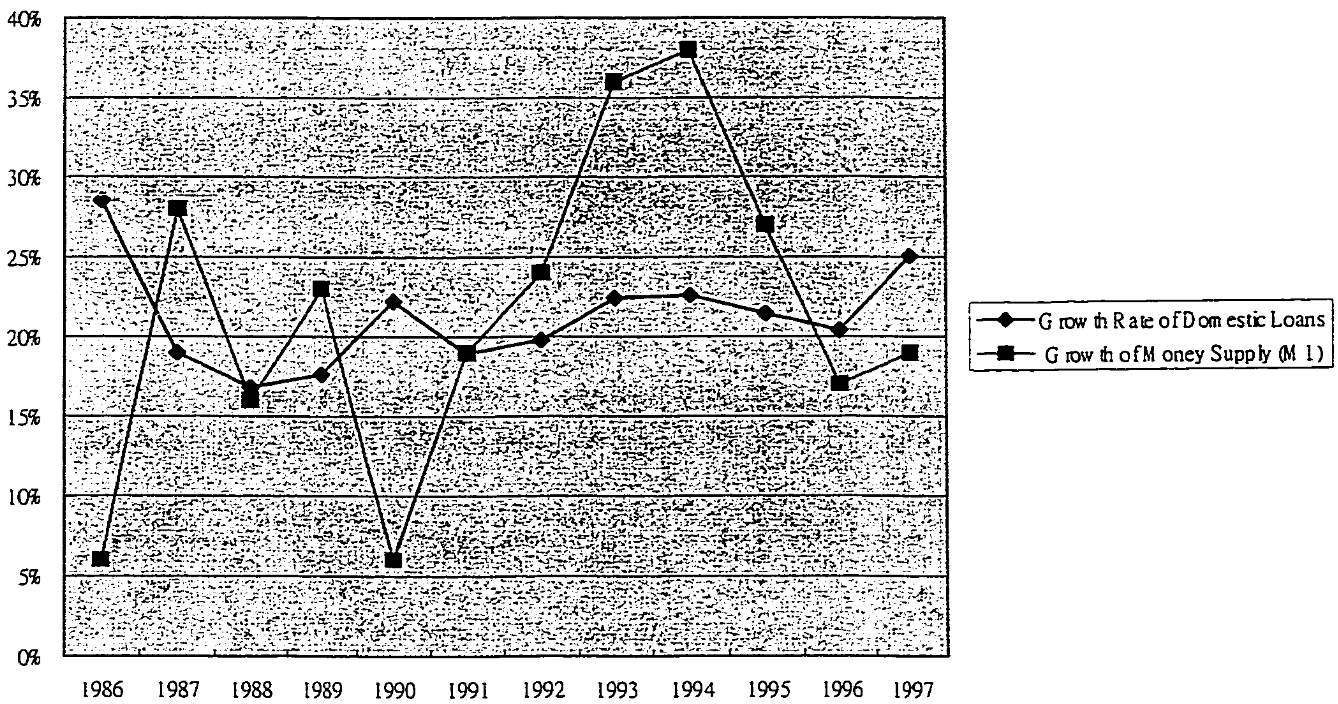
fluctuation of interest rates. The adjustments of interest rates thus usually targeted on the saving behavior of individual depositors.

were mounting. As the economy grew at a high speed and banks extended more loans to finance investment, the PBC was not only unable to cut down the growth of base money by raising the reserve requirement ratio, but was also obliged to print even more money to supplement the relending quotas for policy loans that had been diverted to other projects. From this picture, we can clearly see that the conflicting role of the PBC as both the monetary-stability watcher and government financier at the same time prevented it from performing either job in an increasingly decentralized financial system.

The Gap between the Creidt Plan and the Money Supply

Another problem of central banking prior to 1993 was the ineffectiveness of the credit plan. Originally, the credit plan only covered the lending activities of the four specialized banks. The increasingly profit-oriented bank branches had a strong incentive to bypass the constraints of the assigned credit quotas to extend credit in forms that the credit plan did not cover. It usually took the forms of either establishing a new financial institution, such as a trust and investment company, or introducing a new financial instrument, like repurchase agreements for corporate bills, trust transactions, inter-bank lending, etc. At times, the central financial authorities found the spontaneous creation of new financial institutions and instruments supplementary to the old planned system in a transition economy. But when their development impaired the central authorities' goals in development priority and macroeconomic stability, the authorities would restrain, even repress, these activities by incorporating them into the "cage" of the planned system.[7] For example, the lending of all newly established banks and non-bank financial institutions (NBFIs) were brought into the indicative credit plan in the 1989-1990 retrenchment efforts. Planned quotas for annual issuance of shares and bonds were introduced in 1990-1991 when national stock markets were established in Shanghai and Shenzhen. Licensing authority for the creation of new NBFIs was periodocally recentralized from local PBC branches to the head office in Beijing, as in 1989 and again in 1993.

Figure 3-3. Growth of Domestic Loans and Money Supply, 1986-1997.



Sources: World Bank, 1995, *China's Macroeconomic Stability in a Decentralized Economy*, p. 191, 209; PBC, *Almanac of China's Finance and Banking*, 1989, p. 57; 1996, p. 124, 412, and 435; 1997, p.1; 1998, p. 98, 492, and 509.

[7] The "bird cage" metaphor is borrowed from Chen Yun, the guru of China's financial bureaucracy since 1949 and the leader of the conservative faction during the Deng era. For Chen Yun, the economy is like a bird, the state should maintain a bird cage (the plan) to keep the bird from flying away.

Despite all the efforts, the relationship between the growth of money supply and the growth of domestic loans became increasingly irrelevant over the reform period (see Figure 3-3). It indicated that, as more financial instruments were introduced into the economy, the state credit plan through setting ceilings on overall domestic loan growth was no longer an effective monetary instrument for controlling macroeconomic stability.

Another indicator of the declining effectiveness of the credit plan was its ability to redistribute financial resources across regions. Credit quotas for provinces were made to meet state development objectives, independent of the ability of local branches in absorbing deposits. Bank branches in rapidly growing regions may be assigned lower credit quotas even though they could absorb much greater deposits. In contrast, bank branches in slowly growing regions may be assigned higher credit quotas even though they did not have enough deposits to finance the lending. The central financial authorities utilized the credit plan and relending policy to redistribute financial resources between richer and poorer regions.

Nicholas Lardy has used the variation in loan-to-deposit ratios among China's provinces to show central policymakers' policy intention to balance regional disparity in deposit growth (Lardy 1998, p.87-90). Table 3-1 presents these ratios for six provinces for years 1988 through 1993. The table includes the three provinces with the highest ratios and the three provinces with the lowest ratios. Not surprisingly, those three provinces with highest loan-to-deposit ratios – Jilin, Inner Mongolia, and Heilongjiang –

were poorer provinces in the hinterland, while the three with lowest loan-to-deposit ratios, or the most heavily constrained by the credit plan in their lending relative to the rapid growth of their deposits, were the richest provinces – Guangdong, Zhejiang, and Fujian – in the southeastern coast. According to the table, the degree to which the central policymakers redistributed funds among provinces seems to have risen between 1988 and 1993.

Table 3-1. Loan-to-Deposit Ratios in Selected Provinces, 1988-1993.

Regions	1988	1989	1990	1991	1992	1993
Jilin	1.88	1.88	2.01	1.99	1.86	1.89
Inner Mongolia	1.50	1.56	1.61	1.59	1.50	1.59
Heilongjiang	1.56	1.51	1.49	1.48	1.37	1.45
Fujian	1.23	1.18	1.07	0.96	0.88	0.95
Zhejiang	1.26	1.19	1.05	0.97	0.93	0.92
Guangdong	1.34	1.26	1.12	0.94	0.76	0.82

Source: Lardy, 1998, p. 87.

Table 3-2. Total Investment in Fixed Assets in Selected Provinces, 1988-1993 (billion Yuan).

Regions	1988	1989	1990	1991	1992	1993
Jilin	9.33	8.03	9.35	11.40	15.13	24.83
Inner Mongolia	5.89	5.57	6.49	9.07	13.85	20.66
Heilongjiang	15.67	15.76	16.29	18.97	24.43	33.06
Fujian	9.19	8.79	10.85	13.25	19.47	37.10
Zhejiang	23.02	21.27	25.79	32.50	44.38	78.21
Guangdong	40.28	38.20	40.67	50.66	93.85	163.73

Source: China's Statistical Yearbook, 1989, p.479; 1990, p.155; 1991, p.122; 1992, p. 128; 1993, p. 120; 1994, p. 146.

However, if we look at the growth of total investment (including bank loans, government appropriation, foreign sources, and other sources) in these provinces, we find the gap was actually widened despite of the central efforts during the time. Table 3-2 shows the amounts of total investment in fixed assets in these six provinces for the same time period between 1988 to 1993. It appears that the three poorest provinces were further left behind over the six years even with the central bank's efforts to redistribute credit quotas in favor of these regions. Although the rapid growth of investment in coastal provinces can be explained by the much higher foreign direct investment and revenue retention by local governments and enterprises in the regions, capital flows from the poor hinderland to prosperous coast through interbank markets and other illicit funnels to seek higher returns during the 1992-1993 economic boom also contributed to the widening gap. That is to say, all the central authorities' efforts to redistribute financial resources among regions were within the "cage." Bank branches and NBFIs could always find loopholes to channel out the redistributed loanable funds to seek higher returns outside the "cage" in an increasingly diverse economy.

From 1984 to 1993, the PBC basically relied upon the state credit plan and the reserve requirement/relending scheme to direct credit allocation and control inflation. However, as the economy in general and the financial system in particular became increasingly diverse and fragmented, the PBC found it more and more difficult to achieve its policy goals with these outdated socialist instruments. On top of that, its obligation in financing central priority projects through relending scheme further complicated the task and usually led to failure in its dual role of monetary stabilizer and the government financier at the same time. As inflationary pressure mounted with the growth of bank credit, the PBC was forced to fuel, rather than fight, the inflation. From 1978 to 1993, China had experienced four cycles of boom and bust. Each time, it was ended with an ad hoc harsh action of the central authorities to abruptly cut back overall investments indiscriminately to halt inflation and economic disorder (Huang 1996).

The "Decisions" of the Third Plenum of the Fourteenth Party Congress in late 1993 laid out a series of structural reforms in the fiscal and financial systems to tackle the problems of the center's gradually losing control over the distribution of national financial resources. In regard to the reforms of central banking, the reform measures included enhancing central bank authority over the financial sectors, clarifying its functional roles in the government, and restructuring its internal organization. A series of legislation and institutional changes have since been introduced to transform the central banking system.

Rationalization and Recentralization of the PBC Organization

The most important change was the restructuring of the PBC itself during Zhu Rongji's two-year tenure as the head of the organization. First of all, the power to allocate credit quotas was recentralized from the PBC local branches to the Beijing headquarters in late 1993.[8] The bargaining arena for credit quota allocation has thus been moved from provinces to Beijing. Commercial bank branches that needed higher quotas had to negotiate with their headquarters in Beijing, instead of the local PBC branches. Local governments thus can not press the PBC local branches for credit quotas anymore (Zhao and Guo 1998, p.208). Secondly, with the establishment of the three policy banks in 1994, the PBC transferred all the relending operation to the policy banks. The relending windows of PBC local branches would no longer be the 'leakage' for local governments and banks to press the PBC to increase relending funds. From 1994, the four state banks' liabilities to the PBC have been gradually reduced.[9] These two measures enabled the PBC headquarters to monopolize its control over credit quotas and relending funds – the two most important monetary tools for the Chinese central bank to control money supply. In contrast, the PBC local branches lost all the leverage to press the headquarters to increase money supply.

Besides losing the power to distribute credit quotas and relending funds, the PBC local branches were made administratively and fiscally dependent on the headquarters. During the Deng era, the legal status of the PBC as China's central bank had never been clearly defined. "The Provisional Directives for Bank Management" issued by the State Council in 1986 were the only government document to mandate the PBC's central bank status. But there was no clear provision regarding its internal organization. As each PBC branch had its head officials listed on the local *nomenklatura*, its own leeway over the distribution of local credit supply, and an independent budget after the implementation of the profit retention system, it was pretty much like a local central bank that had little relation with the head office in Beijing. Following the "Decision" of the Third Plenum of the Fourteenth Party Congress, the PBC as China's central bank finally was mandated by

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[8] Only the PBC branches in Shanghai and Shenzhen were allowed to reserve the power till entire elimination of the credit plan system in 1998.

[9] However, as shown in Figure 3, the PBC's relending to financial institutions as a whole still grew after 1994. That is because the central bank now uses relending operation to finance policy banks, mainly the Agricultural Development Bank of China. It will be analyzed in detail later.

the "Decision on the Reforms of Financial System" issued by the State Council in early 1994, and then "legalized" by the "People's Bank of China Law" passed by the Standing Committee of National People's Congress in March 1995. In both documents, it is clearly stipulated that 'the People's Bank of China... shall set up branches as its agencies... shall exercise unified leadership and control over its branches.' (Articule 12, People's Bank of China Law). The PBC branches were ordered to delink all profit-oriented subsidiaries that they had set up previously. The profit retention system was abolished. All expenditures in personnel and operations had to be financed by the budgetary funds from Beijing. The branches were made as the local agents of the PBC, and specialized in supervision and investigation of the local financial situation.

The Asian financial crisis in the second half of 1997 created new momentum for the Chinese central leaders to wrap up the restructuring of the financial system. In late November, the Party Center held a national finance work conference (*chuanguo jinrong gongzuo huiyi*) to consolidate national consensus for a new round of central policy initiatives to contain the contagion of the regional crisis and to reduce the risk of domestic-generated financial crises in the future. The measures included restructuring the PBC by further recentralizing the power of local branches into trans-provincial branches set up along the lines of larger economic regions. It actually had been a long-time goal of the PBC main office to completely abolish branches in provinces and cities and eradicate the intervention of local governments in monetary matters. A central finance leading group (*Zhongyang jinrong gongzuo xiaozu*) was soon set up in the Party Center to organize the restructuring work and to be the future superior of the Party committee of the

PBC regional branches.[10] Wen Jiabao, a vice-premier, was appointed to head the group and oversee the restructuring.

In January 1998, the PBC headquarters announced the appointment of 21 senior officials for provincial and municipal branches, including the branch governors in Guangdong and Hunan, and many deputies in other provinces.[11] Most of them were young technocrats sent down from the headquarters to prepare for the establishment of trans-provincial branches. With almost one year of negotiation, the PBC decided to set up nine regional branches across the country. They are in Shanghai, Tianjin, Shenyang, Nanjing, Jinan, Wuhan, Chengdu, Xian, and Guangzhou.[12] The Chinese policymakers are fond of declaring that the restructuring of the PBC organization was aimed to model the U.S. Federal Reserve System. But as argued by a Chinese financial economist, the underlying principles of the two systems are totally different. The U.S. Fed was intentionally designed to be a federalist, bottom-up organization to prevent power concentration in the federal government. On the contrary, the newly-established PBC system was created to be a centralized, top-down organization to eradicate local intervention in monetary affairs (Dai 1994, p. 16).

Through the restructuring of the central bank, the control over the distribution of credit and relending quotas was concentrated from local branches to the headquarters. The local branches were made both administratively and fiscally dependent on the

[10] As mentioned earlier, under the dual leadership system, the provincial Party committee was the superior of the Party cell in the PBC local branches. It had caused divided loyalty of the PBC local officials and served as the major mechanism of local intervention. Now with the creation of the regional branches, a central leading group is necessary, from the Party's perspective, for appointing and supervising the regional branch officials.
[11] *South China Morning Post* (SCMP), January 22, 1998.
[12] *SCMP*, November 19, 1998.

headquaters. Local governments could no longer press the central bank's local branches for credit expansion.

The PBC as the Government Financier and the Establishment of the Three Policy Banks

Although the restructuring helped the PBC get rid of the intervention from local governments, the PBC still played the role of government financier. But now, with the establishment of the three policy banks, it was made to solely serve the policy goals of the central policymakers.

Besides the reserve requirement-relending scheme discussed in the first section of this chapter, the PBC's role as government financier throughout the reform period is also demonstrated by its own financial weakness, as reflected in both the asset and liability sides of the bank's balance sheet. As shown in Table 3-3, from 1985 to 1993, relending to financial institutions on average constituted three-quarters of the PBC's assets. As mentioned earlier, these relending loans, unlike government bonds that most central banks would hold as the major asset for its low risk and fixed interest incomes, were ultimately extended to government priority projects in the form of policy loans that were mostly long-term, high-risk, and with little prospect of repayment. In other words, despite the absence of official estimates of the proportion, the bulk of the central bank's asset base has already become bad loans due to this relending practice and needed to be written off sooner or later.

Table 3-3. Simplified Balance Sheet of the People's Bank of China, 1985-1997 (billion yuan)

	1985	1986	1987	1988	1989	1990	1991
Relending to financial institutions	224.9	269.4	277.4	338.8	424.6	514.8	599.2
As % of the total assets	82%	81%	72%	73%	74%	71%	67%
Foreign Reserves	9.3	3.8	13.2	15.8	26.5	60	122.8
As % of the total assets	3%	1%	3%	3%	5%	8%	14%
Total assets	**273.6**	**334.5**	**383.9**	**462.8**	**574.4**	**722.6**	**901.1**
Liabilities to financial institutions	89.1	112.3	119.8	135	185.4	280.5	384.1
As % of the total liabilities	33%	34%	31%	29%	32%	39%	43%
Currency in circulation	106.1	129.7	153.2	223.8	247.2	278.8	333.6
As % of the total liabilities	39%	39%	40%	48%	43%	39%	37%
Total liabilities	**273.6**	**334.5**	**383.9**	**462.8**	**574.4**	**722.6**	**901.1**

(continued)

	1992	1993	1994	1995	1996	1997
Relending to financial institutions	698.1	989.9	1072.1	1169.2	1463.6	1642.9
As % of the total assets	69%	74%	61%	57%	55%	52%
Foreign Reserves	110.2	87.6	426.4	651	956.2	1264.9
As % of the total assets	11%	7%	24%	32%	35%	40%
Total assets	**1016.9**	**1338.7**	**1758.8**	**2062.5**	**2646.7**	**3141.2**
Liabilities to financial institutions	396.7	554.1	746.8	967.3	1435.5	1611.5
As % of the total liabilities	39%	41%	42%	47%	54%	51%
Currency in circulation	457.5	628.8	788.4	857.4	943.5	1098.1
As % of the total liabilities	45%	47%	45%	42%	36%	35%
Total liabilities	**1016.9**	**1338.7**	**1758.8**	**2062.5**	**2646.7**	**3141.2**

Source: modified from Appendix B.

Because the demand for the central bank's relending was so huge, the PBC could not simply rely upon issuing cash to finance demand without generating inflation even though the transition economy was experiencing 'monetarization,' i.e. the increase in use of cash for consumption and savings. Between 1985 and 1993, the cash issued grew by 25 percent annually, but the PBC's liabilities to financial institutions – the reserves financial institutions held in the central bank - grew even faster, by 27 percent. In order to avoid inflation, the PBC forced domestic financial institutions to hold extraordinarily high reserves in the central bank and paid interests for that. In the table we find, since the early 1990s, the forced bank reserves surpassed currency in circulation becoming the largest source of the PBC liabilities. The phenomena might reflect a fact that, after more than one decade of economic transition, the monetarization was about to be finished and the economy's demand for cash was no longer as high as in the early transition period. If the central policymakers would not print money more than demanded to trigger inflation, and neither would they decisively reduce the amount of the relending loans, they had to force banks holding more reserves in the central bank to finance the loans.

The post-Deng financial reforms were supposed to reverse this trend and relieve the central bank of the burden of financing government expenditures with the reserves/relending scheme. However, in Table 3-3, we find in the PBC's balance sheet both relending to financial institutions on the asset side and forced bank reserves (the liabilities to financial institutions) on the liability side kept growing even after 1993. Although since 1994 the sharp increases in foreign reserves due to the reform of the foreign exchange system dramatically enlarged its proportion in the PBC assets, the relending continuously constituted more than half of the PBC's total assets. By 1997, it had grown to 1.6 trillion yuan. On the liability side, the forced bank reserves tripled from

554 billion yuan in 1993 to 1.6 trillion yuan in 1997. As the economy's demand for currency grew modestly for the austerity policy and the recession in the non-state sector's 'cash economy,' the proportion of the forced bank reserves in the PBC's total liabilities increased to more than 50 percent. From this picture, we find the PBC continuously relied upon the reserve/relending scheme to play the role of government financier even after the 1993 financial reforms. The only difference is that now, with the phasing-out of the PBC provincial branches and the establishment of the three policy banks, the relending scheme was made to exclusively serve the development goals of the central policymakers.[13]

Since 1994, the PBC's relending funds were primarily used to finance the state procurement of agricultural product – mainly the annual procurement of grain, cotton, and edible oil. Prior to 1993 more than 90 percent of the central bank relending funds were earmarked policy loans to finance central priority projects. Within these earmarked policy loans, about 60 percent were actually designed for the central government's annual procurement of grain, cotton, and edible oil. The other 40 percent were earmarked loans to finance long-term infrastructure projects and the credit needs of the largest SOEs for the expansion of investment and foreign trade. In 1994, the State Council established three new policy banks to take care of the distribution of these policy loans. The State Development Bank of China, the largest of these three in terms of registered capital (50 billion yuan), was organized on the basis of six investment corporations of the State Planning Commission to finance long-term infrastructure projects and strategic or "pillar"

[13] But the PBC did cease to finance both central and local government overdrafts since 1994. In both the Budget Law (passed by NPC in 1994) and the People's Bank of China Law (1995), it is

industries. The Agricultural Development Bank of China was created to take over products from the Agricultural Bank of China (ABC) the policy loans for state procurement of agricultural. And the Import-Export Bank of China, the smallest of the three, was established primarily to provide credit for large state-owned exporters to promote the international sale of Chinese capital goods.

Table 3-4. Simplified Balance Sheets of the Three Policy Banks, 1997.

	Assets			Liabilities		
		RMB (billion)	**as % of total assets**		**RMB (billion)**	**as % of total liabilities**
State Development Bank	Long-term loans	365.2	96%	Bond sale	305.3	80%
	Short-term loans	4.5	1%	Capital	44.2	12%
	Total	**381.1**	**100%**	**Total**	**381.1**	**100%**
Import-Export Bank	Loans	24.8	79%	Bond sale	24.5	79%
				Capital	3.3	11%
	Total	**31.3**	**100%**	**Total**	**31.3**	**100%**
Agricultural Development Bank	Long-term loans	354.9	38%	PBC relending	816.8	88%
	Short-term loans	508.9	55%	Bond sale	27.6	3%
				Capital	14	2%
	Total	**923.3**	**100%**	**Total**	**923.3**	**100%**

Source: calculated from *Almanac of China's Finance and Banking, 1998*, p. 556-8.

Since established, the three policy banks alone made about one third of the total

stipulated that the central bank shall not finance government deficits. The central government's loans made by all financial institutions in China.[14] The funding of these loans has been basically from two sources – one was the sale of financial bonds to the existing financial institutions; the other was the relending funds provided by the PBC. As shown in Table 3-4, the sale of financial bonds to existing financial institutions constituted 80 percent and 79 percent of the total liabilities of the State Development Bank and the Import-Export Bank respectively in 1997. The funding provided by the Ministry of Finance as their registered capital was barely above 10 percent. In case of the State Development Bank, 96 percent of the funds was used to finance long-term investments in large infrastructure projects and strategic or "pillar" industries. In order to balance regional development, the bank intentionally skewed its loan distribution towards the mid-west regions. In 1997, 70.1 percent of the loans went to the mid-west. The most famous projects include the Three Gorges Dam, the Yellow River Xiaolangdi Project, the Taishan Nuclear Power Plant, the Sichuan Ertan Hydropower Plant, the Beijing-Kowloon Railroad, the investment projects of the Jilin Chemical Industrial Company, the Liaoyang Petrochemical Company, and the Sichuan Panzhihua Iron and Steel Corporation, etc.[15]

Since now long-term infrastructure projects and investments in strategic industries were financed by bond sales to the existing financial institutions, the PBC's relending fund was made primarily to finance the state procurement of agricultural products. As we can see in Table 3-4, 88 percent of the total liabilities of the Agricultural Development Bank in 1997 was from PBC relending. Bond sale and capital provided by the central

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budget deficits would now mainly rely upon the issuance of government bonds.

[14] For example, in 1995, the loans made by all financial institutions in China totaled 973.6 billion yuan and the loans made by the three policy banks loan were 358.6 yuan, equal to 36.8 % of the national total.

[15] *Almanac of China's Finance and Banking, 1998*, p. 60.

government together only contributed 5 percent. As the central bank has raised the relending rate for other financial institutions and most of the policy loans made by the State Development Bank and Import-Export Bank are financed by financial bonds, we should expect to see a significant reduction of the PBC relending in the last several years. However, as shown in Table 3-3, the PBC relending kept growing rapidly since 1993. That is because the newly established Agricultural Development Bank (ADB) still can not heal the problems the ABC faced when it was the designated bank for policy loan distribution – the new local branches of the ADB continuously diverted funds to other investments and issued IOUs to peasants for the state procurement of their products. Partially for this reason, the central policymakers would not let the ADB branches expand too fast and have the ABC branches and RCCs to help distribute the policy loans to the grassroots. The PBC thus also extended relending loans to the ABC and RCCs.

In theory, the three policy banks were created to take over all policy lending of the four specialized banks and pave the way for the "commercialization" of the four banks. In reality, they only took over the policy lending that concerned the central planners the most. A vast bulk of policy loans demanded by local governments, especially the so-called 'unity and stability loans' (*tuanjie anding daikuan*) extended to relieve local SOEs' social burdens, were still shouldered by the four state banks. On top of that, because the central policymakers were reluctant to issue the policy bank bonds at commercial rates in the market and absorb all the subsidies of the interest payments by the state budget, the PBC and the existing financial institutions were forced to keep playing the role of government financier. The PBC played the role of government financier by making relending loans to the policy banks while the state banks played the role by holding their bonds at extremely low interest rates. In other words, the assets of both the PBC and the state banks were continuously used to share government's budgetary burdens after the 1993 reforms.

Central Bank Independence?

To characterize the post-Deng financial reforms in the area of central banking, we can also evaluate the reforms by assessing the degree of China's central bank independence from other government agencies after the reforms.

Zhu Rongji's two-year tenure as the PBC governor helped to bolster the PBC authority significantly. In the power hierarchy of the Chinese Communist Party, the PBC governor usually is a position for Central Committee junior members, but powerful ministers or provincial Party secretaries can be either Central Committee senior members or even Politburo members. It was very difficult for the former to have the latter take his or her authority seriously. Now a Politburo Standing Committee member who was in charge of national economic affairs took over the PBC's governor position. The political mandate of the central bank was thus higher than any other administrative agencies for the time being. This situation made it easier for the PBC to redefine its relations with other government agencies. After the PBC legal authority was obtained with the enactment of the Central Bank Law in 1995, Zhu handed the governor position to Dai Xianglong. Although Dai, like conventional governors, is also a junior member of the Central Committee, he is the first PBC governor who came from financial sector since the

PBC became the central bank in the mid-1980s.[16] His professional background provides him with better chance to establish professional authority to those concerned both at home and overseas.

Besides the political and legal mandates, the PBC ought to be equipped with enough instruments to conduct monetary policy and supervise the financial system. A Monetary Policy Committee was set up in the PBC headquarters in 1995 to conduct monetary policy. However, it was actually a cross-ministry organization under the control of the State Council, and so far, neither monetary targets nor monetary tools are under control of the Monetary Policy Committee.[17] It's still unclear how the Committee conducts China's monetary policy. In regard to supervision over financial sectors, state commercial banks since 1994 have been ordered to delink with all their subsidiary non-bank financial institutions. A series of clean-up campaigns in several financial sectors have been going on for several years. With the unification of several financial markets, such as the foreign exchange market and interbank money market, the enactment of the Negotiable Bill Law, the Securities Law, and the Trust Law, and the restructuring of the PBC headquarter organization along the lines of distinct financial sectors, the legal and regulatory framework for the PBC supervision over the entire financial sectors has been

[16] Before he took the position, he was the president of the Bank of Communication. Previous PBC governors, such as Chen Muhua and Li Guixian, had never worked in financial sector and knew little about banking before they became the central bank governors. Li Guixian was the Party secretary of Anhui province before he took the position. Chen Muhua, although from the financial sector, had no finance knowledge background. 'She was nothing but a nurse during the Long March time.' Interview, No. 98.

[17] The Ninth Five Year Plan passed by the NPC in 1996 formally set money aggregate (M1 at 18% and M2 at 23%) as the intermediary target of monetary policy in the coming five years. But the Plan was a product of cross-department negotiation with the State Council and State Development Planning Commission having the final say. In the meantime, the PBC Law

greatly improved.

To be sure, the structural reforms described above have significantly enhanced the PBC's authority to oversee China's macroeconomic stability and financial order for the time being. But does it mean that the PBC has really been delegated the power to be solely responsible for monetary policy? How autonomous it has become vis-à-vis other government agencies, such as the Ministry of Finance and the State Planning Commission? Is its authority sustainable even after Zhu Rongji steps down as premier? Where is the PBC now in the continuum of central bank independence?

In the studies of central bank independence, there is still no consensus on how to measure it. Some prefer to measure it formally, in terms of the laws stipulating the organization and operation to a central bank, such as the legal statutes of the objectives of the central bank, sources of tenure appointment, tenure length of office, etc. [Banaian, 1983 #210] (Grilli, Masciandaro, and Tabellini 1991) (Goodman 1991). It is precise and easy to quantify and compare. However, a cross-national quantitative study has found that 'legal independence is inversely related to inflation in industrial, but not in developing, countries' (Cukierman, Webb and Neyapti 1992, p.353). Given the relatively low degree of the rule of law in most developing countries, it is conceivable why legal independence is not an efficient measurement for central bank independence in developing countries. As Maxfield points out, 'there is a considerable disjuncture between formal independence, on the one hand, and actual central bank behavior and capacity, on the other,' in these countries (Maxfield 1994, p. 557). Therefore, students of financial politics in developing countries are usually inclined to measure central bank

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stipulates that interest rates and credit plans – still the major instruments of monetary policy – are independence, or autonomy, in terms of behavior.[18] That is how much discretion the central bank has over the goals and tools of monetary policy vis-à-vis government as a whole or particular government agencies, such as fiscal authorities and planning technocrats, in the policymaking process (Woo 1991) (Haggard 1993) (Maxfield 1997) (Chu 1999). With a political system in which Party documents and top leaders' speeches are still given more weight than laws, China is no exception. Although the ongoing enactment of laws in the 1990s might indicate the post-Deng Chinese leaders' attempt to gradually establish the rule of law in the system, some critical statutes in the PBC Law are still ill-defined and subject to test. The *real* autonomy of the PBC should be examined by careful scrutiny.

First of all, since 1994 the PBC is no longer requested to finance government deficits. It is a very important indicator of the enhancement of the central bank autonomy from the interference of government's fiscal goal. However, given the fact that the Chinese central authorities have no intention to reduce government roles and expenditures drastically, their fiscal goal has continued to compromise central bank autonomy in a subtle way. The termination of central bank financing led the Ministry of Finance to go to the financial markets to raise funds for the mounting budgetary deficits that the concurrent revenue increases caused by tax reforms still could not cover.[19]

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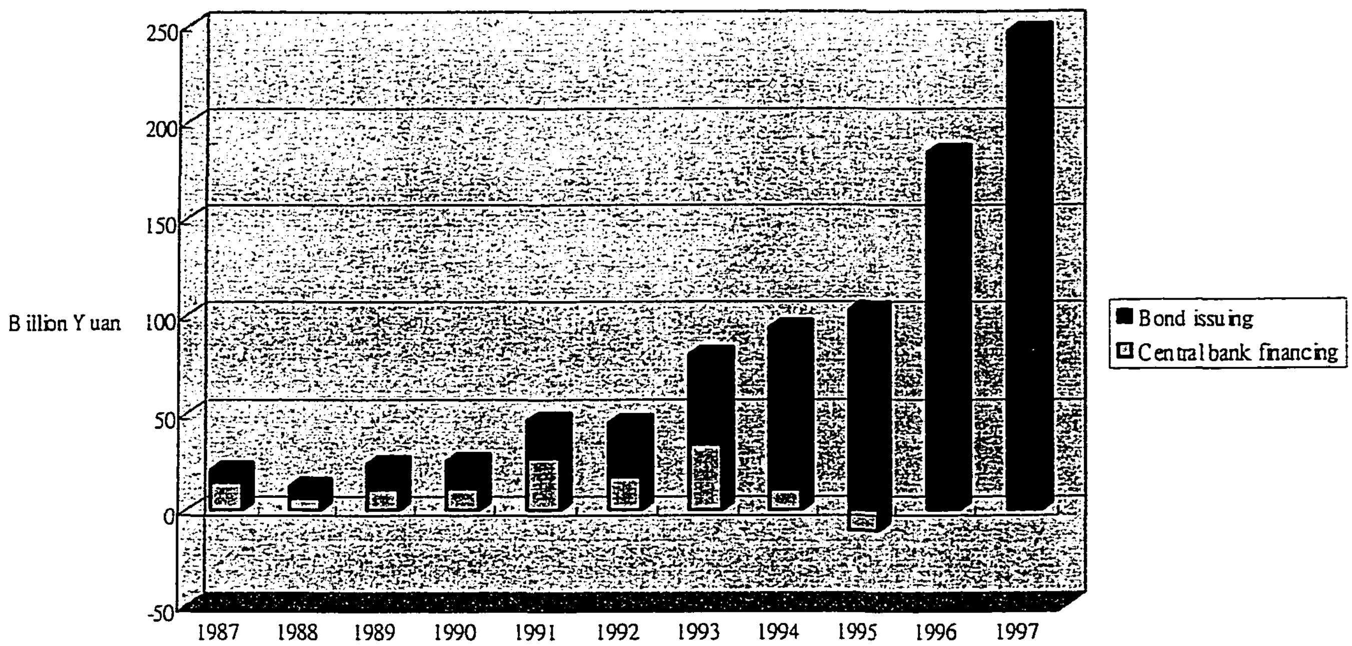
determined by the State Council. See (Xie 1996, p.47-49).

[18] Bowles and White suggest to use "autonomy" instead of "independence" because autonomy for them is 'a scalar concept and may be graduated differently in specific national contexts' while independence could be understood as 'full autonomy' which is not the case for most countries and should not be taken as an absolute criterion to evaluate different systems (Bowles and White 1994).

Figure 3-4. Government Deficits Financing, 1987-1997.



Sources: State Statistical Bureau, *China's Statistical Yearbook*, 1998, p. 291; PBC, *Almanac of China's Banking and Finance*, 1992, p.517; 1994, p.508; 1995, p.464; 1998, p.492.

As shown in Figure 3-4, government bond issuing has increased sharply since 1994 to cover the reduction of central bank financing. From the figure we find that the increases were much larger than that needed to cover the reduction of direct financing by the central bank. This development reflects an ongoing trend that the financial markets will become the most important source, for the Ministry of Finance to raise funds to satisfy the government's fiscal need, only second to tax collection. In 1997, 27 percent of

[19] Unlike most capitalist countries, in China only the central government can issue government bonds to finance its expenditures. Local governments are not allowed to do so.

the total government budgetary expenditure was financed by bond issuance, and 58.74 percent of the central government budgetary expenditure was financed by bond issuance (Li 1999).[20] The sharp increases in government bond issuance in such a short period of time have distorted the distribution of financial resources and postponed the development of other financial markets. Moreover, because the terms and interest rates the fiscal authorities were willing to offer were unattractive in the markets, administrative measures, such as quota distribution and limitation on transaction, were often employed in the process. As a result, the treasury bonds issued by the Ministry of Finance were still distributed in the manner of a socialist planned economy and hardly traded in the secondary market. All these developments have obstructed the PBC to Liberalize interest rates and implement its monetary policy through open market operation. The PBC is thus forced to continuously rely upon credit control to adjust monetary expansion.[21]

The steering power of the central bank is also abated by the continuous dominance of the planning agencies over the state credit policy. The State Development Planning Commission, formally the State Planing Commission (the SPC), has complete control over the three policy banks established in 1994. All the loans they make are

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[20] One may interpret the sharp increase in central government bond issuing since 1994 as a way to help fighting inflation. It was the case during the 1980s. Actually, it was the major reason for the Chinese policymakers to start issuing bonds in 1981. During the austerity programs of 1985 and 1989, the policymakers also increased bond issuing by 42 % and 109 % to absorb currency in circulation. But at least one thing has illuminated that the increases in bond issuing since 1994 was not simply for inflation control, but reflects a new orientation in fiscal policy. That is, when the economy began to suffer *deflation* since mid-1997, the central authorities did not stop the trend. Instead, it decided to issue more bonds to finance public investment-led stimulation program.

[21] It is very common to see the interest conflict between the monetary and fiscal authorities in other countries. In China, the situation is also complicated by the fact that the PBC had for long time been in the subordinate status to the Ministry of Finance before 1978 (Bachman 1989; Byrd 1983). In the post-Deng era, they also have interest conflict over how to submit the PBC's

therefore immune from the PBC supervision. Since established, each year the new loans they made are as high as one third of the total loans made by all Chinese financial institutions. By 1997, their share of the total outstanding loans was 16.7 percent. Again, due to the huge budget deficits, the policy loans were financed neither by the state budget nor by government bond issuing. They were mostly financed by central bank relending and forced bond holding by the existing financial institutions. As a result, as discussed in last section, the central bank relending continuously grew even after the 1994 reforms. This obligation makes the PBC still have no control over its own assets, only now it is the central government, rather than the local governments, who take charge.

The State Economic and Trade Commission is another planning agency that menaces the central bank authority. Since July 1996, a so-called "main bank system" has been established between the four state banks and the 1000 largest state owned enterprises (SOEs). The big 1000 were hand-picked by the State Economic and Trade Commission. Under the system, the state banks were required to sign contracts with these big 1000 and guarantee their loan supply. In regions where large SOEs are concentrated, such as Shanghai, about 70 percent of the loans made by the four state banks were covered by the main bank system. It has undermined the regulatory authority of the central bank over the banking system.[22]

The above analysis shows that, although the 1993 reforms have helped China's central bank get rid of the intervention from local governments, the central bank still does

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profits, how to write off banks' bad loans, and whether banks should continue to make loans to pay welfare programs of the SOEs.

[22] Interview, No. 89.

not have enough discretion over its goals and tools for it to function effectively in implementing monetary policies and supervising the financial system. On the one hand, the continuous imposition of treasury bond sales to financial institutions forced the central bank to postpone its own agenda on the liberalization of interest rates and the development of open market operations, both of which are important for the central bank to develop alternative monetary instruments. On the other hand, through the creation of three policy banks and the establishment of the "main bank system," government planning agencies, such as the State Development and Planning Commission and the State Economic and Trade Commission, still played a dominant role in determining the allocation of bank credits. The practice would undermine the central bank's functions in both maintaining monetary stability and supervising the financial system. By comparing its authority with other government agencies over the financial system, we find the Chinese central bank after the 1993 reforms is still far from independent.

Conclusion

The recentralization and rationalization initiatives since 1993 had demolished the intervention of local governments in the PBC operations. But the PBC, through relending practices, continuously served as government financier for central priority projects. In the meantime, the resumption of central control, though enhancing the central bank authority for the time being, did not provide sustainable institutional ground to safeguard central bank autonomy from the interference of other central government agencies. The Ministry of Finance, the State Development Planning Commission, and the State Economic and

Trade Commission still play decisive roles in the making of China's monetary and credit policies.

The "soft landing" of the overheating economy since 1993 is often cited as evidence of the post-Deng leaders' success in the reforms of central banking.[23] However, if we carefully look into the mechanism of how the "soft landing" has been achieved, we will find it was far from a consequence of successful reforms in the autonomy and instruments needed for the central bank to conduct monetary policy with advanced methods. It was rather a result of *reallocation* of financial resources among different economic sectors. Although the overall money supply has been reduced steadily over the years,[24] it was achieved by the sharp reduction of both credit and relending quotas to the local investment projects as well as the funds diverted out of the state banking system into the non-state sectors in the market. On the contrary, with the creation of the three policy banks and the establishment of the so-called "main bank system" between the four state banks and the 1000 largest SOE conglomerates, the credit and relending quotas to the central priority projects kept growing over the years. In other words, the "soft landing" was achieved at the expense of those sectors flourishing and proliferating during Deng's decentralized reforms – namely, the smaller SOEs as well as collective and private enterprises in the sectors of light industries and commerce. The "soft landing" at

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[23] Soft landing usually refers to the economic situation that inflation is controlled without abruptly slowing down economic growth. From 1993 to 1997, China has achieved soft landing by keeping annual inflation rates gradually slowing down from 13.2 %, 21.7 %, 14.8 %, 6.2 % to 0.8 % and the annual economic growth rates from 13.5 %, 12.6 %, 10.5 %, 9.7 %, to 8.8 %.

[24] As shown in Figure 3-3, the growth of money supply (M1) has decreased from 38 % in 1994 to 19 % in 1997.

the aggregate level might actually be "overshooting" for these sectors in particular.[25] The sluggish consumption price since the summer of 1997 may be the sign of severe recession in these sectors.

[25] The growth in recent years mostly came from the sharp growth of government investments in infrastructure and strategic industries and growth in exports and foreign direct investments (FDIs). The growth in exports and FDIs can partially be a compensation to those sectors of light industries and commerce, but its effects are only limited in the coastal area.

Chapter 4

The Transformation of the Banking System as a Whole in the Post-Deng Era

The Chinese banking system as a whole has experienced large-scale restructuring since late 1993. In the four largest state banks, through centralization of decision power and financial flows into the hand of their Beijing headquarters and the establishment of a long-term credit-supply relationship between the banks and 1,000 "double big" (i.e. big firms in big industries) conglomerates selected by central planning agencies, the central leaders have essentially undermined the intervention of local governments in their control over credit allocation within the state banking system. The nine comprehensive banks established after reform were ordered to terminate their involvement in direct finance[1] and only focus on lending operations. The scale of these new banks was enlarged by substantial capital injection on the order of either central or provincial governments for their own different reasons. In contrast, the "growing out of the plan" non-state financial intermediaries experienced the most serious crackdown since the late 1970s when they started emerging in the increasingly liberalized economy – the Trust and Investment Companies were forced to close or merge, the Urban Credit Cooperatives were ordered to be converted into the city governments' banks, and the Rural Cooperative Foundations

[1] That is, involvement in issuing and trading bonds and stocks in financial markets. In contrast, taking deposit and extend loans is considered as indirect finance.

and other informal financial institutions in the countryside have been experiencing sporadic cleanups and still faced with an uncertain future.

A "main bank system" with Chinese characteristics has been created in post-Deng China, whereby a few big banks dominate the landscape of the financial system and supply long-term loans to the largest SOEs on government-set terms; there are clear market division and little competition among these banks; and smaller newcomers are severely repressed by the regulatory authorities in order to protect the dominant status of the big banks.

The term "main bank system" usually refers to the banking system intentionally maintained by the Japanese government in cooperation with banks and industrial firms during the high-growth era from the early 1950s to the early 1970s. The Japanese financial authorities used regulatory restrictions and economic disincentives to discourage the development of financial markets as well as to strictly control the entry of new banks and the competition among the existing banks. The banking system was dominated by a dozen or so nationwide private banks that served as the main commercial banks for associated big firms. The main banks provided long-term loans to these big firms and closely monitored their operations. The system was created to serve an industrial development strategy with the assumption that 'large firms were the engines of growth and should receive credit on preferential terms relative to everybody else.' (Patrick 1994, p.387) The same development strategy also created similar financial systems in countries like France, Germany, and South Korea during the time.

Because of the close working relationship between banks, firms, and the government, the system has successfully helped the Japanese banks to write off numerous bad loans accumulated during the Second World War, as well as supported the Japanese firms to avoid the problems of insider control in an underdeveloped financial market. [2] As a result, the Japanese economy recovered and took off sooner than expected. The Japanese main bank system is thus recommended by some economists to the transition economies. These economists argue that, given the similarity of the problems facing postwar Japan and transition economies. That is, mounting bad debts caused by huge economic disruptions (war v.s. post-socialist transition), the tendency toward insider control of the corporate governance due to the information problems in financial markets, and the need of a financial mechanism to promote government industrial policies for economic recovery. The main bank system is an appropriate model for transition economies to create a market financial system and resolve their financial problems simultaneously. (Aoki and Patrick 1994) (Aoki and Kim 1995)

However, the "main bank system" the post-Deng Chinese leaders created is more similar to the banking system established in postwar South Korea or the munitions industrial system in wartime Japan. In both cases, the dominant banks were state-owned and the government intervened in the banks' lending policy through mandatory political orders rather than indirect economic incentives. The banks exercised close supervision over the big firms not as the major shareholders, but as government agencies. Moreover, it was the government planning agencies, rather than the powerful private banks, that carried out the country' industrialization drive. The banking systems were more centralized in terms of scale and number of the dominant banks. China's banking system

[2] By insider control, it means capture of controlling rights by the managers and the strong representation of their interests in corporate strategic decisionmaking, often in collusion with the workers.

after the 1993 financial reforms shared all these characteristics. Rather than establishing a main bank system similar to the one in postwar Japan, the Chinese central policymakers just established a main bank system *with Chinese characteristics* that is closer to the financial system in wartime Japan and postwar South Korea.

The next section reviews the structural change of the banking system prior to 1993. First, there is an analysis of how the central planners have lost control over bank credit allocation to the local officials and lost market share of domestic savings to the competitive non-state newcomers during Deng's decentralized reforms. Then, there are three sections discussing how the post-Deng central policymakers have resumed their control over the credit allocation in the state banking system and reduced the competition from the non-state financial intermediaries.

Structural Change of the Banking System from 1978 to 1993

As mentioned in Chapter 2, thanks to the extremely high saving rates, financial sector was among the fastest growing sectors in Deng's China. From 1979 to 1994, while China's nominal GNP grew about 10 times, bank deposits increased about 20 times (Cheng, Fong, and Mayer 1997, p.205). The mounting domestic savings provided a precious alternative to the dwindling state revenues for Chinese central planners to finance the vast government expenditures and investments in the state sectors and prevented China from the irresponsible monetary policy and consequent financial turbulence often suffered by transition economies. The deliberately maintained dominant status of the state banking system has safeguarded its function as the major state instrument to mobilize the newly generated resources from the society to sustain the obsolete socialist apparatus. Nonetheless, the repressed financial system also created strong incentives for financial actors to shirk from the constraints and seek higher returns from outside. As the market transformation in the 'real' economy demanded more diverse financial services and created more opportunities for higher returns in the market, the inherent tension within the repressed financial system intensified. Throughout the Deng era, we found the state banking system was increasingly unable to compete with various financial institutions that spontaneously emerged from the flourishing market economy. Funds in the traditional planned system were channeled out for higher returns. The central policymakers, reluctant to give up a major financial source for the survival of the SOEs in the communist core, had used sporadic recentralization measures to subdue the challenges of the new market forces and maintain the dominant status of the state banking system.

Before the post-Deng restructuring started in late 1993, the Chinese financial system was by and large dominated by the traditional state banking system, with numerous 'growing out of the plan' financial institutions striving on the fringe of the system. Due to the absence of clear and consistent regulations and the sporadic crackdown by the central authorities, the market share of the 'growing out of the plan' financial institutions in terms of domestic deposits was slightly above 10 percent by 1994, hardly compatible to the growth engine status of the 'growing out of the plan' sectors in the 'real' economy (i.e., 60 percent of China's GDP). But the challenges they brought to the state banking system – creating 'leakage' for the outflows of the state bank funds, undermining the effectiveness of the central policymakers' credit control, and competing for deposits with the state bank branches – were already severe enough for the central policymakers to make up their minds to take determined action.

The Traditional State Banking System

Prior to 1993, China's socialist monobank system has been transformed into a two-tier banking system with the People's Bank of China (PBC) at the top as the central bank, and the four specialized banks and a network of rural credit cooperatives (RCCs) at the second tier to serve as the financial intermediaries between savers and investors. The four specialized banks, though allowed to operate across fields since 1985, basically operated in four distinctive policy areas – the Industrial and Commercial Bank of China (ICBC) was specialized in financing SOEs' working capital (80 % of the total loans), the Construction Bank of China (CBC) was specialized in financing SOEs' fixed asset investment (56 %), Agricultural Bank of China (ABC) was in charge of loans for agriculture, and Bank of China (BOC) was for foreign trade (87 %).[3] The RCCs, since their establishment in the 1950s, were designed as deposit mobilizers in the countryside and engaged in relatively little lending. Since the late 1970s, the RCCs' funds and operations were subject to the control of the ABC local branches.[4]

In order to mobilize savings from the increasingly flourishing society, in the 1980s the four specialized banks were encouraged to set up as many branches as possible

[3] Industrial and Commercial Bank of China, 1995 annual report, p.16; People's Construction Bank of China, 1995 annual report, p. 28; and Bank of China, 1995 annual report, p.18.
[4] The China Investment Bank can be seen as another member of the traditional state banking system. It was created by the Ministry of Finance in 1981 to disburse project funds provided to China by the World Bank and later the Asian Development Bank.

throughout the country to dig out savings from households, enterprises, and government units. With soft budget constraints, the banks were willing to expand their branch networks at any cost. From 1985 to 1995, the numbers of the PBC and the four specialized bank branches had tripled from 58,000 to 158,000. Their employees also doubled from 925,000 to 1,876,000.[5] The deposits in the four specialized banks and the RCCs had since sharply risen from 459 billion yuan in 1985 to more than 3,300 billion yuan in 1994, about 81 percent of the national total.[6] The deposits mobilized by the state banking system replacing the declining state revenues became the major financial sources of government expenditures and investments. As discussed in Chapter 3, the central government and the central bank relied on the state credit plan and the reserve requirement/relending scheme to control the quantity and direction of lending in these four specialized banks. However, the *dual leadership* on the one hand and the *profit retention system* on the other provided political and economic incentives for local branches of the specialized bank to collaborate with local governments to circumvent the central credit control.

Fiscal decentralization made provincial governments solely rely upon the profits of the state-owned enterprises (SOEs) under their jurisdiction to finance their budgetary expenditures and develop distinctive economic interests from the central government. The provincial governments would invest as much and as fast as they could in local SOEs to generate more revenues, while the central government, worried about inflation and political stability, would contain the impetus of the local "investment hunger." Since the provincial branch bank officials, like their counterparts in the PBC branches, were listed

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[5] Calculated from Almanac of China's Finance and Banking, 1996, p.542.

on the local *nomenklatura*, they would choose to obey the local boss when the orders from the Beijing headquarters and provincial governments were in conflict. After all, their careers were controlled in the hand of the local party committee and, therefore, determined by how much contribution they had made to local economic development. Even in the event that their collaborative behavior really infuriated the central authorities and permanently damaged their development in the banking system, the provincial governments still could offer alternative, even better, career path to them as a compensation.[7]

In the banking system, the dual leadership only worked at the level of the provincial governments. Local party committees below the provincial level had no right to appoint bank branch personnel. But they still exerted considerable control over branch bank officials. The profit retention system created economic incentives for branch bank officials to expand their operation. From housing employees to collecting loan payments, they could not achieve anything without the assistance of local governments. For example, an ICBC sub-branch in Shanghai could not find a good location to open a new office in its district simply because it rejected a loan request of the district government.[8] Another sub-branch director in a rural area was denounced as a "permanently rejected person" by the county party committee because he did not make a loan to a construction project of the county government.[9] Given the fact that there were no legal sanction of

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[6] Almanac of China's Finance and Banking, 1987, p. II-7; 1995, p.465.
[7] For example, several provincial branch directors of the state banks in Shanghai were sacked by Zhu Rongji in 1997 for their involvement in manipulating local stock prices under Shanghai government order. The Shanghai governments thus arrange for them to become the presidents of certain Hong Kong companies owned by the Shanghai government. Interview No. 29, 32.
[8] Interview, No. 23.
[9] Interview, No. 21.

loan contracts and property rights, and most enterprises that the bank branches made loans to were controlled by the local governments, branch bank officials also had to rely upon the goodwill of the local governments for the repayments of their loans.

There were several ways the bank branches and local governments commonly used to circumvent the constraints of the state credit plan and "relending" policy. One was to use up all the annual credit quotas to finance local projects in the middle of the year and force the central bank to grant extra quota later for those central projects left by the local bank branches. In consequence, the final credit growth always surpassed the original credit plan over the entire reform era.[10] The second way to bypass the limit of the credit quotas was to make loans to local enterprises through the subsidiary companies of the bank branch, such as the Trust and Investment Companies (TICs). Some Chinese economists estimate, from 1986 to 1994 there was at least 100 billion yuan of investment that was made through these channels (Wu 1996, p.87). Another way was to provide guarantee to the debts that local SOEs borrowed from foreign banks or other financial institutions. When the debts were due, the specialized bank branches would 'voluntarily' pay the debts for the SOEs as the guarantors and break the limit of the credit quotas. The collaboration between bank branches and local governments gradually eroded the effectiveness of the central control over the specialized banks with the planning schemes.

The Newly Established Comprehensive Banks

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[10] According to one estimate, in the 1980s the largest difference between the final credit growth and the original annual plan is 135 % and the smallest is 17 percent (Wu 1992, p. 162).

From 1986 to 1993, another nine state-owned comprehensive banks were established in coastal China.[11] They were the Bank of Communication (1986), CITIC (China International Trust and Investment Corporation) Industrial Bank (1987), Merchant Bank (1987), Shenzhen Development Bank (1987), Guangdong Development Bank (1988), Fujian Industrial Bank (1988), China Everbright Bank (1992), Huaxia Bank (1992), and Shanghai Pudong Development Bank (1993). As a product of the economic reforms, these banks from the outset were created to do what the four specialized banks were prohibited from doing in the traditional planned system. On the peaks of the decentralized reforms in the late 1980s and early 1990s, they were encouraged to set branches according to operational needs, and engage in inter-regional lending, foreign exchange transaction, securities underwriting and trading, and overseas borrowing. Basically, they were designed to be another channel for the SOEs to raise funds outside the credit plan system.

Although they all were newly established banks, they were diverse in size, geographic scope of business, and ownership arrangements. The Bank of Communication and CITIC Industrial Bank were the two giants in the group. Their national market share in terms of deposits was 4 percent, twice the size of all other seven comprehensive banks together. The Bank of Communication had branches covering almost all major cities in China. CITIC Industrial Bank and China Everbright Bank put

[11] The term *comprehensive banks* (zonghexing yinhang) means that these banks were allowed to engage in a variety of operations that were prohibited in the traditional planned system. Some would call them the 'financial department stores.' The banks preferred to call themselves *commerical banks* (shangye yinhang) to indicate that they are solely for commercial interests and don't take policy lending of the traditional planned system as the specialized banks. But prior to the Fifteenth Party Congress in 1992, the term *commercial banks* was still a taboo in the socialist economy. The banks thus named themselves as comprehensive banks.

their focus more on expansion abroad, especially in Hong Kong. Merchant Bank, Shenzhen Development Bank, Guangdong Development Bank, Fujian Industrial Bank, and Shanghai Pudong Development Bank were more regional-oriented in their business operation.

In terms of ownership arrangements, the Shenzhen Development Bank was the first and the only listed company among all Chinese banks. Two-thirds of its shares were held by individual investors and traded on the Shenzhen stock market. Another three regional banks (Guangdong, Fujian, and Shanghai Pudong) were joint stock financial institutions, predominantly owned by provincial governments and their subordinate SOEs. Merchant Bank, China Everbright Bank, and Huaxia Bank were banks essentially owned by a single industrial group – Merchant was set up by the Guangdong-based Merchant Group (*Zhaoshang Ju*), China Everbright was run by the State Council-controlled China Everbright Group Co. (*Guangda Jituan Gongsi)*, and Huaxia was by the Capital Iron and Steel Group Co. (*Shoudu Gangtie Gongsi*). As a nationwide fund-raiser for local SOEs, Bank of Comunication from the beginning had a very decentralized ownership structure, jointly owned by various local governments and their subordinate SOEs. In parallel, the CITIC Industrial Bank as a nationwide fund-raiser for the largest central SOEs was also jointly owned by various SOE industrial groups, or conglomerates (Jin and Xia 1996) (Lardy 1998).

As the financial authorities set strict limits on their branch expansion, these banks were by no means able to compete with the four specialized banks for household savings – the predominant source of deposit growth during the reform era. Most of their deposits were from the extra-budgetary funds of local governments and SOEs. By 1994, the market share of these banks together in terms of deposits was about 6 percent, still tiny relative to the four specialized banks (67 %) and RCCs (14 %).[12] With relatively clear ownership structure and more flexibility in operation, these commercial banks were generally more profitable than the four specialized banks. However, their close affiliations with either a regional government or an industrial group also caused a variety of lending irregularities. On top of that, operating outside the credit plan, these commercial banks were beyond the central authorities' control when the latter intended to tighten up overall credit supply.

'Growing out of the Plan' Financial Institutions

The state banks usually do not lend to non-state enterprises and individuals. It thus created considerable room for the development of other financial institutions. In general, the newly emerged financial institutions, according to its ownership structure, can be divided into three categories: the state unit-run Trust and Investment Companies and Finance Companies, the collective-owned Urban Credit Cooperatives and Rural Cooperative Foundations, and the individual-run private money houses, pawn shops, credit rotation associations, etc. These financial intermediaries commonly existed in the form of non-bank financial institutions (NBFIs) because private banks were still strictly prohibited in the system. They played an indispensable role in improving the efficiency of credit allocation in the flourishing market economy. However, the ignorance, if not hostility, of the central financial authorities toward these small financial players forced

[12] *Almanac of China's Finance and Banking*, 1995, p.465, 519.

them to survive in an environment that government regulations were ambiguous (in some cases absent) and fluctuating with the swings of macroeconomic as well as ideological concerns among the top leaders. Prior to 1993, these financial institutions had experienced three cycles of expansion and crackdown (1980-1982, 1984-1985, and 1986-1988) in tandem with the climatic policy changes. The policy uncertainty shortened the time horizon of these financial institutions, rewarded risk-takers, and, in a broad sense, hindered the long-term development of this 'growing out of the plan' sector. According to official data, by 1994 these NBFIs all together only held slightly above 10 percent market share of domestic deposits, hardly commensurate with the 60 percent contribution of the non-state sectors to the GDP in the 'real' economy.

Trust and Investment Companies and Finance Companies. The demand of the local governments and their subordinate enterprises for channels other than the credit plan to allocate investment funds intensified as economic decentralization proceeded in the 1980s. The mounting extra-budgetary funds accumulated by local government units sought investment opportunities with higher returns, and local priority projects needed investment funds much more than the credit plan would supply. The demand was ubiquitous, but only in the late 1980s were a number of the most privileged regions and industrial groups allowed to establish their own comprehensive banks to address this problem. Against this backdrop, the central authorities allowed state-owned banks to set up the Trust and Investment Companies (TICs) beginning in 1980 to partially satisfy this demand. From central government units, such as the People's Bank of China and the Ministry of Finance, to county-level bank branches, it soon became a nationwide movement for state-owned banks and government financial departments to set up their own TICs. Due to policy fluctuations, the number of TICs went up and down throughout the reform era, and peaked at 745 (rumored being over 1,000) in 1988. In parallel, other state units with extra funds on hand but no permission to open a bank or a TIC would also run their own NBFIs of various kinds to channel funds outside the credit control. The most conspicuous were the 100 or so finance companies run by the SOE industrial conglomerates.

In theory, the TICs could only engage in 'agency business,' where it acted 'as a financial fiduciary, taking *entrusted* deposits from institutional sources, for loans and investments at the discretion of the client' (Anjali Kumar, 1997, p.4). But they actually were a local industrial bank in anything but name. They took deposits, made loans, traded various financial assets in legal and black markets, invested in production projects, engaged in real estate development, and, in case of the largest TICs, issued bonds and stocks in the international financial markets.[13] In spite of their high profile, the TICs actually only had 5.2 percent market share of domestic deposits in 1994, even less than the Urban Credit Cooperatives (5.8 %). However, the TICs caused the most serious concern and crackdown from the central authorities since late 1993 for they were identified as the major 'leakage' for the state banks to transfer funds out of the state banking system and the major source of inflationary pressure at the time.

Urban Credit Cooperatives, Rural Cooperative Funds, and informal financial institutions. If the TICs and Finance Companies were the state units' institutional

[13] The structure of the sector is highly skewed, with the largest internationally oriented International Trust and Investment Companies (or ITICs) dominating the sector. The combined assets of the four largest ITICs – the China International Trust and Investment Company, Shanghai International Trust and Investment Company, Guangdong International Trust and

innovations to provide financial services for their extra-plan investments, Urban Credit Cooperatives (UCCs), Rural Cooperative Foundations (RCFs, *nongcun hezuo jijinhui*), and various informal financial institutions were the non-state sector's answer to their own explosive financial needs after reform, which the traditional state banking system simply would not supply. Both UCCs and RCFs were developed from the collective retained funds (*jiti tiliu*) in the early 1980s to serve the financial needs of the emerging non-state enterprises, i.e. collective and private enterprises. Since obtaining the central authorities' endorsement for their development in the mid 1980s, both UCCs and RCFs rapidly expanded throughout the country. By 1994, the number of licensed UCCs had reached 5,200, and the number of RCFs was estimated to be around 130,000 nationwide (Qian 1994, p.558). In theory, both UCCs and RCFs are cooperative financial institutions and allowed to collect funds only from the cooperative members for collective investments. In practice, they operated like private banks, taking deposits from and extending loans to the public in rates and terms determined by the market. In areas of the vibrant non-state economy, such as cities and coastal countryside, most UCCs and RCFs were privately owned, wearing the so-called collective 'red cap' (*hong maozi*) to avoid political risks in a socialist country.[14] These de facto private banks absorbed deposits at market clearing rates and opened thirteen hours a day, seven days a week. Their better terms and services created fierce competition to the local branches of the four specialized banks and RCCs

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Investment Company, and Shandong International Trust and Investment Company – accounted for roughly half of all assets of TICs in 1994 (Anjali Kumar, 1997, p.9).

[14] In relatively poor rural areas, the RCFs were generally run by the township or village governments as their own 'small coffers' (*xiao Jinku*). Their functions were similar to the TICs to the provincial or county governments – raising funds for the local government controlled enterprises. In some cases, when the villages were so poor that it was difficult to run TVEs, the

(Wang 1994) (Qio and Shen 1997; Zhang, Zou, and Yao 1994).[15] In those private economy dominated areas, such as Wenzhou and Taizhou in southern Zhejiang province, UCCs and RCFs could obtain as high as 80 percent market share of deposits and threaten the survival of the state bank branches (Shi, Sun, and Yan 1997). The UCCs' market share of the deposits was estimated as 5.8 percent nationally in 1994. There is no official estimation for the RCFs and other informal financial institutions. One study gauged that the accumulated volume of non-state lending was 30 billion *yuan* by 1992 (Zhu and Hu 1997, p.44), about 15 percent of the total lending of the four specialized banks.[16] But from the case studies of the competition between these financial institutions and the state bank branches in specific areas, we can argue without exaggeration that the flood of these non-state financial institutions has seriously eroded the foundation of the state banking system.

To sum up, due to its importance in sustaining the survival of the traditional state sectors, in the mid 1990s the financial sector was still tightly controlled by the state and its development was far behind the transformation of the economy in general after fifteen years of reforms. As shown in Figure 4-1, the financial sector was dominated by a hierarchical state banking system, consisting of four specialized banks, a nationwide network of rural credit cooperatives, and a number of region- or industrial group-run comprehensive banks, with numerous 'growing out of the plan' financial intermediaries

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RCFs became government-run usury to exploit poor peasants. See (Li and Zhang 1995b) (Zhong 1996a).

[15] Interviews, No. 85, 143 and 145.

[16] Calculated from *Almanac of China's Finance and Banking*, 1993, p. 357.

surviving on the fringe of this formal banking hierarchy. In terms of deposits and loans, the state banking system still held the vast bulk of market share (See Figure 4-2 and 4-3).

Figure 4-1. The Structure of China's Financial System in 1993.

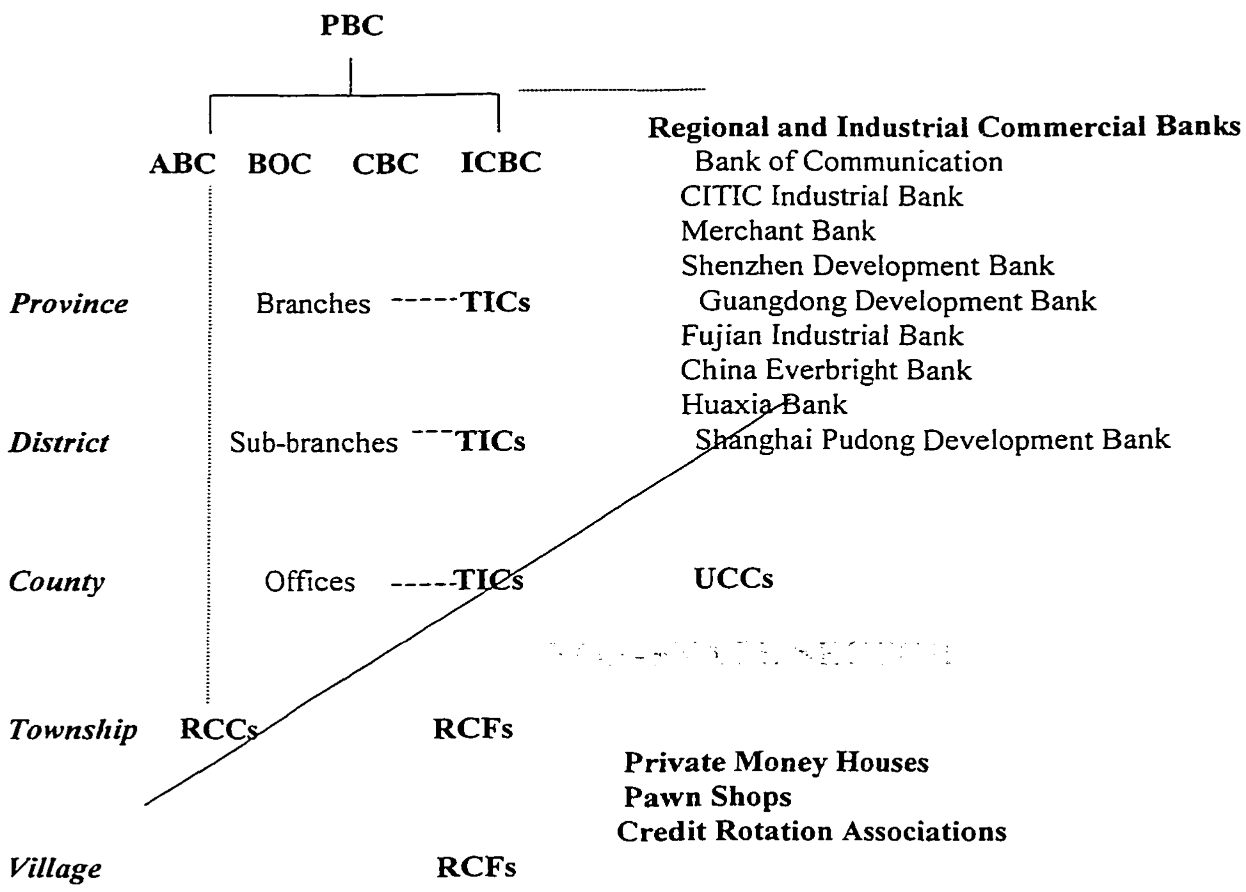


Figure 4-2. Market Share of Different Financial Institutions in Deposits, 1994.

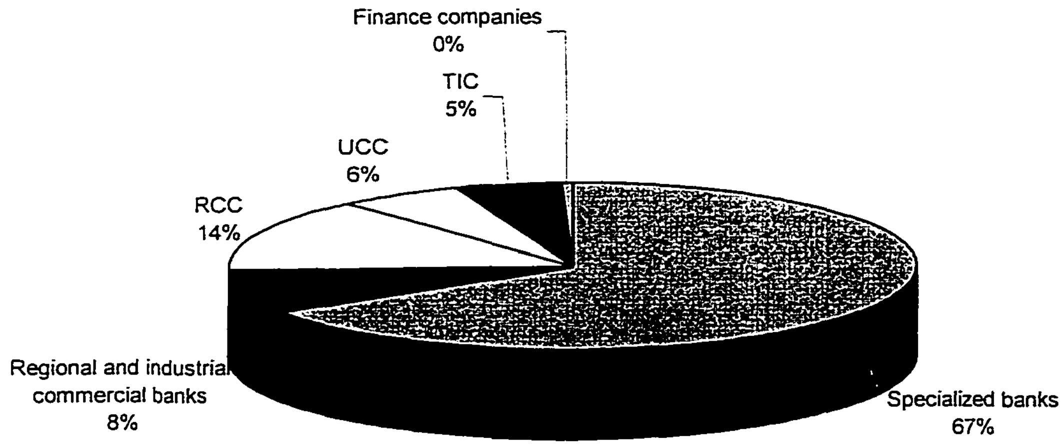
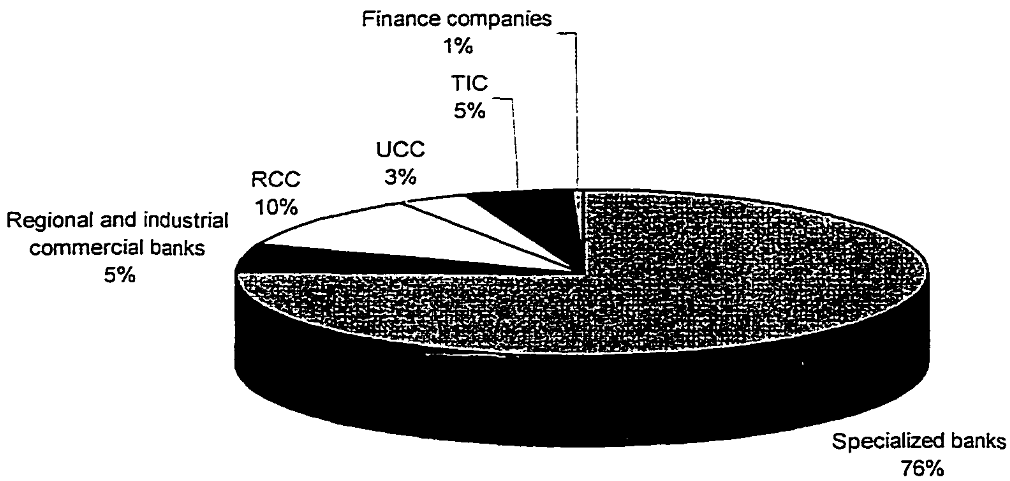


Figure 4-3. Market Share of Different Financial Institutions in Loans, 1994.



Sources: PBC, *Almanac of China's Finance and Banking*, 1994, p. 477 and 519.

Two opposite forces co-determined the shape of the Chinese financial pyramid – one is the government regulations and policies from above to safeguard financial sources as a substitute for state budgetary funds; the other is the financial needs of the growing market economy from below to stimulate spontaneous financial innovations and diversification. In the financial pyramid, the lower the level of the financial institutions, the less legal sanctions and policy constraints they had, the more flexible and vigorous their operations would be. Much academic research has found that the 'growing out of the plan' financial institutions on the bottom of the pyramid generally had stronger awareness of costs and risks for their harder budget constraints, and were usually more efficient and profitable than the state banks. They had made an indispensable contribution to the economic transition and deserved more government support. [17] But from the central policymakers' point of view, they were reckless, chaotic, hard to control, and threatening to both the state credit distribution schemes and macroeconomic stability. They were centrifugal forces to be harnessed rather than fostered.

Consolidation of the "Big Four" under the Central Government

By 1993, the state banking system's budgetary functions had extended to financing government infrastructure construction projects, SOEs' losses, and workers' welfare. Most of the 'loans' were never expected to be repaid. Nonetheless, the continuous supply of funds by the state banking system provided an indulgent environment for the obsolete state sectors to postpone comprehensive restructuring. The

[17] Interview, No. 115 and 130.

economic costs of this 'gradualist' approach to SOE reforms included prevalent productivity and profit deterioration, sharp state revenue decline, heavy indebtedness of the SOEs, and mounting non-performing loans of the four specialized banks. According to Chinese official data, the liability-to-asset ratio of the SOEs was 75 percent and the four specialized banks had accumulated non-performing loans as high as 20 percent of their total assets in 1994. Even with these significantly understated estimates, the majority of the SOEs and all four specialized banks are already technically insolvent (Lardy 1998, p. 4-5). They were kept operating by the continuous confidence and deposit accumulations of the Chinese households in the state banking system. Given the repressed interest rates and SOE-quality services the state banks offered, they would lose in competition with the newly emerging financial institutions as long as the latter were allowed to proliferate in a relatively liberal environment. The 1988 and 1993 state-bank disintermediation and inflation following liberalized reforms were signs of the state banks' incompetence and served as a final call for a comprehensive restructuring.

The Third Plenum of the Fourteenth Party Central Committee in November 1993 set the course for a gradual transformation of the four specialized banks into commercial banks.[18] In 1994, three policy banks were created to take over the policy lending of the four specialized banks. In 1995, the enactment of the Commercial Banking Law gave legal status to the four state banks as state-owned, yet profit-oriented independent legal

[18] The term commercial banks finally was accepted to name the *commercialized* state banks. It means that state banks from now on should operate for commercial interests, i.e. maximizing profits. It also indicates the commercial banks should primarily engage in deposit-taking and gradually eliminate their investment banking business. See (Jin 1998).

entities.[19] The credit quota controls for working capital were gradually replaced by asset-liability ratios as the central bank's monetary instrument, and eventually abolished in 1998.[20] In theory, the reforms should gradually transform the four state banks into real market players, sensitive to risks, costs, and profits. They should be able to get rid of all the budgetary burdens they shouldered for the government, clarify their property rights structure, establish more dynamic corporate governance, and borrow and lend in terms and rates determined by the market. But given the fact that the Chinese policymakers had no intention to cut back their excessive expenditures and investments to the scale commensurate with the government revenues, they must continuously rely upon their control over the four state banks to finance their ambitions. Therefore, as it turned out, the transformation of the four state banks since late 1993 put more emphasis on the resumption of central control, rather than commercialization.

First of all, bank branches were deprived of the channels for horizontal financial flows. The state banks were ordered to 'delink' from all the NBFIs and other associated companies they had previously set up. After the establishment of the two-tier nationwide interbank money markets among the headquarters of the state banks in Beijing and the local branches in 35 major cities in January 1996, bank branches, except those in the 35 cities, were prohibited from engaging in interbank lending. Although these were necessary measurements for restoring financial stability after the 1993 economic disorder, they deprived local branches of the channels for horizontal financial flows. With the

[19] However, the four specialized banks, unlike those newly established comprehensive banks, do not have a corporate structure of independent legal entity. There is no board of trustees in the four specialized banks. The bank president is appointed by the State Council and the PBC as a cabinet member, equivalent to deputy minister. In this sense, the four specialized banks are still more like government departments, rather than banks.

crackdown of the NBFIs and local interbank markets, now bank branches can only borrow from or lend to their superior within the bank hierarchy if they have fund shortage or surplus.

Secondly, the internal organization of the four state banks was restructured towards greater vertical control. The profit retention system for bank branches was abolished. The whole bank became a single budgetary unit for accounting expenditures, profits, and benefits. Bank branches must submit all profits to the headquarters and support their expenditures by the budgetary funds distributed from the headquarters. The bank headquarters also recentralized all the lending decision rights and redelegated some of them with much lower ceilings to branches at provincial and district levels. In the meantime, the headquarters also set new internal rules and interest rates to encourage bank branches to submit as much funds upward as possible. As a result, the county-level branches basically don't make loans now. Most of the time, they are simply local deposit absorbers and deliver loans on behalf of their superiors (Song and Huang 1994) (Li 1996a) (Bai, Wang, and Zhang 1997).

Finally, the restructured state banks were made to be part of the state instruments to finance the central policymakers' efforts to support the expansion of the largest state-owned companies since 1995. Following the guidelines of the Ninth Five Year Plan and the 'Prospectus of the 2010 National Economic and Social Development' passed by National People's Congress in March 1995, the PBC issued the 'Circular on Further Improving Financial Services for the Big and Medium State-owned Enterprises' in June 1996, ordering the four state banks to support the "strategic" SOE conglomerates selected

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[20] But the credit quota control for fixed asset investment is still held.

by the State Economic and Trade Commission (SETC). Among the ten points in the circular, the most significant was the one to establish the so-called 'main bank system' between the four state banks and the strategic SOEs.

As mentioned earlier, the Japanese main bank system has been seen by many economists as an appropriate model for corporate finance in transition economies (Aoki and Patrick 1994) (Aoki and Kim 1995). However, the main bank system established in China in 1996 was quite different from the original model the economists recommended. In July 1996, the SETC selected 300 'double big' (*shuang da* – that is, big enterprises in big industries) SOEs to join the main bank system. The four state banks were ordered to sign 'bank-enterprise cooperation contract' with and supply credits to these 300 SOEs. In 1997, the number of the SOEs under the main bank system expanded to 512, and eventually it would expand to all the 1,000 largest SOEs selected by the SETC. Most of these 'double big' SOEs have nationwide, even international, operations. They, together with their numerous subsidiaries at home and abroad, own various channels for external finance. The main banks that they signed contracts with are hardly able to acquire information about their operations and financial situations to exercise effective supervision, not to mention intervention when necessary. The implementation of the main bank system in China turned out to have nothing to do with either preventing insider control or restructuring bad debts as suggested by the proponents of the Japanese main bank system. It functions more as a mechanism to guarantee sufficient credit supply for the largest SOE conglomerates and to merge smaller SOEs and expand their domestic market share during the current industrial restructuring.

Actually, the main bank system works the best when banks and firms have a long-term commitment to each other, and the banks do play an effective supervisory role in corporate governance, usually through board participation as the major shareholders. Even when banks are not allowed to hold company's shares, like the case in China now, the banks should have enough incentive and information to monitor the firms. The property rights structure of the banks must be clear enough for them to really care about the risks and profits involved in extending loans to firms. And the firms should have relatively few alternative sources of external finance other than loans obtained from the main banks. Therefore, many Chinese economists suggest that the main bank system would work the best in China if it had been established between small-scale regional banks and numerous small- and medium- size enterprises on a voluntary base (Li 1996b) (Yin 1996).[21] But the Chinese central policymakers did not choose to do so. It seems that, when they established the main bank system, they cared more about the credit supply for the largest SOEs, rather than a long-term healthy relation between the banks and firms.

[21] Corporatization and competition should be the focus of both banking reforms and SOEs reforms. Thus, most of Chinese and Western economists suggest that China should establish a competitive banking system centered around regional commercial banks for their size and scale are optimal in dealing with agency costs in corporate governance and engaging in meaningful

Table 4-1. The Asset Compositions of the Four State Banks, 1992-1997 (billion yuan).

	1992	1993	1994	1995	1996	1997
Total assets	**4539.8**	**5812.5**	**7122.5**	**8056.3**	**8754.7**	**9536.3**
ASSETS USED TO FINANCE CENTRAL GOVERNMENT EXPENDITURES	**n.a.**	**257.8**	**423.8**	**558.5**	**674.6**	**890.2**
Required reserves	n.a.	257.8	341.8	446.9	544.6	658.4
Central bank bonds	0	0	1.0	17.4	0	6.2
Treasury bonds	0	0	38.0	48.7	96.7	76.2
Policy bank bonds	0	0	43.0	45.6	33.2	149.4
As percentage (%) of the total assets[a]	**n.a.**	**4.5**	**6**	**6.9**	**7.7**	**9.3**
LOANS	**1956.8**	**2315.2**	**2730.1**	**3317.8**	**4177.1**	**4692.5**
% of the total assets	**43.1**	**39.8**	**38.3**	**41.2**	**47.7**	**49.2**
Fixed asset investment	392.5	517.1	693.9	833.2	1034.5	1156.2
% of the total assets[a]	8.7	8.9	9.7	10	12	12
Working capital	1564.3	1798.2	2036.2	2484.6	3142.6	3536.3
% of the total assets	34.5	30.9	28.6	30.8	35.9	37.1
Of which, loans to collective and private enterprises	116.7	139.9	119.5	110.0	125.4	16.1
% of the total assets	2.6	2.4	1.7	1.4	1.4	0.2[b]
OTHER ASSETS	**n.a.**	**3239.5**	**3968.6**	**4179.9**	**3903.1**	**3953.6**
% of the total assets	**n.a.**	**55.7**	**55.7**	**51.9**	**44.6**	**41.5**

Sources: *Almanac of China's Finance and Banking 1994*, pp. 440, 509-512; *Almanac 1995*, pp. 530, 532, 535; *Almanac 1996*, pp. 414, 429, 472-473, 491-492, 495, 499; *Almanac 1997*, pp. 529-530, 534, 538; and *Almanac 1998*, pp. 494, 509, 558-560, 581, 583, 586, 589.

a. Funds allocated solely by the central government.

b. Due to category change in original data, collective enterprises are not included.

n.a. Not available.

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market competition. Interviews, No. 21, 29, 68, 104, 113, 119. Also see (Liu and Qian 1994)

Table 4-1 shows the centralizing trend in asset compositions of the four state banks as a result of the central policymakers' restructuring efforts. At first, the total assets of the four state banks doubled in this period. This can be seen as evidence of capital flowing back to the state banking system as a result of successive crackdowns on non-state and quasi-state financial intermediaries. Secondly, the decline of other assets from 55.7 percent in 1993 to 41.5 percent in 1997 also shows the effectiveness of enhancing vertical control within the state banks to contain against capital outflows. The category consists of assets such as cash, trust funds, investments, securities, lending to other financial institutions, foreign assets, etc. As local branches of the state banks were prohibited from engaging in business other than making loans and holding government bonds, and encouraged to channel as many deposits upward as possible, it is natural to see the shrinkage of assets like trust funds, investments, securities, and loans to other financial institutions. Thirdly, the centralizing trend is also demonstrated by the increase in the assets held to finance central government expenditures. They rose from 4.5 percent in 1993 to 9.3 percent in 1997. The sharp increases resulted mostly from the four state banks' holding of central bank bonds, treasury bonds, and policy bank bonds since 1994. As the central policymakers had the four state banks increase their holding of these assets, the four state banks not only became the major sponsors (through their holding both of required reserves and policy banks loans) for the establishment of the three policy banks,

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(Qian 1995).

but also, by holding treasury bonds for the first time since the bonds were issued in 1981, further enhanced their role in financing government expenditures.

Since the socialist era before 1978, Chinese investment funds have traditionally been divided into two categories – fixed asset investment for long-term investment and working capital for seasonal production costs. As the state banks gradually took over government's budgetary obligations since late 1970s, bank loans were also divided into these two categories. After two decades of reforms, the loans for fixed asset investments still belong to the mandatory plan (*zhilingxing jihua*) and are under the control of the State Planning Commission (now the State Development Planning Commission) and the State Economic and Trade Commission (World-Bank 1995) (Lo, Xu, and Xie 1998). Therefore, the increases in loans for fixed asset investments can also been seen as evidence of greater central control. In this table we find from 1992 to 1997 loans for fixed asset investments had grew from less than 9 percent to 12 percent of the four state banks' total assets. Together with the assets used to finance central government expenditures in group one, the assets under central control had increased from 13.3 percent in 1993 to 21.3 percent in 1997.

In the meantime, loans for working capital are part of the indicative plan (*zhidaoxing jihua*) and have been gradually made subject to bank discretion over the years. The proportion of loans for working capital in total assets declined first and then increased after 1996 when the main bank system was established between the four state banks and the strategic SOE conglomerates. There is no published aggregate data to show how much working capital loans have been directed into the main bank system. But according to interviews with high-ranking bank officials, loans to the largest SOEs have increased from less than 60 percent in the late 1980s to around 75 percent in 1996 in both ICBC and CBC.[22] In some industrial cities, such as Nanjing and Shengyang, more than 90 percent of loans newly made in 1997 went to the strategic 1000 SOEs.[23] Another way to observe the structural changes in loans for working capital is to see the proportion to the non-state sector. We find the absolute value of loans to collective and private enterprises were consistently declining since 1994 in spite of the increases of the total assets in general. As a result, the proportion of loans to the non-state sector fell from 2.6 percent in 1992 to 1.4 percent in 1996.[24] The decline somehow reflected the fact that many bank branches at the county level – the most accessible level for non-state sectors - no longer had the rights to extend loans. Most of the loans were extended through centralized channels either in Beijing headquarters or in provincial branches to the largest SOEs.

The consolidation of the four state banks under central control, while if prevented capital from further flowing out of the state banking system, has weakened branch bank officials' morale. As the three policy banks only took over policy loans for the center's priority projects, the four state banks continuously shouldered most policy lending at preferential rates. The new regulations prohibiting banks from engaging in operations other than loans and government bond transactions that have reduced the sources of profits for banks to cover the losses caused by their policy lending. Bank profits therefore

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[22] Interviews with Zhang Xiao, the ICBC president, and the CBC headquarter officials, see (Jinrong yanjiu 1996). Also see author's interview, No. 100.
[23] See *Special Surveys* in *Almanac of China's Finance and Banking 1998*, pp. 280-283.
[24] The sharp decline to 0.2 percent in 1997 was caused by the category change in original data. Due to the structural reforms of the collective enterprises, the whole category was removed from the data since 1997. Some of them became private, some of them became state-owned. It is hard to find comparable data.

declined sharply. In comparison to the profits in 1992, the profits of the four state banks fell by 51.8 percent in 1994. Since 1995, they even began losing money (Jiang 1996). On the other hand, the recentralization of the four state banks also encountered passive resistance from local governments. The most commonly used method was the so-called 'pseudo bankruptcy' of the local SOEs. The local governments, usually local bank branches' intended ignorance, would have an old SOE transfer all valuable assets and personnel to a new company and call for bankruptcy of the old SOE. Thus, all the debts the old SOE owed the banks would be defaulted (PBC 1996).[25] From 1994 to 1997, the magnitude of nonperforming loans in the four state banks grew from 20 to 25 percent of the total outstanding loans (Lardy 1998, p.235). The situation soon forced the central policymakers to halt SOE bankruptcy reforms.

The restructuring made the local officials in the four state banks more like state bureaucrats than commercial bankers. Similar to their counterparts in the state-owned banks in Taiwan and South Korea during the 1960s and 1970s, these state bureaucrats would expand their operations only to the extent that state policy demanded. They would no longer enthusiastically seek market opportunities as they did in the 1980s when the profit retention system linked their personal benefits to branch profits. In 1997, for the first time the four state banks could not use up the credit quotas the PBC assigned to them. After fulfilling all the assigned policy tasks, local bank officials would rather deposit extra funds upward to superior branches than find good clients to make loans.[26]

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[25] Interviews, No. 21, 73 and 74.
[26] Interviews, No. 62, 67, 77, 134, and 137.

Reorganizations of the Comprehensive banks

As the four specialized banks were commercialized in 1994 and the Commercial Bank Law was enacted in 1995, the newly established comprehensive banks now would call themselves commercial banks. However, under the new regulatory regime, the term commercial banks means not only being for-profit, but also that they should get rid of all those non-bank financial businesses that they had been deeply involved. Like the four state banks, these newly established commercial banks were required to delink with all the non-bank financial departments or institutions, such as trust, securities, and insurance businesses, that they had previously set up. From now on, the competition among these commercial banks should be primarily based on savings and loans business at government-determined interest rates.

In comparison to the heyday of decentralized reforms in the late 1980s and early 1990s, the proliferation of the new commercial banks since late 1993 was modest in number and scale. Besides renaming one policy bank and two housing savings banks as commercial banks, only two commercial banks – the Hainan Development Bank and Minsheng bank - have been created since 1994 and the Hainan Development Bank was soon ordered to close by the PBC in 1998.[27] The Hainan Development Bank was established by Hainan provincial government in 1995. The bad timing crippled it with

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[27]The three banks converted to commercial banks after 1994 are the China Invsetment Bank, the Yantai Housing Savings Bank and the Bengbu Housing Savings Bank. The China Investment Bank was created in 1981 to disburse the project funds provided to China by the World Bank and later the Asian Development Bank. Since 1994, it was allowed to take deposits from the public, but still mostly involved in government project funding. The two housing savings banks were established in 1987 as experiments to help facilitate ownership transfer from enterprises to

bad loans after the bursting of the province's real estate bubble in 1993 as well as the government-forced merger with local urban credit cooperatives in 1997. Amid the Asian financial crisis, the PBC determined to pick it up as an example to demonstrate the center's willingness to let Chinese banks go bankrupt if they continued to ignore the problems of bad loans.[28] Minsheng Bank was established by the All-China Federation of Industry and Commerce (*Chuanguo gongshang lianhehui*) in 1995 as China's first private shareholding bank. Since it was designed to be owned by private enterprises and provide services for private enterprises, it should be seen as a test case of China's financial liberalization. Although the bank's chairman, Jing Shuping, has set a goal of being one of China's biggest banks within ten years, it has grown quite slowly. By 1997, it was still one of the smallest banks in China, with the total assets of 18 billion yuan, less than one-fourth of the assets of the China Investment Bank, the tenth biggest bank in China (see Figure 4-4).

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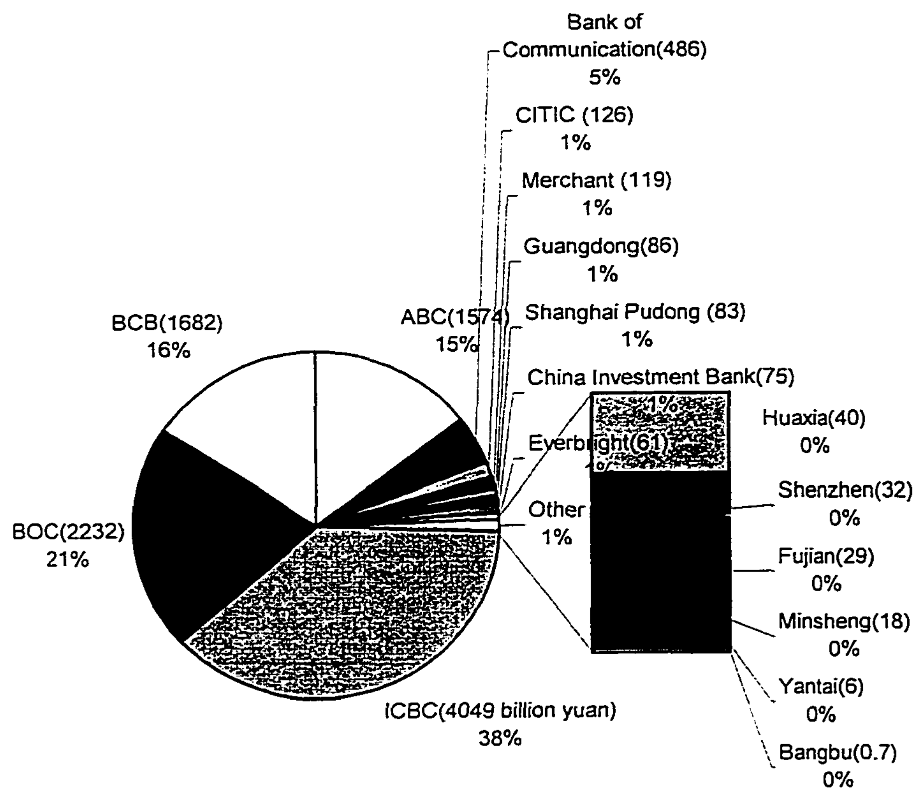
occupants. They are still not allowed to take deposits from public and still operate in small scale (Lardy 1998).

[28] Local officials in Hainan province may not agree that the Hainan Development Bank was the worst case in terms of bad loans accumulation. Agence France Presse Intl., 22 June, 1998, search through www.globalarchive.ft.com.

Figure 4-4. Market Share of the Four State Banks and the 13 Commercial Banks in Assets, 1997.



Sources: PBC, *Almanac of China's Banking and Finance*, 1998, p. 558-567, 571-578.

The nine commercial banks established prior to late 1993 have experienced different degrees of ownership restructuring since 1994. The most dramatic ownership change happened to the Bank of Communication. As mentioned earlier, the Bank of Communication was created to help local SOEs raise funds outside the traditional state credit plan. Since the bank was set up in 1987, it had a very *decentralized* ownership structure with each bank branch as an independent legal entity. In each bank branch, the local government and SOEs as the major shareholders of the branch exercised real control over the branch operation, and the bank headquarters in Shanghai had little say about it. In practice, the bank was more a federation of dozens of local banks than a bank with numerous branches. In 1994, the bank was ordered to centralize its ownership under the Shanghai headquarters. All local shares were concentrated to the headquarters and the local shareholders were made to exercise their rights of decision and dividends according to the size of their shares. The local bosses of each branch suddenly became numerous small shareholders of a big bank. The inherent collective action problem among these local shareholders ensured a better control of the central authorities over the restructured Bank of Communication. But the cost was the bank's profitability. As its governance structure became similar to the four state banks, so did its profitability. While other newly established commercial banks managed to keep profitability growing over the last several years, the Bank of Communication, similar to the four state banks, saw its profitability decline sharply. Measured by return on assets, i.e. return as the percentage of the total assets, the bank's profitability fell from 1.5 in 1995 to 0.6 in 1997. By comparison, the averaged profitability of the four state banks declined from 0.3 to 0.1

while the averaged profitability of other commercial banks increased from 1.5 to 1.9 (See Appendix C).

The reorganization of other commercial banks was accomplished by a substantial injection of new capital. The capital and assets of the CITIC Industrial Bank, Everbright Bank, Merchant Bank and Huaxia Bank expanded by six times on average from 1993 to 1997. Capital injection into these industrial group-run commercial banks was principally directed by the central government. One plain intention was to attenuate the dominance of one single industrial group. For example, in 1995 the financial authorities terminated Capital Steel Group's sole ownership of Huaxia Bank by ordering more than thirty large SOEs to join the ownership of the bank. The reorganization was accompanied by the "retirement" of the Group's chairman, Zhou Guanwu, and the arrestment of the chairman's son, Zhou Beifang, on charges of economic crimes (Lardy 1998, p.68). In the meantime, the Merchant Bank was also turned from a bank solely controlled by the Merchant Group in Guangdong into a bank jointly owned by 89 SOE conglomerates, with the central SOEs holding 51 percent of the shares (Jin and Xia 1996, p.20). The capital and assets of the Guangdong Development Bank, the Shenzhen Development Bank, the Fujian Industrial Bank, and the Shanghai Pudong Development Bank also increased by three times on average during that time. The capital injection to these regional banks was essentially led by regional governments. As the regional governments found that they were less able to control the local branches of the PBC and the four state banks after the recentralized reforms in the state banking system, they would have the SOEs under their control to switch to regional banks for banking businesses.[29]

[29] Interviews, No. 42 and 73.

Due to the modest expansion of the numbers of new commercial banks, the substantial capital injection into these banks did not change the minor status of this group of banks as a whole in China's banking system. As shown in Figure 4-4, by 1997 the 13 new commercial banks together only held 10 percent of the total bank assets, still tiny relative to the 90 percent held by the four state banks. Meanwhile, a clear division of labor between the Big Four and these small commercial banks has emerged with the Big Four focusing on the 1,000 largest SOE group and the small commercial banks servicing those SOEs that held their shares. Together with the new constraints on their non-banking operations and the room for interest rate fluctuations, the competition in the Chinese banking system has become even less market-oriented since the "commercializing reforms" started in 1994.

Repression on the Non-Bank Financial Institutions

The Party Center's 16-point austerity program (See Table 3-3 in Chapter 3) called for government units to immediately stop collecting funds illegally from enterprises and individuals, raising interest rates on state bank deposits and loans, and mandating all state banks to recover loans previously extended to the NBFIs. Together with the introduction of value-guaranteed long-term deposits by the state banks in July 1993, the previously disintermediated funds soon flew back from the NBFIs into the state banking system. Following the spirit of the Third Plenum Decisions, a series of regulations were carried out to clean up the NBFIs. It was the fourth time of the central crackdown against these 'growing out of the plan' financial intermediaries since the economic transition started in the late 1970s. But the measures were much more radical and profound this time.

Crackdown on the Trust and Investment Companies (TICs). The rise of interest rates in the state banks and the ordered 'delink' of the TICs from the state banks abruptly cut out the supply of funds the TICs. Deposits, the predominant source of supply funds, in the TICs fell by 30 percent from late 1993 to the first half of 1995 (Chong 1996, p.27). However, in the meantime, loans grew by 34 percent in the TICs (Chong 1996, p.28). It was because credit contraction in the formal banking system made the financially distressed local SOEs willing to pay higher interest rates for loans from the TICs in order to stay in business. The opposite development in demand and supply of funds in the TICs sent most of them into a credit crunch. The TICs thus became more inclined to engage in illicit activities in order to find alternative channels for funds. In 1994, they went to the stock market. In 1995, they crowded into the bond repurchase markets. Their rush for cash led to the irregular developments and subsequent government crackdowns of these markets.[30] Some TICs were charged with illegal transactions and financial crimes, and shut down one by one. The number of the TICs declined rapidly from 391 in 1993 to 244 in 1997.[31] Since then, the Asian financial crisis created a new momentum for another round of cleanup. The target at this stage was on the internationally-oriented TICs. Following the closure of the Guangdong International Trust and Investment Company (GITIC) in October 1998, the central financial authorities issued a series of directives to

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[30] Following the '*327 Incident*,' the most famous financial scandal of the non-bank financial institutions in recent years, the bond repurchase markets were completely closed at the order of the People's Bank of China in late 1995. See (Chong 1996, p.29), also Interviews, No. 79, 84, 104, and 136.
[31] *Almanac of China's Finance and Banking, 1998*, p. 652.

restructure the industry. Eventually, the central policymakers planned to reduce the number of the TICs to around 40, about one company per province, through merger and acquisition by large SOE conglomerates or government-authorized asset management companies.[32]

Nationalization of the Urban Credit Cooperatives (UCCs). By 1994, there were already more than 5,200 UCCs nationwide, holding substantial market share in many major cities - near 6 percent of the national deposits. They were private banks in everything but name, specialized in financial services for small- and medium-sized, non-state enterprises. The fact that they were not restrained by any banking regulations, such as credit quota control, reserve requirement, and capital adequacy, caused deep concerns of the central bank for its effects on macroeconomic stability. State-owned commercial banks also complained that the loose regulations and few tax obligations on the UCCs posed unfair competition to the state banks (Cai 1996) (Lin, Zhong, Huang, and Ye 1996). The central financial authorities thus decided to convert the UCCs into the Urban Cooperative Banks (UCBs). The Third Plenum Decisions clearly stipulated that 'the UCCs are to be converted into UCBs on a trial base.' From early 1995 to mid 1996, the State Council approved four groups of cities, 95 in total, to convert the UCCs in their jurisdiction into the UCBs (Song 1997, p.8). Although it was economically legitimate to incorporate the UCCs into the general banking regulations, the methods the Chinese policymakers opted for were actually to *nationalize* these collective and private financial intermediaries. First of all, all UCCs in the same city, regardless of their preferences, were required to join UCB in one city. The process was driven by administrative

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[32] Interview, No. 136. Also see *South China Morning Post* April 17, 1999, and *Dow Jones*

mandates rather than market forces. The forced conversion somehow resembled the centralization reforms of the Bank of Communication. Secondly, the financial authorities required the city governments to hold 30 percent of the shares in the newly converted UCBs. This requirement guaranteed that the city government would be the single largest shareholder and the chief manager of the new bank. The management personnel of the new bank would also be incorporated into the *nomenklatura* of the city Party committee. The collective or private-owned UCCs were now all turned into the state-controlled banks. Finally, as the newly converted UCBs as de facto city government-run banks no longer made loans on voluntary base as they used to be, their lending policies were now subject to the economic plans of the city governments.

The nationalization of the UCCs is contradictory to the 'growing out of the plan' reform strategy and at odds with the general trend of privatization in the 'real' economy. A Chinese economist from Zhengzhou, the city that set up the first UCC in China in 1979, drew parallels between the current nationalization of UCCs and the communization of agricultural production units during the Great Leap Forward in the late 1950s, and fiercely criticized its negative effects on the economic incentives of the converted financial intermediaries.[33] Official data for the profitability changes after conversion is not available yet. But the 'eating in a big pot' (*chi daguofan*) mentality is ubiquitous in the UCBs. Most of the original UCC owners were reluctant to join as a branch director or staff in the UCBs. They would no longer work 13 hours a day, seven days a week to provide financial services for customers. In the worst scenario, the original owner would transfer all the good assets into a new private company under his name and dump all bad

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Newswires May 24, 1999.

loans to the UCBs.[34] Many UCBs were thus from the onset crippled with the burdens of bad loans and from time to time fell into liquidity crisis. For example, the Zhengzhou City Cooperative Bank was experiencing severe bank run in the summer of 1998. The bank run even led to citywide protests lasting for months. Therefore, why would the Chinese policymakers turn the vibrant UCCs into inefficient state-controlled banks? It is actually quite conceivable in the context of current recentralized reforms of the banking system. As the central policymakers had reinforced the vertical control of financial flows within both the PBC and the state banks, the 6 percent of the national deposits held by the UCCs may be a good compensation to the city governments and their subordinate SOEs.

Ups and downs of informal finance in rural areas. The recentralization of financial flows in the formal banking system left little capital in the grassroots bank branches and RCCs to provide credits to peasants and small enterprises in rural areas. As the credits from the formal banking system became even less accessible, smaller SOEs, TVEs, private enterprises as well as poor peasants were forced to go 'underground' for their financial needs. As a result, informal finance in rural areas proliferated, rather than declined, since the financial recentralization started in late 1993. Local governments at county and township levels, with the support of the Agricultural Ministry, also intended to halt capital from being funneled out of the locale and started to set up more informal financial intermediaries to absorb deposits. The financial intermediaries they set up are usually called Rural Cooperative Foundations (RCFs, *nongcun hezuo jijin hui*) or Rural Mutual Savings Associations (*nongcun huzhu chujin hui*). They are seen as informal financial intermediaries because they usually don't bother to get approval from the PBC.

[33] Interview, No. 140.

There is no aggregate data to show the national trend of the RCF proliferation since late 1993. But individual case studies show that the deposits in these rural financial intermediaries had grown by 5 to 15 times in only a couple of years since 1994. In many townships, the RCFs had already gained market share as large as the ones of the forty-year-old RCCs (Li and Zhang 1995a) (Luo and Lei 1997). The development immediately caused serious concerns for the central financial authorities.

The rapid growth of the RCFs was worrisome to the financial authorities for several reasons. First of all, it may menace financial order in rural areas. Due to heavy intervention of the local governments, the asset qualities of the RCFs are generally bad and unsustainable in the long run. In order to collect as many deposits as possible, local governments would attack privately run informal financial institutions, such as credit rotation associations and pawn shops, in their jurisdictions to reduce local competition. It usually resulted in defaults and bank runs in these informal financial institutions, and even regional financial panics. In many poor areas where TVEs had already stopped operating for the economic recession in recent years, local governments simply lived on usury exploited from poor peasants who had to borrow to maintain basic living and pay taxes. The RCFs in these areas are potential sources of social unrest (Zhong 1996b). Secondly, the PBC as the regulator of China's financial system can not fully control the regulation and development of the RCFs. From the beginning, the development of the RCFs was not mandated by the PBC. It was spontaneously initiated by local governments in the countryside and then endorsed by some central government agencies in charge of agriculture. Thirdly, and to the deepest concerns of the central financial authorities, the

[34] Interviews, No. 40, 142, 144.

rapid growth of the RCFs in recent years has posed severe competition to the state bank branches and RCCs, and seriously eroded the foundation of the traditional state banking system in the countryside (Yu 1996).

In 1994, the PBC issued 'the Circular on Strengthening the Regulations of the Rural Cooperative Foundations' to mandate the PBC branches the authorities to regulate the RCFs. In 1996, the State Council issued 'the Decisions on the Reforms of Rural Financial System' to mandate the PBC local branches to clean up the RCFs (Shen 1997). The central financial authorities' idea was to incorporate the RCFs into the RCCs and restore the RCCs as the major financial intermediaries in the countryside. However, since the RCCs could not get rid of their obligations in financing government expenditures and investments in the near future, the idea was doomed to encounter the resistance from central agricultural departments and local governments.[35] On top of that, the reign of the PBC could only reach as low as the county-level administration, it simply did not have the capacity to implement the policy. Therefore, as long as the recentralized state banking system, represented by the RCCs in the countryside, could not satisfy the financial needs of the grassroots, the RCFs will survive the sporadic crackdown from the financial authorities.

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[35] Although the RCCs were ordered to 'delink' from the ABC in 1995, the ABC still held most assets of the RCCs. In addition, the RCCs were now, like the state banks, required to hold both required reserves and extra reserves in the PBC and purchase government bonds and financial bonds. As a result, the RCCs have been shouldered even more burdens of financing government expenditures and investments after the financial reforms. They were left with little capability to provide financial services to enterprises and individuals in rural areas. See (Qio 1994) (Feng 1995) (Liu 1996) (Wang 1997).

To sum up, the vibrant NBFIs, striving at the mercy of the state, were once again suppressed by the central financial authorities as greater concentration of capital was needed to guarantee the credit supply for the central priority projects and cool down the overheating economy. However, the sudden credit contraction and recentralization in the formal banking system created enormous demand for alternative credit supply in the economy. Economic actors ranging from local SOEs to poor peasants were willing to pay higher interest rates as alternative sources for their survival. The strong demand in turn induced the NBFIs to take risk and expand in an environment full of policy and market uncertainties. In the worst match of state power and market forces, the post-Deng financial reforms witnessed government despotic rules and market opportunistic behaviors reinforcing each other and together triggering a downward spiral of financial disorder and recession. Bank runs and financial crimes, reported and unreported, have pervaded everywhere and still see no sign of decline.

Conclusion

In order to regain better control over the allocation of national financial resources, the post-Deng central leaders have re-established a highly centralized banking system in an increasingly diverse economy. The enhancement of vertical control over internal governance and financial flows within the four state banks has largely reduced the intervention from local governments in the lending operation of the four state banks. With the vast sale of policy bank bonds to the four state banks and the establishment of the so-called "main bank system" between the four banks and the 1,000 "double big" industrial conglomerates, the central planners obtained greater control over the credit allocation of the four largest state banks. Meanwhile, through substantial capital injection to the newly established commercial banks, some SOE conglomerates and provincial governments obtained a better position to control these smaller banks and increasingly relied upon them to finance their investment projects. A clear division of labor has therefore emerged between the four largest banks and dozens of new commercial banks, with the "big four" serving the development goals of the central planners and the rest serving the financial needs of some regional governments and SOEs.

On the other hand, the "growing out of the plan" financial intermediaries emerging from the decentralized reforms during the Deng era were identified as the source of "leakage" for capital outflows from the state credit allocation system; the wily competitors to the local branches of the state banks; and the villains for financial disintermediation and economic disorder during inflation. The central financial authorities have launched series of campaigns to "clean up" these newcomers. They were either ordered to close or forced to be incorporated into the broader state banking system – such as the conversion of the UCCs into the UCBs in the cities and the merger of the RCFs into the RCCs in the countryside. The serial "clean-up" campaigns were attempts to reduce the role of these non-state players in channeling national financial flows and the competition they created to the state banks. However, as long as the restructured state banks, preoccupied by the tasks to finance government expenditure and investment, are left with little capacity to serve the financial needs of the non-state sectors in an increasingly diverse economy, the non-state financial intermediaries will continue emerging to fill this gap.

Part II

Political Succession and Economic Policymaking

Chapter 5

Reorientation of Policy Platform amid Political Succession

"Social and political unrest may come about if we fail to bring the economy under control... We must grasp well the priority task of fighting inflation and other dislocations."
– JIANG ZEMIN, *the general Party secretary in a speech to senior cadres in mid 1993.*[1]

"There's no overheating in securities investment... There is no overheating in the property market, either. The city's economy is fast developing in a healthy and coordinated manner."
- WU LIANG, *a deputy mayor of Guangzhou, referring to local economic situation in mid 1993.*[2]

"Policies are the major weapons in the struggle for power in the [Soviet] system."
– ZBIGNIEW BRZEZINSKI and SAMUEL HUNTINGTON.[3]

As analyzed in Part One of this dissertation, the post-Deng Chinese leaders' policy reorientation from "devolving power and yielding benefit" (*fang quan rang li*) to "macro-level adjustment and control" (*hong guan tiao kong*) has successfully stabilized the overheating economy since late 1993. The inflation rate was pulled down from 13.2 percent in 1993 and 21.7 percent in 1994 to 0.8 percent in 1997.[4] But

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[1] Willy Wo-Lap Lam, 'Jiang warns of political chaos,' *South China Morning Post* (thereafter, SCMP), May 25, 1993.
[2] Willy Wo-Lap Lam and Carrie Lee, 'Plan to reverse cash drain,' *SCMP*, July 1, 1993.
[3] See (Brezezinski and Huntington 1963, p.191).
[4] Although the austerity program started from the summer of 1993, the inflation rate kept growing until 1994. Because, as discussed in chapter 3, despite the tightening of overall credit expansion, the central government had to keep pumping in more money to finance those priority projects whose earmarked policy loans had been diverted to other use in the old distribution system of the relending funds.

the overall economic growth rate also fell from 13.5 percent in 1993 to 8.8 percent in 1997. The economic slowdown was especially salient in those go-go provinces of the Deng era. For example, the growth rate declined from 40.2 percent to 8.3 percent in Hainan, from 22 percent to 10.2 percent in Guangdong, and from 26 percent to 11 percent in Jiangsu. While most economists would agree that the economic slowdown was necessary for inflation control and the rate of the slowdown was within an acceptable range, the political leaders in Chinese provinces did not think so. In fast growing areas such as Guangdong, Fujian, Jiangsu, and Shangdong, local officials were unanimous that the economy was not overheating and their regions could and should grow even faster. On the other hand, officials in poorer inland regions did not want to be left behind and argued that they should grow even faster than the richer coastal regions (Lin 1999, p.323). Trapped in the competition for beating the average growth rate, the localities simply did not share the sense of urgency with the central leaders for the center's declining control over the economy. They would, rather, have more investment funds being allocated to their regions to achieve higher growth, regardless of its effect on macroeconomic stability.

The dismay of local governments against the policy reorientation was evident in the constant arguments, implicitly or explicitly, between the center and localities over how the reforms should proceed in the last several years. The most significant evidence of their disagreement on the post-Deng reform direction was the timing of the Third Plenum of the Fourteenth Party Congress itself. It was originally scheduled to convene in late June 1993, forced to be put off several times, and finally held in November. During the time, top leaders, especially Jiang Zemin and Zhu Rongji, made a series of tours to different regions and gave pep talks to relatively small groups of regional chiefs to seek support for the center's new policy platform.[5]

Another indicator of the antipathy of local cadres towards the policy reorientation was the low approval rates for the passage of both the Budget Law and the Central Bank Law – the most important legislation for the post-Deng fiscal and financial reforms – in the National People's Congress (NPC). In 1994, the Budget Law was passed by a rate of 77.5 percent – a very low rate in the NPC history. The provincial representatives were unhappy with the Law because the provincial governments were prohibited from the same right as the central government to run budget deficits and issue bonds.[6] One year later, the Central Bank Law was passed at an even lower rate of 66 percent in 1995, following a two-year contention between the State Council and the provincial representative-participating NPC Standing Committee over the control right to the Monetary Policy Committee of the People's Bank of China, the central bank's formal decision-making body.[7]

The local resistance was also unveiled in the post-Deng top leaders' own words. The best known was Zhu Rongji's gruesome joke about asking his aides to prepare 100 coffins for his rectification campaigns against wayward regional officials – 99 for recalcitrant local cadres and one for himself.[8] In the meantime, officials in powerful regions tried several ways to resist the reversal of decentralized reforms. For example, local leaders from Guangdong, such as Guangdong Party secretary Xie Fei, former secretary Lin Ruo, and Shenzhen Party secretary Li Youwei, had constantly lobbied Party elders and Politburo members for the continuity of Deng's policy lines,

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[5] Willy Wo-Lap Lam, 'Party's power is frozen by overheated economy,' *SCMP*, June 23, 1993.

[6] Shi Yinfeng, 'Datan sanzijin – zhonggong gaoceng litu wenjian qiojing' (Speaking in three-word slongans – the Chinese Communist leaders tried to promote progress with stability), Zhongguo shibao zhoukan (China Times Weekly), *CTW* thereafter, April 10, 1994, p. 6-8.

[7] Wang Fang, "Zhongnanhai jiefa jiaojin – 'zhongyang yinhang fa' beiho de zhengzhi jiaoli" (The contention through legislation among top leaders in Zhongnanhai – the political struggle behind the passage of the 'central bank law'), *CTW*, April 2, 1995.

especially after Deng Xiaoping appeared to be dying and no longer active in policymaking.[9] In order to broaden their alliance, the Shenzhen city government even set up a special fund in showering favors on the People's Liberation Army, the single most important power bloc in the political system.[10]

In short, the post-Deng policy reorientation resulted in serious tension between the center and localities, although the consequent macroeconomic stability, in theory, should have benefited the localities as well.

Conventional theories of central-local relations portray provincial officials as the new establishment of entrenched interests who were the most important beneficiaries and constituencies of Deng's decentralized reforms. With increasingly abundant economic resources and complicated local patronage networks on their side, these provincial officials have proved themselves being able to block central policymakers' attempts to recentralize or rationalize the distribution of national financial resources in the late 1980s when the central leadership was severely divided (Goodman 1994) (Lieberthal 1997). Some also argue that the division then in the central leadership was mostly caused by succession competition that doomed the contending successors to promote policies that appealed to provincial officials in order to earn their political support. They would find it 'unthinkable' to roll back the decentralized reforms (Shirk 1993).

According to these theories, it is therefore puzzling how the post-Deng leaders have the political power and incentive to reverse the seemingly irreversible trend of decentralization in the distribution of national finance. Political succession should

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[8] Willy Wo-Lap Lam, 'No joke about Zhu's bid for premiership,' *SCMP*, July 17, 1996.
[9] Daniel Kwan, 'Three SEZ bosses clash with Beijing,' *SCMP* March 9, 1995.
[10] 'A shadow over Shenzhen,' *SCMP*, January 25, 1995.

have presumably engaged them into the competition of promoting decentralization in exchange for local support. The puzzle calls for a revisit of the theories of central-local relations.

The Central-Local Relations Revisited

Given that China is the only large country in the modern world that is still governed under a unitary governmental structure, the intragovernmental relations between the center and localities, especially provinces, have always been one of the major concerns of the Chinese top leaders,[11] and so has it been among the most heavily researched fields in the study of Chinese politics.[12] The central-local relations even drew more attention during the Deng era for the realignment of power and resources between the center and localities was from the outset the linchpin of Deng's reform strategy. Under the slogan of "eating in separate kitchens" (*fenzhao chifan*), the local governments shouldered more spending responsibility as well as granted more autonomy in mobilizing and allocating various financial resources, such as SOE profits, bank loans, budgetary and extra-budgetary revenues, foreign capital, etc, to meet local development needs. Although there was no consensus among students of central-local relations on whether the redistribution of financial resources was in favor of the localities, they all agreed that the evolution made the local governments more self-reliant and created strong incentive for local officials to preserve as much power and resources under their control as possible (Shirk 1990) (Oksenburg, 1991) (Wong 1991) (Wang 1995; Yang 1994) (Zhang 1999).

[11] As early as in the 1950s, the central-local relations were considered by Mao as one of China's major problems. See Mao's "On the Ten Great Relationships," see (Schram 1974).
[12] See (Chung 1995) for a comprehensive review of the field.

Local officials gradually developed their own distinct preferences vis-à-vis the central policymakers' for the speed and structure of investment expansion, and became more willing to bargain with the center for local interests. As to the political implication of these changes in local preferences and bargaining power, while some quickly jumped to the conclusion of a "weak center and strong localities" situation and started warning the possible disintegration of the Chinese political system (Wang and Wu 1993) (Wang 1995), others would cautiously examine the implication by studying the real bargaining process within an institutional context. After all, political institutions, as an essential intervening variable between the constellation of preference and power on the one hand, and policy outcomes on the other, have always played a crucial, if not the determinant, role in the policymaking process. As a framework to provide opportunities and constraints to the choices of political actors, political institutions have their own independent effects on policy outcomes, that are intertwined with, rather than determined by, changes in social preferences and power constellation (Riker 1980) (Moe 1990).

The works to examine the impact of changes in local preferences and bargaining power on China's policy outcomes within an institutional context can be roughly divided into two groups. One is to identify several policy areas and then systemically examine the evolution of bargaining relations between the center and localities at the macro level (Lieberthal 1988) (Lieberthal and Lampton 1992) (Shirk 1993). The other is to conduct in-depth case studies of one or several provinces to examine the degree of local discretion in policy implementation (Goodman 1997) (Cheung, Chung, and Lin 1998) (Li 1998). A general impression of these works together can be summarized as following: First of all, the decision-making authority, at least for economic bargaining, has become increasingly "fragmented." It is argued that, as the bargaining process becomes quite complex and involved more units as a result of the decentralized reforms, there is an increasing need for "consensus decision-making" among various units in order to initiate an investment project or a new policy (Lieberthal 1988) (Lieberthal 1992). Secondly, as the localities developed more alternative sources to the funds allocated by the central projects, some local units have become the "centers of economic power" and acquired better bargaining positions vis-à-vis the central planners in policy implementation (Goodman 1994). Thirdly, as the bargaining position of the local units was bolstered by their economic power, it has become less and less clear whether it is the center that holds the localities accountable, or *vice versa*. For example, David Goodman finds that the impasse of the center's attempt in taxation reforms and the emergence of regional mercantilism 'appear to support an argument that economic and by extension political power has passed, or is passing, from the centre to the provinces' (Goodman 1994, p.6). In other economic policy areas, scholars also find that 'bargaining involves negotiations over resources among units that effectively have mutual veto power' (Lieberthal 1992, p.9).

In an ambitious attempt to adopt rational choice theory to analyze the political logic of China's economic reforms, Susan Shirk goes even further to make falsifiable propositions of the changes in accountability flow between the center and provinces in the Chinese political system. Inspired by new institutionalism, Shirk sets the focus of her study on the roles of delegation and accountability in the policymaking process. She argues that economic decentralization was Deng's political strategy to nurture local officials as a political counterweight against the powerful central bureaucracy, who presumably had vested interests in perpetuating central planning. In comparison to its Soviet counterpart, the political structure Deng inherited was a fairly decentralized one with relatively strong local power and less entrenched central bureaucracy. Under this circumstance, Deng could "play into the provinces" rather than, like Gorvachev, opening up the political arena to mass participation in order to build a policy coalition against the entrenched interests in the traditional socialist system. As economic decentralization endowed provincial governments with more economic power, the provincial officials, through their holding of an increasingly significant number of seats in the Central Committee of the Chinese Communist Party, would have both the incentive and clout to hold top leaders "reciprocally accountable" in the policymaking process. In the meantime, the top leaders in the face of succession competition would have the incentives to earn political support from these increasingly powerful economic warlords by making policies in the form of "particularistic contracting" (Shirk 1993).

Although none of the above analyses has explicitly claimed that the Chinese political system has evolved into a pluralist one as a result of Deng's decentralized reforms, they all assert that in the reform era leading provincial officials have become the most important, or at least one of the most important, groups of political constituents for the Chinese central policymakers. The economic decentralization endowed them with the incentive and power to play the middlemen for interest articulation and, when necessary, voice out for local interests in the central policymaking process. Nonetheless, this general impression still leaves a few unresolved questions for further examination. First of all, have the provincial chiefs replaced the central bureaucrats to be the vested interests in the system that had provided indispensable support for Deng's reform approach, and yet become the major resistant force against further reforms? The majority of the works cite the impasse of fiscal rationalization and SOE liberalization in the late 1980s and early

1990s as evidence of the local political clout in blocking the central leaders' policy initiatives. It seems that these economic warlords have become the most conspicuous entrenched interests standing in the way of China's transition towards a market economy.

The situation therefore leads to the second question that needs to be clarified in future studies: Can the center still hold the local officials accountable? Or now it is the local chiefs holding the central policymakers accountable? Almost all of the works have pointed out that, no matter what else happened in the bargaining between the center and localities, the center still controls the appointment of the local leaders! In formal political institutions, it has never changed that the center still can hold the local leaders accountable by threat of dismissal (Goodman 1994, p.4) (Lieberthal 1997, p.12). However, the central policymakers would never enjoy the degree of discretion in policymaking that Mao had enjoyed. Informally, the local officials, bolstered by their newly acquired economic and political power, were increasingly able to influence central policymaking. Some would see this kind of influence as a form of accountability (Shirk 1993).

Finally, related to the above two questions, how much policy autonomy do the central policymakers still possess? Is the devolution of resources and power from the center to localities irreversible? Some would say so. As argued by Shirk, the new situation, combined with the factors of succession politics, made it 'unthinkable for ambitious central politicians such as Hu Yaobang, Zhao Ziyang, and even Li Peng to attempt to roll back the reforms' (Shirk 1993, p.196). It seems that the fierce opposition from provincial officials would block any attempt of the central leaders to recentralize or rationalize the distribution of financial resources in particular, and the economic reform approach in general.

However, the central policymakers' efforts to rationalize and recentralize the distribution of national finances since late1993 demonstrated the opposite to the impression these theories have presented. In this new round of bargaining for fiscal and financial reforms, the localities were not as formidable as these studies portrayed. In several occasions, the rationalization and recentralization proceeded in a quite arbitrary and assertive manner. The local officials, made scattered attempts to protest, but were unable to formulate an effective political action against this policy reorientation. On the contrary, the central policymakers appeared quite effective in holding local chiefs accountable in implementing new reform measures. When the central leaders were not satisfied by local compliance, they would not hesitate to remove the local chiefs as punishment. The presumably fierce succession competition among the post-Deng leaders seemed not to make them vulnerable to local resistance. The central leaders appeared to preserve much more policy autonomy than the above theories allow. The contradiction calls for further examination of how the political institutions play the role of intervening variable between the changes in social forces and policy outcomes in the Soviet-type political system, and how the role has evolved in China's reform era.

The Political Institutions of the Soviet-type Political System

The Soviet-type political system had traditionally been portrayed as a totalitarian system whereby the use of terror, ideology, and rigorous party organization allows a handful of communist leaders at the apex of the system to monopolize all political power (Friedrich and Brzezinski 1966). However, in reality the system was not as monolithic as the totalitarian model depicts. Interest divisions and conflicts in the system are found to be as prevalent as in any other political system. In the case of China, the study of political cleavages and coalitions started to flourish in the 1970s when the Great Leap Forward and the Cultural Revolution unveiled severe power struggles within the Chinese political elite. Because of the unsettled nature of Chinese political institutions, the locus of the analyses during the time was mainly put on informal political institutions where patron-clientel networks were the major forms of political coalitions and particularistic favors are the interests to be delivered in the system (Nathan 1973) (Tsou 1976) (Dittmar 1978) (Pye 1981).

In the 1980s, as economic reforms enhanced interest differentiation among bureaucratic departments, and information of interest articulation and bargaining became more accessible to researchers outside the system, the focus of studying coalition politics in China thus gradually shifted to the policymaking process in formal political institutions (Shirk 1985) (Lampton 1987) (Lieberthal 1988). While the studies of informal politics are more able to capture the pure power logic in coalition building, the analyses of policymaking in the formal bureaucratic system were better at identifying the substantial interests of particular bureaucratic units and predicting their potential political lineups. For example, in his factionalism model, Andrew Nathan's hypothesis of 'live-and-let-live,' 'no win' pattern of factional contests (Nathan 1973) vividly captures the logic of coalition building in political oligarchy whereby, as rational choice theorists assert in their deductive models, political actors have strong incentives to cheat and a political cartel is difficult to sustain (Ramseyer and Rosenbluth 1995; Riker 1967). In contrast, by focusing on sectoral interests in the formal bureaucratic system, Kenneth Lieberthal and Michel Oksenberg can trace the conflict and coordination step by step in the policymaking process in China's energy industry (Lieberthal 1988).

The recognition of political cleavages and coalitions in the Soviet-type political system highlights a fact that, despite the authoritarian nature of the system, top policymakers, even as predominant as Mao Zedong and Deng Xiaoping, need political constituencies when making policy. Thus, the problems are how they mobilize their political constituencies, what is the nature of the policy coalition between the policymakers and their constituencies, whether we can find a distinctive logic of coalition politics in the system, and how similar or different it is from the coalition politics in democratic systems. As mentioned in the last section, in her work *the Political Logic of Economic Reforms in China* (Shirk 1993), Susan Shirk tried to answer these questions by adopting the theories and concepts that rational choice theorists developed to analyze delegation and accountability flows in the democratic system to the case of China. While recognizing that the Chinese Communist Party, rather than the Chinese citizens, is the ultimate "principal" in the delegation relationship of the system, and that the low degree of institutionalization of the formal institutions results in a preeminent role of informal authorities, such as the "retired" revolutionary elders, in the decision making process, Shirk draws our attention to the delegation relationship *within* the formal institutions of the Party. She argues that the "reciprocal accountability" between top leaders in the Party Politburo and their selectorate in the Party Central Committee provides strong incentives for the top leaders to 'promote policies that appeal to groups in the selectorate' (Shirk 1993, p.90). [13] And during succession struggles, 'contending leaders promote policies that

[13] "Reciprocal accountability" defines a situation where 'selectors such as bureaucrats can be appointed and removed by the very leaders whom they appoint and remove' (Roeder 1993, p. 27). In the Leninist party-state system, 'according to the party rules, the Central Committee has the authority to choose the party leaders, and the Central Committee consists of party, government, and military officials appointed by party leaders. The leaders appoint the officials and the officials in the Central Committee choose the leaders... The lines of accountablity run in both directions, turning a hierarchical relationship into one of "reciprocal accountability"'(Shirk 1993, p.83). The model is developed by Philip Roeder and Susan

transfer authorities and resources to groups in the selectorate and avoid policies that retract benefits' (Shirk 1993, p.91). The "reciprocal accountability" model indicates that, under certain circumstances, such as succession struggles, the central policymakers would become the "agents" of the powerful groups in the selectorate in this "reciprocally accountable" relationship. And as a result of Deng's political strategy of economic reforms, the provincial officials together had constituted the largest group in the Central Committee and could hold contending successors accountable in making economic policies in their favor.[14]

In the same enterprise of adopting the language of Western institutional economics to analyze the delegation relationship between top leaders and the provincial officials in the Chinese political system, Yasheng Huang, concerned with the problems of bureaucratic control, conceptualizes the relationship as one of an administrative hierarchy where the top leaders are the principals, and the provincial officials are the agents (Huang 1996). Therefore, he provides us a somehow opposite picture to Shirk's, of the evolution of delegation relationship between the top leaders and provincial officials during the reform era. Huang argues that, by firmly holding the monopoly over personnel decisions, the top leaders can effectively hold provincial officials accountable. Like agents in all hierarchical organizations, provincial officials have an ultimate goal of remaining in office and would 'behave strategically and

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Shirk together. While Shirk uses this model to explain polcymaking in China, Philip Roeder adopts the model to the case of the Soviet Union. Given that the formal institutional power of the Party Central Committee had been highly institutionalized in the former Soviet Union since the Khrushchev era, the model is more appealing in explaining Soviet politics. Similar concept, such as "a circular flow of power," actually has been used to analyze Soviet politics for a while, see (Daniels 1971).

[14] During the Thirteenth Party Congress (1987-1992), the provincial representatives composing 38.6 percent of the Central Committee membership was the largest bloc in the selectorate. However, in the 14th Congress and the 15th Congress, members the Party center and central government together increased from 35.4 percent in 13th Congress to 40.2 percent and 42 percent. Members from provinces declined from 38.3 to 32.8 and 32.1. The central bureaucracy thus became the largest bloc in the Central Committee in post-Deng China. See

opportunistically' in response to the incentives provided by the institutions (Huang 1996, p.4). Although economic decentralization has provided strong incentives for provincial officials to pursue local economic development and cultivate local patronage, when central leaders tighten their political controls, the provincial officials will have the incentive to comply with the center's policies in order to remain in office. Yasheng Huang further subjects this argument to a statistical test of the effects of both political and economic incentives on local officials' compliance to the center's inflation control and finds a result in favor of his argument (Huang 1996, Part III).

The opposite pictures in Shirk versus Huang's models provide result from their distinct research interests. Interested in the politics of coalition building in an authoritarian regime, Shirk assumes that the provincial officials have constant preferences for particularistic favors to local benefits and puts her focus on how political institutions constrain the top leaders' behavior in policymaking. Her model therefore ends up stressing on the *bargaining* aspects of the communist political system in which bargaining between top policymakers and their political constituencies has become increasingly manifest in the policymaking process. On the other hand, concerned with the effectiveness of bureaucratic control in the authoritarian regime, Yasheng Huang assumes that the central leaders have coherent interests in providing public goods, such as inflation control in his case, and focuses his analysis on how political institutions constrain provincial officials' behavior in implementing central policy. His model therefore emphasizes on the *hierarchical* aspects of the communist political system in which political control still plays a predominant role in explaining local agents' behavior in spite of the economic reforms. While Shirk's model has been faced with a severe challenge in explaining

China News Analysis No. 1347, p.7 and No. 1594, p.4.

the post-Deng central leaders' willingness and capability to rationalize and recentralize the allocation of national finance amid succession competition, Yasheng Huang's model cannot explain why a faction of top leaders, such as Deng Xiaoping, Hu Yaobang, and Zhao Ziyang, had initiated economic decentralization and encouraged the expansion of local investments in the first place.

Anyone familiar with the Chinese political system would find both the bargaining and hierarchical accounts of the communist system are true in describing the operation of current polity. The problem thus is under what circumstances one mode will prevail the other. As observed by Lieberthal, 'the grant of flexibility [to localities] is conditional not constitutionally based.... When national leaders are united... the Chinese system thus still functions in a centralized, remarkably disciplined fashion' (Lieberthal 1997, p.11-12). In fact, Susan Shirk already recognizes that 'when the leadership is unified, the Central Committee normally ratifies the leadership's policy decisions. But when the leadership is divided by succession competition, the Central Committee may become the bargaining arena' (Shirk 1993, p. 91). Yasheng Huang also points out, in inflation control, 'when there are sharp policy conflicts at the top, it appears that local officials might doubt the credibility of the central austerity programs and choose to ignore central strictures against investment expansions' (Huang 1996, p.5). The vacillation of the delegation relationship between the central policymakers and their constituencies in the bureaucratic system seems largely contingent upon *the resolution of collective action problems in top leadership.*

Indeed, as argued by Philip Roeder, in the two-tier model of "reciprocal accountability" that he and Shirk together developed, policymakers on the top and selectors on the bottom are both faced with collective action problems within their own tier. 'Within the first tier policymakers struggle for power, while in the second tier interests, bureaucratic or social, compete for policy favors' (Roeder 1993, p.30). In the meantime, policymakers in the first tier have collective interests in reducing their dependence upon the selectorate and increasing control over it; selectors similarly have common interests to do the same thing vis-à-vis policymakers. When actors in one tier are severely divided, the balance of power between the tiers will shift toward the other tier.

The Soviet-type political system stressing democratic centralism is inherently in favor of the central policymakers in regard to collective action because it strictly prohibits horizontal communication and coordination in the rank and file of the bureaucratic system. Selectors in the system, constrained by this rule, cannot undertake effective collective action unless certain top leaders initiate it in the first place. Thus, as long as the first-tier leaders are united, collection action of the second-tier political elite is almost impossible. This institutional constraint may help explain why the Leninist system is the most stable system among all types of authoritarian political institutions.

However, collective action is also hard to achieve within the top collective leadership. When the top authority is shared by a handful of leaders, rather than monopolized by one dictator, each leader will have the incentive to reach out for political support in order to increase his share of power in the collective leadership. As each leader privately sells political favors to outsiders to build up his own faction, the political cartel of the collective leadership becomes hard to sustain. The factionalism will continue until one dictator emerges, or the intensifying competition leads to the opening of the political arena to previously disenfranchised participants.[15]

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[15] The enlargement of participation may finally result in democratization, see (Roeder 1993)

Therefore, in the collective leadership of the Soviet-type system, division is normal and unity is the exception.

In the People's Republic of China's history, we have witnessed that succession competition would further intensify the factionalism in the collective leadership. Two of the most serious leadership splits in the history – the Cultural Revolution in 1968 and the Tiananmen Incident in 1989 – occurred during the time when top leaders were enthusiastically engaged in faction buildup for political succession. It is thus natural for Shirk to argue that political succession is destined to divide the top leadership and make the leaders particularly vulnerable to demands from entrenched political constituencies in the bureaucratic system.[16]

Nonetheless, a unique feature of the Soviet-type institution would complicate the relationship between political succession and collective action in the top leadership. That is, the need for the top leadership to take assertive action to demonstrate the effectiveness of their collective authority *when they have just assumed power.* As argued by Valerie Bunce in her pioneering study of the connection between policy cycles and succession politics in the Soviet system, 'power in the Soviet system, even more than in Western states, is fluid, particularly in the aftermath of a succession struggle.... By introducing policies that are more responsive to mass demands...the new leader and his colleagues in the Politburo could anticipate and thereby dampen any mass unrest that may break out during the uncertain times of a succession crisis' (Bunce 1980, p.967-368).

When uncertainty is high, it is especially important for the top leadership to confirm the populace's perception of the effectiveness of their authority.[17] The

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and (Ramseyer and Rosenbluth 1995) for examples.

[16] Similar pattern was also observed in the Soviet Union since the 1920s. See (Roeder 1985).

[17] Steven Solnick has argued that, in comparison to the erosion of the credibility of the top

introduction of a new policy platform in a determinant manner is a way to demonstrate to the society the effectiveness of the top authority during the uncertain period of political succession. It is even more important for the top leaders to confirm this perception among officials in the bureaucratic system. In his analysis of the collapse of the communist regimes in the Soviet Union and Eastern Europe, Mancur Olson argues that:

> 'The fragility of autocracies grows out of the *perceptions* of the government's civil and military officials. If a government's operatives, and especially those in the police and the military, *believe* that they will be punished if they fail to carry out their orders and rewarded if they do, an autocracy is secure. If the cadre perceive that a dictatorship is invincible, it cannot be overthrown by its subjects' (Olson 1990, p.16).

In the language of institutional economics, unlike the principal-agent relations in the public and private hierarchical organizations in Western societies, the authorities of the principals, i.e. the top leaders, over the agents, i.e. the rank-and-file officials, in the Soviet-type hierarchy are not enforced by clear legal or procedural norms. Instead, in the absence of a third-party adjudicator of jurisdictional conflicts, the authorities of the principals in the Soviet-type hierarchy can only be enforced by the fact of control. That is, the agents' continuing expectation of punishment when violating the principals' command. As the expectation erodes, agents' opportunistic behavior in the principal-agent relationship will go from shirking to outright appropriation and may finally lead to the collapse of the system (Solnick 1998). Therefore, continuous demonstration of the effectiveness of the top authority, especially in a situation with high uncertainty, such as during political succession, is crucial for the survival of the collective leadership as well as any individual successor.

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authorities in other Soviet systems, the harsh crackdown on the Tiananman movement has served the function to demonstrate the effectiveness of the Chinese Communist authorities

Each contending successor thus has the incentive to temporarily work together to maintain the perception.

Proponents of the "reciprocal accountability" model may question why the new leaders 'should appeal to the broad populace during a succession crisis rather than to more powerful constituencies' within the bureaucratic system when introducing new policies to show their effectiveness, since 'it is the proximate elecorate [within the bureaucratic system] that must be satisfied during a succession' (Roeder 1985, p.959). However, the powerful constituencies of the precedent leaders may not offer the same degree of support to the new leaders as they did to their predecessors, even if the new leaders carry out the old policy lines to please them. To the contrary, the new leaders will be better off in the two-tier relations if they reorient the policy platform and set new recruitment criteria to replace the old officials (or the selectors) with new ones who are grateful for the promotion and thus more loyal to the new leaders. As long as the top leadership holds the *nomenklatura* of the selectorate, the top leaders can replace those recalcitrant selectors with their own loyalists as long as they are united and firm in exercising their appointment right.

In sum, when contending successors of the Soviet-type system have just collectively assumed power from their predecessors, the need to manage the populace's expectation and the power to replace high-ranking political elite will temporarily unify the successors to introduce their own policy platform and establish their own constituencies. It was evident in both the former Soviet Union and China. In the case of the former Soviet Union, Jerry Hough finds a correlation between the ascent of new generations of technocratic elite and the successions of Khrushchev and Brezhnev (Hough 1980). Various research on China's political elite recruitment also

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and helped save the regime from collapse (Solnick 1996).

find that in the late 1970s and early 1980s Deng and his colleagues, in order to consolidate the power they had just assumed collectively, also utilized reforms to set new recruitment criteria to replace the Cultural Revolution beneficiaries with "rehabilitated" technocrats as the new leadership's major constituencies. For example, in his study of how the changes in organizational and personnel structure provided a friendly environment for policy implementation in post-Mao China, Christopher Clarke argues that 'reform of the structure would have to proceed along with, and in some cases await, removal of opponents, co-optation of neutral and still useful bureaucrats, and promotion of "good successors"' (Clarke 1987, p.32). Hong Yung Lee, in his study of the changing patterns of cadre recruitment criteria in China, also finds the correlation between policy reorientation and cadre reshuffle during the consolidation period of the Deng regime: 'The shift of the regime's main task from revolutionary change to economic development resulted in a change in the composition and recruitment of the cadres' (Lee 1991, p.2).

Therefore, one may benefit from dividing succession in the Soviet-type system into two periods: *succession preparation* and *succession consolidation*. During the preparation period when the incumbent leaders are still in charge of major policy platforms and personnel decision, contending successors will thus be eager to earn political support from powerful constituencies of the existing leaders. That is what Susan Shirk observed in the behavior of Hu Yaobang, Zhao Ziyang, and Li Peng in the late 1980s. Once the succession proceeds into the consolidation period (that is, when the successors collectively have assumed power, and the incumbent leaders no longer control policy platforms and personnel decisions), the successors will temporarily work together to demonstrate the effectiveness of their collective authority by reorienting policy platform on the one hand, and replacing the constituencies of the old regime with their own men on the other. It was in this fashion that Deng and his colleagues consolidated their power in the late 1970s (Dittmar 1990). The post-Deng leaders would have the incentive to do the same thing in the mid 1990s.

Figure 6-1. New Appointments of provincial Party secretaries and governors, 1979-1997

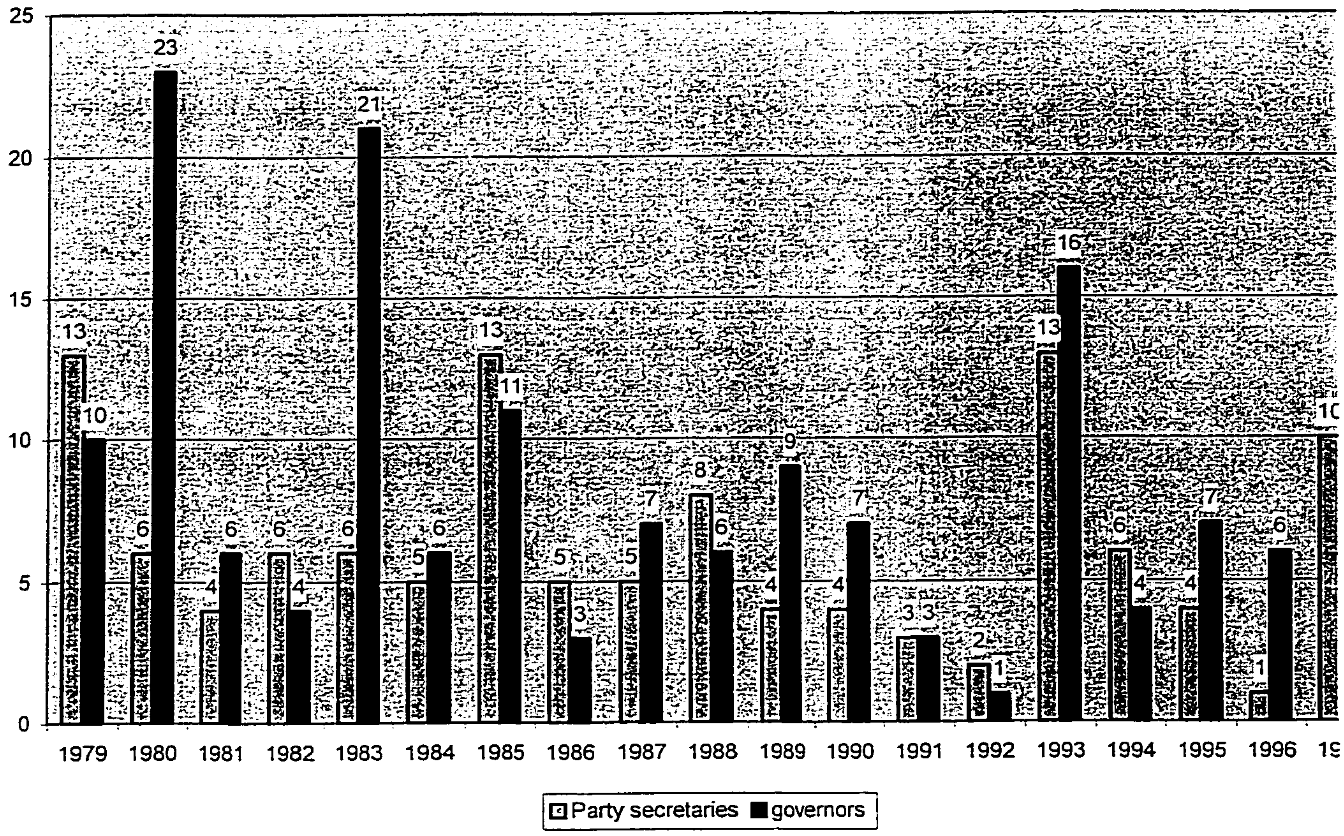

Figure 6-1 shows that during the reform era the turnover of provincial Party First Secretaries and governors was particularly frequent in the intervals of the five-year terms of the provincial leaders right after the Eleventh Party Congress in 1977 and the Fourteenth Party Congress in 1992 – the time periods of succession consolidation for the Deng regime and the Jiang regime. In the next section, a qualitative analysis of how the post-Deng policy reorientation proceeded will be used to illuminate the political logic of succession consolidation discussed above. A statistical test of the argument against hypotheses derived from various theories of central-local relations is provided in Chapter 6.

Political Succession and the Reorientation of Policy Platform in Post-Deng era

In the summer of 1993, China's top leaders were faced with the sharpest decline in both state budgetary revenue and bank deposits since the reform started in 1978, despite the rapid growth of the general economy. The situation in turn led to inflation, lack of sale of treasury bonds, enlargement of regional disparity, as well as financial disorders in selective areas. In the absence of a well-fledged legal system and social safety net, the financial turbulence was accompanied with rampant political corruption and social unrest. But what concerned the central leaders the most was that they were increasingly perceived as losing control over the polity as well as the economy. Not only did some Chinese intellectuals start to warn that the country would move from economic collapse to political breakup soon, Western China watchers also began to wonder, 'Can the center hold?'[18] The speculation was furthered intensified by the surprising breakdowns of the Communist regimes in Eastern Europe and the former Soviet Union and the foreseeable passing-away of the

[18] Wang Shaoguang and Hu Angang made an internal report to the Chinese government to state that "If 'a strongman' [Deng] dies, it is possible that a situation like post-Tito Yugoslavia will emerge." Quote from (Yang 1994, p. 60). For the speculation of Western China watchers,

'political strongman' Deng Xiaoping and his cohorts. The post-Deng central leaders therefore had to show the world that they were able to rule; they were even more effective than their predecessors in tackling chronic structural problems in the economic system. To do what their predecessors failed to do – to reverse the drain of power and funds from the center to localities - was a good way to demonstrate the effectiveness of the central authority.

The intention to show their assertiveness was evident in the way the policy reorientation was launched. First of all, the reform measures were usually carried out in an arbitrary manner without consultation with local governments in advance. As Lou Xiaopeng, a preeminent Chinese economist, observed, 'it was unprecedented during the reform era. The center in the 1980s always consulted with localities in advance when policies involving the redistribution of local interests were about to be carried out.'[19] In the post-Deng financial and fiscal restructuring, the reform measures were usually announced unilaterally by the central authorities with a deadline for implementation and a punishment measure for those who missed the deadline. The announcements were followed by several cross-ministry investigation teams being sent down to the regions to supervise the implementation of the policies. For example, in the conference called by the People's Bank of China to tighten central control over the financial system in July 1993, the central financial authorities announced the so-called "three dos and 10 don'ts" to national and local banking officials, and set deadlines for implementation. And Zhu Rongji, the executive vice

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see (Shambaugh 1993) and *The Economist*, 'Can the Centre hold?' November 6, 1993.

[19] Luo further argues that the chronic problem of the central-local relations should not, and would not, be resolved by recentralization. Recentralization will do nothing good but enhancing the distrust between the center and localities and decreasing transparency of the system. The problems could only be resolved through institutionalized negotiation and delegation between the center and localities. See He Ping, 'Difang quanli kuozhang youli gaige – zhuanfang jingjixuejia Luo Xiaopeng (The expansion of local power is good for reforms – interview with economist Luo Xiaopeng),' *CTW*, April 3, 1994, p. 21-23.

premier and then central bank governor, told the banking officials in the conference that 'he would not hesitate to fire or punish those bankers who would not comply with the financial tightening measures.'[20] The way the policy measures were delivered seemed to assume that the localities would not comply without the center's threat of punishment, and thus the center has to show its resolute.

Secondly, as the center needed to bargain with the localities for the details of policy implementation, such as the implementation of the newly established tax assignment system, the central leaders would negotiate with local officials individually with credible instruments of sanctions on hand. Since the summer of 1993, the post-Deng central leaders, Jiang Zemin and Zhu Rongji in particular, have made extensive tours to regions to negotiate with localities one by one for the redistribution of budgetary revenues under the new system. They usually went down with an army of investigation teams and the resolution to sack local officials if the localities were reluctant to compromise. For example, it was reported that Shen Daren lost his job as Jiangsu provincial Party secretary in October 1993 because he had a heated argument with Zhu Rongji earlier when Zhu came down to negotiate for the shares of revenues (Yang 1994, p.86). Another example is Shao Qihui, the Heilongjiang Party secretary. During a trip to Heilongjiang in the spring of 1994, Zhu Rongji severely criticized and then sacked the provincial party boss in front of the province's high-ranking officials when Zhu found the province was beset by rampant corruption and lawlessness.[21] With the willingness to exercise the center's personnel appointment, the top leaders proved that they still had the upper hand when bargaining with local officials in spite of the economic power the localities obtained

[20] Willy Wo-Lap Lam, 'Cadres handed list of strict dos and don'ts,' *SCMP*, July 9, 1993.
[21] 'Governor of lawless province replaced,' *SCMP*, May 23, 1994; Zhong Xingzhi, *CTW*, August 21, 1994.

during Deng's decentralized reforms.

Thirdly, in propaganda the central leaders packaged the battle between the center and localities over the redistribution of national financial resources as a fight between collective interests and self interests. Slogans such as "sacrificing for the national interests" (*gu quan da ju*), "stability above everything" (*wending yadao yiqie*) , etc. were often made the major themes in top leaders' policy speeches and official newspapers' editorial articles. It posed a very interesting contrast to those famous slogans, such as "let a part of people get rich first (*rang yibufen ren xian fuqilai*)," during the heyday of Deng's decentralized reforms.

By packaging the conflicts between the center and localities as a crusade of the center to fight for collective interests, the central leaders could boost the central authorities and earn popular support at the same time. In the name of ensuring the success of the center's efforts to preserve national interests, the top leaders since the Fourth Plenum of the Fourteenth Party Congress in 1994 have issued a series of regulations to boost "absolute party leadership" over the regions and individual economic units.[22] Furthermore, recalcitrant economic warlords under the pressure of collectivity were forced to comply with the center's edicts. For example, in the summer of 1995, Xei Fei, the Party secretary from Guangdong, the richest but the most unruly province in China, was pressed to make self-criticism of Gaundong's failure to follow the central policy line closely enough at the annual leadership meeting in the north China seaside resort of Beidaihe. In explaining why Guangdong failed to make more contributions to central coffers and comply with 'macro-level

[22] "The Central Committee of the Communist Party of China's Decision on Several Important Issues in Strengthening Party Builing" was issued in the Fourth Plenum in September 1994. It dealt with three sets of issues in strengthening Party building: democratic centralism, strengthening of Party organizations, and cadre selection and appointment. Serial regulations were therefore introduced by the Organization Department of the Party. For the documents and detailed discussion, see(Bo 1999).

adjustments and controls' of the central government, this Politburo member reportedly said, 'my understanding of central instructions may not be deep enough. That's why I have modified them to suit the conditions of Guangdong.'[23]

Another example of the mixture of the central-local conflicts and the crusade for national interests is the anti-corruption campaign. By directing the commonly shared resentment against the structural problem to specific political figures in the localities, the center could earn popular applause on the one hand, and purge those locally powerful, who arose in the Deng era on the other. The most conspicuous example is the corruption case of Chen Xitong, the Beijing Party secretary, which exploded in 1995. The case drew nationwide attention not only because people were shocked by the degree of corruption in the national capital's high-ranking officials that was incrementally revealed during the investigation, but also because they were impressed by Jiang Zemin's ability to replace a deeply-entrenched native patronage network in the capital with his own non-native protégés. In sum, by portraying the struggle between the center and localities as a fight for collective interests, the top leaders have successfully utilized the pressure of collectivity to make those once powerful regional leaders the villains of the post-Deng central leaders' crusade.

Finally, as the central authorities vis-à-vis localities were gradually consolidated, more comprehensive rules for selection and appointment of regional cadres were introduced to undermine regionalism. For example, in the Party Organizational Department's "Circular on Resolutely Preventing or Rectifying Unsound Practices in the Work of Cadre Selection and Appointment" issued in 1994, it is clearly pointed out that the unsound practice to be rectified includes favoritism, personal favors, and using personal power in selecting or appointing cadres. "The Temporary Regulation

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[23] Willy Wo-Lap Lam, 'Party chief to face rough ride,' *SCMP*, August 15, 1995, and "Party

on Selection and Appointment of Party and Government Leading Cadres" subsequently issued by the Party Central Committee in 1995 made undermining regionalism an even more explicit goal: besides emphasizing "the Party controls the cadres," it also made "avoidance" a primary criteria for selection and appointment of leading cadres (Bo 1999). The "law of avoidance" was a well-known practice of the traditional Chinese central government and had been adopted by Mao in the early 1960s to weaken increasingly serious localism (Teiwes 1967) (Kau 1969). It was revived again by the post-Deng central leaders to undermine powerful economic warlords nurtured by Deng's decentralized economic reforms. The cadre rotation is both between the heartland and coastal areas and between the central-level ministries and provinces.[24] Since 1999, even county-level cadres were affected by the new rules for cross-region rotation.[25]

As the rules for cadre rotation were enforced, more and more powerful local patronage networks were broken up and replaced with either central bureaucrats or local irrelevants to constitute the new leadership's loyalists in local officialdom. For example, as Jiang Cunyun was transferred from the position of Shangdong provincial Party secretary to the central cabinet in 1994, the center preferred to appoint a non-native, rather than Zhao Zhihao, the Shangdong governor, to fill the position because Beijing thought Zhao is 'too independent-minded.'[26] Zhao Zhihao was thus unable to sit in the position long. Three years later, he was replaced by Wu Guanzheng, a non-native technocrat from Hubei. The chronic battles between the post-Deng central leadership and Guangdong were finally settled with the replacement of both the

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boss 'to be sent away'," *SCMP*, September 7, 1995.

[24] Willy Wo-Lap Lam, 'Beijing steps up official job swaps,' *SCMP*, June 23, 1994, and "Rule change to halt 'warlords'," *SCMP*, August 1, 1995.

[25] Willy Wo-Lap Lam, 'Jiang rotates cadres to curtail fiefdoms,' *SCMP*, February 3, 1999.

[26] WillyWo-Lap, 'Xie exclusion concerns cadres,' *SCMP*, September 30, 1994.

outspoken party bosses of Guangdong and Shenzhen, Xie Fei and Li Youwei, with non-natives, and comprehensive reshuffles of local officialdom with the appointments of many fresh faces from the central bureaucracy.[27] The large-scale cadre rotation in last several years have not only prevented regionalism from emerging again, but also placed a group of young officials in the localities, who are grateful to the current leadership for promotion and cautiously staying within the lines of the central policy goals.

To sum up, being perceived as fragile and unable to rule the bureaucratic system and the economy, the post-Deng Chinese central leaders had strong incentive to temporarily work together to demonstrate the effectiveness of their collective authority. By doing what their predecessors failed to do – to reverse the drain of power and funds from the center to localities - in an assertive manner, the post-Deng leaders could confirm to society and, even more so, to the rank-and-file in the bureaucratic system that the top authority was as effective as ever. Furthermore, by reorienting the policy platform, the post-Deng leaders could set new recruitment criteria to replace the recalcitrant economic warlords who had arisen under the previous regime with new officials as their own constituencies in the local officialdom.

[27] Xie Fei was replaced by Li Changcun, the Party secretary of the northern province Henan and Jiang's protégé, and Li Youwei was replaced by Zhang Gaoli, Guangdong vice governor. A group of central bureaucrats were also sent down to take part in the local leadership to ensure the province staying in lines with center's policy reorientation. The most noticable is the new vice governor, Wang Qishan, who is not only from the financial sector of the central bureaucracy (serving as the president of the Construction Bank of China before being sent to Gaungdong), but also a protégé of Zhu Rongji and the son-in-law of Yao Yilin, the right-hand man of the former conservative guru Chen Yun. The importance of Wang Qishan in rectifying the unruly behavior of the southern province was evident in the dominant role he played during the GITIC financial crisis.

Conclusion

The post-Deng Chinese central leaders' efforts to rationalize and recentralize the distribution of national financial resources seemed to show that the Chinese top leadership, even during political succession, have much more policy autonomy than conventional theories of central-local relations suggest. The previous fifteen years of devolution of funds and decision-making power to the localities did not create the local leading officials as the new establishment of entrenched interests in the decentralized reforms, who had the political clout to block any attempt of the top leaders to reverse the decentralized trend. Although economic decentralization endowed the local officials with more incentives and bargaining power to demand for particularistic favors from time to time, it has never changed the primary rules of the game in the former political institutions. In the two-tier relations between the top leadership on the one hand and the provincial chiefs on the other, the democratic centralism still preempts the possibility for provincial leaders to make horizontal communications and coordinate collective action. Therefore, when central control over the distribution of national financial resources resumed, they could not conduct effective political action to defend their collective interests, if it had not been initiated by a paramount leader, like Mao Zedong or Deng Xiaoping, in the first place. On the other hand, the monopoly of personnel allocation still grants a united central leadership the political power to hold provincial leaders accountable, no matter how rich and recalcitrant the economic warlords have become.

The resilient effects of the Soviet-type political institutions result in a distinctive political logic of leadership succession that has been ignored in previous studies of central-local relations. To be sure, most scholars agree that a united central leadership still possesses high policy autonomy because, united, they can hold officials in the bureaucratic hierarchy accountable and obtain their compliance to unwelcome policies. But they did not realize the fact that succession consolidation will temporarily unify, rather than divide, the contending successors to enhance the authority of the collective leadership vis-a-vis the bureaucratic hierarchy. In the Soviet system, the distinctive need of continuous acknowledgement of the top authority during uncertain time drives the new successors to work together to confirm the general perception of their effectiveness. While they are united, the control over local *nomenklatura* provides these successors with the power to repress any resistance from below against their policy reorientation. Thus, when consolidating their newly acquired power, successors in the Soviet system would not compete with each other to continue the old policy lines in order to placate the political constituencies of the previous regime. Rather, they would temporarily work together to overcome the temptation of factionalism in the collective leadership in order to maintain their collective survival. Once the consolidation of central leadership vis-a-vis the bureaucracy and the society is accomplished, the potential opponents of the new regime has been undermined, and the survival of these top leaders are ensured, the oligarchic logic of collective leadership will resume and factionalism will prevail if no successor is powerful enough to inaugurate himself as the new dictator. The factional political struggle between the reformers led by Deng Xiaoping and the conservatives led by Chen Yun since 1981 is one example (Dittmar 1995). The same dynamic is foreseeable in the post-Deng collective leadership.

In retrospect, in the absence of political reform, economic decentralization in the Deng era has never really made provincial officials the entrenched interests of the system that have veto power over any central policy initiatives against their interests.

As argued by Shirk, the provincial power elite was intentionally nurtured by Deng Xiaoping to serve as a political counterweight against the central bureaucrats in Deng's gradual approach to socialist transition. The political power of this political counterweight has never been institutionalized in any meaningful sense. Without the paramount leader's support, the provincial officials have no substantial political power to defend the economic privileges they enjoyed in previous regime.

Chapter 6

Political Succession and the Turnover of Provincial Leaders

> How could the top leaders resume central control over the financial system? Didn't the local governments protest?
> 'Because the center controls the *wu shia mao ji zhi* (personnel system)!' – a leading financial economist in Beijing.[1]

> 'Don't think because you have money now you can bargain with the center. I tell you, although you have money, your appointments are still controlled in the hand of the center!' – JIANG ZEMIN, the general Party secretary in an internal talk to provincial leaders.[2]

In last chapter, we have drawn evidence from anecdotal stories and government documents to show how the post-Deng central policymakers used their control over the provincial *nomenklatura* to obtain compliance from the increasingly wayward regional economic warlords with the resumption of central control over the financial and fiscal systems. We argue that the political institutions of the Soviet system creates a distinctive dynamic of political succession, in which the contending successors during *succession consolidation* – that is, when they have just assumed power and need assertive action to demonstrate the effectiveness of their collective authority – will temporarily work together to introduce a new policy platform and replace political constituencies of the old regime with their own loyalists. By

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[1] Interview, No. 104.
[2] Zhong Xingzhi, 'Zoxiang ho-Deng Xiaoping shidai – Zhongnanhai anzhong jiaojing' (Step into the post-Deng Xiaoping era – the underlying power struggle in Zhongnanhai), *Zhongguo*

reorienting Deng's decentralization platform in an assertive manner and exercising appointment rights over local leading cadres in higher frequency, the post-Deng central policymakers could reassure the public about the effectiveness of the top authority.

The purpose of this chapter is to employ quantitative methods to demonstrate the above argument as well as to test competing hypotheses derived from different theories of the central-local relations. By subjecting various theoretical hypotheses to a statistical test designed according to commonly accepted scientific rules of inference, if not being falsified, we can accept the theories with more confidence. Moreover, by combining both qualitative and quantitative methods to make observations on a research question – in our case here, whether succession politics in the Soviet system affects the balance of power between the top leaders and their constituencies, we improve the reliability of our conclusion (King, Keohane, and Verba 1994).

The political survival of provincial leaders, i.e. the provincial leaders' turnover, is a good indicator of the changes in the balance of power between the Chinese central government and the provinces. On the one hand, the *nomenklatura* system in the Leninist regime makes control over the appointments of local leading cadres the primary instrument for the Chinese central leaders to maintain their rule (Burns 1987) (Burns 1999). On the other hand, remaining in office has been approved in different political systems to be the prerequisite and thus the first priority for any ambitious politician in pursuit of political goal. It is therefore logical to expect the political survival of provincial leaders to be the major battlefield in the tug of war between the central and provincial governments during the reform era. Moreover, to observe the

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shibao zhoukan (China Times Weekly), August 21, 1994.

political survival of provincial leaders over time, we can also test the effects of succession politics on the dynamics of central-local relations.

Based upon the contending theories of central-local relations and our succession politics proposition, we formulate a set of testable hypotheses on the correlation between various explanatory variables and the political survival of provincial leaders and employ event history analysis methods to estimate the hypotheses. We expect that the provincial leaders are faced with higher risk of turnover during succession consolidation.

Theories and Hypotheses about the Political Survival of Provincial Leaders

Most existing quantitative studies of the tenure of Chinese local leadership focus on the recruitment, rather than turnover, of local leading cadres.[3] By comparing the attributes of newly recruited local leaders with their predecessors, these studies can trace the transformation of the political elite in the political system, and then analyze its relations with broader social, economic, and political changes in society. For example, in his systemic study of the transformation of leading cadres in the bureaucratic system from Mao to Deng era, Hong Yung Lee finds that, as economic

[3] Both recruitment and turnover are the results of the center's exercise of its appointment right. While the study of recruitment analyzes the composition of newly appointed officials, the study of turnover focuses on the relations between the attributes of the *removed* officials and the action of removal itself. In other words, it usually uses the frequency of turnover to estimate with which attributes the officials are more likely to be removed. In this study, the turnover simply refers to the removal of an existing provincial leader. We don't make distinction between promotion and demotion because it is very difficult to make a judgement of that. For example, Ye Xuanping, the former Guangdong Party boss, was "promoted" to be the vice chairman of National People's Congress in the early 1990s, but everyone knows that was the center's effort to *xiao fan* (purge feudalism), and Ye and Guangdong officials fought against the "promotion" for a while. In fact, according to Zhiyue Bo(Bo 1996), promotion is very rare for the provincial leaders because their positions are already very high in the bureaucratic system. According his estimation, over 1949-1994, only 3 % of provincial leaders experienced promotion.

development replaced socialist revolution as the primary goal of the nation, pragmatists and technocrats have largely replaced ideologues and party hacks in the Deng era (Lee 1991). In their analysis of the demographic composition of the Thirteenth Central Committee of the Chinese Communist Party, Li Cheng and Lynn White find that the political elites in the late 1980s were much younger and better-educated than their predecessors (Li and White 1988). Later in a follow-up analysis of the "fourth generation of leaders" in the 1990s, Li Cheng asserts that the leaders from the "fourth generation," defined as leaders who were born between 1941 and 1956, and shared similar experiences during the Cultural Revolution, have gradually taken over the leading positions of the bureaucratic system from the third generation in the late 1990s. This new generation of leaders is 'more diversified than previous generations in terms of formative experiences, political solidarity, ideological convictions, career paths, and occupational background' (Li 2000, p. 3).

Besides demographic composition, various studies of local leadership recruitment also show some political patterns underlying the general trends that reflect the dynamics of the central-local relations in the reform era. For example, in their study of the pattern of 247 mayoral recruitments in Chinese major cities during the mid-1980s, Li Cheng and David Backman find that the issue of localism has risen 'to a degree of importance perhaps unprecedented in the political history of China.' In their estimation, over 70 percent of all mayors in the study were natives or were born in a neighboring province (Li and Bachman 1989, p.65 and 71). However, the increase in the proportion of native sons in the local leadership by itself tells us little about how the center responded to this new trend. Did the center passively accept the trend and recruit more natives to local leading positions? Has the emergent localism caused tension and conflict between the center and localities that in turn resulted in more frequent turnover of local leaders? Only when we shift our focus from recruitment to turnover of the local leading cadres can we answer these questions.

Frederick Teiwes pioneered the field by using the purge of provincial leaders to analyze the conflicts between the Chinese central and local governments in Mao era. In his study of the purge of provincial leaders in 1957-1958, he uses the cases to discuss the disagreement between the center and the provincial governments over several policy issues before the Great Leap Forward (Teiwes 1966). In the 1980s, James Tong also used the turnover of the provincial Party First Secretaries to measure the conflicts between the central and provincial governments over revenue distribution in the 1970s. In his analysis of the relationship between political status of provincial Party First Secretaries and the fiscal status of the provinces, he finds that, from 1971 to 1982, the Party First Secretaries from those provinces that remitted more revenues were more often removed by the center than those that remitted less. Tong therefore argues that the positive correlation between the removal of provincial leaders and their contribution to central revenues indicated higher conflicts between the center and these provinces, and the center's intention of ensuring local compliance with central policies by replacing the local leadership (Tong 1989). Following Teiwes and Tong, this chapter also uses the turnover of provincial chiefs, i.e. provincial Party First Secretaries and governors, as an indicator of the propositions about the central-local relations that we discussed in last chapter.

As analyzed in last chapter, there are generally two perspectives on the evolution of the central-local relations in post-Mao China. The *bargaining* perspective stresses the effect of economic decentralization on the evolution of central-local relations. It argues that devolution of economic resources and decision-making power in Deng's economic reform has resulted in the expansion of local economic power as well as the fortification of local patronage networks, that in turn would bolster local bargaining power vis-à-vis the central policymakers. On the contrary, the *hierarchical* perspective emphasizes the top leaders' remaining control over personnel allocation in local officialdom. It argues that, despite the economic decentralization, the central policymakers can still hold local leading cadres accountable in policy implementation. Inspired by a broader theoretical tradition in the studies of elite politics in the Soviet political institutions, this study proposes that the central-local relations are neither evolving in a linear fashion towards greater political power in the localities, nor did the center hold constantly tight control over time. Rather, it varies with the political dynamics in the broader political context. And succession politics is an important factor to determine which mode, the bargaining or the hierarchical, prevails.

Based upon these theories, we build three models for the statistical test. In each model, the probability of a provincial chief's turnover, i.e. the dependent variable, is seen as a function of a set of independent variables that were derived from specific theoretical hypotheses.[4] First, the *bargaining model* includes four independent variables. They are local economic power (ECOPOWER), birthplace of the provincial chief (BIRTH), career path of the provincial chief (CAREER), and the numbers of the province's representatives in the Party Central Committee (CC). The bargaining perspective generally supposes that the expansion of local economic power bolsters the local bargaining position vis-a-vis the center by either providing alternative sources to central grants for local investments or nurturing the development of local patronage networks (Goodman 1994) (Bo 1996). Therefore, the ECOPOWER should have a *negative* effect on the probability of a provincial chief's

[4] Turnover as a dichotomous variable can only have two values – 1 for the occurrence of the turnover and 0 otherwise. For dichotomous variable, we usually the logit model, instead of Ordinary Linear Square model, to estimate the probability for the occurrence of the event.

turnover. That is, the more economic power the province possesses, the less likelihood the provincial chief will be removed. Another popular theory in the pluralist perspective is that the increase of local power leads to localism and immobilism in the appointment of local leading cadres (Li and Bachman 1989). Thus, both BIRTH and CAREER should also have *negative* effects on our dependent variable. That is, if the provincial leader is a native son/daughter, or has developed his/her career mostly in the province, it is less likely for him/her to be removed from the position. Finally, in Susan Shirk's controversial theory of "reciprocal accountability," she argues that increases in the number of provincial representatives in the Party Central Committee have bolstered the provinces' bargaining position and forced the top leaders to make policies appealing to these power blocs in their selectorate. Therefore, we can test this theory by examining whether the number of provincial representatives in the Party Central Committee help the provincial leaders' to maintain their own survival. We thus also expect a *negative* correlation between the number of CC representatives and the probability of a provincial leader's turnover in the bargaining model.

Secondly, the *hierarchical model* includes three independent variables to test whether the central policymakers use their control over personnel allocation to hold provincial leaders accountable in implementing policies that concern the central policymakers. The three variables are chosen according to three different assumptions of the central policymakers' role in the economic reform. If we assume that the central policymakers' major concern in policy implementation is the provinces' revenue contribution to the central coffers (Tong 1989), we should expect the provinces' willingness to contribute to the central coffers (REVENUE) to have a *negative* effect on the probability of provincial chief's turnover. That is, the more willing the provincial chief is to compromise with the center in bargaining for revenue distribution, the less likely he/she is to be removed.[5] If we assume that the central policymakers' major policy concern in monitoring local officials' behavior is inflation control (Huang 1996), we should expect a *positive* effect of the province's investment growth (INVGROW) on the probability of the provincial chief's turnover. That is, the more rapid the province's investment grew (the less willing the province is to comply with the center's investment control policy), the more likely the provincial chief is to be removed from the position. Finally, if we accept the assumption that the central policymakers' major policy concerns is regional disparity (Wang and Hu 1999), we should expect a *negative* correlation between the provision of public services, such as public health and education, and the probability of provincial chief's turnover. Due to the problem of data availability, we can not find a measurement for the provision of education with data complete enough to create a testable variable. We use the growth rate of hospital bed (HOSPBED) as an indicator for the provision of public health. We anticipate the higher growth rate of hospital beds should lead to lower probability for the provincial chief's removal form office.

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[5] The independent variable here is different from the one in James Tong's model. In Tong's model, the higher the revenue contribution a province made, the more likely the Party First Secretary of the given province would face turnover. See (Tong 1989). But the high revenue contribution cannot measure the compliance of the province. It usually reflects the wealth of the province. Thus, the positive correlation between revenue contribution and provincial leaders' turnover in Tong's model does not mean a positive correlation between the province's compliance and the leaders' turnover. Rather, it means that leaders from richer provinces were more likely to have conflicts with the center over revenue contribution and, thus, were more likely to be removed. In our model, we are interested in the correlation between the province's compliance and its leaders' turnover. Thus, we test the effect of the *willingness* of the provinces to contribute to the central revenues rather than the absolute monetary values. Therefore, the anticipated direction of the correlation between the two variables in our model is different from that of Tong's model. We will discuss how to measure the willingness of the provinces to contribute to central revenues in detail in the section where we build the analytical models.

Thirdly, the *succession model* proposes that the provincial chiefs experience a higher risk of turnover during succession consolidation periods because the top leaders during this period are more willing to exercise their appointment rights demonstrate the effectiveness of the central leadership's authority. Therefore, we expect the succession consolidation period (SUCCESSION) to have a *positive* effect on the probability of provincial chief's turnover.

In addition, we also include three control variables that are anticipated to have strong effects on our dependent variable, but not related to the theories of interest here. Thus, we incorporate them into our model to control their effects, but do not put particular focus on them when interpreting the testing results. These variables include the tenure length of the provincial chief (DURATION), the legal age for retirement (RETIRE), and whether the provincial chief has college or higher education (COLLEGE). By intuition, we can expect a *positive* effect of tenure length on the probability of provincial chief's turnover. That is, the longer the provincial leader has served the position, the more likely he/she is to be removed. Beginning in 1982, the Chinese central leaders abolished the life tenure system for Party and government functionaries. A retirement age of 65 was set for provincial Party First Secretaries and governors (Manion 1992, p.234) (Burns 1999, p.588). Therefore, we should add the retirement age of 65 (RETIRE) into our model as a control variable. We expect those provincial chiefs whose ages are 65 and above to be more likely to face turnover. Finally, education has generally been seen as an important criterion for leadership recruitment throughout the reform era (Li and Bachman 1989) (Burns 1999). In 1995, the Party center even explicitly stipulated that 'candidates for provincial or departmental leading posts should have at least a four-year college education' (Bo 1999, p.7). Therefore, in regard to removal, we expect provincial chiefs with college education or above are less likely to be removed.

Table 7-1. Summary of Hypotheses

Models	Independent Variables	Predicted Effects
Pluralist Model		
	ECOPOWER	Negative
	BIRTH	Negative
	CAREER	Negative
	CC	Negative
Bureaucratic Model		
	REVENUE	Negative
	INVGROW	Positive
	HOSPBED	Negative
Succession Model		
	SUCCESSION	Positive
Controls		
	DURATION	Positive
	RETIRE	Positive
	COLLEGE	Negative

Table 7-1 summarizes the hypothesized effects of all the independent variables on the probability of provincial chief's turnover. We anticipate that those provincial chiefs experiencing higher local investment growth (INVGROW), active during succession consolidation period (SUCCESSION), possessing longer tenure (DURATION), or at/above the retirement age (RETIRE) are more likely to face turnover. Conversely, provincial leaders who are in provinces that have higher economic power (ECOPOWER), possess more representatives in the Party Central Committee (CC), were born in the province (BIRTH), developed their careers mostly in the province (CAREER), are more willing to make revenue contribution to central coffers (REVENUE) or provide public health (HOSPBED), or obtained a college degree and above (COLLEGE), are less likely to face turnover.

The Data and Analytical Method

The study compiled a data set of the tenures of both Party First Secretaries and governors in all provincial units from 1978 to 1998.[6] From 1978 to 1987, there were 29 provincial units and 58 positions each year. Since 1988, Hainan has been separated from Guangdong province which added another independent provincial unit into the data set. As a result, there were 30 provincial units and 60 positions each year from 1988 to 1998.[7] A provincial chief enters our observation once he or she assumes office, and leaves the observation when he or she is removed from that position. If the provincial chief assumed office before 1978, we only make observation of the case since 1978. That is, all data compiled for this case, such as the number of Central Committee representatives, revenue contribution to the center, etc., begins from 1978. The only exception is that we code his/her tenure starting year from the very first year of his/her term. For example, Xu Jiatun served as Jiangsu province's Party first secretary since 1977, so we code his starting year in 1977. But we make observation of the effects of our independent variables on the probability of his turnover only since 1978. Conversely, even if the provincial chief continued to serve in the position after 1998, we stop our observation in 1998. In other words, the case is *right censored* at the point of time because observation is artificially terminated before the case *naturally* leaves our observation.[8] For example, Jia

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[6] By provincial units, we refer to all province-level administrative units that include cities like Beijing and Shanghai, provinces like Guangdong and Shandong, and autonomous areas like Guangxi and Tibet.
[7] Chungqing city was made an independent provincial unit since 1997, but this study does not include Chungqing into our data set for the observation period would be too short.
[8] Censoring comes in many forms and occurs for many different reasons. An observation on a variable T is right censored if all we know about T is that it is greater than value c. In our case, because we cannot know when the provincial chief will be removed from the office after

Qinglin has been Beijing city's Party First Secretary since 1997, and remains so today. To complete our data set, we must arbitrarily set a point in time to terminate our observation of, i.e. censor, his case. Moreover, if the provincial chief died in office, the case is also treated as being censored, rather than removed from the office. For example, Tan Shaowen died in office as Tianjin city's Party First Secretary in 1993. We treat the case as a censored case. In total, there are 332 provincial chiefs being observed in the twenty-year observation period.[9]

There are basically two kinds of independent variables in our data set: one is constant across time through our observation period, such as the provincial chief's education, place of birth, and the major place for career development. The other kind is time-varying variable whose value differs annually. Most of our independent variables, such as the provincial chief's age, tenure length, the province's economic power, revenue contribution, investment growth, etc. are time-varying variables. Their values change every year. The time-varying variables need to be handled with special estimate methods.[10]

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the termination of our observation period in 1998 (most of them are still serving in the positions today), the only thing we can do is to arbitrarily *censor* the case in 1998. For more precise definition and detailed discussion of censoring, see (Allison 1984).

[9] For example, in the twenty years between 1978 and 1998, Beijing had seven Party First Secretaries. They were Wu De, Lin Hujia, Duan Junyi, Li Ximin, Chen Xitong, Wei Jianxing, Jia Qinglin. Thus, it composes seven cases of our observation. In total, the thirty provincial units over the twenty-year period have 332 observations. When the provincial chiefs leave the office, we code 1 for the dependent variable to indicate that the event (turnover) happens to him. But, if the provincial chiefs leave our observation because he died in office or because we arbitrarily terminate the study in 1998, we code 0 for the case to indicate it as a non-event case.

[10] The information for provincial chiefs' tenure, social background, and career path, and the annual changes in numbers of provincial representatives in the Party Central Committee is mainly from following sources: *Zhi guan zhi* (published by Zhongguo shehui chubanshe, Beijing, 1996), *Zhonggong nianbao* (Yearbooks on Chinese Communism, 1978-1998) (published by Zhongguo yanjiu zazhishe, Taipei), *Zhongguo dangdai mingren lu* (The Index of Celebrities in Contemporary China) (published by Shanghai renmin chubanshe, Shanghai, 1991), *Xiandai Zhongguo zhengzhi yaoren zhuanlue daquan* (The Biographic Encyclopedia of Important Political Figures in Modern China) (published by Zhongguo guangbo dianshi chubanshe, Beijing, 1993), *Who's who in China: Current leaders* (published by Waijiao chubanshe, Beijing,1994), and *Zhonggong renmin lu* (Who's who in Communist China)

The study employs the *event history analysis* method to analyze the data. Event history analysis is a statistical method for studying the occurrence and timing of events, such as the onset of disease, equipment failures, job terminations, marriages, promotions, regime duration, congressman career path, war, etc. The method is designed to analyze the probability that an event will occur at a particular time to a particular individual. It allows both *censoring* and *time-varying explanatory variables* - the two problems that are difficult to handle with conventional statistical methods. Given that we are interested in observing the probability of provincial chiefs' turnover, and there are censored cases and time-varying explanatory variables in the data set, this method is best suited to analyze our data.

There are many different methods developed to deal with different data types in event history analysis. Given that our data is discrete-time data with time-varying independent variables, we should use the discrete-time method. This involves a shift in the unit of analysis from provincial chief to event that occurs at specific points in time. To do so, we transform the 332 observed cases of provincial chiefs into 1,504 person-year spells.[11] The 1,504 person-year spells are treated as distinct observations. Then we estimate logistic regression models to predict the proportional odds for an event to occur in each spell.

(published by the Center of International Relations, National Chengchi University, Taipei 1999). The information for provincial economic data is mainly from three sources: the annual *Chinese Statistical Yearbooks* (published by the PRC's State Statistical Bureau, Beijing, 1981-1999), *China's Provincial Statistics, 1949-1989* (published by Westview Press, New York, 1990), and *Xin Zhongguo wushi nian tongji ziliao huibian* (Comprehensive Statistical Date and Materials on 50 Years of New China) (published by the PRC's State Statistical Bureau, Beijing, 1999).

[11] To provide a concrete example, the case of Chen Xitong (CXT) as Beijing first secretary from 1992 to 1995 is now transformed into four person-year spells – CXT-92, CXT-93, CXT-94, CXT-95. In total, the 332 cases of provincial chiefs are now transformed into 1504 spells. Each spell has its own value of all independent variables. We, therefore, estimate the probability of the turnover to happen in each spell.

The Models

A general model can therefore be built in this form. We let P_{it} represent the conditional probability that provincial chief i has an event (turnover) at time t, given that an event has not already occurred to that provincial chief. The model says that P_{it} is related to the covariates by a logistic regression equation:

$$\text{Log}\left(\frac{P_{it}}{1 - P_{it}}\right) = \alpha_t + \beta_1\text{ECOPOWER}_{t-1} + \beta_2\text{BIRTH} + \beta_3\text{CAREER} + \beta_4\text{CC}_t$$
$$+ \beta_5\text{REVENUE}_t + \beta_6\text{INVGROW}_t + \beta_7\text{HOSPBED}_{t-1}$$
$$+ \beta_8\text{SUCCESSION}_t + \beta_9\text{DURATION}_t + \beta_{10}\text{RETIRE}_t$$
$$+ \beta_{11}\text{COLLEGE}$$

where P_{it} = the probability of a provincial chief i leaving the position in year t;

ECOPOWER_{t-1} = the province's economic power, measured by 1-year lagged Gross Domestic Production (GDP) of the province at 1978's constant price;

BIRTH = 1 if the provincial chief was born in the province, and 0 otherwise;

CAREER = 1 if the provincial chief's political career mostly developed in the province, and 0 otherwise;

CC_t = number of representatives and alternate representatives in the Party Central Committee from the province where the provincial chief presides in the given year t;

REVENUE_t = the province's willingness to contribute to central revenues, measured by the ratio of growth of local expenditures in the given year t to its revenue base in previous year t-1:

$$R_t = (\text{Exp}_t - \text{Exp}_{t-1}) / \text{Rev}_{t-1},$$

where R is the province's willingness to contribute, Exp is the province's expenditure, and Rev is the province's revenue.

INVGROW_t = the province's investment growth, measured by the ratio of growth of local renovation investment in the given t to its GDP in previous year t-1:

$$I_t = (\text{RI}_t - \text{RI}_{t-1}) / \text{GDP}_{t-1}$$

		where I is the province's investment growth, and RI is the province's renovation investment.
$HOSPBED_{t-1}$	=	1-year lagged growth rate of hospital beds in the province.
$SUCCESSION_t$	=	1 if the observed year is during the succession consolidation periods (1978-1983, 1993-1998), and 0 otherwise;
$DURATION_t$	=	year-length of the provincial chief's tenure in the given year t;
$RETIRE_t$	=	1 if the provincial chief's age is equal or above 65 (age for retirement) in the given year t, and 0 otherwise;
COLLEGE	=	1 if the provincial chief received college or above college education, and 0 otherwise;

The choice of measurements for some of the independent variables needs to be clarified here. First, we measure CC by the number of both representatives and alternate representatives in the Party Central Committee because the center usually uses more alternate representatives to compensate those provinces who have fewer representatives. As a measurement for the political weight of each province, it would make more sense if we include both representatives and alternates.[12] Secondly, given that we cannot access the exact revenue contribution of each province and the arrangements for revenue remittance differed by region and over time, the ratio of current year's expenditure growth to previous year's revenue is used to measure the willingness of the province to contribute to the central coffers (REVENUE). Previous studies have tried the difference between (Tong 1989) (Bo 1996) or the ratio of (Huang 1996) (Yang 1996) a province's annual revenue and expenditure to measure its contribution to central coffers. This study finds that the ratio of current year's expenditure growth to previous year's revenue may be a better measurement not only because by using ratio of, rather than difference between, revenues and expenditures, we can compensate for richer provinces' inevitably greater contribution in absolute

[12] I have also tried to use representatives only as a measurement. It does not affect the results of the statistical analysis.

amounts. The ratio of current year's expenditure growth to previous year's revenue can also more accurately reflect the result of the previous year's budgetary bargaining between the center and provinces. It can thus be seen as an indicator for the province's willingness to compromise with the center. Thirdly, because the data for local fixed asset investment in early reform years is not available, we instead use the rates of renovation investment to measure local investment growth (INVGROW).[13] The ratio of current year's renovation investment growth to previous year's GDP is used, because it is more reflective of the bargaining results of the annual economic plan, and, therefore, the provincial leaders' willingness to comply with central policy lines. Finally, we treat the intervals between 1978 and 1983 and between 1993 and 1998 – the regular terms for local leaders following the Eleventh Party Congress (1977) and the Fourteenth Party Congress (1992) – as the two succession consolidation periods during the reform era. In the first period Deng and his cohorts consolidated their newly acquired power, while in the second one Jiang and other post-Deng central leaders reshuffle the provincial officialdom in large scale to demonstrate the effectiveness of their collective authority.

We first construct a general model that includes all independent variables and three theory-driven models (bargaining model, hierarchical model, and succession model) for the entire period under study (1978-1998). In order to further probe the effect of succession consolidation on the political dynamics of central-provincial relations, we divide the period into three intervals (1978-1983, 1984-1992, and 1993-1998), and estimate a model combining both bargaining hypotheses and hierarchical hypotheses for each interval to determine whether the effects of the independent

[13] According to Yasheng Huang, these two figures are highly related. In his analysis of local investment behavior, he treats the two figures as two measurements of the same variable. See (Huang 1996, p. 270).

variables on the likelihood of the provincial chief's turnover differ from one interval to another.

Results of the Analysis

Table 7-2 presents the analytical results of the general model and three theory-driven models. First of all, in both the general model and the succession model, we find that the explanatory variable Succession, as our theory predicts, has a positive effect on our dependent variable. That is, during succession consolidation periods (1978-1983 and 1993-1998), the provincial chiefs are more likely to face turnover than the non-consolidation period (1984-1992). The logit coefficients of 0.33 shown in the table is counter-intuitive because the logit model assumes a nonlinear relationship between the dependent and explanatory variables. By transforming the coefficient into odds ratio ($\beta \Rightarrow e^{\beta}$), we get an odds ratio of 1.39. It tells us that the odds for provincial chiefs' turnover during succession consolidation periods are 1.39 times the odds for the turnover during non-consolidation period. Or the chances for provincial leaders to face removal during consolidation are 39 percent greater than the chances during non-consolidation.[14]

[14] Although odds sounds more complicated than probability, it in fact is widely used by professional gambler. To put it simply, the odds of 1/5 means "1 to 5" chances for the occurrence of an event (i.e. to win in gambling circles). The operationalized definition of odds is 'the ratio of the expected number of times that an event will occur to the expected number of times that it will not occur.' If expressed in probability, odds equals to (probability of event / probability of no event), or P/ (1-P). Back to our provincial leaders' turnover, we can say, if the odds for provincial leaders to face turnover is 2 during non-consolidation periods, then the odds for them to face turnover is 2 x 1.39 = 2.78 during consolidation periods. In other worlds, if the chance for provincial leaders to be removed is "2 to 1" during non-consolidation, then the chance is "2.78 to 1" during consolidation.

Table 7-2. Regression Coefficients from Logit Models for Discrete-time Data Predicting Turnover of Provincial Chiefs in China, 1978-1998.

Independent Variable	*General Model*	*Succession Model*	*Pluralist Model*	*Bureaucratic Model*
CC	.06		.04	
	(.06)		(.05)	
BIRTH	-.37*		-.31*	
	(.19)		(.17)	
CAREER	-.26		-33**	
	(.18)		(.16)	
ECOPOWER	.03		.002	
	(.03)		(.002)	
REVENUE	-.004			-.002
	(.03)			(.026)
INVGROW	-.102			.027
	(1.42)			(1.44)
HOSPBED	.02			.016
	(.02)			(.013)
SUCCESSION	.32*	.33**		
	(.18)	(.15)		
DURATION	.21***	.27***	.27***	.19***
	(.03)	(.03)	(.03)	(.03)
RETIRE	1.11***	.96***	1.01***	1.17***
	(.18)	(.15)	(.16)	(.17)
COLLEGE	.02	-.02	-.003	.05
	(.18)	(.15)	(.16)	(.18)
Constant	-2.85	-3.05	-2.85	-2.54
	(0.37)	(0.21)	(0.31)	(0.23)
Log Likelihood	-466.0150	-651.5264	-595.4952	-474.3185
Number of Spells	978	1504	1386	978
Number of Events	222	294	269	222

Note: Numbers in parentheses are standard errors.
* $p < 0.1$ ** $p < 0.05$ *** $p < 0.01$

In both the general model and the bargaining model, we find both Birth and Career have negative effects. While the effect of Birth reaches a significant level in both models, the effect of Career reaches a significant level only in the bargaining model. The slight differences in the values of these coefficients and degrees of significance between the two models may result from two factors. One is the different population size. The general model, which includes some variables, such as Hospbed and Invgrow, that have missing data in the early years, only has 978 observation spells, but the bargaining model, with less missing data, has 1386 spells. The other factor may be that slight correlation between some independent variables, such as Ecopower, Invgrow, and Succession, make the coefficients less stable.[15] The negative effects of Birth and Career seem to support the bargaining hypotheses: that those provincial leaders who were born in the provinces and/or developed their political career mostly in the provinces are less likely to be removed during the entire reform era. By transforming the coefficients into an odds ratios ($e^{-.31}= 0.73$, $e^{-.33}= 0.72$), we find the odds for native provincial chiefs to face turnover are 0.73 times the odds for non-natives, and the odds for provincial chiefs who developed their political career mostly in the province they currently served are 0.72 times the odds for those otherwise. This evidence seems to confirm the arguments for the emergence of localism and immobilism in local leadership during the reform era (Li and Bachman 1989). However, neither the numbers of provincial representatives in the Party Central Committee (CC) nor the provincial economic power (Ecopower) has any significant effect on the survival of the provincial chiefs. If any, both of them appear to have positive effects. That is, they increased the chances of turnover. Therefore,

[15] There is slight correlation between some variables in these models, but a tolerance examine finds all the correlation is far above tolerance level. It means we can trust that the estimates in these models have no serious multicollinearity problem.

the results only partially support the bargaining arguments.

In regard to hierarchical hypotheses, none of the explanatory variables appear important in determining the probability of a provincial chief's turnover, although the provincial chief's willingness to make contributions to central coffers (Revenue) affects the turnover probability in the same direction as the hypothesis predicts. That is, the willingness to contribute decreases the probability of removal. It is not statistically significant. Meanwhile, neither local investment growth (INVGROW) nor the provision of public health (Hospbed) supports the hypotheses of hierarchical model. According to this evidence, we can tentatively say that the central policymakers did not make provinces' revenue contribution, investment growth, and provision of public services the main criteria for evaluating provincial leaders. At least, we may say none of them was the main criterion through different phases of the reform era. When we estimate the models for different periods later, we may find different pattern.

Finally, we find that in all four models, both Duration and Retire are highly significant in determining the probability of provincial chief's turnover. As we expect, both of them have positive effects on our dependent variables. That is, the longer the provincial chief served in the position, the more likely he/she would face turnover. Once the provincial chief reaches the age of 65, his/her removal becomes more likely. The odds ratio for Retire is about 3, which means during the reform era the chances for provincial chiefs passing the age of 65 to face turnover are 3 times the chances for leaders under 65. However, to our surprise, college education appears unimportant in determining the survival of provincial chiefs. Education may have become an important criterion for local leadership recruitment, but the evidence here shows that it was not a factor in determining the turnover of local leadership.

Table 7-3. Regression Coefficients from Logit Models for Discrete-time Data Predicting Turnover of Provincial Chiefs in Different Time Periods during Reform Era.

Independent Variable	*Model 1 (1978-1983)*	*Model 2 (1984-1992)*	*Model 3 (1993-1998)*
CC	-.008	.152*	-.102
	(.177)	(.090)	(.140)
BIRTH	-.37	-.41	-.395
	(.53)	(.29)	(.345)
CAREER	.48	-.44*	-.353
	(.50)	(.26)	(.319)
ECOPOWER	-.044	.051	.036
	(.331)	(.077)	(.753)
REVENUE	-2.35	.0002	-.75
	(1.88)	(.0274)	(.75)
INVGROW	-25.65	-27.48***	2.21
	(23.199)	(8.18)	(2.05)
HOSPBED	.028	.021	.025
	(.092)	(.035)	(.027)
DURATION	.14	.15***	.28***
	(.11)	(.06)	(.05)
RETIRE	.36	1.30***	1.44***
	(.55)	(.27)	(.37)
COLLEGE	-.14	-.07	.23
	(.47)	(.26)	(.36)
Constant	-1.01	-2.70	-2.22
	(0.98)	(0.54)	(0.71)
Log Likelihood	-61.6659	-261.0101	-172.4759
Number of Spells	104	517	357
Number of Events	33	95	94

Note: Numbers in parentheses are standard errors.
* $p < 0.1$ ** $p < 0.05$ *** $p < 0.01$

Table 7-3 tests the hypotheses derived from both bargaining and hierarchical models on three different sub-periods in the reform era. For the bargaining hypotheses, we find that both Birth and Career have negative effects on the probability of provincial chiefs' turnover, but only Career in Model 2 (1984-1992) reaches the level of significance. CC and Ecopower continue to show no importance in determining the survival of provincial chiefs throughout the three time periods. With regard to hierarchical model, a very interesting phenomenon is that Invgrow has a highly significant *negative* effect on the probability of provincial chiefs' turnover during the time interval of 1984-1992, which means those provincial leaders who had local investment growing at a higher rate had a much better chance to survive during the heyday of Deng's decentralized reform. However, the effect of Invgrow turns positive in post-Deng era (1993-1998). That is, those who maintained high growth rates in local investment were more likely to be removed after 1993, although the figure does not reach the level of statistical significance. The dramatic change in statistical significance of the effects of Invgrow across different time periods is partially caused by the sharp decline of the standard errors (as shown in the parentheses). It may reflect a fact that, as reform proceeded, there was a convergence of the effect of the speed of local investment growth on provincial leaders' survival. In other words, the differences between provinces' investment growth became less a factor in determining provincial chiefs' survival. Finally, in regard to our control variables, we find the effects of both Duration and Retire statistically significant only after 1984. The results are consistent with the fact that the Party set 65 as the age for retirement since 1983 and the policy of cadre rejuvenation became rigorously implemented in the mid-1980s (Manion 1992).

Broader Implications for the Central-local Relations

The results of our statistical analysis provide mixed evidence for the hypotheses derived from the theories of central-local relations that flourished during the Deng era. Although the evidence does not support the hierarchical hypotheses, neither does it support all the bargaining hypotheses. The only thing assured in the analysis is that the effects of various forces on the probability of provincial chiefs' turnover varied over time, and succession politics mattered greatly in determining the fluctuation. In both succession consolidation periods (1978-1983 and 1993-1998), provincial chiefs faced a higher risk of turnover. During the heyday of Deng's decentralization reforms (1984-1992), those provincial chiefs who were native sons and who ran a local economy growing at a higher rate had a better chance of survival. However, these trends faded, and even reversed course, after 1993. In general, the findings of this study should not prompt us to conclude whether it is the bargaining argument or hierarchical argument that prevails in explaining the overall development of central-local relations during the reform era. But the findings do confirm the proposition that exogenous political dynamics, such as succession politics, are critical in determining the patterns of central-local relations.

Turnover in Local Leadership: to embrace or to correct the decentralization trend?

Although the findings that those provincial chiefs who were born in the provinces or developed their political careers mostly in the provinces are less likely to be removed from office seem to confirm the arguments for the emergence of localism, they should not lead to the conclusion that economic decentralization has resulted in an increase in local political power and secured the political survival of local leading cadres. As is also revealed in the analytical results, neither local economic power (measured by the 1-year lagged GDP of provinces) nor local political power (measured by the numbers of provincial representatives in the Party Central Committee) has any significant effect on the probability of provincial chiefs' turnover. We thus lack solid evidence here to argue that the correlation between the birthplaces and career paths on the one hand, and the turnover probability on the other, is caused by the increases of either economic power or political power in localities. The correlation may rather result from other factors. For example, it may be the central leaders' intention, rather than the local officials' design, to keep those native sons in position longer, especially in the 1980s when local autonomy and innovation were considered beneficial to economic growth and therefore encouraged.

In the meantime, although the results of the statistical analysis do not support any of the hierarchical hypotheses, it should not lead to the conclusion that the central policymakers did not intend to enhance central control by exercising their monopoly over local personnel allocation. After all, the average term for provincial Party First Secretaries and governors together in our study period was only 4.2 years shorter than the regular term of five years for provincial chiefs. The central leaders did reshuffle local leadership more frequent than necessary. The apparent insignificance of the three explanatory variables – revenue contribution, investment growth, and provision of public health – in determining the probability of provincial chiefs' turnover may result from the central leaders' inability to maintain any coherent policy goal throughout the entire reform period. The central leaders may stress inflation control at one point in time, but be concerned about economic growth at the other. They may be worried about central revenue collection today, but the provision of public services to the grassroots tomorrow. For example, according to the results of our statistical analysis, local investment growth had a strong negative effect on the probability of provincial chiefs' turnover in the time period between 1984 and 1992. However, as the central policymakers focused on inflation control after 1993, the effect became insignificant and turned positive. It is hard for the central policymakers to maintain any policy goal as a coherent criterion for the turnover of provincial leaders through time. The criteria would change with power struggle among factions in the central leadership, along with the external economic situation. Their effects on turnover may thus cancel out each other.

New Constituencies for a New Regime

The results of our statistical analysis show that provincial chiefs faced a higher risk of removal during succession consolidation periods. However, the higher probability of turnover does not mean generation shift. By itself, it can not fully prove our argument that, in the Soviet political system, the top leaders during succession consolidation period would replace their predecessors' political constituencies with their own loyalists. A comparison of the demographic characteristics and career paths of the provincial chiefs in the post-Deng era with the ones in the Deng regime is needed to examine whether the new regime has really replaced the political constituencies of the old regime with a new generation of political elites. If the provincial chiefs in the post-Deng era collectively do appear to be a new generation of political elites who had distinct background and experiences from their predecessors, then we can argue that the post-Deng top leaders have appointed a new generation of political elites to the positions of provincial chiefs to be their own constituencies.

Table 7-4. The Demographic and Career Characteristics of the Provincial Chiefs in Deng Era and Post-Deng Era.

	Deng Era (1978-1992)	Post-Deng Era (1993-1998)
Averaged year of birth	1925	1938
Averaged year of joining the Party	1946	1961
Percentage of college/above graduators	62%	87%
Percentage of native sons (defined by birthplace)	31%	33%
Percentage of native sons (defined by career path)	55%	44%
Percentage of centralists	13%	21%

Table 7-4 is a comparison of the demographic characteristics and career paths of those provincial chiefs appointed during and after 1993 with the ones appointed before 1993. First of all, we find the average year of birth for the post-Deng provincial chiefs is 1938, much later than the average year of birth for their predecessors in 1925. The oldest post-Deng provincial chief, Wu Liji, the chairman of Inner Mongolia since 1993, was in fact born in 1928, three years later than the average for their predecessors. Secondly, on average the post-Deng provincial chiefs joined the Chinese Communist Party in 1961, while their predecessors joined in 1946. Actually only one post-Deng provincial chief joined the Party before 1946. He is Yu Qifeng, the Heilongjiang Party secretary from 1994 to 1997, who joined the Party in 1945. The more-than-ten-year differences in the year of birth and beginning of a political career defined totally different life experiences separating the two groups of provincial chiefs. The findings are consistent with Li Cheng's study of the "fourth generation" political elite (Li 2000).

Moreover, the post-Deng provincial chiefs were better educated than the previous generation. Eighty-seven percent of the provincial chiefs appointed after 1993 possessed college education or higher, in comparison to 62 percent of their predecessors. In regard to the issue of localism, while 33 percent of post-Deng provincial chiefs were born in the provinces where they currently served, slightly more than their predecessors' 31 percent, fifty-six percent of them developed their political careers outside the provinces, much higher than 45 percent among their counterparts. The increase of "outsiders" in the appointment of provincial chiefs is consistent with the "rule of avoidance" restored by the post-Deng central leadership.[16] In addition, career central bureaucrats composed 21 percent of the post-Deng provincial leaders, an increase from 13 percent prior to 1993. This career background suggests that the new generation of provincial chiefs appointed by the post-Deng central leaders is a group of political elite who have more professional training and a technocratic mentality, but are perhaps lacking the political experiences and skills needed to handle increasingly complicated local politics, in contrast to their counterparts in the previous regime. Nonetheless, these qualities ensured that they would be the most loyal constituencies of the post-Deng top leadership.

In sum, our statistical analysis of the probability of provincial chiefs' turnover for the entire reform era presents a more complicated picture than that suggested by conventional theories of central-local relations. Economic decentralization did not lead central-local relations towards greater local bargaining power as asserted by the

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[16] For details, see the last section of Chapter 5.

bargaining perspective. Nor were the central leaders able to maintain coherent policy goals and stringently monitor the behavior of provincial leaders accordingly, as the hierarchical perspective would argue. The effects of the social, economic, and political transformation of Deng's reforms on the survival and, by extension, the bargaining power of provincial leaders are more unstable than we imagined. Moreover, political dynamics, such as succession politics, in the broader institutional context, a factor that we used to ignore in the studies of central-local relations, makes the situation even more complicated.

Conclusion

This chapter has tried to contribute to the studies of central-local relations in Chinese politics by bringing the analysis of the political survival of the provincial chiefs into the discussion. Through a statistical test of competing hypotheses about the probability of the provincial chiefs' turnover for the period from 1978 to 1998, the chapter has extended our discussion of central-local relations to three new frontiers. First of all, it adds one more indicator to measure the changes in central-local relations. Traditionally, revenue distribution and policy implementation are the two most important indicators to measure the power relations between the central and local governments. The re-introduction of provincial leaders' turnover as an indicator to measure the changes, i.e. following Teiwes and Tong, enable us to observe the development in a broader context. Secondly, it includes a new time period (1993-1998). With few exceptions, most existing studies of central-local relations focus on the time period between 1978 to 1993. By including both pre- and post-1993 periods, this study can compare the differences in central-local relations between the two regimes and observe the impacts of regime change. Thirdly, it employs a new research method to analyze the change in central-local relations. By using event history analysis, the study can make observations of both occurrence and timing of the provincial leaders' turnover. The effects of time-varying variables, such as succession, can be evaluated against the effects of constant variables, such as education and place of birth, in the same model. We thus obtain more precise estimates of the effect of succession politics on provincial chiefs' turnover.

Bringing the analysis of the political survival of provincial chiefs into the discussion of the central-local relations, we have three new findings: (1) the political context, succession politics in this case, matters in determining the dynamics of central-local relations. When the top leaders are in a succession consolidation period, they have strong incentive to exercise their appointment rights over provincial chiefs more frequently in order to demonstrate their authority and replace political constituencies of the old regime with their own men; (2) the development of central-local relations are less predictable than we originally perceived. Namely, the center was neither gradually losing control over the localities, nor constantly maintaining effective supervision of the provincial governments with coherent policy criteria. The relationship varies over time; (3) for the first time, we confirm the implementation of cadre retirement policy since 1983 with evidence obtained from quantitative analysis. The analytical results of our models show that age for retirement has been the most significant factor in determining the turnover of provincial chiefs ever since 1983. The findings confirm the conclusion of previous qualitative studies (Manion 1992).

Nonetheless, the study is still exploratory, for it does not make distinction between promotion and demotion in the turnover of provincial chiefs. Although the fact that very few provincial chiefs get promoted from their position can justify the way we deal with the problem, we shall try to find a good criterion for distinguishing promotion from demotion in future studies.

Chapter 7

Conclusion

In this study, we find that financial system has played an indispensable role in China's economic transition. As Mancur Olson once argued, 'the single most important source of the collapse of communism, I believe, was that the communist governments are broke' (Olson 2000, p.159). In all communist countries, economic transition had turned the state-owned enterprises from government's primary revenue source into its major fiscal burden. The deteriorating budgetary position in turn led these governments to borrow heavily both at home and abroad. As these heavily indebted governments increasingly relied upon printing money to repay their debt, they had to make a choice between mounting inflationary pressure and cutting subsidies to the vest interests in state sector. The dilemma between financial turmoil and political crisis usually resulted in constant political conflicts and poor sequencing of reform, and thus led to both financial and political disasters. In contrast, the extremely high domestic savings as a result of the explosive growth of the non-state sector saved China from this scenario. Through the still state-monopolized banking system, the Chinese government successfully mobilized enormous domestic savings to finance its investment and expenditure in the traditional planned system. Therefore, it could simultaneously maintain a relatively stable financial environment and a continuously swelling state sector for a long time.

Nonetheless, using the outdated socialist financial system to control the flows of financial resources in an increasingly liberalized economy still caused problems to the Chinese central policymakers. On the one hand, as the financial system shouldered more fiscal burdens by the government, the distribution of bank credits became more and more politicized. The local governments, driven by the impetus of "investment hunger" after economic decentralization, would compete with the center for control over the allocation and expansion of bank credits. On the other hand, as numerous non-state financial intermediaries emerged on the fringe of the formal state banking system to circumvent the constraint of the state plan as well as to serve the financial needs of the non-state sector, the formal state banking system was faced with unprecedented attraction to as well as competition from these newly emerging market players. The same challenges from both the local governments and the market were also felt by the Chinese central policymakers in the fiscal system.[1] As a result, the central policymakers, increasingly losing control over the allocation and expansion of both bank credits and budgetary funds, felt the urgency to restructure the financial and fiscal systems on a large scale.

Since late 1993, the post-Deng central leaders launched a series of reforms to resume central control over the distribution of national financial resources. As analyzed in Chapter 3 and 4 of this dissertation, through vertical integration within the central bank and the four big state banks, intervention from local governments was largely undermined within the state banking system. Through the creation of the three policy banks and the establishment of the so-called "main bank system" between the four big state banks and the 1,000 "double big" state conglomerates, the role of central planning agencies in the allocation of bank credits was further enhanced. Through serial crackdowns on the non-state financial intermediaries, the "leakage" for

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[1] As mentioned in Chapter 2, the fiscal system also suffered from both the shirking behavior

funds to flow out of the state banking system was mostly contained. The reform measures clearly demonstrated a fact that "devolving power and yielding benefit" (*fang quan rang li*) has given way to "macro-level adjustment and control" (*hong guan tiao kong*) as the major policy platform in post-Deng China. It is no longer appropriate to characterize the evolution of the Chinese central-local relations as a process of economic decentralization.[2]

The post-Deng policy reorientation proved that a united Chinese central leadership still enjoys high autonomy in making policy against the interests of important political constituencies. The fifteen years of decentralized economic reforms during the Deng era, although endowing the localities more economic resources and decision-making power in local economic affairs, did not institutionalize a decentralized political structure in any meaningful way. When the decentralized distribution of national financial resources was reversed, the local officials were unable to conduct effective political action to defend their interests. On the contrary, in the formal political institutions, the Chinese central leaders can still hold these increasingly wealthy local officials accountable through their control over the local *nomenklatura*. As long as the central collective leadership is able to overcome its small-group collective action problem and unite behind the same policy line, its control over the localities is still quite effective.

However, we cannot take the unity of the top leadership for granted, because the logic of political oligarchy usually makes the unity of the central collective leadership difficult to achieve. When the top authority is shared by a handful of leaders, rather than monopolized by one dictator, each leader will have the incentive to reach out for

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of the local governments and its inability to tax the booming non-state sector.

[2] With the introduction of tax-sharing system (*fen shue shi*), the establishment of a nation-wide Central Tax Bureau, and the re-definition of the extra-budgetary funds, the

political support in order to increase his own share of power in the collective leadership. It is why we have witnessed that factionalism is so prevalent and unity is so rare throughout the history of the Leninist collective leadership. And the faction build-up is particularly intense during succession competition. Nevertheless, this line of thinking ignores an important factor in the political succession of the top leadership in a Soviet-type political system. That is, the need for the top leadership to earn continuous acknowledgement from the bureaucracy as well as the society for the effectiveness of its authority, when the top leaders have just collectively assumed power from their predecessors. This need of *succession consolidation* will provide incentives for these newly inaugurated leaders to temporarily work together to introduce a new policy platform and replace the constituencies of the old regime with their own men, in order to confirm the populace's perception of the effectiveness of their collective authority. In Chapter 5 and 6, we combine both qualitative and quantitative methods to illuminate this underlying logic of succession consolidation. Chapter 5 employs qualitative data to analyze how the post-Deng leaders have reoriented Deng's decentralization platform in an assertive manner to demonstrate the effectiveness of their authority. The results of a statistical test of provincial leaders' turnover in Chapter 6 also support the argument. Thus, we can conclude that, although salient economic problems provided momentum for bold reforms, it is the logic of succession consolidation that drove the post-Deng leaders to reverse the persistent drain of financial resources from the center to the localities.

Benevolent Dictatorship?

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decentralization trend in the fiscal system was also reversed since late 1993 (Zhang 1999).

The consequent macroeconomic stability of the post-Deng policy reorientation can easily lead to an argument for benevolent dictatorship. That is, authoritarian policymaking process is necessary for the success of economic adjustment and transition. Economic adjustment and transition always involve large-scale redistribution of social resources that will encounter fierce resistance from entrenched interests in the society. An authoritarian policymaking process can isolate the policymakers from the pressure of these entrenched interests, and, thus, give them a free hand to introduce the needed policies for the adjustment.[3] The coincidence of political liberalization and financial turmoil in the former Soviet Union and some Eastern European countries seems to further enhance this argument, and, therefore, lead to the conclusion that political authoritarianism is necessary for economic transition in today's China. And the policy implication is that a right sequence for the socialist transition toward democratic capitalism is to reform the economy first and the politics later, because, "when an economy finds that its traditional central planning apparatus is being abandoned and its economic resources are becoming more dispersed, in the short run political control can serve, in a way, as a 'surrogate' for macroeconomic policy levers" (Huang 1996, p.324).

However, as the 'surrogate' takes charge, it may enjoy the reins of power and hinder the development of the real macroeconomic policy levers. Economists tend to see inflation control as a public good because the resistance – the major industrial investors - are so concentrated, and the potential beneficiaries – general consumers - are so diffuse. But the emphasis on its public-good feature blinds us to the

[3] Similar argument is also found in the literature of developmental state. See (Gerschenkron 1962) (Johnson 1982) (Amsdem 1989) (Wade 1990) (Haggard 1991) (Haggard and Lee 1995). In these literatures, the policymakers, or the state, are usually portrayed as foresighted public-good providers who are willing and able to introduce right policies to heal market failure and facilitate economic development (also see Evens, Kauffman).

distributional effects of the inflation control. For example, in the broadest sense, lower inflation will benefit creditors, but hurt debtors. When the inflation control is achieved by administrative measurements (i.e. mandatory reduction and reallocation of bank credits), rather than market instruments (i.e. interest rate rises), the distributional effects will be even more salient. As revealed by the analysis in Part One of this dissertation, the post-Deng financial reforms, unlike the killing-all austerity programs employed before, have particularly hurt the interests of local governments, local labor-intensive SOEs, and the non-state sector – that is, all the major players of the economic boom during the Deng era. On the contrary, besides general consumers, central planning bureaucrats and capital intensive sectors, especially construction and transportation sectors, were the biggest beneficiaries of the policy reorientation. The redistribution of financial resources from the beneficiaries of the previous regime to those 'neglected' sectors further demonstrates the logic of political succession – that is, to create political constituencies for the new regime.[4] Thus, it is apolitical to simply stress the consequent macroeconomic stability of the policy reorientation and see the post-Deng leaders as public-good providers.

Once the institutions for the distribution of national financial resources were restructured, they would have their own dynamics and set constraints for future policy options. When the "macro-level adjustment and control" became too "effective" and resulted in persistent deflation since the summer of 1997, the Chinese central policymakers started to worry about the situation and tried to find policy measures to

[4] In the late 1970s, Deng's policy reorientation was also designed with the intention to benefit those previously 'neglected' sectors, such as agriculture, light industries, and coastal provinces. After fifteen years of decentralized reforms, the central planning bureaucrats and capital intensive sectors – the traditional communist core – had become the 'neglected' sectors in China when the post-Deng leaders took the charge.

stimulate the economy. This time, the Deng regime's decentralization measures were no longer in their toolbox. Rather, they would choose those measures that benefited their constituencies the most. Since the summer of 1998, in the name of weathering the effects of the Asian financial crisis, the Chinese central policymakers launched a series of Keynesian stimulus programs in attempt to invigorate the economy. From 1998 to 2001, the central government issued five rounds of fiscal stimulus packages, more than RMB 1,500 billion in public spending, including government bond issuing, state bank loans and local government investments.[5] The stimulus programs consist of 1,000 infrastructure projects identified by the government. Most of them are big infrastructure projects designed to develop the impoverished western part of the country – the biggest two are the Three Gorges Dam and the cross-country oil pipeline from Xinjiang to Shanghai. While much of the money has been wasted or embezzled in the implementing process, the effects of these capital-intensive construction projects on stimulating consumption and providing jobs are really in doubt.[6] Nonetheless, these stimulus projects precisely reflected in the interests of the new regime's major constituencies – that is, the central planning bureaucrats, capital-intensive sectors, and the interior provinces.

Moreover, the stimulus programs have sharply increased the government budget deficit and deteriorated the composition of the state banks' assets.[7] The mounting budget deficits and bad loans in state banking system will in turn postpone interest

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[5] James Kynge. "China mulls Pounds 12bn stimulus plan," *Financial Times*, Dec. 20, 2000.
[6] Even Chinese government officials themselves have admitted the limited effects of the stimulus programs in invigorating the economy. See "China admits results from massive stimulus package disappointing," *Agence France Presse Intl.*, May 19, 1999.
[7] The government budget deficits increased from Rmb 58.2 billions in 1997, to 92.2 in 1998, 179.7 in 1999, and 229.9 in 2000. See China's National Bureau of Statistics, 1999, *Xin Zhongguo Wushi Nian Tongji Ziliao Huibian* (Comprehensive Statistical Data and Materials on 50 Years of New China), p. 8; and "Beijing to prolong big budget deficit," *Financial Times*, March 7, 2000. For the deterioration of state bank assets, see Chapter 4 of this dissertation.

rate liberalization. In the meantime, the huge spending in infrastructure projects also has a squeeze effect on the agenda for the Chinese government to write off bad bank loans and to take over SOEs' social burdens – the two prerequisites for the state banks and SOEs to transform into real market players (Lardy 1998, p.160).[8] All these factors will hinder the development of real macroeconomic policy levers for inflation control. In other words, political control has to serve as a 'surrogate' for a long while.

Authoritarian rulers certainly have higher discretion in making economically rational policies. But authoritarianism by itself does not guarantee the supply of optimal economic policies, although self-claimed *benevolent dictators* often use the supply as an excuse to seize power and maintain their rule. In fact, it has recently become a consensus in the political economy literature that there is no causal relation between regime types and the success of economic reforms (Haggard and Kaufman 1992) (Bates and Krueger 1993). Bold reforms need compelling authority to implement, but, with good will, skill, and luck, compelling authority can be obtained in both democratic and authoritarian systems.

Authoritarian Rule and the Credibility of China's "Market-preserving Federalism"

Another emerging consensus in the political economy literature is that societies are most likely to prosper when individual property rights are clearly defined and well protected. While a *Leviathan* is needed to protect property rights in the Hobbesian world, a check-and-balance mechanism in the political institutions, such as democracy

[8] Economists estimate repairing the social welfare network and cleaning up the banking sector could cost the Chinese government trillions of yuan. So far the government's spending in both regards is still too modest to solve the problems.

and federalism, is also needed to prevent the *Leviathan* from seriously abusing its power. As argued by Barry Weingast, 'a government strong enough to protect property rights and to enforce contracts is also strong enough to confiscate the wealth of its citizens' (Weingast 1995). A check-and-balance mechanism built in the political institutions can make the government's commitment to the protection of property rights more credible.

It has long been a puzzle that, in the absence of rule of law and private property rights, how China, especially those entrepreneurs in the non-state sector, can sustain economic prosperity for so long. A popular explanation is that the fiscal decentralization toward local government has created a "market-preserving federalism, Chinese style," in which, despite the absence of a constitutional foundation, a de facto check and balance between the central and local governments is *self-enforcing* because fiscal decentralization provides both the incentive and power for local governments to protect property rights in their jurisdiction and sets limits on the discretion of the central government. And 'these limits seem to endow the reform with a degree of durability, making reversal more costly, if not impossible' (Montinola 1995, p.67). As long as the division of labor between the central and local governments over political and economic responsibilities is self-enforcing, "the Chinese style of federalism," like the constitutionally codified Western federalism, is market-preserving.[9]

However, the durability of fiscal decentralization has been put into question by the post-Deng central leaders' attempt to resume central control over both the fiscal and financial systems. While it is unclear whether the central leaders' current efforts

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[9] See (Montinola 1995) (Huang 1996) and (Qian and Weingast 1997) for the discussion of the Chinese style of federalism. For the general theories of market-preserving federalism, see (Weingast 1995) (Ferejohn and Weingast 1997) and (Inman 1997).

in promoting the rule of law can make a credible commitment to the protection of property rights and the enforcement of contracts for small market players, the de facto protection of individual property rights from the discretion of the central government that had long been provided by the growth-driven local governments has certainly diminished. A noticeable paradox of the economic boom in the non-state sector during Deng's China was that, given the vague attitudes of Communist leaders toward the market economy, the protection of individual entrepreneurs' claims on the gain of their investment against predatory behavior of both the central government and other parties were provided by the local governments' *rent-seeking* practice.[10] Although this study cannot directly address the question of how the post-Deng rationalization and recentralization reforms have affected the non-state market players that flourished in the gray area between plan and market as well as legal and illegal territories, it does find that the non-state financial intermediaries, both in urban and rural areas, have been experiencing the most serious crackdowns ever in this round of reforms. While we cannot precisely estimate their impact on the private and collective enterprises whose credit supply solely relied upon the non-state financial intermediaries, the crackdowns have certainly resulted in a credit crunch in these sectors, and partially contributed to the recession in the domestic market these days.

Although the non-state sector had replaced the state sector as the growth engine during Deng's decentralized economic reforms, its prosperity was, however, facilitated by the ignorance, intentional or unintentional, of the Chinese central policymakers. The Chinese central policymakers' ignorance of the informal, or illicit,

[10] Empirical researches on foreign direct investment and Chinese private businesses found that, in order to ensure the continuous supply of *rent* (illicit levies and fees) from the emerging non-state sector, local governments would provide protection of private entrepreneurs from both tax obligations to the central government and investment uncertainties caused by policy fluctuation. See (Wu 1998) and (Tsai 1999).

institutional arrangements in localities has brought about the phenomenal growth of the non-state sector on the one hand, but created a twilight zone for central control and taxation on the other. When the central policymakers were no longer willing to tolerate the gray area where their power could not reach, and began to reconstruct central-local relations, the institutional arrangements trickily created to protect de facto private property rights were endangered. It is still unclear whether the Chinese central policymakers are aware of this problem and able to provide alternative arrangements, such as constitutional amendments, to make a credible commitment to the protection of private property rights. Given that private ownership is still a taboo in the Chinese Communist doctrine, and the non-state sector will not have the political power to challenge this doctrine in the foreseeable future, there seems to be no political incentive for the Chinese central policymakers to seriously address this issue.

Therefore, even though decentralization has been detrimental to macroeconomic stability, it is the last resort that can check the discretion of the Chinese central policymakers, and thus serves as an important institutional foundation for China's transition toward a market economy. Thus, an optimal plot for the post-Deng central leaders to reclaim the commanding heights of China's fiscal and monetary systems should have been a political process that could have converged the central and local interests toward macroeconomic stability on the one hand, and reinforce the shared authorities between the central and local governments over economic affairs on the other. In other words, it ought to be undertaken as part of a wider effort to build a national consensus on the respective economic roles of the central and local governments – that is, to formally institutionalize Chinese-style federalism. By doing so, the post-Deng central leaders could have not only made China's market-preserving federalism more credible to market entrepreneurs, but also obtained a compelling authority on the basis of a national consensus, rather than coercion, to launch bold reforms.

However, the post-Deng central leaders chose to pursue recentralization in an arbitrary manner. Local compliance with the center's authority was based upon coercive punishment, rather than bargaining agreement.[11] This authoritarian decision-making process has not only undermined the market-preservation of the Chinese federalism, but also increased the monitoring cost for the center to oversee the localities. As observed by Yasheng Huang, 'the inability to influence anti-inflation policies during their formulation... do not leave the localities many options with respect to protecting their self-interest during a period of austerity, other than not fully implementing the central policies' (Huang 1996, p.311). As long as the central policies are made in the absence of local governments' consent, it would not be in the local governments' *self-interest* to implement the central policies. The central leaders therefore need more discipline effort in monitoring the implementation.

In order to stringently discipline local governments' behavior, the central leaders have showed even more toughness and decisiveness when carrying out new policies in recent years. However, the fear that their discretionary authority might be revoked in any minute further induced local governments to focus on quick returns and pay no attention to the negative externalities of their actions on the national economy. Thus, it is not accidental that financial crimes increased sharply these days although the Chinese central leaders kept enhancing disciplinary measures in the bureaucratic

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[11] Barry Naughton uses "policy decisiveness" and "policy credibility" to distinguish these two styles of policymaking. In his framework, 'policy credibility is provided by an institutional setup with sufficient checks and balances built into the system to provide a real assurance that established policies and political rights or property rights will be fully respected. By contrast, policy decisiveness is most easily achieved.... without significant checks and balances, allowing an authoritative policy maker to promptly and fully respond to changing conditions.' And he continues to assert that 'China is moving toward a much more decisive type of policy making' in this new round of reforms. (Naughton 1999, p. 220)

hierarchy. As long as the Chinese central leaders are unwilling to establish a formal policymaking body where the increasingly resourceful local governments can take part in the formulation of national economic policies, the local governments will continue to engage in ad hoc shirking behavior, and the central policymakers have to employ even tougher measures for centralized oversight. The argument for an authoritarian decision-making process to continue China's economic reforms is thus self-fulfilling.

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Appendix A. List of Field Interviews 1997-98

#	Date	Place	Interviewee	Position	Name of Institution	Institution Type
1	03/16/97	Hong Kong	{code}	Lawyer	Private Law Firm (international)	International
2	03/20/97	Hong Kong	{code}	Banker	Private Investment Bank (international)	International
3	03/20/97	Hong Kong	{code}	Banker	Private Investment Bank (international)	International
4	03/22/97	Hong Kong	{code}	Political Scientist	Chinese University of Hong Kong	Research
5	03/25/97	Hong Kong	{code}	Political Scientist	Chinese University of Hong Kong	Research
6	04/01/97	Hong Kong	{code}	Journalist (former)	China Times Weekly	Press
7	04/01/97	Hong Kong	{code}	Journalist (former)	China Times Weekly	Press
8	04/05/97	Hong Kong	{code}	Columnist (former)	Ming Bao, Xin Bao	Press
9	04/10/97	Hong Kong	{code}	Journalist (former)	China Times Weekly	Press
10	04/15/97	Hong Kong	{code}	Publisher	Zhong Guo Tong (Taiwan)	Press
11	04/18/97	Hong Kong	{code}	Sociologist	Science and Technology University of Hong Kong	Research
12	04/20/97	Hong Kong	{code}	Economist	Hong Kong University	Research
13	05/25/97	Taiwan	{code}	Journalist	Business Times (Taiwan)	Press
14	05/25/97	Taiwan	{code}	Journalist	Business Times (Taiwan)	Press
15	06/02/97	Taiwan	{code}	Journalist	United Daily News (Taiwan)	Press
16	06/08/97	Taiwan	{code}	Economist	Hong Kong University	Research
17	06/28/97	Taiwan	{code}	Publisher	Zhong Guo Tong (Taiwan)	Press
18	07/02/97	Shanghai	{code}	Sociologist	Shanghai Academy of Social Sciences (SASS)	Research
19	07/03/97	Shanghai	{code}	Foreign Investor	Foreign Company (Taiwan)	International
20	07/04/97	Shanghai	{code}	Economist	SASS	Research
21	07/06/97	Shanghai	{code}	Economist	Shanghai Finance and Economics University	Research
22	07/09/97	Shanghai	{code}	Economist	SASS	Research
23	07/09/97	Shanghai	{code}	Director (former)	District Sub-branch, Industrial and Commercial Bank of China (ICBC)	Big 4 Bank
24	07/10/97	Shanghai	{code}	Banker	General Management Department, Shanghai Branch, Construction Bank of China (CBC)	Big 4 Bank
25	07/10/97	Shanghai	{code}	Banker	General Management Department, Shanghai Branch, CBC	Big 4 Bank
26	07/10/97	Shanghai	{code}	Journalist (former)	Xinhua News Agency	Press
27	07/11/97	Shanghai	{code}	Researcher	Pudong Reform and Development Institute	Research
28	07/11/97	Shanghai	{code}	Researcher	Pudong Reform and Development Institute	Research
29	07/11/97	Shanghai	{code}	Economist	SASS	Research
30	07/12/97	Shanghai	{code}	Manager	State-owned enterprises (SOEs)	SOEs
31	07/15/97	Shanghai	{code}	Bureau Deputy	Shanghai Branch, People's Bank of China (PBC)	Central Bank

32	07/16/97	Shanghai	{code}	Director (former)	District Sub-branch, ICBC	Big 4 Bank
33	07/17/97	Shanghai	{code}	Bureau Director	Headquarter, Bank of Communication	Local Bank
34	07/17/97	Shanghai	{code}	Bureau Staff	Headquarter, Bank of Communication	Local Bank
35	07/18/97	Shanghai	{code}	Bureau Deputy	Headquarter, Shanghai Pudong Development Bank	Local Bank
36	07/19/97	Shanghai	{code}	Economist	SASS	Research
37	07/20/97	Shanghai	{code}	Economist	SASS	Research
38	07/21/97	Shanghai	{code}	Bureau Deputy	Shanghai City Cooperative Bank	Local Bank
39	07/21/97	Shanghai	{code}	Bureau Staff	Shanghai City Cooperative Bank	Local Bank
40	07/22/97	Shanghai	{code}	Bureau Staff	Shanghai Branch, Bank of China (BOC)	Big 4 Bank
41	07/22/97	Shanghai	{code}	Bureau Staff	Shanghai Branch, Bank of China (BOC)	Big 4 Bank
42	07/23/97	Shanghai	{code}	Bureau Staff	Headquarter, Shanghai Pudong Development Bank	Local Bank
43	07/25/97	Shanghai	{code}	Manager	Foreign Bank	International
44	07/27/97	Shanghai	{code}	Lawyer	Private Law Firm (International)	International
45	07/27/97	Shanghai	{code}	Foreign Investor	Foreign Company (Taiwan)	International
46	07/28/97	Shanghai	{code}	Journalist (former)	Xinhua News Agency	Press
47	07/28/97	Shanghai	{code}	Director (former)	District Sub-branch, ICBC	Big 4 Bank
48	07/29/97	Shanghai	{code}	President	Reinsurance Company (international)	International
49	07/29/97	Shanghai	{code}	Economist	SASS	Research
50	07/29/97	Shanghai	{code}	Foreign Investor	Foreign Company (Taiwan)	International
51	08/01/97	Hong Kong	{code}	Economist	Hong Kong University	Research
52	08/03/97	Hong Kong	{code}	Lawyer	Private Law Firm (International)	International
53	08/06/97	Shenzhen	{code}	Entrepreneur	Private Company	Private Company
54	08/07/97	Shenzhen	{code}	Director	District Branch, Shenzhen City Cooperative Bank	Local Bank
55	08/07/97	Shenzhen	{code}	Bureau Deputy	Shenzhen Branch, PBC	Central Bank
56	10/05/97	Taiwan	{code}	Executive Vice President	Chiao Tung Bank (Taiwan)	International
57	10/05/97	Taiwan	{code}	Director	Taipei Finance Association (Taiwan)	International
58	10/12/97	Taiwan	{code}	Journalist	United Daily News	Press
59	10/20/97	Taiwan	{code}	Political Scientist	National Taiwan University	Research
60	10/24/97	Shanghai	{code}	Economist	SASS	Research
61	10/25/97	Shanghai	{code}	Director (former)	District Sub-branch, ICBC	Big 4 Bank
62	10/27/97	Shanghai	{code}	Bureau Director	Shanghai Branch, PBC	Central Bank
63	10/28/97	Shanghai	{code}	Bureau Director (former)	Shanghai Branch, PBC	Central Bank
64	10/30/97	Shanghai	{code}	Director	Shanghai Branch, Agricultural Development Bank	Policy Bank
65	10/31/97	Shanghai	{code}	Manager	District-level SOEs	SOEs

66	11/01/97	Shanghai	{code}	Economist	Shanghai Finance and Economics University	Research
67	11/02/97	Shanghai	{code}	Director	District Sub-branch, ICBC	Big 4 Bank
68	11/03/97	Shanghai	{code}	Bureau Director	Shanghai Branch, PBC	Central Bank
69	11/03/97	Shanghai	{code}	Bureau Director	Shanghai Branch, PBC	Central Bank
70	11/03/97	Shanghai	{code}	Bureau Director	Shanghai Branch, PBC	Central Bank
71	11/03/97	Shanghai	{code}	Bureau Staff	Shanghai Branch, PBC	Central Bank
72	11/04/97	Shanghai	{code}	Director	Shanghai Branch, ICBC	Big 4 Bank
73	11/04/97	Shanghai	{code}	Bureau Director	Shanghai Branch, ICBC	Big 4 Bank
74	11/04/97	Shanghai	{code}	General Economist	Shanghai Branch, ICBC	Big 4 Bank
75	11/05/97	Shanghai	{code}	Bureau Director	Headquarter, Bank of Communication	Local Bank
76	11/05/97	Shanghai	{code}	Staff	District Sub-branch, ICBC	Big 4 Bank
77	11/06/97	Shanghai	{code}	Bureau Director	Shanghai Branch, Agricultural Bank of China (ABC)	Big 4 Bank
78	11/06/97	Shanghai	{code}	Deputy Director	Planning Commission, Shanghai Municipal Government	Government
79	11/07/97	Shanghai	{code}	Economist	SASS	Research
80	11/07/97	Shanghai	{code}	Staff	Headquarter, Shanghai Pudong Development Bank	Local Bank
81	12/27/97	Taiwan	{code}	Economist	Chung-hua Institute for Economic Research	Research
82	04/07/98	New York	{code}	Staff	The PRC Consulate General in New York	Government
83	05/26/98	Shanghai	{code}	Vice President	Shenyin & Wanguo Securities Co., Ltd.	NBFIs
84	05/26/98	Shanghai	{code}	General Economist	Shenyin & Wanguo Securities Co., Ltd.	NBFIs
85	05/26/98	Shanghai	{code}	Economist	SASS	Research
86	05/27/98	Shanghai	{code}	Bureau Director	Bank of Communication	Local Bank
87	05/27/98	Shanghai	{code}	Journalist (former)	Xinhua News Agency	Press
88	05/27/98	Shanghai	{code}	Director (former)	District Sub-branch, ICBC	Big 4 Bank
89	05/28/98	Shanghai	{code}	Bureau Director	Shanghai Branch, PBC	Central Bank
90	05/28/98	Shanghai	{code}	Economist	Shanghai Finance and Economics University	Research
91	05/28/98	Shanghai	{code}	Economist	Shanghai Finance and Economics University	Research
92	05/29/98	Shanghai	{code}	Director	County Branch, ABC	Big 4 Bank
93	05/29/98	Shanghai	{code}	Staff	County Branch, ABC	Big 4 Bank
94	06/01/98	Beijing	{code}	Economist	China Center for Economic Research (CCER), Peking University	Research
95	06/01/98	Beijing	{code}	Entrepreneur	Private Company	Private Company
96	06/02/98	Beijing	{code}	Manager	Beida Securities Co., Ltd.	NBFIs
97	06/03/98	Beijing	{code}	Official	Ministry of Domestic Trade	Government
98	06/04/98	Beijing	{code}	Staff (former)	BOC Trust Company	NBFIs

99	06/05/98	Beijing	{code}	Economist	CCER, Peking University	Research
100	06/06/98	Beijing	{code}	Deputy Director	First Bureau, Headquarter, CBC	Big 4 Bank
101	06/07/98	Beijing	{code}	Research Fellow	Research Department, the NPC Standing Committee	Government
102	06/07/98	Beijing	{code}	Research Fellow	Research Department, the NPC Standing Committee	Government
103	06/08/98	Beijing	{code}	Economist	Chinese Academy of Social Sciences	Research
104	06/08/98	Beijing	{code}	Economist	Chinese Academy of Social Sciences	Research
105	06/09/98	Beijing	{code}	Bureau Director	Headquarter, PBC	Central Bank
106	06/10/98	Beijing	{code}	Economist	CCER, Peking University	Research
107	06/10/98	Beijing	{code}	Economist	CCER, Peking University	Research
108	06/11/98	Beijing	{code}	Economist	Guanghua School of Management, Peking University	Research
109	06/11/98	Beijing	{code}	Economist	Guanghua School of Management, Peking University	Research
110	06/12/98	Beijing	{code}	Director (former)	Headquarter, PBC	Central Bank
111	06/13/98	Beijing	{code}	Economist	CCER, Peking University	Research
112	06/14/98	Beijing	{code}	Economist	CCER, Peking University	Research
113	06/15/98	Beijing	{code}	Economist	Chinese Academy of Social Sciences	Research
114	06/16/98	Beijing	{code}	Director (former)	Headquarter, PBC	Central Bank
115	06/16/98	Beijing	{code}	Economist	CCER, Peking University	Research
116	06/17/98	Beijing	{code}	Economist	CCER, Peking University	Research
117	06/18/98	Beijing	{code}	Economist	CCER, Peking University	Research
118	06/19/98	Beijing	{code}	Executive Vice President	Stock Exchange Executive Council	Research
119	06/19/98	Beijing	{code}	Research Fellow	Stock Exchange Executive Council	Research
120	06/20/98	Beijing	{code}	Bureau Director	Headquarter, PBC	Central Bank
121	06/20/98	Beijing	{code}	Entrepreneur	Private Company	Private Company
122	06/21/98	Beijing	{code}	Deputy Director (former)	PBC	Central Bank
123	06/21/98	Beijing	{code}	Journalist	China Economy & Trade Weekly	Press
124	06/22/98	Beijing	{code}	Economist	Qinghua University	Research
125	06/23/98	Beijing	{code}	Economist	State Development Center, State Council	Research
126	06/23/98	Beijing	{code}	Director	CBC	Big 4 Bank
127	06/24/98	Beijing	{code}	Official	State Planning Commission	Government
128	06/24/98	Beijing	{code}	Journalist	China Securities News	Press

129	06/25/98	Beijing	{code}	Deputy Director	First Bureau, CBC	Big 4 Bank
130	06/26/98	Beijing	{code}	Economist	Guanghua School of Management, Peking University	Research
131	06/26/98	Beijing	{code}	Economist	CCER, Peking University	Research
133	06/28/98	Zhengzhou	{code}	Director (former)	District Sub-branch, ICBC	Big 4 Bank
134	06/28/98	Zhengzhou	{code}	Director	District Sub-branch, CBC	Big 4 Bank
135	06/29/98	Zhengzhou	{code}	Economist	Henan Academy of Social Sciences	Research
136	06/29/98	Zhengzhou	{code}	Staff	Huang He Securities Co., Ltd.	NBFIs
137	06/30/98	Zhengzhou	{code}	Staff	Zhengzhou Branch, BOC	Big 4 Bank
138	06/30/98	Zhengzhou	{code}	Staff	Henan Branch, PBC	Central Bank
139	07/01/98	Zhengzhou	{code}	Director	District Sub-branch, Bank of Communication	Local Bank
140	07/01/98	Zhengzhou	{code}	Economist	Henan Academy of Social Sciences	Research
141	07/02/98	Zhengzhou	{code}	Manager	Investment Company	NBFIs
142	07/02/98	Zhengzhou	{code}	Staff	Zhengzhou City Cooperative Bank	Local Bank
143	07/03/98	Zhengzhou	{code}	Staff	Investment Company	NBFIs
144	07/04/98	Zhengzhou	{code}	Director (former)	Urban Credit Cooperative	NBFIs
145	10/23/98	New York	{code}	Economist	Chinese Academy of Social Sciences	Research

Appendix B. Balance Sheet of the People's Bank of China, 1985-1997.

(billion yuan)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Net foreign assets	19.4	15.1	32.3	35.8	46.8	87.1	150.2	141.2	122.4	445.1	667.0	956.2	1322.9
Foreign reserves	9.3	3.8	13.2	15.8	26.5	60.0	122.8	110.2	87.6	426.4	651.0	933.0	1264.9
Relending to financial institutions	224.9	269.4	277.4	338.8	424.6	514.8	599.2	698.1	989.9	1072.1	1169.2	1463.6	1642.9
Direct lending	1.8	13.0	22.7	30.6	34.5	40.7	44.9	53.4	68.2	72.8	68.0	68.6	17.1
Government overdrafts	27.5	37.0	51.5	57.7	68.5	80.1	106.8	124.1	158.2	168.8	158.3	158.3	158.3
Total assets	**273.6**	**334.5**	**383.9**	**462.8**	**574.4**	**722.6**	**901.1**	**1016.9**	**1338.7**	**1758.8**	**2062.5**	**2646.7**	**3141.2**
Liabilities to financial institutions	89.1	112.3	119.8	135.0	185.4	280.5	384.1	396.7	554.1	746.8	967.3	1435.5	1611.5
Required reserves	42.5	56.5	67.0	84.1	104.2	139.1	181.0	233.5	288.5	396.1	524.7	761.2	924.9
Excess reserves	47.0	55.8	52.8	50.9	81.2	141.5	203.2	163.1	265.7	350.7	442.6	674.3	686.6
Currency in circulation	106.1	129.7	153.2	223.8	247.2	278.8	333.6	457.5	628.8	788.4	857.4	943.5	1098.1
Government deposits	69.4	70.8	75.6	66.4	92.2	99.5	123.9	91.8	120.0	83.3	97.3	122.5	148.6
Government bonds											19.7	0	11.9
Foreign and other liabilities	-11.5	1.2	12.4	12.4	24.4	34.6	25.0	20.0	-30.6	-72.9	83.7	108.5	234.5
Capital	20.5	20.5	22.9	22.9	25.2	29.2	34.5	50.9	66.4	26.6	37.1	36.7	36.6
Total liabilities	**273.6**	**334.5**	**383.9**	**462.8**	**574.4**	**722.6**	**901.1**	**1016.9**	**1338.7**	**1758.8**	**2062.5**	**2646.7**	**3141.2**

Source: PBC, *Almanac of China's Banking and Finance*, 1992, p.517; 1994, p.508; 1995, p.464; 1998, p.492.

Appendix C. Performance of the Four State Banks and Nine Commercial Banks, 1995 and 1997.

(billion yuan)

Bank	Assets(A)		Profits(B)		Profitability(B/A)	
	1995	1997	1995	1997	1995	1997
Industrial and Commercial Bank of China	3107.0	4049.0	4.7	3.1	0.15	0.08
Bank of China	1995.0	2232.0	10.4	5.9	0.52	0.26
Construction Bank of China	1723.0	1682.0	6.2	1.9	0.36	0.11
Agricultural Bank of China	1231.0	1574.0	4.3	0.8	0.36	0.05
				Average	0.36	0.05
Bank of Communication	362.0	486.0	5.6	2.9	1.55	0.59
CITIC Industrial Bank	86.5	126.0	1.0	2.0	1.16	1.59
Everbright Bank	33.7	61.0	0.5	1.6	1.34	2.62
Merchant Bank	64.8	119.0	1.8	2.9	2.70	2.41
Huaxia Bank	n.a.	40.0	n.a.	0.5	n.a.	1.33
Guandong Development Bank	54.7	86.0	0.2	0.3	0.38	0.35
Shenzhen Development Bank	20.3	32.0	0.5	1.0	2.51	3.13
Fujian Industrial Bank	19.7	29.0	0.2	n.a.	1.07	n.a.
Shanghai Pudong Development Bank	n.a.	83.0	n.a.	1.3	n.a.	1.60
				Average	1.53	1.86

Source: PBC, *Almanac of China's Banking and Finance*, 1996, p.472-480, 482-489; 1998, p. 558-567, 571-578.