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Factions and Finance in China

The contemporary Chinese financial system encapsulates two possible futures for China's economy. On the one hand, extremely rapid financial deepening accompanied by relatively stable prices drives a vigorous growth trajectory that will one day make China the world's largest economy. On the other hand, the colossal store of nonperforming loans in the banking sector augurs a troubling future. Factions and Finance in China inquires how elite factional politics has given rise to both of these outcomes since the reform in 1978. The competition over monetary policies between generalists in the Chinese Communist Party and politically engaged technocrats has time and again prevented inflation from spinning out of control. Nonetheless, elite politicians, whether party generalists or technocrats, continue to see the banking sector as a ready means of political capital, thus continuing government intervention in the banking sector and slowing down reform. Through quantitative analysis and in-depth case studies, Shih shows that elite politics has exerted a profound impact on monetary policies and banking institutions in contemporary China.

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Factions and Finance in China

Elite Conflict and Inflation

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CAMBRIDGE UNIVERSITY PRESS

Cambridge, New York, Melbourne, Madrid, Cape Town, Singapore, São Paulo

Cambridge University Press

The Edinburgh Building, Cambridge CB2 8RU, UK

Published in the United States of America by Cambridge University Press, New York www.cambridge.org

Information on this title: www.cambridge.org/9780521872577

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First published in print format 2007

ISBN-13 978-0-511-36639-0 eBook (EBL)

ISBN-10 0-511-36639-6 eBook (EBL)

ISBN-13 978-0-521-87257-7 hardback

ISBN-10 0-521-87257-X hardback

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To My Grandmother, Lau Kim-ping

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Acknowledgments

This book is the culmination of nearly a decade of research and reflection, and it would not have succeeded without the inspiration and encouragement of numerous friends, colleagues, and family members. First of all, I would not have entertained social science as a career without a childhood spent reading the many history books my grandmother Lau Kim-ping procured for me. I am grateful that she continues to take great pride in what I have achieved since I immigrated to the United States at the age of twelve. My interest in Chinese politics began at the George Washington University. Bruce Dickson introduced me to the discipline, and I am grateful that he continues to help me navigate the treacherous terrain in my career. I am likewise grateful for the guidance I received from Harry Harding, Ed McCord, and Marty Whyte. It is of great pleasure that I continue to interact with them on a regular basis.

After my freshman year in college, I spent a listless summer in Hong Kong, where I filled my time reading several of the classics of Chinese politics. Three books I read made particularly deep impressions. The Origins of the Cultural Revolution Part I and II, as well as The Politics of China: The Eras of Mao and Deng first introduced me to the meticulous and well-honed scholarship of Roderick MacFarquhar, as well as the fascinating world of elite Chinese politics. It was an unimaginable delight later when I learned that I would go to Harvard and study with Professor MacFarquhar. Beyond a great scholar, I have since learned that he is also a great mentor and, by popular consensus, one of the most mesmerizing teachers at Harvard. Without his critical inputs, encouragement, and inspiration, this work could not have been completed.

During the same listless summer, I also read Elizabeth Perry's *Rebels and Revolutionaries in North China*, which left a deep impression as well. It has been a rare privilege to first participate in her engaging seminar on Chinese politics and political science and later receive her valuable feedback on my dissertation. I continue to look to her for guidance and mentorship, especially on my new project, which comes much closer to her previous work. Robert Bates's work greatly influenced my thinking as I explored rent-seeking in the Chinese banking

sector. It was a great honor to have one of the most respected political scientists of our time serve on my dissertation committee. I benefited enormously from his insightful input. As I contemplated ways to test my framework rigorously, I immediately thought of inviting Jas Sekhon to serve on my committee. His methods lectures were paragons of clear pedagogy, and I have benefited greatly from his methodological and career advice, as well as friendship. Last, but certainly not least, Dwight Perkins brought to bear his decades of experience observing the Chinese economy and helped me avoid a great many pitfalls and blind alleys.

Graduate school is often a lonely enterprise, but it was made tolerable by a good group of friends who provided both intellectual and emotional support. The heart of this support network was the "Dimick Street Gang": Christian Brunelli, Robert Fannion, Magda Hinojosa, Maria Goff, Elisabeth Ivarsflaten, Andy Karch, Piret Loone, and Endre Tvinnerheim. Poker also provided an important reprieve from the daily grind of graduate studies at Dimick Street, and those who dared to venture to Dimick Street regularly included Mette Eilstrup, Andrea Sangiovanni, and Alan Silverleib. Others also joined from time to time, but Christian's no-fold pledge was too much for some to stomach. Joe and Jen Wong provided crucial friendship and grilled sustenance. Joe, in his usual genius, came up with the best possible title for this book.

In Beijing, I was honored to befriend a group of extremely bright young scholars, whose input and help were crucial to the success of this project. Our joint interviews with Chinese officials and forays into the Central Party School remain some of the highlights of my stay in China. I still look for advice and counsel from Bill Hurst, Kun-chin Lin, and Matt Rudolph. Maria and I were further kept sane by a generous group of friends, including Adam Bunds, Jen Lin-Liu, Jens Fischmann, Markus Muessig, Colin Wan, Lorenz Luthi, Shirley Hung, and Nick Bartlett. Five a.m. breakfasts at the Den remain some of my fondest memories. Without a doubt, I owe a great debt to the seventy or so officials and bankers I interviewed for the book. In order to protect their identities, they remain anonymous. For the most part, I admired their determination to perform their duty honorably in the face of great pressure and temptations. Lawrence Alberts provided some crucial introductions that gave early momentum to the interviews. Professor Hexing Shi at Peking University generously offered to host me during my year there.

Other teachers and classmates also provided important input and encouragement throughout various stages of my graduate studies. I am especially grateful to members of the performance of democracy workshop and the postcommunist workshop, including Sam Huntington, Robert Putnam, Susan Pharr, Eva Bellin, Yoi Herrera, Gerald Easter, Lily Tsai, Kellee Tsai, Ben Read, Maria Popova, Rory MacFarquhar, Dan Gingerich, Naunihal Singh, and Peter Bruland. Yasheng Huang's work greatly influenced my own thinking on the political economy of China, and it was a privilege to work with him on a project. Suzanne Nielsen, Dave Campbell, Ethan Handelmann, James Fowler, Noah Dauber, Chris Adolph, Shang Ying, Brian Garsten, Sonal Pandya, and Julian

Blake all generously offered their support and friendship. I also learned a great deal from those outside my discipline through working at the *Harvard Asia Quarterly*. It was a great pleasure to work with Ed Cunningham, John Ruwitch, Virginia Harper-Ho, Mike Forsythe, and Nate Bush. Nancy Hearst tolerated my sudden appearances and departures from the Fairbank Center Library and generously lent her vast expertise throughout this project.

As I undertook to transform my dissertation into a monograph, many came to my aid with counsel and – in some cases – critical support. None has contributed more to the final publication of this manuscript than Lew Bateman at Cambridge University Press, who saw potential in the manuscript even at a difficult time. His patience and professionalism motivated me to make this manuscript as good as possible. It is no coincidence that he is universally respected in the field. My reviewers, especially the one reviewer for Cambridge University Press, provided invaluable suggestions for improvements. My colleagues at Northwestern University also generously shared their wisdom and encouragement throughout the publication process. I especially appreciate the guidance from my senior colleagues, including Mike Hanchard, Ed Gibson, Will Reno, Ben Ross Schneider, Hendrik Spruyt, and Kathie Thelen. Although the junior faculty crowd is getting much bigger these days, it wasn't always the case. I appreciate the camaraderie from Andrew Roberts, leff lenkins, Risa Brooks, and Sean Gailmard. The evolution of this manuscript also greatly benefited from insightful comments from colleagues in the China field, including Sebastian Heilmann, Pierre Landry, Mingxing Liu, Andy Mertha, Margaret Pearson, Tom Rawski, Susan Whiting, Dali Yang, and Oi Zhang.

Although a book publication represents the public side of our lives, our private lives are what make public accomplishments possible. I am deeply grateful to my parents, James and Sophia Shih, for courageously starting a new life in America and for devoting themselves to giving us every opportunity to succeed. I hope this book in a small way makes up for the great sacrifices they endured in raising us. My sister Clara, who was only four when we came to the United States, confronted her new environment with innate courage and intelligence. She has blossomed into a Stanford graduate, a Marshall Scholar, a senior executive in a leading company, and – most important – a generous and resourceful person. I am grateful that our bond remains so strong in the face of great changes in our lives. Finally, throughout my studies and the book process, I was greatly inspired by my spouse Maria Goff, who faced her many illnesses with great courage and determination. She has endured some of the most trying experiences anyone can have but still found emotional resources to help me through difficult times. Compared to what she has overcome, this book is a minor accomplishment.

Abbreviations

ABC Agricultural Bank of China **AFC** Asian Financial Crisis **AMC** Asset Management Company BOC Bank of China CCCentral Committee **CCB** China Construction Bank CCP Chinese Communist Party CDIC Central Disciplinary and Inspection Commission Central Finance and Economic Leading Group **CFELG CFWC** Central Finance Work Commission **CMC** Central Military Commission COD Central Organization Department CYL Communist Youth League FEC Finance and Economic Committee **GDP** Gross Domestic Product **ICBC** Industrial and Commercial Bank of China **MOF** Ministry of Finance **NPC** National People's Congress NPL. Nonperforming Loan **PBOC** People's Bank of China PLA. People's Liberation Army **PSC** Politburo Standing Committee **SETC** State Economic and Trade Commission SEZ Special Economic Zone SOE State-Owned Enterprise SPC State Planning Commission WTO World Trade Organization

One of the most memorable interviews that I conducted in the course of researching for this book took place in a provincial capital along China's prosperous eastern coast. I interviewed the manager of an asset management company (AMC), which was established to recover the myriad nonperforming loans that had accumulated in China's state banks. Throughout the interview, he belabored the importance of central directives on reducing nonperforming loans (NPLs) in the banking sector. After Zhu Rongii, with the full backing of the Chinese Communist Party (CCP), had imposed a rigid nonperforming loan reduction quota on all Chinese banks, banks were scrambling to remove NPLs from their balance sheets. The manager himself had to meet a cash recovery quota for the NPLs under his charge or face dismissal. He accomplished this by speedily selling the collateral tied to the NPLs to private and foreign investors. When asked about the fate of NPLs not backed by collateral three or four years down the road, his response was simply, "That's for my successor to worry about. I plan to get out after a couple of years with my bonus." Following the interview, he asked if I was hungry. As it was late in the afternoon and my lunch had been a simple bowl of noodles from a street vendor, I thought I could treat him to dinner and we could continue the conversation.

It turned out, however, that he would host the dinner. He first invited six of his friends to join us, then summoned his driver to take us to the most expensive restaurant in town. I was rather nervous by that time because I did not want to spend my entire trip's budget on a single lavish meal for him and his friends. My worries were quickly allayed when he said off-handedly that dinner was on him. When we arrived at the elegantly decorated club for China's newly rich, the concierge, who apparently knew my host quite well, directed the eight of us to a private room, where the rich often entertained their guests. My host told us to order whatever we wanted; he was entertaining clients upstairs and would put our expenses on the same tab. He seemed very practiced in this billing method. He then left to discuss the sale of state assets with his clients. Halfway through our sumptuous dinner, he returned to check on our progress.

Ι

After looking at our spread, he berated us for not ordering the most expensive items; this would cause him to lose face at the restaurant. Summoning the concierge, he then ordered us an enormous plate of imported sashimi, whole shark-fins, and other exotic seafood, along with several bottles of fine French wine to wash it all down.

When he had completed his negotiations and after several rounds of *ganbei* (bottoms-up), I asked him whether such extravagance would affect the company's bottom line at the end of the year. He told me not to worry. All he had to do was fulfill the cash recovery quota for NPLs. The AMC negotiated its annual operating expenses separately with the Ministry of Finance (MOF), which made expenses much more flexible. The MOF, taking its cue from Premier Zhu Rongji's decrees about NPLs, was similarly concerned only with the recovery quota and gladly provided the asset management companies with the necessary funds to fulfill their quotas. Of course, when the MOF ran short of money, it could always draw on another source of funds, the banking system, thereby creating more NPLs for the future. I dared not think about how many families' life savings ended up in our stomachs that night.

This particular episode reveals two important features of the CCP-dominated financial system. First, when the CCP is determined to achieve a particular outcome, it has the power to mobilize the vast bureaucracy, whether at the local or central level, to do its bidding. As this book shows, Deng Xiaoping was able to mobilize local officials to invest at an astonishing rate, whereas Chen Yun suppressed inflationary pressure virtually overnight with just a few decrees. This book provides a framework that specifies the conditions under which the highest leadership can garner sufficient political will to achieve various financial outcomes. At the same time, the fundamental fact remains that bank deposits are viewed by officials, including state bankers, as an amply supplied public good that can and should be exploited at will to fulfill a host of policy, political, and private ends. For us that night, bank funds filled our stomachs with exotic seafood and wine. For Zhu Rongji that year, bank deposits financed the enormously expensive and likely wasteful Western development drive. As I spent more time in China, I could not help but grow more sympathetic to the argument made by corrupt officials that their ill-gotten house or car is minuscule compared to the billions and even trillions that are wasted each year on dams, airports, highways, and stadiums. And the banking sector makes it all possible. Why, indeed, would anyone want to change such a wonderful thing?

Not Quite a Miracle

Since China launched its economic reform nearly three decades ago, the rest of the world has watched in astonishment as it grew rapidly from a poverty-stricken and isolated state to a country poised to take over from Japan as the premier economic powerhouse in Asia. A number of studies have attempted to

explain China's seemingly miraculous growth. The goal of this study is not to provide vet another account of China's spectacular growth. Rather, it seeks to explain two important financial outcomes intimately tied to China's longterm growth trajectory: inflation and the efficiency of capital allocation. As Chapter 2 explains, an important precondition of China's spectacular growth has been its rapid financial deepening accompanied by relative price stability compared with many developing and postcommunist countries. China's ability to constrain inflation is puzzling, given that it has no institutional credibility against government intervention in monetary policy. With a dominant presence in the banking sector, the CCP can intervene in monetary policy at any time to achieve a host of political and policy objectives. Added to this mix is the at times severe elite rivalry, which has a tendency to engender suboptimal economic outcomes (Alesina and Drazen 1995; Rosenbluth 1989; 287). Indeed, China has witnessed repeated episodes of rapidly rising inflation in the two decades of reform. Yet none of them has exploded into hyperinflation, as has been the case in many developing and postcommunist countries. This study provides an account of how elite political tension provided credibility to monetary policies under certain conditions, thereby preventing hyperinflation from taking place.

However, the miracle is not all that it seems. A study of the Chinese financial system cannot possibly ignore China's enormous store of NPLs, estimated at around 50 percent of China's gross domestic product (GDP) in 2001.² Chapter 2 also discusses how this pool of bad loans potentially can inflict serious consequences on China's long-term growth trajectory. The buildup of this harrowing debt stems directly from the persistent failure to reform China's lumbering banking sector, which continues to serve as an instrument of state policies. Given China's apparent success in reforming many sectors of the economy, why has reform in the banking sector lagged so far behind? This study makes the argument that the same political dynamic that constrains China's inflation also precludes fundamental banking reform.

- ¹ See, for example, Naughton, Barry, 1996. Growing Out of the Plan: Chinese Economic Reform 1978–1993. New York: Cambridge University Press; Shirk, Susan. 1993. The Political Logic of Economic Reform in China. Berkeley: University of California Press; Qian, Yingyi, Barry Weingast, and Gabriella Montinola. 1995. Federalism, Chinese style: the political basis for economic success in China. World Politics 48 (1):50–81; Oi, Jean Chun. 1999. Rural China Takes Off: Institutional Foundations of Economic Reform. Berkeley: University of California Press.
- Nonperforming loan ratio is the ratio of total loans that are lapsing in timely interest payment or payment of principal. According to U.S. financial accounting, loans are classified into five categories depending on the financial health and future business prospects of the borrower: normal, special mention, substandard, doubtful, and loss. The last three categories of loans are considered nonperforming. Loans in China have long been divided into four categories: normal (zhengchang), overdue (yuqi), congested (daizhi), and bad (daizhang), which mostly are based on the time period for which loans and interest payments are overdue. In the Chinese system, the last three categories are considered nonperforming.

The political dynamic in question is factional politics. The starting point of this study is that top Chinese leaders perpetually face threats to their power due to the lack of an institutionalized succession mechanism and the dearth of clear indicators of power. To mitigate this uncertainty, the leaders form factions, which are composed of a loose group of lower officials who have an incentive to provide political support to top leaders in times of political challenges. Senior officials acquire their factions as they cultivate personal relations with junior colleagues during the course of their careers. Over time, these loose networks of mutual obligation and exchange become conduits whereby appointments, economic goods, and policy power are channeled (Nathan 1973: 43). The definition of faction used throughout this study is simply this: a personal network of reciprocity that seeks to preserve and expand the power of the patron. This definition incorporates the three fundamental elements of a faction. First, a faction forms on the basis of personal relationships between the patron and the clients, cultivated as the patron rises in the party hierarchy. Second, this web of personal relationships exists as a channel to exchange goods and influence between the patron and the clients (Cox and Rosenbluth 1996; Nathan and Tsai 1995: 171). Finally, factions ultimately aim to maximize the power of the patron, as every member of a faction benefits from a powerful patron (Huang 2000: 5).

Although factions generally serve the same functions for their political patrons, they are not created in the same fashion and are exogenously endowed with different resources and membership. These distinct endowments have enormous implications for their policy preferences and political strategies, both of which ultimately shape policy-making in China. On the one hand, factions led by senior party functionaries mainly comprise provincial officials and have the strongest control over the party apparatus. Historically, factions of this type – labeled generalist factions – vied for supreme power in the CCP precisely because they had broad membership and controlled crucial party apparatuses. This type of faction includes officials from broad segments of the party because of the wide-ranging experience of the patrons. After the establishment of the People's Republic in 1949, this meant a membership structure dominated by local cadres because they make up the bulk of the cadre population.

On the other hand, there are factions led by senior officials with narrower experience in the regime. They often rise vertically within a certain bureaucratic group (xitong) with short stints elsewhere (Lieberthal 2004: 218). This career pattern affects both the preference and favored political strategy of their factions. In the economic arena, factions led by senior economic officials, which I label technocratic factions, have by far the greatest influence among the narrow factions as they directly oversee monetary and investment policies.

Because of their membership composition, generalist factions had a distinct preference for monetary decentralization. In the reform era, local economic performance became a key indicator of evaluating cadres, leading to competition among local officials to maximize local growth (Huang 1996). Although growth promotion can come in the form of an investment-friendly environment

(Oian and Weingast 1997), given the soft-budget environment in reform-era China, the most expedient method of accelerating growth often was more investment, financed by local coffers and by the rapidly growing banking sector (Huang 1996; Ma 1996). Thus, the preferred monetary policy of the generalist faction is to decentralize money creation to the local level, providing ample liquidity for local development. As many observers have noted, this policy is highly inflationary, precisely because local officials desire to expand money supply regardless of overall price stability (Chen 2005: 263; Ma 1996). In essence, because each local official seeks to maximize investment in his or her jurisdiction, they engage in competitive intervention in the banking sector, which results in a prisoner's dilemma in which price stability is sacrificed. If local officials voluntarily adhere to borrowing restrictions, inflation would be averted. However, because exceeding central borrowing restrictions is the dominant strategy – it is rational to do so regardless of what other local officials do – every local official has a strong incentive to borrow as much as possible. Thus, the preferred policy of the generalist faction, if unconstrained by another political or institutional force, is expected to generate one consequence: hyperinflation.

Because their membership is dominated by central technocrats, technocratic factions have a clear preference toward central control over policy tools, including financial resources. Their preference for financial centralization stems from incentives that link promotions and jurisdictional expansion with their ability to solve pressing problems confronting the regime, which often require massive amounts of capital. In the recent past, each monumental task undertaken by the central bureaucracy – building the Three Gorges Dam, developing western China, and state-owned enterprise (SOE) restructuring – has required enormous amounts of capital concentrated at the hands of the central bureaucracy. The preferred policy of this type of faction, financial centralization, decreases inflationary expectation because centralization solves the prisoners' dilemma problem by putting the lead technocrat rather than a loose collection of local officials in charge of monetary stability. With clear designation of responsibility, the lead technocrat has much stronger incentive to preserve monetary stability.

Beyond preference for financial centralization, the narrow membership base of this type of factions means that it is unlikely to make a bid for ultimate power within the CCP. Unlike leaders of generalist factions, senior technocrats mostly have careers in a few central agencies, peppered with short stints in local government. Thus, a bid for overall control, which usually requires broad-base support, becomes difficult for senior technocrats. Senior technocrats, however, still maintain ample political resources at their disposal, giving them enormous influence over elite selection. Thus, instead of seeking ultimate control of the Party, leaders of narrow technocratic factions maximize their power through promoting members of the factions and enlarging resources available to agencies controlled by faction members. As the rest of this work reveals, they accomplish these objectives by taking advantage of economic conditions and by bargaining with generalist factions.

Because technocratic factions do not claim ultimate control, the two types of factions generally coexist in a symbiosis, at times punctuated by sharp disagreements over monetary policy. As Chapter 4 details, in a dynamic economy, different economic conditions determine which type of faction holds the upper hand in shaping monetary policy. When perceived high inflation or an economic crisis strikes the economy, the dominant generalist faction does not have the option of doing nothing or of imposing austerity on itself. While doing nothing would lead to an economic collapse, imposing austerity measures on one's own faction would encourage free-riding from rival generalist factions and the defection of faction members. Given the disastrous outcomes of these options, the dominant generalist faction would rather delegate financial policies to a technocratic faction, which is highly motivated to deprive all provinces of financial authority regardless of factional affiliation. At the same time, as a result of the narrow support base of senior technocrats, they are unlikely to usurp the ultimate power of the dominant generalist faction. In other words, the dominant generalist faction facing an economic crisis and factional rivals prefers preserving the status quo political balance by delegating financial policy to a technocratic faction over the short-term political benefits of financial decentralization. Because technocratic factions have an incentive to lower inflation and the political muscle to sustain centralization policies in the face of opposition, restrictive monetary policy implemented by technocratic factions becomes credible, which successfully lowers inflationary expectation.

With the passing of an economic crisis, however, the dominant generalist faction no longer needs the technocratic faction to maintain the status quo balance of power and would rather decentralize financial control to faction followers in the provinces. Although technocratic factions fight such decentralization attempts and are at times successful in blocking them, the agenda-setting power enjoyed by the dominant generalist faction ultimately trumps the preferred policies of the technocrats. Monetary decentralization sets off another round of competitive intervention in the banks by local officials. This competition for bank loans gives rise to another round of monetary accumulation and ultimately leads to high inflation or another form of economic crisis. Thus, inflation serves both as dependent and independent variables. It is affected by the type of faction holding sway over monetary policy, but it also influences which type of faction gains the upper hand in monetary policy in a subsequent period. The interplay between generalist and technocratic factions, mediated by varying economic conditions, has engendered monetary cycles in China throughout the nearly three decades of reform.

At the same time, because top leaders of both generalist and technocratic factions face persistent political threats, they are reluctant to forego the use of a vast supply of funds provided by the banking sector. Party leaders can bolster factional support by giving followers access to bank funds for local development. Rather than reforming the banking system when they control it, bureaucrats also see the banking system as a rich source of funds to build up impressive administrative records, which make them indispensable to the regime and

permit them to increase or retain power. As a consequence, the leader of a technocratic faction provides only short-term improvements to the financial sector and pursues a strategy of maximizing central control over the financial system, which increases the power of his faction and his personal standing in the Politburo. Because top leaders do not have an interest in truly reforming the banking sector, proposals for reform are either vetoed or diluted, and direct and indirect interventions in the banking system continue unabated.

The factional framework thus provides an explanation of two conflicting outcomes in the financial sector: relative success in constraining inflation and an insolvent banking system. The framework, however, leaves room for contingencies. First, although high inflation or an economic crisis provides the structural condition for a takeover by the central bureaucrats, this explanatory framework does not predict the precise timing of such a transition. Similarly, low inflation and high growth do not immediately translate to monetary decentralization. The theory put forth here merely suggests that high growth and stable prices provide the conditions for the generalist faction to decentralize monetary policy. As subsequent discussion reveals, there were instances of failed takeoff and failed retrenchment as the two types of factions employed political weapons at their disposal to obtain or maintain their preferred monetary policy. As Chapters 6 through 8 detail, the health of various leaders, the leaders' charisma, bargains struck between political elites, and the discovery of corruption cases all intervened to influence the ebb and flow of monetary cycles in China.

The State, Bureaucracy, and Financial Outcomes

The political model developed here seeks to explain two distinct but related outcomes in China: China's unique inflationary cycles and persistent inefficiency caused by the stagnation of financial reform. This unique combination of outcomes in China cannot be explained adequately by previous understanding of the state's role in the financial market, which either dismisses state intervention as completely harmful or praises it as the solution to underdevelopment. The explanatory framework presented here provides a more nuanced understanding of state intervention in the economy. Although state intervention can eliminate certain volatility in developing countries, intervention almost inevitably produces rampant inefficiency in the financial system.

At the broadest level, this research follows a long line of scholarship exploring the relationship between the state and development. Gerschenkron (1962: 20) argues that backward countries often need state intervention to concentrate capital and to leap over the technological gap. Theorists of postwar industrialization follow this tradition and further specify preconditions for successful state intervention. Haggard (1986), for example, contends that successful export-oriented growth in East Asia requires a government insulated from the traditional elite and a bureaucracy dedicated to growth promotion. Other scholars examining the East Asian "miracle" have developed similar sets of preconditions for successful state intervention (Amsden 1989; Evans

1995; Johnson 1982; Wade 1990). Haggard and Lee (1995: 7) further point out that, given poor market institutions in developing countries, state intervention reduces information asymmetry and opportunism and increases the efficiency of capital allocation.

Although the state played an important role in promoting industrialization in Germany and Russia before the war and in Asia after the war, state intervention imposed a price on the long-term growth trajectories of these economies, a fact that is often downplayed by state theorists. The case of reform-era China suggests a more nuanced interpretation of the state's impact on the financial sector. On the one hand, the tight grip that the CCP has on the banking system and China's elite political dynamic prevented inflation from becoming uncontrollable. On the other hand, the case of China demonstrates that even with an insulated government and a competent technocracy, state intervention in the financial market ultimately resulted in rampant inefficiency in the allocation of capital. In other words, the Chinese case suggests that intervention by a strong, coherent state provides the preconditions for spectacular growth through ensuring macroeconomic stability, although state allocation of capital constitutes a drag on the economy.

The state theorists' optimism about state intervention is intimately tied to their assumptions about technocrats in the government. Ever since Weber (1958) defined the bureaucracy as impersonal, apolitical, and rule abiding, scholars of all stripes, including both state theorists from political science and sociology and neoclassical economists, have put enormous faith in competent technocrats to implement policies that promote growth, price stability, and efficiency. Beginning with Johnson's (1982) work on Japan's growth miracle, scholars of the Asian "miracle" have placed technocrats at the center of their respective success stories (Amsden 1989; Aoki and Patrick 1994; Haggard, Lee, and Maxfield 1993; Wade 1990). Interestingly, many neoclassical economists place similar faith on "change teams" of technocrats, especially those trained as economists, to overcome entrenched interests and to implement reform (Blanchard and Schleifer 2000; Harberger 1993; Nelson 1988, 1993; Williamson 1994). In the same vein, the literature on central bank independence (CBI) makes similar assumptions about the leanings of central bankers. Because central bankers are presumed to prefer price stability, giving them legal autonomy from political intervention would impose an anti-inflationary bias in monetary policy (Cukierman 1994; Fischer 1995; Rogoff 1985).

In light of the financial problems across Asia in the late 1990s, as well as unsuccessful reform in many Latin American countries, we have to ask whether the ghost of Weber has blinded us from closely examining the actual motives of bureaucrats and central bankers. Even highly insulated bureaucrats in a professional bureaucracy have an interest in getting promoted, and financial resources constitute a powerful policy tool that can quickly bolster one's administrative accomplishments and thus speed up promotion (Grimes 2001; Kessler 1998; Schamis 1999; Silva 1997). At the same time, technocrats who control credit allocation gain little from the efficient allocation of capital (Kang 2002). If

government officials have the incentive to manipulate state-controlled financial resources to gain a political or career advantage, does it matter if the state is completely insulated from societal forces? Even if politicians and bureaucrats have no career ambitions, without a stake on the returns of the investment, they would hardly bother to allocate capital efficiently.³ Closer scrutiny of the careers and political incentives of bureaucrats and bankers allows us to make realistic predictions about their preferred policies and whether these policies are likely to generate real reform.

This is not to say that the self-interested intentions of bureaucrats and politicians who intervene in the financial system cannot produce any positive results for the economy. A perennial problem in developing countries is that they seldom enjoy the luxury of a completely credible legal framework that makes effective central bank independence possible (Alesina and Summers 1993; Cukierman 1994; Fischer 1995; Maxfield 1994). The lack of credible institution is a problem in China, particularly because the CCP dominates in every part of the formal financial system. Moreover, because China has relatively effective capital control, it cannot establish monetary credibility through a fixed exchange rate regime (Broz 2002). Given the political reality in China, technocrats can only set credible monetary policies in one way; by playing the political game and defending their turf against encroachment by generalist factions. Contrary to the causal logic of the CBI framework, the inclusion of Chinese technocrats in elite politics provides credibility for their credit plan and anti-inflationary policies. Political motives drive Chinese technocrats to exploit inflationary crises to hoard power, which lowers inflationary expectation. The politicized technocrats might not be successful in centralizing monetary policies all the time, but their political clout enables them to exact a substantial toll on generalist factions attempting to wrest financial control away from the central bureaucracy. Knowing that, local officials find credibility in anti-inflationary policies when the Politburo delegates financial authority to the bureaucrats. The broader lesson for developing countries is that independent central banking institutions may be insufficient to ensure price stability. Rather, what developing countries first need are politically powerful actors who have a stake in fighting for stable monetary policy.

The distinction between generalists with broad-based support and powerful technocrats with a narrow support base further resolves a general paradox that arises in delegation under incomplete legal institutions. That is, given incomplete legal institutions in an authoritarian regime, politicians who want to delegate economic authority to technocrats credibly must give further authority to already powerful technocrats. If the technocrats are only servants of the political generalists, policy delegation would not be credible. However, if technocrats are politically powerful, why are the generalists not afraid that the technocrats would usurp their power, especially given that most authoritarian

³ This brings to mind the senior banking officials I interviewed in China, who were much more interested in trading stocks than in their work.

regimes are toppled by insiders (Bueno de Mesquita et al. 2003)? The Chinese case reveals that, although delegation to powerful technocrats comes with a heavy price, generalist politicians are willing to do so because they know that technocrats lack the political base to compete with them for ultimate authority. At the same time, knowing that in most cases the incumbent generalist controls vital political resources, politicized technocrats have an incentive to support the incumbent in crucial political struggles even as they bargain with the incumbent to obtain the maximum concession. Although the delegation literature focuses on the expertise and policy bias of technocrats (Bates 1994; Boylan 2001), technocrats' expertise also tends to limit them to highly specialized positions, which precludes them from gaining ultimate control over the political system even if they are politically active.

Inflationary Cycles and the Impetus for Reform in China

Within the literature on the political economy of China, the introduction of a membership-based factional model increases our ability to explain two important outcomes in China: inflationary cycles and the pattern of economic reform. The literature on inflationary cycles in China is quite extensive and has long reached the dangerous threshold of having more articles (explanations) than the number of observations. The earliest attempt to explain reform era inflation in China applies the quantity theory of money, in which an increase in money supply would lead to an increase in price to the same degree. In this vein, Chow (1987) finds that money growth systematically affects inflation. Naughton (1991) disputes this conclusion by arguing that the first inflationary cycles in the early 1980s were fueled by a rise in the relative price of agricultural output, whereas the 1988 inflation was caused by the expansion of the money supply. More recently, Hasan (1999) showed that money supply and inflation are cointegrated, indicating a reliable long-term positive relationship between the two variables. The factional framework adopts quantity theory in that it assumes stable money velocity and predicts a positive relationship between lending – the prime generator of money supply – and inflation rate. However, it is recognized that this relationship is more stable in the long run and may not be as apparent in the short run. In the short run, quantity theory alone does not provide a satisfactory explanation to the cyclical nature of inflation in China. especially given fairly high growth of money supply throughout the reform period.

In the political economy vein, several explanations have been put forth to account for inflationary cycles in China. The dominant tradition among political explanations is the decentralization explanation. This argues that inflation in China is a result of the decentralization of monetary authority to the local governments, which have an incentive to competitively intervene in the banking sector to maximize local investment and growth (Bowles and White 1993; Brandt and Zhu 2000; Fan, Woo, and Hai 1996; Gore 1999a; Huang 1996). At the same time, Huang (1996) argues that China manages to contain its

inflation because the CCP ultimately can recentralize through its formal institutions, especially its power to demote and dismiss local officials. Although there is little doubt that decentralization of financial authority is intimately tied to inflation and recentralization is tied to price stability, these explanations do not address the cyclical nature of inflation in China. Logically, the central government's preference for economic stability should trump local preference for high growth all the time because higher party committees demand obedience from subordinates in a Leninist party. With the exception of information asymmetry, the local government has little leverage over the center in the formal institutions. In reality, formal institutions alone have a hard time explaining why some central leaders seemed clearly in favor of local interests and why local interests at times trumped central preferences. Conversely, if decentralization has greatly weakened central authority, why was the center able to impose financial austerity on the provinces repeatedly?

To answer these questions, Zhu and Brandt (2000) argue that the central government's utility function is composed of economic growth and the danger of an economic crisis. Typically, decentralization is conducive to growth because local agents have more information about local enterprises and, hence, can allot money more efficiently, giving the center incentive to decentralize. However, when inflation creeps up, the cost of growth becomes dangerously high because inflation signals an increasing chance of economic collapse. As such, the central government is forced to recentralize financial authority at the expense of growth to avert a crisis. The crucial variable under this framework would be the central leadership's level of inflation-aversion.

If we assume relatively stable leadership aversion to inflation and if the level of financial decentralization is a continuous variable, however, there must be a level of centralization at which the utility of the central government is maximized. The government simply can target this level of centralization to ensure both growth and monetary stability. In fact, the credit plans before 1998 and the current indicative credit plan are precisely such targeting instruments. According to Ma (1996), these plans, if followed by the provinces, would generate reasonable growth as well as price stability. Nonetheless, local officials only followed these plans when the central bank could credibly punish them and borrowed beyond these plans during nonausterity periods. If the government engaged in a process of fine-tuning monetary policies, we would expect to see decreasing swings in inflationary cycles. In reality, what we see in the reform era instead is an increasing swing in inflationary cycles, that is, the inflation rate at the peak of each cycle rises higher than in the previous cycle (see Figure 2.1). Moreover, if austerity is simply a temporary fix, why have some austerity periods lasted for several years, for example, 1988 to 1991?

Another way to explain the cyclical nature of Chinese inflation is to assume shifting preference on the part of the central government (Lin 1996; Ma 1996). In other words, the Chinese government suffers from a time consistency problem, in which it prefers growth when inflation is low and price stability when inflation is high. Although this comprises a more satisfying explanation, it raises

further questions about the Chinese government. If the central government is a unitary actor, from where does the inconsistent preference arise? If it is not a unitary actor, what are the forces within the central government behind these two preferences? What are the mechanisms that shift the central government's preference from growth to price stability?

Answering these questions requires an examination of the political dynamic in China. Scholars of elite Chinese politics in the reform era have long noticed a cyclical pattern of reform in China, which is loosely correlated with inflationary cycles. However, most have interpreted economic signals such as inflation and economic growth as exogenous variables that affect the fortune of ideological groups within the CCP, giving rise to reform cycles (Dittmer and Wu 1995; Fewsmith 1994). Specifically, Dittmer and Wu (1995) predict that rapid growth elevates the reformers, whereas inflation gives ideological conservatives the upper hand. Although historical evidence from the 1980s works fairly well with their argument, the diminishing importance of ideology and the continuation of inflationary cycles in the 1990s suggest that factors other than ideology may have been at work throughout the reform era. As Chapter 7 reveals, the post-Tiananmen bargain between Deng Xiaoping and Chen Yun demonstrates that ideological disagreement was not at the root of the divide between the two leaders. If that were the case, Chen Yun could easily have sided with the ideological conservatives in 1989 to put an end to the reform. Instead, Chen Yun sided with Deng Xiaoping on the issue of reform in exchange for continued central control over the economy.

The ideological explanation, moreover, once again begs the question of why the incumbent ideological group cannot simply adjust policies to maximize its chance of retaining control over economic policies. If its preference is simply ideological, the incumbent faction can simply adjust the level of financial centralization to ensure continual control, as long as it does not infringe on its ideological preference. Because centralization and decentralization have been features of both Maoist and reform periods, there is no reason why either centralization or decentralization is fundamentally unpalatable to either the reformers or the conservatives.

This book develops instead a membership-based framework of factions to account for the inconsistent preference of the Chinese government. Rather than seeing factions as ideologically oriented, this framework posits that factional preference stems from the membership composition of factions, which is a function of the factional patron's career path. As Chapters 6 through 8 show, generalist factions, primarily composed of provincial officials, have an incentive to intervene in the banking system to distribute capital to selected provinces controlled by faction members. If local government officials sense that this type of faction is in charge of financial policy, the credibility of the People's Bank of China (PBOC) would be undermined, increasing credit expansion and heightening inflationary expectation. By contrast, a faction composed of central economic bureaucrats has an incentive to pursue policies that centralize financial authority. Thus, when the technocratic faction controls monetary policies, inflationary expectation is lowered. Chapters 5, 6, and 7 provide both

quantitative and qualitative evidence that high inflation induces the generalist factions to impart financial control to technocratic factions.

In sum, the factional explanation accounts for several anomalies not addressed by previous frameworks. First, the existence of two tendencies within the CCP explains why the Chinese government favored monetary decentralization in some periods and centralization in others. It also explains why the central government repeatedly failed to target an optimal money supply level to maximize its utility in terms of growth and price stability. Moreover, basing factional tendencies on membership composition rather than on ideological orientation accounts for the persistence of the centralization/decentralization cycles into the twenty-first century. Finally, identifying the narrow membership base of technocratic factions explains why the leaders of generalist factions were willing to delegate financial authority to politically powerful technocrats.

The second issue in the China literature that this research addresses is the impetus of reform in China. The gradualist reform path China took has indeed produced impressive results in many parts of its economy. Scholars, both political scientists and economists, studying various sectors in China have derived multiple explanations for China's impressive reform record (Lau, Qian, and Roland 2000; Naughton 1996; Oi 1999; Perkins 1988; Shirk 1993). Yet, China's reform trajectory has not been without setbacks and stagnation (Fewsmith 1994; Lardy 1998; Steinfeld 1998). As Lardy (1998) points out, the stagnation of reform is particularly evident in the financial sector, in which loan allocation still follows rules made in the late 1970s.

The prevailing explanation of reform in China relies on the leadership's desire to reform and the diffusion of market-enhancing ideas. In the now famous analogy, Chinese leaders have been "crossing the river by feeling for stones" (moshi guohe). Because Chinese leaders have an intrinsic desire to reform, they are willing to experiment with a wide range of reforms. Any setbacks in the reform stem from incomplete information on how to implement a particular reform, not from entrenched interests that block reform. With the diffusion of ideas on the market economy, "mistakes" should decrease over time, and market-promoting institutions should replace socialist institutions to increase the efficiency of the economy. In a slightly different version of the ideational model, Fewsmith (1994) and Baum (1994) argue that setbacks in reform are caused primarily by the resistance of ideological conservatives in the CCP. According to this framework, reform should proceed smoothly if ideological conservatives die or lose power.

Although not disputing the importance of pro-reform leadership, the diffusion of ideas, and shifting ideology, these explanations alone cannot explain the persistent stagnation in financial sector reform. As Chapter 8 details, technocratic control and the universal acceptance of the market did not bring about

⁴ The notion that better ideas and institutions can resolve China's problems underlies many of the policy recommendations made by the World Bank and the International Monetary Fund (IMF). See, for example, Prasad, Eswar. 2004. China's Growth and Integration into the World Economy: Prospects and Challenges. In *IMF Occasional Paper*. Washington, DC: IMF.

any significant changes in the logic of capital allocation in China in the late 1990s. Meanwhile, ideological opposition to market-oriented reform in effect ended at the Fifteenth Party Congress when General Secretary Jiang Zemin announced that "[we] must encourage and guide the healthy development of individual, private, and other non-state economic entities" (Jiang 1997). Although Western models of financial organization have affected the configurations of some key institutions such as the central bank and the stock market, the state continues to have the same enormous leverage over the distribution of capital that it had in 1978. In fact, throughout the reform era, even into the current administration, the main variation in financial policy has been whether the central government or the provincial governments held control over the distribution of money, not whether policies favored a planned or market economy.

The two most compelling among the remaining alternative explanations are opposition by rent-seeking coalitions against financial reform and bureaucratic capture of the premier's agenda. Although I am not denying that these explanations, as well as ideational ones, play some role in driving policy outcomes, their predictions are not as accurate as those of the factional framework. Shirk (1993) and Qian, Lau, and Roland (2000) assume that Chinese leaders prefer reform. On that basis, they argue that reformers have divided and conquered rent-seeking coalitions by offering a subset of the rent-seekers continuing rent or new rent-seeking opportunities. In this manner, inconsistencies in the reform path stemmed from incomplete information and complications in building a pro-reform coalition. Although costly, the overall path of the reform eventually would turn China into a fully marketized economy.

Despite the applicability of this framework in other sectors of the economy, it still has a hard time explaining the continuing stagnation in financial sector reform. As Chapters 7 and 8 detail, Premier Zhu Rongji managed to implement reforms that substantially weakened a politically powerful group: local government officials. Zhu's centralization effort deprived local officials access to cheap credit from banks, drastically increasing their dependence on the central bureaucracy for funding. Under the framework of manipulating rent-seekers to implement reform, we would have expected Zhu to steadily move toward a marketized financial sector during his tenure. Contrary to this prediction, however, after financial control was taken away from the local government, Zhu simply concentrated financial power in the central bureaucracy and the large SOEs. At the same time, more fundamental reforms, such as the legalization of private banks and interest rate liberalization, were not pursued despite enjoying strong support by affluent coastal provinces.

Bureaucratic capture, which argues that bureaucratic interests dictate the implementation of financial policies, provides another compelling alternative explanation. According to the framework, financial policies implemented by central technocrats should have systematically benefited the interests of a subset of bureaucracies (Bachman 1991: 8). As Chapters 7 and 8 demonstrate, the centralization efforts by Zhu Rongji indeed expanded the authority of the State Economic and Trade Commission (SETC), the PBOC, and the MOF.

Nonetheless, although Zhu's policies increased the discretion of these bureaucracies dramatically, they also created enormous problems for them in the medium and long term. As faction members who cared only about maintaining and expanding the influence of the factional patron, however, it was perfectly logical for them to support short-term solutions. For example, although many bank and PBOC officials supported interest rate liberalization, the premier and the governor of the PBOC felt that it might engender instability and, more important, deprive the center of a source of cheap capital in the short term. Thus, they repeatedly vetoed or amended proposals to liberalize interest rates, despite Zhu's known sympathy toward the PBOC (he had served as governor).

Although it is difficult to confirm the effects of any specific explanatory framework on a small number of policy outcomes, the factional framework provides predictions that are most consistent with patterns of financial policy implementation. In the factional framework, both types of factions seek first and foremost to maintain and expand power vis-à-vis the other factions. When generalist factions control the banking sector, they encourage provincial followers to utilize bank deposits for local development. Although local control over the financial sector encourages local experiments with interest rate liberalization and other reform, it is difficult for generalist factions to coordinate national-level reform efforts. When technocratic factions control the banking system, they aggressively pursue a strategy of maximizing central control, regardless of the reform implications.

Overall, the factional argument by no means contradicts the rent-seeking framework. In fact, the politics of factionalism is the politics of rent-seeking because factions primarily distribute economic rent and offices in exchange for political support. Olson (1982) and works on postcommunist reform (Schleifer, Treisman, and Development Centre of Organisation for Economic Co-operation and Development. 1998; Treisman 1999) ascribe difficulties in reform to the struggle between rent-seekers and reformers. In the case of China, two types of rent-seekers, central and local officials, engage in the struggle for financial authority, perpetuating financial inefficiency for decades. Although this competition has an effect on money supply and inflation, it makes no significant improvement on the efficiency of capital allocation. In other words, Chinese factional politics is a struggle of rent-seekers against rent-seekers.

Methodology

The overall research strategy used in this study is one of induction-deduction-induction, in which empirical observations about elite political motivations in China are first collected from various sources. From these observations, a theory about how elite incentives drive financial outcomes is derived deductively. Finally, the empirical implications of the theory are systematically tested through both qualitative case studies and statistical analysis.

In the first stage, I conducted more than seventy interviews with midand high-level cadres from both the central and the local level in both the

	Government Officials	State Bankers
Local	15	14
Central	17	22

TABLE 1.1. The Distribution of Interviewees in the Chinese $Bureaucracy^a$

government and the state banks to discern the motivation of different types of officials (see Table 1.1). Although the heart of this study concerns top-level leaders beyond the reach of most Western investigators, mid-level officials often have an accurate idea about the political incentives facing top-level leaders, and the consistency of their answers about elite motivation reflects this knowledge. The single clearest message that emerges from the interviews is that, above all else. Chinese leaders care about political survival and actively formulate strategies to expand or maintain power. The interviews also suggest that the survival strategies of individual leaders have an enormous impact on the banking sector. The other important insight from the interviews is that different types of cadres have different ways of bolstering their careers. For local cadres, bringing additional investment and growth to the region is extremely important for promotion. In contrast, central bureaucrats are primarily preoccupied with having sufficient authority and resources to solve pressing policy problems, which speeds up their promotion. Integrating these insights with previous works on Chinese politics, I derive the factional framework of how elite politics impacts financial outcomes.

The logic of the factional framework, presented in its entirety in Chapter 4, is then tested both quantitatively and qualitatively. The quantitative tests presented in Chapter 5 comprise two parts. First, I test the distributive implications of the factional model by examining whether generalist factional ties and technocratic factional ties have different impacts on provincial loan allocation. By regressing provincial bank lending from 1978 to 2004 on factional ties and a host of economic indicators, I show that only ties with a top CCP generalist increase provincial bank lending, whereas ties with a top bureaucrat bring no additional advantage in terms of loan allocation. This finding indicates that there are in fact divergent factional strategies in terms of intervention in the banking sector. The second set of quantitative models tests an important implication of the factional model, that high inflation triggers bureaucratic control over monetary policies, thereby lowering inflationary expectation. To test this, I

a "State bankers" includes those who work in the Big Four state banks, the policy banks, and the joint-stock banks, whereas "government officials" are government bureaucrats who do not work in the banks. I include PBOC officials in the category of "government officials." "Local" level denotes provincial level or below. Most of the local-level interviews were conducted with provincial or city-level officials. In addition to those on this chart, I interviewed four Western journalists and bankers with deep knowledge of China. I interviewed twelve of these subjects more than once.

collected a quarterly data set from various sources and regress current inflation and lending on past inflation and past growth using time-series models. This analysis reveals that, contrary to the predictions of conventional economic theory, past inflation has a negative impact on current lending, which triggers lower inflation in subsequent quarters, suggesting that past inflation increases the chance of a central bureaucratic takeover. At the same time, high growth in one period is expected to heighten inflationary pressure in a subsequent period. These findings provide strong quantitative support for the notion that elite political struggle constrains inflationary tendencies in China.

Qualitatively, I test the implications of the factional framework through close scrutiny of the five reform era monetary cycles. Cases throughout the entire reform period are examined in Chapters 6 through 8 for several reasons. First and foremost, this work develops a general explanation of monetary and banking outcomes for the entire reform period. As such, testing the claims of the theory requires careful examination of the entire period. Second, all the relevant actors in the 1990s and even today had served in important positions in the government in the 1980s and thus made policies informed by events in the 1980s. As such, readers would greatly benefit from understanding the origins and political motivations of financial policies in the 1980s. Third, I have much more reliable information about elite politics for the 1980s and early 1990s than for the contemporary period. Although the political context has shifted with the passing of Chen Yun and Deng Xiaoping, the persistence of the CCP and factional politics in the 1990s allows us to use information from the 1980s to help make inferences about the 1990s.

Embedded within each inflationary cycle are two sets of subcases. First, each cycle is divided into the takeoff phase and the retrenchment phase. Instances of both successes and failures occurred in each of the two phases. A failed takeoff occurs when a top CCP leader's attempt to decentralize finance by making a significant speech in its favor is frustrated by the technocratic faction. Thus, failed takeoffs also can be interpreted as bureaucratic successes in maintaining centralization. Successful takeoffs occur when the dominant generalist faction's exhortation for decentralization and rapid growth translated to actual financial decentralization and a substantial increase in the money supply. Inquiring about both the success and failure of takeoffs allows us to test whether perceived improvement in economic conditions indeed provided a basis for decentralization and whether central bureaucrats indeed possessed the political clout to block attempts to decentralize finance, as predicted by the factional framework.

The second half of an inflationary cycle comprises the success and failure to impose central retrenchment. A failed attempt to impose retrenchment occurs when the central bureaucracy signals a recentralization drive through an important speech or through the issuance of a major decree, only to be vetoed or countermanded by a generalist faction. A successful retrenchment, by contrast, is one in which the dominant generalist faction cooperates with the technocratic faction to recentralize the financial system. Tracing the entire life of an inflationary cycle enables us to gain an intimate understanding of the political processes

that give rise to inflation and retrenchment. Chapter 6 examines both the first (1978–1982) and the second (1983–1986) inflationary cycles, whereas Chapter 7 inquires about the third (1987–1990) and fourth (1991–1996) cycles. Finally, Chapter 8 provides an in-depth discussion of the most recent cycle (1997–2006). In all but the 1987–1990 cycle, there were instances of both successful and failed takeoffs and retrenchments, providing a wide array of variation in the policy outcomes.

In addition to cases of success and failure, each inflationary cycle includes the contrasting cases of monetary policies and banking policies. A central contention of this study is that elite factions have strong incentives to fight over which level of government controls monetary policies but little incentive to defend the autonomy of the banking system. Thus, in addition to accounts of the elite struggles over monetary policy, Chapters 6 through 8 describe the elite neglect of banking reform throughout the nearly three decades under examination. Evidence presented in these chapters shows that both types of factions were equally willing to manipulate the banking sector for their own purposes.

Finally, given the opacity of the Chinese regime, a full set of historical records concerning monetary policy making is simply unavailable. In any event, one can never truly establish the preferences of central leaders through historical records alone. Nonetheless, I use a wide array of internal speeches, party documents, decrees, internal policy documents, and official and unofficial biographies to piece together the main issues of contention: senior leaders' signals to various audiences, interelite subterfuge, and the linkages between elite signals and policies. The most important empirical implications that the historical evidence establishes are that different types of senior leaders sent different signals to local officials and that their signals also varied depending on the state of the economy at the time.

I gain the most intimate look at elite politics from *The Compilation of Important Documents since the Third Plenum* (Sanzhong Quanhui Yilai Zhongyao Wenxian Huibian), a two-volume collection of top-secret (jimi) speeches and decrees compiled for senior officials that covers the years between 1978 and 1982.⁵ Although it is more than two decades old, the main actors covered in these volumes – Deng Xiaoping, Chen Yun, Zhao Ziyang, and Hu Yaobang – remained active in elite politics for much of the 1980s and 1990s. These two volumes tell us unambiguously that monetary policy constitutes a crucial point of disagreement between central leaders in the reform period. In these speeches and transcripts, the leaders' annoyance, frustration, and resentment for each other show through clearly on the issue of monetary centralization. The second major source for the 1980s, A Collection of Central Instructions to Work in Guangdong (Zhongyang dui Guangdong Gongzuo Zhishi Huibian), is a collection of speeches and discussion minutes compiled by the Guangdong Party Committee, which contains fascinating accounts of bargaining sessions between

⁵ This is the top-secret (*jimi*) version of the *Sanzhong Quanhui Yilai*, which contains more than twice as many speeches and decrees as the internal (*neibu*) version.

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Guangdong cadres and various central leaders. More so than other sources, this collection demonstrates the different relationships that various central leaders had with the province. Zhao Ziyang, who had strong ties with Guangdong, treated Guangdong much more sympathetically than did Yao Yilin, who acted the part of an unforgiving central planner.

For the entire period under examination, I also had access to internal financial regulations compiled by the PBOC, published annually in A Collection of Financial Regulations and Systems (Jinrong Guizhang Zhidu Xuanbian). These volumes, which have an internal (neibu) classification, include financial decrees issued by the State Council, the PBOC, and the individual state banks. They enabled me to discern changes in the direction of monetary and banking policies and provide hints of elite disagreements over various policies. Because these volumes are classified and are extremely tedious. I am the first to make extensive use of them. My understanding of the financial policies in the 1990s is further bolstered by a group of internal periodicals about economic and financial policies. These publications offer a rare glimpse into the policy process by publishing debates about a wide range of policy issues. These debates also supply strong indications of elite disagreements on various issues because lowerlevel bureaucrats offer disparate policy proposals according to the preferences of senior leaders (Lieberthal and Oksenberg 1988). Finally, these periodicals provide a more accurate view of the failures and problems of various policies, which tend to be beautified in the unclassified journals.

In addition to official publications, I made full use of official and unofficial memoirs written by elite participants in the financial policy process. Three particularly useful official memoirs are written by Xue Muqiao (1996), Chen Jinhua (2005) – both veteran State Council officials –and Liu Hongru (2006), a seasoned central banker who lobbied for financial reform for more than two decades. The most compelling unofficial memoirs germane to this work were written by the leftist ideologue Deng Liqun (2005) and one-time Zhao Ziyang speechwriter Wu Guoguang (1997), both of whom provide scintillating accounts of elite politics in the 1980s. These memoirs offer biased, but intricate, accounts of policy debates and elite tension over monetary policy spanning the 1980s and 1990s. In addition to memoirs, the *Chen Yun Chronicle* (*Chen Yun Nianpu*) and the *Deng Xiaoping Chronicle* provide crucial information on the preferences and actions of senior leaders.

The final group of primary sources used in this study includes unofficially leaked documents, as well as political commentaries published in the Hong Kong press. The two most compelling collections of unofficially leaked documents are the *Tiananmen Papers*, which provides a top-secret look at the decisions that led up to the Tiananmen massacre, and the *Fourth Generation*, which offers a summary of the ultra-secret assessment of potential top leaders (Nathan and Link 2001; Zong 2002). While the first collection, if genuine, gives us an unprecedented look at the elite bargaining that took place after the massacre, the second collection contains numerous anecdotes that paint a Machiavellian portrait of elite Chinese politics. I also make use of commentaries on elite Chinese

politics made by Hong Kong journalists, who base their columns, presumably, on interviews with knowledgeable insiders in Beijing (Gao and He 1998; He and Gao 2000; Lam 1989, 1995; Ren 1999). Although the reliability of these accounts is questionable, I try to only make use of facts that are mentioned by more than one commentator. Although the use of all of these sources still falls far short of complete access to Politburo meeting minutes, I believe that all of these sources together provide reasonable support for the main arguments of this work.

China's Financial Performance in Comparative Perspective

Why do we care that China's inflation has been relatively low and that the banking sector is squandering vast sums of money? In important ways, the inflationary and efficiency outcomes of the Chinese financial system represent two disparate future paths for the Chinese economy. On the one hand, sustained financial deepening, coupled with relatively low inflation, can propel China to become a global economic powerhouse. On the other hand, inefficient financial intermediation, which generates a high nonperforming loan ratio, augurs a financial crisis that spells the end of the "China Miracle" and ushers in a period of economic and possibly political instability. China's financial system produces the seeds of both future trajectories.

This chapter first discusses why inflation and efficient allocation of capital are important outcomes for China's growth trajectories. Second, it empirically compares China's inflationary and efficiency performance relative to other developing and transition countries. Compared with these countries, China's low rate of inflation has been impressive, if not stellar. This is puzzling, given the lack of institutional guarantees against political intervention in the financial system. At the same time, the banking system's efficiency, measured by the nonperforming loan ratio, is among the worst in the world.

Inflation, Efficient Intermediation, and Long-Term Growth

The two main reasons for thinking that inflation might be harmful to growth are transaction costs and uncertainty. High inflation compels companies to change prices on goods constantly and drives consumers to quickly turn cash into durable goods or precious metals or to deposit money into banks (if banks provide inflation-indexed interest rates). Essentially, these activities waste time, and the economy functions much more efficiently without them (Mankiw 1994). The more damning effect of inflation on the economy is that it creates a sense of uncertainty among investors, which decreases both human and physical capital investment, ultimately lowering a country's long-term growth trajectory.

Within this rubric, two main mechanisms work to undermine investor confidence. First, inflation usually implies higher price volatility, which decreases the certainty of return to investors. Second, high inflation rates signal to investors that the government is prone to engage in short-sighted macroeconomic policies to appease its constituencies (Fischer 1993). This implies more price volatility and higher taxes in the future, both of which increase the cost of operating a business.

The Philips Curve provides that, in the short run, inflationary financing by the government might decrease unemployment temporarily. Nonetheless, empirical works conducted in the past ten years suggest that the medium- and long-term relationship between inflation and growth is in fact negative. Using lagged inflation and prior colonial status as instruments and controlling for a host of developmental indicators, Barro (1995) finds that inflation lowers both growth and investment, although price volatility does not seem to have an independent effect on growth. This suggests that inflation's primary damage to the economy stems from the negative signal it sends to current and potential investors rather than from the menu cost. The slightly modified model used by Andres and Hernando (1997) also finds a negative relationship between inflation, on the one hand, and growth and investment in OECD countries, on the other. These findings further confirm the conventional wisdom that price stability constitutes an important ingredient for development (Easterly 2002).

If low inflation can be maintained, recent research suggests that the sustained accumulation of financial resources in an economy can bring great benefits to it. Financial deepening, a process whereby financial assets constitute a rising share of the economy, promotes growth through facilitating information exchange and through increasing liquidity to capital intensive firms and to new firms (Beck and Levine 2000; Cetorelli and Gambera 1999; Fisman and Love 2003). The combination of low inflation and financial deepening additionally maintains growth through creating a stable environment in which investors are willing to invest in financial instruments, which contributes to growth (Khan 2002).

As with inflation, there is an increasing body of evidence that suggests the importance of a well-functioning banking system in sustaining growth. In a financial system dominated by banks, inefficient allocation of capital often means loans are not made and interest is not charged on the basis of the expected return. In many developing countries, this comes about either through government control over credit allocation or through interest rate regulation imposed by the government. In the short and medium run, it is debatable whether such intervention leads to dead-weight loss to the economy or the channeling of necessary funds toward development (Haggard, Lee, and Maxfield 1993).

¹ Expected return of a loan is the sum of the different possible returns multiplied by their respective probability. See Fabozzi, Frank J., Franco Modigliani, and Michael G. Ferri. 1998. Foundations of Financial Markets and Institutions. 2nd ed. New York: Prentice-Hall International Inc.

Over the long run, however, it is inevitable that such distortions in the money market would lead to deterioration in bank asset quality.² In addition to the opportunity cost of not allocating money according to market signals, if banks lend money according to criteria other than expected return, banks would not receive interest payments adequate to cover the high risks they undertake for some of the loans. What is more, government intervention in lending creates serious moral hazard problem as banks, often state-owned entities, come to expect government bailouts in the event of financial trouble. This leads to more reckless lending and further deterioration of asset quality, lowering bank profitability and liquidity (Bisignano 1999).

Sooner or later, a steady deterioration in bank asset quality leads to a banking crisis, defined as "...significant segments of the banking system [becoming] illiquid or insolvent" (Demirguc-Kunt, Detragiache, and Gupta 2000).³ In essence, when a bank's creditors, including depositors and bond holders, demand more cash from the bank than that which the bank can provide, the bank is illiquid. When illiquidity occurs to a large proportion of banks in a financial system, the system faces a banking crisis. In such a crisis, banks no longer have enough liquidity to lend to needy businesses or must lend at a high interest rate. Depositors might have their deposits frozen, which lowers consumption. Furthermore, the government might have to issue bonds or raise taxes to bail out illiquid banks, both of which discourage future investment. Finally, a desperate government might resort to printing money to provide liquidity, which raises inflationary pressure. In sum, there are multiple mechanisms by which a banking crisis can adversely affect growth.

An emerging empirical literature shows that banking crises are in fact associated with and partially responsible for significant negative shocks to the economy. According to Hutchison and McDill (1999), the average output loss during sixty-one episodes of banking crises in the past twenty years is 7.3 percent of GDP. Although growth after a banking crisis tends to recover within three years (Demirguc-Kunt, Detragiache, and Gupta 2000), some countries, the most prominent of which was Japan, became trapped in decade-long recessions during which scarcity of bank credit and low growth reinforced each other (Hutchison and McDill 1999). Data on recent crises also indicate that they cause prolonged contractions in available credit to the private sector and a higher inflation rate, especially in countries where banks play an important role in the economy (Demirguc-Kunt, Detragiache, and Gupta 2000).

² In banks where loans constitute the majority of assets, which is most often the case for banks in developing countries, asset quality refers to the risk profile of loans. Different countries classify loans differently. See footnote 2 in Chapter 1 for details on loan classification in the U.S. and in China.

³ Although major banking crises are usually related to the deterioration in asset quality, a banking crisis can be triggered by a number of exogenous factors, including the devaluation of a central commodity in the economy, financial liberalization, and changes in government policy. See Allen, Franklin, and Douglas Gale. 2001. *Comparing Financial Systems*. Cambridge, MA: MIT Press.

In the medium and long run, banking crises can prompt reform and more efficient practice by banks. Thus, banking crises per se are not necessarily harmful to the economy in the long run. Nonetheless, the longer one delays reform, which often triggers a crisis, the more severe the crisis is likely to be (Allen and Gale 2001). Delayed reform often translates into a larger bailout when a crisis occurs, which causes a more severe contraction in credit and a higher bailout cost as a percentage of GDP. Again, Japan's prolonged recession amply illustrates this point. More ominously, as demonstrated by the tragic case of Indonesia, the negative economic shock caused originally by a severe financial collapse can degenerate into political instability and, ultimately, widespread political violence.

Inflationary Cycles and Bank Loan Allocation in Comparative Perspective

Compared with much of the developing world and postsocialist states, China's growth and inflation record has been stellar. As a result, the investment community expects China to overtake the United States as the biggest destination of FDI (O'Neill 2002). At the same time, China continues to have among the highest level of nonperforming loans as a percentage of GDP. Although the investment community is now paying little heed to the latter phenomenon, both sets of indicators will have an impact on the future growth trajectory of China.

Inflation

Throughout much of the Mao period, China experienced virtually no overt inflation because prices were administratively set by the State Planning Commission. The one exception occurred during the Great Leap Forward (1958–1961), when the devolution of monetary authority was accompanied by a sharp drop in output. The resulting inflation reached 16 percent. In contrast, China witnessed five inflationary cycles during the reform era (1978–present), each, except for the most recent one, more severe than the previous one. Nonetheless, as Figure 2.1 shows, inflation, measured in consumer price index (CPI), has been kept under 30 percent.

The first inflationary cycle, which began in the late 1970s, generated inflation upward of 10 percent. The second inflationary cycle reached around 15 percent of inflation before descending. The middle two inflationary cycles, in the late 1980s and the mid-1990s, respectively, both reached nearly the 30 percent level. Finally, the most recent inflation cycle, which began in 2002, only generated inflation rate around 7 percent, although the rate of monetary expansion was similar to previous inflationary cycles. The pattern of these inflationary cycles suggests a strong impetus in the financial system to increase inflationary pressure. When inflation rose, it did so rapidly within a matter of one or two quarters. At the same time, there also was the political will to suppress inflation fairly quickly, usually within three quarters. Inflation inertia – current

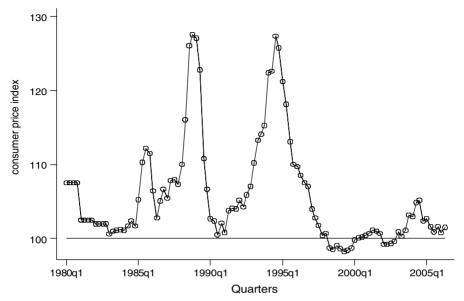


FIGURE 2.1. Inflationary Cycles in Reform China, 1980–2006 (Quarterly, CPI). *Note: Quarterly Database.* See Appendix for details.

inflation causing even more severe inflation in a subsequent period – does not seem to be a problem in China (Fischer, Sahay, and Vegh 2002).

Relative to other developing countries, China's inflationary record has been impressive. Although China's inflation has been more volatile than some of its more developed Asian neighbors, its inflation remained well below the disastrous record of Latin America and the former Soviet transition states. Russia, Ukraine, and Kazakhstan all experienced sustained inflation of over 1,000 percent, with Ukrainian inflation reaching as high as 3,500 percent in 1993 (World Bank 2001). In terms of severity, Chinese inflation was similar to that in Eastern European countries. In those countries, however, the inflation rate was much less volatile than that experienced by China. In Hungary, for example, the inflation rate hovered around the 20 percent range for much of the 90s, whereas Chinese inflation fluctuated between -3 percent and 30 percent (World Bank 2001).

Relative to other major Asian economies, China's inflationary record also has been more volatile. From the 1980s to the 1990s, the inflation rates in Japan, Korea, and Singapore all generally remained below 10 percent, with minor fluctuations. Hong Kong's inflationary record was slightly more volatile, partially as a result of influence from China. Nonetheless, its inflation rates remained well below 15 percent even when Chinese inflation reached the 20 percent range. Given that China has a state dominated financial system, inflation volatility suggests that the political impetus for both the expansion and contraction of money supply exists.

	Average	Minimum	Maximum
China 1978–2002 Market Economies 1960–1996	7.5 months 41 months	6 months 12 months	9 months 313 months
Transitional Economies 1987–1996	56.5 months	16 months	104 months

TABLE 2.1. Duration of High Inflationary Episodes (in months)^a

Despite such volatility, accelerating inflation was suppressed quickly in China time and again. China's ability to suppress inflation finds expression in the relatively short duration of high inflationary episodes, defined as an annualized inflation rate of over 25 percent (Fischer, Sahay, and Vegh 2002).

As seen in Table 2.1, although Chinese inflation rose above the dangerous threshold of 25 percent twice, high inflation was much more quickly suppressed than in other developing and transition countries that experienced high inflation. On average, high inflationary episodes in China were over thirty months shorter than similar episodes in market economies between the 1960s and the 1990s and forty-nine months shorter than similar episodes among postcommunist countries. Brazil, for example, had inflation above 100 percent from at least 1981 to 1996, whereas Russia experienced high and hyperinflation from 1991 to 1996 and again in 1999.

The truly remarkable aspect of China's financial development is that it managed to maintain relatively stable monetary environment amid rapid financial deepening. In 1978, financial asset as a share of the economy stood roughly at 50 percent. By the end of 2004, total bank loans stood roughly at 140 percent of GDP, whereas M2 broad money was 185 percent of GDP (PBOC Monetary Policy Analysis Team 2005). This high level of financial deepening is not seen in other developing countries. Most developing countries at China's stage of development have a financial asset–GDP ratio of between 30 to 60 percent, except for Japan in the 60s (Ghatak 1995). However, Japan in the 1960s was already much more developed on a per capita basis than China is today. Clearly, Chinese firms have much better access to liquidity, but the question is whether this liquidity is allocated in an efficient way.

Nonperforming Loans and Inefficiency

Despite the relatively healthy performance in terms of inflation, the efficiency of the banking system is evidently very low, as China has one of the sickest banking systems in the world. Although the incomplete availability of data makes rigorous comparisons difficult, several indicators suggest that the Chinese banking sector was in much worse shape than many of its Asian neighbors even at the height of the Asian Financial Crisis, when asset prices in many of these economies collapsed.

^a Data come from (Fischer, Sahay, and Vegh 2002).

	1990	1994	1996	2001	2001 Estimated	
China	13	26	30	28	40-45	
Indonesia	4.5	12	8.8	12	60	
Korea	2.1	I	0.8	10	16	
Malaysia	20.4	8.1	3.9	II	25	
Thailand	9.7	7.5	NA	12	45	
Mexico	2.3	10.5	12.5	5.8	NA	
Argentina	16	8.6	9.4	NA	NA	

TABLE 2.2. Official Nonperforming Loan Ratios and 2001 Estimated NPL Ratios (%)^a

As can be seen in Table 2.2, even semiofficial nonperforming loan (NPL) figures reported by a Chinese government researcher indicate that the NPL ratio in China was much higher than many of its Asian neighbors throughout the 1990s. The official NPL ratio rose steadily throughout the decade despite several rounds of supposed banking reform. After the Asian Financial Crisis, banks in some Asian countries got into even more trouble as asset prices collapsed, but, officially, China was still doing the worst in 2001. According to unofficial figures calculated by private consulting firms, shown in Table 2.2, only Indonesia might have performed worse than China in terms of NPL ratio after the financial crisis.

What is perhaps more important is NPLs as a percentage of GDP because it gives an indication of the cost of fixing the banking sector to the economy. In this regard, independent private sector estimates shown in Figure 2.2 paint a bleak picture of China. Although the NPL ratio in Indonesia in 2001 was at an astounding 65 percent, NPLs as a percentage of GDP stood at a mere 10 to 15 percent, suggesting a relatively manageable banking problem. In contrast, because loans outstanding in China have exceeded GDP since the mid-1990s, a 40–45 percent in NPL ratio translated to an astounding 44–55 percent of the GDP in 2001. Again, this indicates that the cost of making the banking sector solvent in China is likely to require an enormous bailout. Although the government devised various schemes to write off the bad debt over an extended time period, it nonetheless translated to significant losses in terms of foregone growth (see Chapter 8). Moreover, despite government injections totaling at least U.S.\$322 billion to fix the problem, official NPLs as a share of GDP during the third quarter of 2005 remain dangerously at nearly 50 percent.⁴

Official NPL figures for all countries except China come from (Sachs and Radelet 1998). Semiofficial figures for China come from (Fan 2000). 2001 estimates for all countries come from (Berger, Nast, and Raubach 2002).

⁴ Official NPL amount is the sum of NPLs on banks' balance sheets, undigested NPLs on asset management companies' balance, and PBOC loans outstanding to financial institutions. See People's Bank of China. 2006. Huobi dangju zichan fuzhaibiao (Assets and Liability of the Monetary Authority) PBOC, 2006 [cited 7/12 2006]. Available from http://www.pbc.gov.cn/diaochatongji/

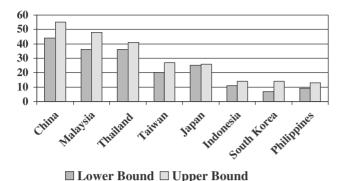


FIGURE 2.2. Estimated Range of NPLs as a Percentage of GDP in 2001. *Note:* Data from (Berger, Nast, and Raubach 2002).

In addition to the high NPL ratio, another indicator of inefficient capital allocation is China's artificially low interest rates through substantial lengths of time in the reform period. According to financial repression theory, governments in developing countries fix interest rates at an artificially low level and channel cheap capital toward state objectives, which gives rise to the nonmarket allocation of capital (Demetriades and Luintel 1997). Although complete statistics on black market interest rates are unavailable for China, which precludes direct calculation of the level of "repression," sustained periods of negative real interest rates strongly suggest severe financial repression. Since the reform, China saw twenty-eight quarters of negative real interest rates, something that would not have occurred in a fully functioning financial market. As one PBOC veteran admits, negative real interest rates were maintained because the Chinese government wanted to reduce explicit deficit by providing cheap capital to SOEs, grain procurement, and state construction projects (Dai 2002a).

Although incidents of negative interest rates essentially mirrored inflationary episodes shown in Figure 2.1, there is no evidence to suggest that capital allocation by state banks was more efficient when inflation rate was low. In fact, negative interest rates increased the incentive for private entrepreneurs to form informal financial institutions to absorb deposits, which may have increased the efficiency of overall capital allocation during high inflationary episodes. The persistent climb in the NPL ratio, seen in Table 2.2, also implies continuous state intervention in capital allocation regardless of the real interest rates. The negative interest rates merely demonstrate the state's willingness to maintain low interest rates even when the opportunity cost of doing so dramatically rose.

China is unique as perhaps the only developing country that sustained this extraordinary level of NPLs and inefficiency without triggering a financial panic. The primary reason for continual stability in the face of insolvency is

China's enormous foreign exchange reserve, combined with the lack of capital mobility. By the spring of 2007, China held U.S.\$1.2 trillion in the foreign exchange reserve, giving it the highest reserve in the world. This has greatly assured both domestic and foreign investors of the solvency of the Chinese financial system. Moreover, despite a thriving underground money-changing and smuggling industry, the cost of smuggling large sums of money out of China remains relatively high and beyond the reach of most ordinary depositors. Even as foreign banks expand their operation in China, they remain highly constrained by regulations that restrict the transfer of funds out of China.

Without the threat of capital flight, the Chinese government can resort to authoritarian tactics to prevent a domestic banking panic. The state was successful in containing several local runs on the banks, which occurred in Zhengzhou in 1999, in Lu'an County right next to Beijing in 2000, and in the Kaiping District of Guangdong Province in 2001 (Chang 2001; Lague 2002). These panics were by no means minor affairs. In the Kaiping case alone, some 900 million yuan, or over U.S.\$100 million, was withdrawn in one day from a single branch bank. In each case, rumors of corruption at a local state bank branch triggered a bank run that threatened to spread across the country.

Nonetheless, because of its strict control over the banking sector, the police, and the media, the regime quickly quelled panic by shipping trainloads of cash to the trouble spots and by imposing a media blackout on the incidents. The regime's continual presence in the financial sector also assured depositors of its resolve to provide sufficient liquidity to the banking system. As Allen and Gale (2001) point out, however, it is difficult to predict the precise event that would trigger a financial collapse. This is especially the case in China, because a host of economic and political shocks can undermine people's confidence in the regime and hence in the banking sector.

Implications

If one takes into account growth, inflation, and banking sector solvency, one can see elements of the China "Miracle," as well as seeds of a future financial crisis. On the one hand, China has managed to grow at a healthy clip while keeping inflation in check. On those indicators alone, foreign investors are right in choosing China as their favorite investment destination. Yet China's banks have long since exceeded the bounds of solvency. Even if Chinese banks adopt international best practice today, the current level of NPL will take a long time to completely digest. Unfortunately, the political economy that governs China's banking sector is far from ready to follow international best practice. Although factional politics in China produced an internal political check on high inflation, the same factional dynamics also provided scant incentive for political leaders in China to introduce fundamental reform in China's banks.

The Banking System: Flexible Institutions and Party Domination

Throughout the nearly three decades of reform, the Chinese banking sector has evolved from an appendage of the Ministry of Finance to a sprawling bureaucracy with specialized roles and an increasingly diversified ownership structure. It also has become a central aspect of China's economy as total lending climbed well over China's GDP. As a result of its immense size, the banking sector is also the key to understanding China's inflation and financial efficiency performance. To the extent that money supply affected inflationary expectation, the speed with which the banking system created money has played a major role in inflationary outcomes. At the same time, the banking sector is still the predominant channel for financing investment in China, making it the key to understanding the efficiency of capital allocation.

Undeniably, the enormously complex set of institutions governing China's banking sector has affected both monetary expansion and the allocation of capital. Nonetheless, the waves of institutional changes in the reform era have not had a significant, independent impact on our dependent variables: inflation and the efficiency of capital allocation. As this chapter demonstrates, institutional changes often followed shifts in political signals. In other instances, institutional changes, although designed to achieve monetary and distributive outcomes, ultimately had little impact on them. Rather than being an independent causal agent, changes in banking institutions were crucial steps in the causal chain that led from elite political shifts to fluctuations in the dependent variables.

The complexity of China's banking institutions allowed the political elite to mobilize them toward disparate political purposes. When the Party center urged high-speed growth, local governments and firms blackmailed the state banks for more funds, and the state banks, in turn, forced the central bank to expand the money supply. However, when the Party center signaled its resolve to suppress monetary expansion, the People's Bank of China – China's central bank – mobilized its impressive organization and monitoring capacity to enforce the

loan ceiling, quelling inflationary expectation. Ultimately, the most significant feature of the Chinese banking system was the pervasive influence of the Chinese Communist Party, which induced a high sensitivity among bankers to political signals from the top.

General Characteristics

Throughout much of the Mao era (1949–1976), the People's Bank of China (PBOC) served as the primary financial intermediary in China. It mainly absorbed deposits from residents, state-owned enterprises (SOEs), and government units and provided short-term working capital loans to SOEs (Miyashita 1966: 190–200). In 1977, the central government began to use banks more actively as a policy tool for economic growth. This generated two changes in the banking sector. First, rather than merely providing small working capital loans to SOEs, the central government demanded banks to lend more and to support long-term fixed asset investment for SOEs and other government investment projects (Yi 1994). The process of "fiscalizing" the banking sector was by no means uncontroversial and is the subject of Chapter 6. Second, the fiscalization of the banking system led to the rapid growth of financial assets, especially bank loans, in subsequent decades.

Despite the recent changes and reforms, the institutional course that the Chinese banking sector took in the early 1980s continues to influence the banking structure today. In 1979, the Agricultural Bank of China (ABC) was reconstituted to handle government financing of grain procurement and rural development. In the same year, the Bank of China (BOC) broke off from the PBOC and took over the foreign currency portfolio. In 1984, the Industrial and Commercial Bank of China (ICBC) separated from the PBOC and financed China's state-owned enterprises (SOEs). At the same time, the China Construction Bank (CCB), which had been an arm of the Ministry of Finance, gained operational independence and continued providing loans to long-term state investment projects. Thus, the Big Four state banks, which dominate the banking sector even today, were born.

The birth of the Big Four also coincided with two important trends. First, because the government decided to use the banking sector to finance much of the economic reform, banks came to dominate the Chinese financial market. The enormity of the Chinese banking sector gave politicians an almost unlimited supply of money to distribute for political purposes. At the same time, the Big Four banks were required to lend to most of the projects in their respective policy areas, which meant they bore the bulk of the burden in policy loans and loans to the state sector (Lardy 1998). Whereas fiscal expenditure totaled 2.2 trillion yuan in 2002, the state banking system lent over 9 trillion yuan in the same period, most of which to the state sector (National Bureau of Statistics 2004).

The vital role of the Big Four in economic development allowed their assets and deposits to balloon along with China's economic growth. Most enterprises

and individuals had no choice but to deposit their savings into the Big Four banks. In return, the Big Four banks were obligated to lend to enterprises within their policy jurisdiction according to state policies and political demands. This trend continues today, with the Big Four and the policy banks still holding well over 60 percent of China's 44 trillion yuan (U.S.\$5.6 trillion) in bank assets. As Figure 3.1 shows the share of state bank lending and deposits stabilized at around 80 percent throughout the 1990s. In fact, their presence increased between 1995 and 1999 with a 3 percent gain in the share of total bank deposits to 74 percent (see Figure 3.1). In 2001, state bank share of the market dropped significantly because of the reclassification of CITIC Bank and the Bank of Communication from the category of "state bank" to "jointstock bank," but these two banks were in reality still controlled by the government. After this reclassification, state bank share of the market remained in the 60 percent range. In 1994, three policy banks, the State Development Bank, the Agricultural Development Bank, and the Export-Import Bank, were formed to take over the policy portfolios of the Big Four banks, in theory leaving them to make commercial loans. However, political incentives for Big Four bank managers and weak institutional capacity of these new policy banks required the Big Four banks to continue their involvement in policy tasks.

Controlling Money Supply

Despite the establishment of institutions that resemble those seen in a Western banking system, administrative decrees rather than monetary instruments such as reserve requirements, interest rate adjustments, and open market operations still played the dominant role in controlling the money supply. The pervasiveness of administrative decrees is symptomatic of the lack of institutional credibility for controlling the money supply. The lack of institutional credibility also meant that the waves of institutional changes in money supply control mechanisms have not significantly affected the trajectories of the various inflationary cycles.

China emerged from the Mao era with a strict system of money control in which PBOC headquarters issued nonnegotiable loan ceilings to the regional branches and channeled most loans only to recipients approved by the State Planning Commission (Miyashita 1966). In the early 1980s, the communist leadership decided to use the banking sector much more actively to finance local development. This policy was formalized when the PBOC issued "A Notice on the Method of Controlling Loan-to-Deposit Difference" (Xindai Cha'e Kongzhi Banfa), which gave local PBOC branches, especially those at the provincial

¹ Year-end 2006 figure from China Banking Regulatory Commission. 2007. Zong Zichan, Zong Fuzhai 2006 (Total Assets and Liability in 2006) CBRC, 2007 [cited 6/7 2007]. Available from http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=2454.

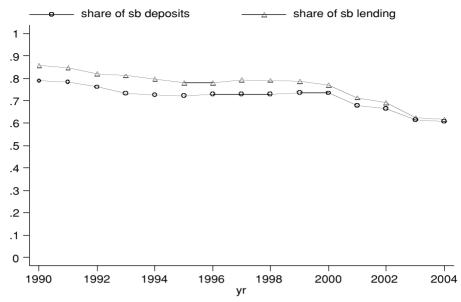


FIGURE 3.1. The Share of State Bank Deposits and Lending: 1990–2004. *Note:* Figures are state bank lending and deposits as a share of total lending and deposits. Data from *Annual Database*. See Appendix for details.

level, room to distribute a part of their respective credit quotas to different local development projects (Xie et al. 2001: 7).

To ensure continual central control over the money supply, the State Council, China's cabinet, responded with a system of strict quantity control over both national level lending and lending at the provincial and sectoral level. The national credit plan became the key to this system of control. The credit plan specified not only the overall quantity of lending in a given province but also the percentage of that amount that went toward fixed-asset investment and working capital loans (Fei 1995a). In the annual credit allocation cycle, the State Council and the People's Bank of China first sent a draft credit plan to the provinces and ministries in the autumn every year. After bureaucratic and political bargaining, the State Council issued a final credit plan to which the provinces and ministries were bound (Holz 2000; Ma 1996). The credit plan, however, served merely as a half-opened cage for money supply. As later chapters detail, when elite political signals called for high-speed growth, the state banks routinely exceeded the credit quotas. Retrenchment periods, however, brought the wrath of the central government on those who violated the credit plan.

The force of the credit plan meant that other monetary instruments served supplementary roles until recently. Reserve requirements limited lending by individual banks, but provincial governments' influence over all the bank branches within their jurisdictions meant that the reserve requirements did little to constrain provincial level lending (Ma 1996). If one bank ran low on

liquidity, the local government simply ordered another bank to lend to a project. Moreover, as one veteran central banker put it, "the effect of increasing reserve requirements is offset by relending (zaidaikuan) by the PBOC" (Liu 2000d). In other words, when there was political pressure to expand lending, banks facing liquidity shortfall as a result of increased reserve requirements simply approached the local PBOC for a loan. The classic example of this was the PBOC's attempt to engineer a "soft landing" in 1987. Rather than contracting money supply, the increase of reserve requirement was neutralized by heightened relending to the Big Four banks (Liu 1993: 73). Interest rate adjustments were also seldom used as a way to control money supply. As Figure 3.2 reveals, lending interest rates, represented by the triangle-dotted line, fluctuated only four times before the late 1990s, whereas lending, represented by the circle-dotted line, fluctuated wildly during the same period. Only during the Zhu Rongji administration were interest rates used as a tool to increase lending. Given that the government eschewed bond issuance until the late 1980s, open market operations also did not play a large role in changing the money supply until recently.² Although these monetary instruments exerted some effect on money supply and inflationary expectation, they made minor noises to the loud bangs of political signals from the Party center.

In the late 1980s and the 1990s, the People's Bank of China began to experiment with asset-liability management as a way to replace the credit plan. Rather than strictly decreeing the quantity of lending by banks, asset-liability management allowed banks to lend up to a specified percentage of total bank deposits.³ This aimed to provide banks with more flexibility on lending quantity and to create more incentive to absorb deposits. With the proliferation of joint-stock banks and smaller city banks in the 1990s, asset-liability management also aimed at reducing the PBOC's cost of controlling the money supply (Xie 1997).

In the late 1980s, the PBOC first experimented with asset-liability targets with the newly reformed Bank of Communications. In late 1993, the State

- ² Starting in late 2002, the PBOC began to issue its own bonds to sterilize the influx of foreign exchange because the supply of treasuries was insufficient to absorb China's current account surplus. See Green, Stephen. 2005. Making Monetary Policy Work in China: A Report from the Money Market Front Line. In SCB Global Research, edited by Standard Charter Bank. Shanghai: SCB Global Research.
- ³ A crude form of asset-liability management was implemented in 1980, when the PBOC issued loan-to-deposit ratios to the provinces. The credit plan still mandated the percentage of loans going to fixed asset investment, but local branch banks could lend more in working capital loans if they absorbed more deposits. This scheme was probably abandoned in the early 1980s in order to strictly control money supply. It also differs from the new asset-liability management in that the credit plan controlled the percentage of loans going to fixed asset investment in the past. See State Council. 1982. Zhongguo remin yinhang quanguo fenhang hangzhang huiyi jiyao (Important points at the PBOC national branch manager meeting). In San Zhong Quanhui Yilai Zhongyao Wenxian Huibian (Compilation of Important Documents since the Third Plenum [of the 11th Central Committee]), edited by Document Research Center of the CCP Central Committee. Beijing: People's Publisher.

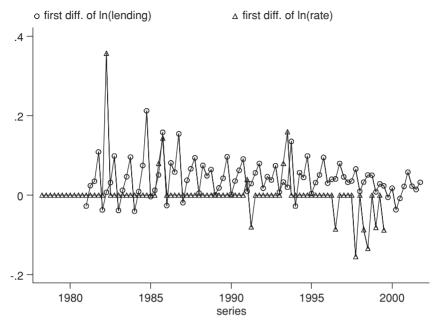


FIGURE 3.2. Quarterly Fluctuations of Lending and Lending Interest Rates: 1980–2000. *Note:* Each observation represents the first difference of the log of lending and lending interest rates, respectively. Data come from *Quarterly Database*. See Appendix for details.

Council required commercial banks to implement asset-liability management while adhering to the credit plan, placing banks under "dual management" (Fei 1995b). In principle, all banks were required to maintain a loan-to-deposit ratio of 75 percent, but exceptions were made for different kinds of financial institutions.⁴ More important, some provinces received higher asset-to-liability ratios, or loan-to-deposit ratios, than others (Fei 1995b).⁵ Finally, on January 1, 1998, the mandatory credit plan was retired in favor of asset-liability management, although a guidance credit plan survived.

The elaborate credit plan and later the asset-liability management not withstanding, loan expansion routinely rose above the lending targets and the mandated loan-to-deposit ratios. A veteran PBOC researcher laments that actual lending during most years of the reform exceeded the quantity mandated by

⁵ Interview in Beijing: 5/14/01.

⁴ In addition to the loan-to-deposit ratio, banks were obligated to maintain capital adequacy ratio, liquid asset ratio, reserve payment ratio, individual loan ratio, cash issuance rate, and non-performing loan ratio. Given the plethora of targets, monitor by the local branches of the PBOC has largely been inadequate. As a result, only two or three targets were closely monitored, including the loan-to-deposit ratio and the nonperforming loan ratio. See Fei, Chuanzhi. 1995b. The debt-asset ratio management and risk management system in our country's financial institutions (Woguo jinrong jigou de zichan fuzhai bili guanli yu fengxian kongzhi). *Financial Reference* (*Jinrong Cankao*) 1995 (8):37–41. Interviews in Shenyang, 12/26/00; Dalian, 5/23/01.

the credit plan; between 1991 and 1996, actual lending exceeded the original targeted amount by an average of 31.9 percent (Xie 1997; Xie et al. 2001). Even after the implementation of asset-liability management, provinces routinely deviated from their respective loan-to-deposit targets. This came about either because the provincial branches of the Big Four banks exceeded the loan-to-deposit targets issued by the headquarters or because the local government pressured local branches of the state banks and other financial institutions into extending more loans (Joint Investigation Team of the Financial Research Institute at the Shandong Branch of the PBOC 1998). Despite PBOC monitoring, local branches of the Big Four banks lent money according to political signals from the local government, which in turn responded to political signals from central politicians. What was worse, both the local and the central offices of the PBOC, which were the main gatekeepers of the money supply, also responded to political signals from the Party center.

Overlending by the Big Four banks, whether under the credit plan or asset-liability management, was made possible by PBOC "relending" (*zaidaikuan*) operations that injected liquidity from the PBOC into the Big Four banks. Although relending declined on the PBOC's balance sheet in the late 1990s, the enormous magnitude of these operations, especially to the agricultural banks, made relending an important venue through which the money supply expanded in China. If the PBOC lent to a bank, the bank would have more to lend, creating a multiplier effect on the money supply. Unlike in most Western banking systems, Chinese central bank lending often involved long-term loans, not short-term "last resort" loans. This crucial tool of financial expansion also was extremely flexible. When central politicians demanded growth at all costs, the PBOC was able to react quickly to liquidity demand from the banks and lent "on demand" via relending (Liu 1997: 18). During times of retrenchment, however, all relending halted, and banks were forced to stop financing ongoing projects.

Policy makers in the early 1990s argued that PBOC relending generated inflationary pressure because local branches of the PBOC lent to state banks in response to local governmental pressure (Zhu 1998b). The 1993 inflationary crisis allowed central technocrats to implement banking restructuring measures that centralized the relending authority to the PBOC headquarters in an attempt to minimize local intervention. Despite this institutional change, money supply and inflationary pressure continued to rise for another year, as was seen in Figure 2.1. This strongly suggests that both central PBOC officials and local officials were reacting to the same political signals from the Party center. Rapid money supply expansion could not be wholly blamed on enthusiastic local officials. Moreover, this case suggests that institutional changes alone without accompanying political shifts had little impact on the money supply.

In the late 1990s, the Chinese government further attempted to minimize political intervention in monetary policy through furnishing policy authorities to a group of financial experts. However, this effort, which culminated to the

formation of the monetary policy committee (MPC) in 1997, also failed to filter political signals out of monetary policy. First, even in the charter of the MPC, it was designed as a "consultative discussion organ" with no final decision power (People's Bank of China 1997b). Second, the MPC was made up of a mix of central bankers, senior technocrats from other economic agencies, and financial experts (People's Bank of China 1997b). Thus, the MPC soon evolved into an arena for bureaucratic bargaining as each agency attempted to sway monetary policy to favor its own policy mission (PBOC Monetary Policy Committee 2000c). For example, during MPC meetings, the representative from the State Economic and Trade Commission, then in charge of SOE reform, repeatedly called for more lending to restructure SOEs (PBOC Monetary Policy Committee 2000a). Moreover, its consultative nature quickly revealed itself. Between 1998 and 1999, the MPC twice decided to hold interest rates in place rather than to lower them to stimulate the economy (PBOC Monetary Policy Committee 2000b; PBOC Monetary Policy Committee 2000d). In both instances, the premier vetoed its decision and lowered interest rates.

Even after banking centralization, the implementation of asset-liability management, and the formation of MPC, a mix of intractable monitoring problems and political intervention continued to create large temporal and interregional variation in the amount of money lent out. When the political signals called for rapid growth, local governments found numerous loopholes in the credit control mechanism to finance local growth. Large sums could be poured into policy tasks within a short time. At the same time, the credit control mechanisms perfected by the State Council throughout the reform era could also halt all lending virtually overnight. The key to this flexibility has been the continual domination of the Communist Party over the banking sector such that all bankers bowed to the prevailing political wind from the Party center or faced dismissal.

Credit Allocation

Because the banking system represented by far the largest portion of the money supply in China, loan allocation by the banks heavily influenced the overall efficiency in capital allocation. Although the formal mechanisms of loan allocation were not the most important factors determining the flow of loans, an analysis of the formal institutions nevertheless allows us to understand the mechanisms by which high politics influenced loan allocation.

During the height of the national credit plan from the 1980s to the mid-1990s, loan allocation was largely controlled by two processes, national priority projects, on the one hand, and loans supporting local economic growth, on the other. Loans to national priority projects, including major construction projects and policy loans for rural development and grain procurement, were embedded in the national credit plan. The provision of these loans was jointly worked out by the provinces, the line-ministries, and ultimately by the State Planning Commission and the People's Bank of China (Fei 1995c). This part of the credit plan closely resembled credit allocation in many socialist countries, with "the Planning Commission ordering the dishes and the banks footing the bill" (*Jiwei diancai*, *yinhang fuqian*). Central politicians intending to provide economic advantages to a province often intervened in this process to ensure a higher number of priority projects approved for the province.

On a separate track, local branches of the Big Four banks consulted with the provinces to determine how much working capital would be lent to local SOEs and other local projects, the overall quantity of which was stated in the national credit plan (Ma 1996). In this process, local officials had enormous leverage because the local Party committee influenced the promotion of local bankers. At the height of the credit plan system, provinces, especially those with the right elite political connections, often exceeded lending targets in the credit plan through lending excessively to local enterprises, forcing the PBOC to increase the lending quota and to "relend" to branches of the Big Four banks to finance national priority projects (Ma 1996).

In the 1990s, local branches of the Big Four banks also lent out substantial amounts of working capital to private or semiprivate enterprises, especially in the coastal region. However, interest rate restrictions and an incomplete credit monitoring system prevented risk-averse state banks from switching their portfolios to the private sector for fear of default. Defaults by SOEs, which occurred quite often, did not cause any problem for state bankers because they simply followed orders when lending to SOEs.

The 1998 banking centralization (discussed in Chapter 8) and the implementation of asset-liability management transformed the traditional planning system, but state policies still played an important role in credit allocation. With banking centralization, local branches of the Big Four banks were formally only answerable to headquarters of these banks and to the central government and no longer to the local government. The abolition of the credit plan in theory provided centrally administered banks autonomy to make loans to obtain the best return, so long as banks complied with the multitude of asset-liability targets and interest rate regulations set forth by the PBOC. By all accounts, including interviews with local bank officials, the 1998 change was for a time successful in insulating the Big Four banks from local political influence.⁶

Nonetheless, this only made banks a tool of national policies. During the Zhu Rongji administration, the banking sector as a whole, and especially the Big Four banks and policy banks, provided trillions in funding to the Three-Year SOE Rescue Plan, the drive to maintain growth at 7 percent, and the massive infrastructure development plan for western China. Through a mix of interest rate policy and administrative decrees, the central government enticed, cajoled, and at times commanded banks to channel credit to fulfill policy goals (PBOC

⁶ The local government continued to have great influence over local banks and rural and urban credit cooperatives. Interviews in Shenyang, 12/26/00; in Dalian, 5/21/01, 5/22/01; in Fuzhou, 6/7/01, 6/8/01.

Monetary Policy Committee 2000d). The lack of interest rate flexibility meant that banks still lacked any incentive to lend to the private sector; the bureaucratic risk of doing so continued to out-weigh any potential gains. Persistent state intervention found expression in the small proportion of state bank loans flowing to the nonstate sector. State bank lending to the nonstate sector only climbed laboriously from 3 percent in 1990 to around 15 percent at the end of 2003.⁷

As with money supply, the allocation of credit remains largely dictated by administrative decrees and state policies rather than by market signals. Although the allocation of loans to the private sector increased rapidly in absolute terms, the vast majority of banking resources was still destined for SOEs and state construction projects. The underlying dynamic for nonperforming loan creation – the misallocation of credit – continues unabated.

The CCP's Dominance over the Banking Industry

Like all other government bureaucracies in China, the state dominated banking sector came under the dual leadership of the state and the Chinese Communist Party (CCP). On the state side, the People's Bank of China (PBOC), in addition to its crucial role in monetary policy, played an active, although by no means exclusive, role in monitoring and selecting managers throughout the banking system. Most recently, this task has fallen on the newly formed China Banking Regulatory Commission (CBRC). The State Council, China's cabinet, also had an important say in appointing senior bankers. On the Party side, the Central Organization Department, the Central Disciplinary and Inspection Commission (CDIC), and, for a time, the Central Finance Work Commission (CFWC) appointed and evaluated most senior managers in the banking system. This constellation of monitoring and enforcement mechanisms dominated by the CCP ensured that bankers at every level paid close attention to policy signals emanating from the highest reaches of the CCP.

Monitoring and supervision of banks fell into two general areas: Party discipline and professional supervision. Party discipline encompasses monitoring adherence to Party policies and regulations, cadre evaluation, and anticorruption investigations. The primary agency responsible for Party discipline work is the CDIC, although the CFWC became heavily involved during the Zhu administration. Professional supervision entails ensuring compliance with state lending quotas, asset-liability ratios, nonperforming loan ceilings, mandatory interest rates, and so on. It also includes quality control and professional evaluation of managers in the banking system. The primary agency for professional

⁷ Source: Quarterly Database. See Appendix.

⁸ The only domestic banks in China that can appoint managers without first consulting either the local or the central level CCP are Minsheng Bank and Shenzhen Development Bank. The appointment of senior managers at these banks still requires CBRC approval. See Li, Qing. 2000. Bianxi Minsheng Yinhang (Identifying Minsheng Bank). *Caijing Magazine* (8/26).

supervision throughout much of the reform has been the PBOC, but the Ministry of Supervision and the recently founded China Banking Regulatory Commission (CBRC) also have played an important role in professional supervision in various periods.

The 1980–1998 System: Decentralized Administration and Monitoring

Under the Maoist system of highly centralized banking, the banking system was governed by the State Planning Commission, the Ministry of Finance, and the State Economic Commission. On the Party side, Party groups (dangzu), composed of hand-picked Party officials, presided over all of these organizations. With the more decentralized credit allocation model in 1979, some of the banking sector's administrative power also devolved to the provincial level. In the decentralized model, senior banking officials were still promoted by the Central Organization Department, which also set the evaluation criteria for all bankers. This meant that bankers had to constantly pay attention to shifting political winds to meet the varying evaluation criteria of the Central Organization Department. For example, "support for SOEs" was included as a new category in the evaluation form for bankers in 1997, causing the state banks to release a deluge of funds to ailing SOEs (Li 1997a).

In the early 1980s, however, local Party committees obtained the authority to jointly appoint local Big Four bank managers and PBOC officials along with the Party groups within the PBOC and the Big Four banks. Local bank managers in turn became important members of the local government, and began to attend local economic planning meetings and to receive "targets" (*zhibiao*) and "tasks" (*renwu*) from the local Party committees. In addition to formal power, the local Party committees also put pressure on local banks in innumerable ways, from the allocation of bank workers to the supply of utilities to fee collection. Thus, as Figure 3.3 indicates, both the headquarters of the Big Four banks and the provincial party committees had administrative jurisdiction (indicated by solid-line arrows) over provincial branch banks, which translated to appointment power over provincial bank managers.

In addition to the Party Committee system, the Party also exerted direct control over the financial system through the disciplinary and inspection network. Party monitoring of the financial sector began in 1985, when the watchdog organization of the Communist Party, the CDIC, stationed special investigation teams at the headquarters of all the banks. Concurrently, local disciplinary and inspection committees (DICs) attached to the local Party committees also stationed investigation teams at local PBOC branches. Within one year of its formation, the financial CDIC/DIC network multiplied to 4,953 teams, involving 13,217 cadres. In this way, the local party committee influenced the banking sector both through appointing local managers and through the DIC team network (CDIC Team Stationed in the Financial System and The Ministry of Supervision Bureau Stationed in the Financial System 1997). Because of the watchdog function of the CDIC/DIC network, it potentially played a crucial role in the appointment and removal of officials in the banking sector. Even

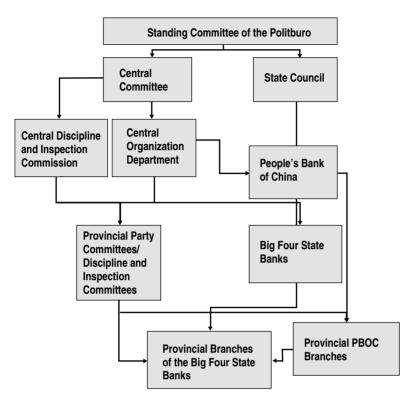


FIGURE 3.3. Decentralized Administration of the Banking System: 1980–1998. *Note:* Arrows indicate the flow of administrative authority.

the initiation of a corruption investigation could ruin careers. Given that the local DIC network took orders from both the local Party committees and from the CDIC, it flexibly served both local and central interests, depending on the prevailing political trend.

For professional supervision, the PBOC served as the lead agency, especially since the enactment of the Central Bank Law in 1995. In addition to the PBOC headquarters in Beijing, which monitored the headquarters of all the banks, PBOC regional and provincial offices monitored the business activities of the Big Four's regional branches, as well as local banks. Through monthly reports by each bank's headquarters and their major branches, as well as "on the spot" auditing of the banks' books, the PBOC ensured that the deposit and lending interest rates did not deviate from the mandated band. These mechanisms also allowed the PBOC to monitor compliance with the national credit plan and, after 1998, the reserve requirements and minimum

⁹ From the beginning of reform, the PBOC allowed a small band within which banks could adjust interest rates. In recent years, interest rates on lending have gradually liberalized. Nonetheless, rates on deposits remain tightly regulated.

asset-to-liability and loan-to-deposit ratios for different banks and regions (People's Bank of China 1999: 138–142). Although central banks in the West monitored some of these figures nationally, the PBOC imposed different mandatory ratios on different localities. Finally, the State Council and the PBOC routinely issued temporary regulations or decrees which the state banks in particular must follow. Failure to adhere to PBOC targets and regulations could result in warnings and administrative punishments for the violating banks or bank branches and, most important, for the bank managers in charge of these entities.

The heart of the PBOC's supervision of individual bankers was a record of all bank managers' professional performance, in terms of adherence to PBOC regulations. This record played an important role in the promotions of bank managers, which required PBOC evaluation and approval. Although the significance of the PBOC vetting process for promotions varied through time and across various localities, the record of administrative accomplishments (*zhengji*) kept by the PBOC nonetheless served as an important foundation for a banker's resume (Wang and Wang 1997)¹¹.

PBOC monitoring aimed at a steady money supply and the allocation of credit according to state policies. Thus, PBOC evaluation criteria at times clashed with the Party's evaluation criteria, which shifted more frequently depending on the political environment. However, because the PBOC itself was governed by the Party, bankers at every level knew that it was more important to obey political criteria set forth by the Party than the technical standards of the PBOC. Only when top bureaucrats gained the political upper-hand did technical standards become important for the bankers. Bankers who broke the credit quota during high growth periods could always blame political pressure and local intervention after the fact. The PBOC, knowing the political reality full well, could do little to punish bankers.

Beyond the PBOC, other government agencies, such as the Ministry of Finance and the State Economic and Trade Commission, also issued regulations pertaining to the balance sheet and write-off procedures of the state banks. Although these agencies did not keep a record of bankers' administrative performance, they were fully capable of alerting the PBOC to a bank or a banker's transgression against these agencies' decrees.

A New Centralization: Bank Structure after the 1998 Change

As will be seen in Chapter 8, Premier Zhu Rongji took the opportunity of the Asian Financial Crisis, which greatly alarmed the Party leadership of the financial system's fragility, to centralize the banking sector to an unprecedented degree. The centerpiece of the restructuring was the Central Finance Work

¹⁰ Interview in Beijing: 10/10/00: interview in Fuzhou: 6/7/01.

¹¹ Interviews in Beijing: 3/2/01; in Dalian: 5/21/01. The CBRC took over this task in 2003 on its formation.

Commission (CFWC), which answered only to the Central Committee (CC). Vice Premier and Politburo member Wen Jiabao served as its chairman, while his longtime protégé, Yan Haiwang, served as the executive vice chairman. Although PBOC Governor Dai Xianglong, who had a long career in the banking sector, was a vice chairman, he took orders from Yan Haiwang, who spent much of his career in propaganda work.

The founding mission of the CFWC was to "lead, guarantee, manage, monitor, and coordinate" the financial sector. In the inaugural meeting of the CFWC, Chairman Wen stated that the CFWC would "... protect the independent legal person status of the state commercial banks and other financial institutions" but also would "guarantee the implementation of the lines, principles, and policies of the CCP Central Committee and the guidance and decisions of the State Council..." (Wen 1999: 797). The Party's longtime conflicting desire to commercialize and to retain control over the banking sector could find no better expression.

After the 1998 restructuring, the headquarters of the Big Four banks nominated senior managers, subject to approval by the PBOC, the CFWC, and ultimately the CCP Central Organization Department (Heilmann 2005). The headquarters of each bank appointed local managers, subject to approval only by the PBOC and the CFWC. The local government no longer played a direct role in appointing Big Four branch managers. Rather than answering to the local Party committees, Party members in the financial system now had their own Party committee hierarchy, headed ultimately by the CFWC (Liu and Lu 1999: 135). The CFWC also gained the authority to approve appointments of managers in joint-stock banks and local banks, although shareholders and local Party committees presumably had more leeway to nominate candidates in these banks (Yan 1999). Institutionally, the era of local domination over the Big Four banks came to an end in 1998. Nonetheless, informal intervention by the local government, especially if the political atmosphere was right, continued to be a regular feature of the banking system. As shown in Figure 3.4, only the headquarters of the state banks had direct control over the provincial branch banks, whereas local government retained only informal influence. Nonetheless, 1998 saw the introduction of an even more bewildering array of central agencies on both the state and the party side that could directly or indirectly influence appointments and major policy shifts in state owned commercial banks (Figure 3.4).

In addition to consolidating management appointments, CFWC also concentrated Party discipline work within the financial system. The CDIC inspection teams transformed into the Central Finance Disciplinary Work Committee (Zhongyang Jinrong Jilu Gongzuo Weiyuanhui), headed by both the CFWC and the CDIC (Wen 1999: 798). The CFWC also had the additional power to send monitoring committees (*jianchahui*) to the headquarters and branch offices of any state-related financial institution in China to examine its books (Heilmann 2005). Although the monitoring committees were tasked with

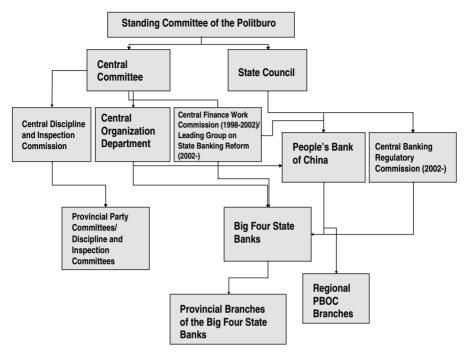


FIGURE 3.4. Centralized Administration of the Banking System: Post-1998. *Note:* Arrows indicate the flow of administrative authority.

investigating cases of corruption, their reports also had a bearing on the promotion of managers.¹² As with the appointment system, this new monitoring structure minimized the influence of the local Party committee.

Despite drastic institutional changes, the weight of the Party in the financial system did not diminished, as shown in Figure 3.4. The CFWC oversaw the PBOC, the Big Four state banks, as well as policy banks and joint-stock banks. After the abolition of the CFWC in 2002, the CCP established the Leading Group on State-owned Banking Reform, headed by Vice Premier Huang Ju and the newly appointed governor of the PBOC, Zhou Xiaochuan. Although some of the regulatory duties of the CFWC were moved to the newly established China Banking Regulatory Commission, a state organ, the Leading Group maintained appointment power and policy power over the major state-owned banks, as shown in Figure 3.4 (Shih 2005). Thus, the Party's tight grip over the financial sector did not relax even after the latest round of restructuring.

Throughout both the decentralized period and the centralized period, senior managers, especially those in the Big Four banks and the policy banks, were

¹² Interview in Beijing: 4/15/01. According to another respondent, because of the lack of expertise of the monitoring committees, all one had to do was to get on their good side to evade their "monitoring." In reality, monitoring translated to just another layer of officials with whom bankers had to establish *guanxi*. Interview in Beijing: 5/19/01.

politicians whose careers rode on the central leadership's perception of them. Banking insiders repeatedly admitted to me that they were still politicians responsive to the political signals emanating from the Politburo.¹³ Because of this, formal institutions, although significant, were not the determining factor in monetary policies and reform outcomes.

To be sure, the decentralized administrative structure of the banking system before 1998 gave local government an advantage in taking control over local monetary policies. Yet, time and again, they ceded that control to the central government when they sensed that the central leadership was determined to centralize monetary policy. Similarly, although the 1998 restructuring gave those who favored centralized monetary policy a weapon to prevent local influence, local government officials continued their intervention in the banking sector when they received favorable signals from their factional patrons in the Standing Committee. The monitoring system governed by the Party was as capable of punishing violators of formal rules as it was of turning a blind eye to them.

Conclusion

The institutions that controlled money supply in China could release a deluge of funds into the economy. At the same time, the central government retained multiple levers to constrain the expansion of money supply. The national credit plan and later the asset-liability management had numerous loopholes, which allowed local officials to exploit the banking system for local growth. Yet the Party and the PBOC retained the ability to track the amount of funds released into the economy such that when the central government had the political resolve, it could still halt the expansion of credit and punish those who violated credit restrictions.

Knowing these institutional features, however, gives us little analytical leverage to predict financial performance in China. Although the central bank independence literature (Alesina and Summers 1993; Fischer 1995; Rogoff 1985) informs us that the Chinese economy probably suffers from higher inflation rates than countries with an independent central bank, we cannot use this framework to predict the extent of China's inflation problem. At the same time, East Asian miracle theorists would have us believe that China, because of its highly insulated financial policy-making process, has the perfect institutional environment for high growth, low inflation, and high efficiency (Lee and Haggard 1995). As Chapter 2 showed, this prediction is also inaccurate.

As later chapters contend, political signals sent through both the formal channels and through the factional network, rather than shifting institutional configurations, were the primary determinants of monetary policy in reformera China. Throughout much of the period, the decentralized structure of the banking system provided an advantage to those in favor of monetary decentralization. Yet, ample mechanisms existed for centralizers, or members of

¹³ Interviews in Beijing: 9/9/00, 10/10/01, 11/27/00, 12/4/00, 5/4/01.

the technocratic factions, to rein in banking power when the political conditions presented themselves. Under the right political condition, central bureaucrats took advantage of these mechanisms to regain control. As we saw in the most recent inflationary cycle, local leaders exploited favorable political conditions to force banks to finance local development projects even under a set of highly centralized financial institutions. It is precisely the political conditions for monetary centralization and decentralization that this work mainly concerns.

Factional Politics and its Financial Implications

How do relatively low inflation in the form of inflationary cycles and chronic inefficiency in capital allocation, two phenomena that suggest different policy making processes, coexist in the same financial system? While manageable inflation rates and the absence of hyperinflation suggest technocratic control over financial policies, chronic inefficiency in the form of high nonperforming loan ratios indicates political intervention in the banking sector. In brief, the answer provided in this chapter – and in the entire work – is that top leaders' desire for power and the uncertain political environment in which they operate compel them to pursue factional politics, which creates the political environment for inflationary cycles and the dearth of significant financial market reform.

This chapter builds on institutional features described in Chapter 3 and on China's elite political dynamics to derive a factional model to explain inflationary cycles and inefficiency in the Chinese financial system. The two types of factions – one endowed with broad membership across the party apparatus and the provinces and the other endowed with technocrats in the central government – compete with one another over the degree of monetary centralization, which induces inflationary cycles. Although the competitions between the generalist and technocratic factions are not zero-sum contests for ultimate control of the party, they have clearly divergent preferences over monetary policies, which compel them to mobilize political resources at their disposal to gain the upper hand. This tense interaction manages to constrain inflation in China. However, because factional politics cultivates short time horizon, both types of factions prioritize short-term factional gains over other objectives. The resulting lack of cohesive long-term financial strategy chronically hinders significant financial system reform.

Power Seeking in an Uncertain Environment

Because of the CCP's total domination over the banking system, top Chinese leaders have ample opportunities to intervene in the banks. That fact alone,

however, does not give us analytical leverage over the preferences of top leaders, which inform us *how* they would intervene in the banking system. Without knowing the origins of elite preferences and the way in which intervention occurs, we cannot generate hypotheses about the effect these interventions have on banking sector performance and on the economy overall. Thus, this chapter first provides an account of the leadership's preferences by examining the role factions play in Chinese politics.

The emphasis on factions stems from two fundamental assumptions about Chinese politics. First, top leaders in the Chinese political system value the retention and expansion of power above any ideological or policy preference. Second, because of the dearth of credible formal institutions and procedures to measure and transfer power at the elite level, top leaders face incessant threats to their authority. These assumptions are by no means uncontroversial, but, on the whole, they accord with political reality in China. The first assumption comes from a rich tradition in political science dating at least from Machiavelli and, more recently, from the concept of the politicians as office-seekers (Mayhew 1974). The argument here is twofold. First, even if politicians have a strong preference for a set of policies or ideas, they need to retain power in order to realize them. Second, as Ramseyer and Rosenbluth (1998: 5) put it, "politicians who ignore their competitors eventually disappear."

In the Chinese context, although official positions do not always translate to actual power, a politician, whether holding an office or not, needs to retain a certain amount of influence in order to affect the policy process (Huang 2000: 5). A strong manifestation of the power-seeking tendency of most senior officials is the prevalence of bandwagoning behavior. Essentially, when senior cadres sense that the tide is turning against a colleague, they seldom lend a helping hand, even if that person is in the right (Goldstein 1991). The most glaring example of this phenomenon took place during the Lushan Conference in 1959. At the conference, the vast majority of cadres stood by while Peng Dehuai, who had written a private letter to Mao on the disastrous result of the Great Leap Forward, was publicly berated then purged by Mao (MacFarquhar 1983: 187). A more contemporary example was Wan Li's support of the 1989 Tiananmen massacre. Although he initially supported a more moderate approach toward the students, he ultimately joined the hard-liners when the tide had turned against Zhao Zivang (Nathan and Link 2001:305). Even at times when a strong moral protest could have made a difference, Chinese leaders seldom chose to exercise that option.

The bandwagoning tendency fortifies the second argument that the process of politics eventually eliminates or transforms the pure idealists. In China, where the same group of leaders interacted for over half a century, this especially holds true. Those who were unwilling to bend with the political wind were inevitably eliminated. Idealists who were eliminated early on included the Communist Party's founder Chen Duxiu and later loyal Comintern agent Li Lisan. The survivors of this three-quarter-century-long political struggle – with the exception

of Mao – often were those who kept quiet rather than those who were the first to advocate an idea. They often tested the political wind before making their positions clear. They also readily abandoned their allies and friends in order to maintain their power. The two great survivors in the Chinese political system, Zhou Enlai and Deng Xiaoping, were skilled at bowing to the strong and at betraying former allies.

The task of retaining and expanding power in the Chinese political system is complicated by the lack of institutional definition of power and procedures for transferring power. Although an official post confers a degree of actual power, the degree to which one is able to exercise official power often depends on one's informal influence. For example, Mao's designated successor Hua Guofeng held all of the top positions but lost most of his informal power at the Third Plenum in 1978 when Deng and his allies overturned Hua's policies (Baum 1994: 66). At the same time, Deng Xiaoping and Chen Yun had an enormous impact on economic policies in reform-era China, although both held only honorary positions by the early 1990s. With vaguely defined authority, Chinese leaders need to ensure that their informal influence keeps up with or even surpasses their formal positions.

To make matters worse, threats to one's power can materialize at any time, not just before elections or Party congresses. Whereas the transference of power in democracies is often well defined and regular, power in China can slip from one's grasp with one unfavorable article in the *People's Daily*, the official mouthpiece of the Party.¹ The reason for this highly uncertain environment is historical. Simply put, the Chinese Communist Party early on invested in an organizational model that bestows enormous power on individual leaders, has a strict hierarchy, and pays little attention to formal procedures (Huang 2000: 6; Lu 2000).

Officially, power is transferred through two mechanisms, the Party congresses, which take place only once every five years, and the annual sessions of the National People's Congress (NPC). The former selects the Party's top leaders, while the latter elects leaders to state positions. In most instances, however, formal elections in these two bodies represent the end of power struggles. With some important exceptions, the formal meetings of the Central Committee (CC), Party congresses, and NPC sessions merely rubberstamped what had already been decided by the top leaders in the Party.² Hu Yaobang

¹ The exception among democracies is the practice of a no confidence vote in parliamentary democracies, which can unseat a prime minister in the middle of a term. However, a certain percentage of legislators need to sponsor it before such a vote can be called, which provides explicit warning to the prime minister.

² There were a few glaring exceptions to this rule. The Thirteenth Party Congress in 1987 first introduced elimination vote (*cha'e xuanju*) to the election of CC members. In this system, there are a few more candidates than there are seats in the CC. Thus, in secret ballot, the bottom ten or so recipients of votes do not get into the CC. At the Thirteenth Party Congress, one of the favorites of the Party elders, Deng Liqun, was prevented in this way from serving on the CC. See

and Zhao Ziyang, the two General Secretaries in the 1980s, both lost their jobs in the midst of their tenures after highly irregular enlarged Politburo meetings.

The uncertainty in elite politics is further exacerbated by the dearth of reliable indicators of power. The resulting fog invites challenges to one's power whenever a rival faction perceives weakness. To deter such challenges, a top leader in China constantly has to signal to potential rivals and lower level officials that he still retains control and influence over vital resources in the system.³ Favorable editorials in the *People's Daily* signal one's influence over the media. The promotion of one's protégé denotes one's control over the *nomenklatura*. Finally, favorable allocation of economic goods to one's protégés signals one's sway over economic policies.⁴ With little legal definition of the scope and tenure of the offices and few transparent indicators of power, a top leader must furnish the means of maintaining power himself.

Factions and Political Survival

With the relentless need to maintain one's influence, practitioners of politics require a coherent strategy to mitigate the fundamental uncertainty in the political system. As others have argued before me, the strategy that emerges to provide just such an insurance policy is the faction system. Lucian Pye long ago argued that "the prime basis for factions among cadres is the search for career security and the protection of power" (Pye 1981: 7).

Founded for this specific purpose, factions thus are distinct from opinion groups and interest groups in important ways. As stated in the introduction to this book, faction is a personal network of reciprocity that seeks to preserve and expand the power of the patron. Whereas a faction is semipermanent, based on a quest for power, and reliant on lower officials for support, an opinion group is temporary, based on a single issue, and composed only of top leaders (Dittmer 1995; Schurmann 1968: 55). At the same time, an interest group seeks to maximize well-defined economic or ideational interests and usually outlasts the leadership of any particular individual, whereas a faction seldom survives its patron.⁵ Although opinion groups have an important impact on some policy outcomes, they are coalitions of convenience and thus cannot provide a

Baum, Richard. 1997. The Road to Tiananmen: Chinese Politics in the 1980s. In *The Politics of China: The Eras of Mao and Deng*, edited by R. MacFarquhar. New York: Cambridge University Press, 408.

- ³ The male pronoun is used in general discussion of Standing Committee members because, sadly, there has not been a female Standing Committee member in the history of the CCP.
- ⁴ Interview in Cambridge, MA: 6/22/2000.
- ⁵ The exceptions are factions in the Liberal Democratic Party (LDP) in Japan, which have evolved into formal organizations. Although these entities are called factions, they would not be considered factions by the definition put forth here. Instead, *koenkais*, or support groups loyal to particular LDP candidates, would be closer to the notion of interest groups put forth here. See Grimes, William W. 2001. *Unmaking the Japanese Miracle*. Ithaca, NY: Cornell University Press, 66.

consistent explanation of financial outcomes throughout the reform. For example, Chen Yun made temporary alliances with ideological conservatives to attack the special economic zones (SEZs) in the 1980s. However, as I will show in Chapter 6, these alliances aimed to protect factional interests through pressuring Deng into acquiescing to financial centralization. Opinion groups were merely temporary means to the consistent end of factional interests. Although there were a few cases of genuine interest groups, most local or sectoral leaders obtained preferential policies and financial allocations through their connections with individual leaders in the Politburo. Moreover, the ultimate goal of lobbying was often personal or factional advancement rather than the promotion of an impersonal interest.

In order to clarify the roles factions play in the political system, I first make a distinction between two strata of officials; top leaders and high level cadres who are not at the center of power. These two strata of officials compose the patrons and clients of elite factions respectively. Top leaders are each their own "mountaintop." They often serve in the Standing Committee of the Politburo, although sometimes they have enormous authority without any formal position (Lieberthal and Oksenberg 1988: 36). Among the top leaders, one "helmsman" often wields more influence than the others, which bestows on him the dominant faction. The dominant faction often controls the most powerful offices in the CC and has a great deal of agenda-setting power in Politburo meetings. Nevertheless, with the exception of a few brief dictatorial periods under Mao, discussions, debates, and political struggle among top leaders played a crucial role in the outcome of almost every important issue. Moreover, despite a strong advantage from holding formal offices, the dominant faction remains vulnerable to political attacks by rival factions, especially when a major policy failure occurs. In the classic example, Hua Guofeng lost power quickly despite concurrently holding the positions of Party Chairman, Premier, and Chairman of the Central Military Commission.

Senior cadres, by contrast, are officials at the vice minister/vice governor/vice provincial Party secretary level or above. Some of them are eventually promoted to the Politburo Standing Committee and even become factional patrons themselves. Although they tend to be outside of the top leadership and obey orders issued by the Politburo, they nonetheless provide valuable resources to top leaders engaging in power competition. The provincial leadership has historically served as the main mover in the implementation of central policies at the grassroots level (Cheung 1998b). As such, central leaders who want to launch a new set of policies have to appeal to the enthusiasm of the provincial leadership. Moreover, provincial leaders control the provincial propaganda

⁶ The most often cited example of collective bargaining was the Southwestern Economic Mutual Help Association, in which a collection of provinces in the poorer Southwestern China coordinated to lobby the central government. See Wu, Guoguang, and Yongnian Zheng. 1995. Lun Zhongyang-Difang Guanxi (On Center-Local Relations). Hong Kong: Oxford University Press.

apparatus, which is often used by senior leaders to launch ideological attacks against rivals.

In the State Council, ministers hold important positions because they set the agenda for specific policies by providing important information to the top leaders (Bachman 1991: 8). Moreover, top bureaucrats can paralyze policy implementation by not resolving the myriad conflicts of interests that arise with every policy (Lieberthal and Oksenberg 1988: 131). Also, the representation of this stratum of officials in the Central Committee confers them at least the formal authority over the selection of top leaders, which affects the ability of faction members to advance into the Politburo (Shirk 1993: 71). Finally, this stratum of officials produces rumors that establish the reputation of top leaders, which can make or break a leader. In sum, provincial and ministerial officials control valuable resources that factional patrons can mobilize in the course of political struggles.

In the exchange relationship of a faction, top leaders use factions to maintain a network of loval officials who support them during political challenges. Factions are also useful to demonstrate the top leaders' power between challenges to discourage attacks. Meanwhile, protégés obtain political protection, either lateral or vertical promotions, preferential allocation of financial resources, and control over policies through the faction system. At its heart, factional distribution of offices and economic goods increases the opportunity cost of defection to another faction, which decreases uncertainty for top leaders. Essentially, if followers defect to another faction, they would forgo certain payoffs at the current faction for uncertain payoffs at another faction (Bueno de Mesquita et al. 2003: 83). This motivates factional followers to remain loval even when another faction launches an attack. Of course, as the probability of being overwhelmed by another faction increases, followers of a faction would inevitably defect to another faction. Despite the inevitability of bandwagoning as the outcome of a struggle becomes clear, the distribution of resources to factional members prevents them from defecting at the first sign of trouble, which allows factional leaders to launch counterattacks against rivals. 8 For example, Mao relied on the Party apparatus in Shanghai to set the stage for the Cultural Revolution. Similarly, Deng mobilized the Shanghai Party apparatus and later the Guangdong

⁷ A similar logic is at work in Japanese factions. See Cox, Gary, Frances McCall Rosenbluth, and Michael Thies. 1999. Electoral reform and the fate of factions: the case of Japan's Liberal Democratic Party. *British Journal of Political Science* 29 (1):33–56; Cox, Gary, Frances McCall Rosenbluth, and Michael Thies. 2000. Electoral rules, career ambitions, and party structure: comparing factions in Japan's upper and lower houses. *American Journal of Political Science* 44 (1):115–122.

⁸ The concept here is similar to but distinct from Hirschman's concept of loyalty. In Hirschman's work, loyalty is purely an irrational phenomenon whereby the consumer remains with a product despite the presence of an obviously better choice. Loyalty, or factional stickiness, here is a product of uncertainty about the outcome of a struggle and the opportunity cost of defecting. See Hirschman, Albert O. 1970. Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States. Cambridge, MA: Harvard University Press.

Party committee in 1991 and 1992 to launch his criticism of the central technocratic faction (see Chapter 7).

Without clear indicators of the top leaders' relative power, the ability to distribute investment and offices to factional followers also signals the power of a top leader. The promotion of a protégé to either the CC or to the Politburo not only increases the patron's political support in these institutions but also communicates to rivals of one's power. Similarly, protection of factional followers from purges or corruption investigations provides security to the followers, but also signals the power of the patron. For example, Jiang Zemin's ability to stop the corruption investigation of his protégé Jia Qinglin, who served as Party secretary of Fujian during the height of smuggling, informed his rivals and followers alike of his rising power (Lin 2000). Essentially, the promotion and protection of factional followers constitute credible signals of power, which deter others from attacking the faction.

Although factions provide political insurance to high-level cadres mainly through the allocation and the preservation of official positions, the faction system has evolved to allocate other scarce goods in the political system, especially economic goods and control over policies. The allocation of economic goods through the factions serves the familiar purposes of maintaining lovalty and strengthening the perceived power of the patron. In Walder's classic study, he shows that the absolute rule of the Party secretary at the firm level enabled him or her to allocate vital resources to favorite underlings, including housing, medical care, and special food (Walder 1986). Although reform has diminished the CCP's monopoly over economic resources to a considerable extent, the Party still has the authority to allocate substantial nonmarket rent, including favorable investment policies, tax breaks, bank loans, and direct fiscal subsidies. Another type of good that can be distributed is the right to distribute nonmarket rent. Top leaders can determine which bureaucracy or level of government has the authority to make favorable investment policies or to dictate the credit ceiling of the various regions and sectors.9

In terms of the allocation of economic resources, at least two distinct types of preferences should be recognized on the demand side. These preferences form the basis of the two types of factions discussed later. First, provincial leaders have a strong preference for the distribution of economic goods for their own sake. Although they scramble for control over policies, their ultimate objective is to obtain more capital with which to pursue provincial economic growth (Gore 1999b; Huang 1996: 63). The single-minded pursuit of money and growth aims at increasing a provincial leader's chance of promotion and at providing more opportunities for rent-seeking activities.

Central bureaucrats who have the rank of vice minister or above constitute the second type of cadres among potential factional clients. Unlike provincial leaders, their careers and prestige are dependent on their control over policies.

⁹ Interview in Beijing: 9.22/2000.

¹⁰ Interviews in Shenyang: 12/25/00; in Fuzhou: 6/8/01.

According to interviewees, central and local governments and different agencies of the central government struggle endlessly for control over various policies. The goal of hoarding discretion over important policy areas is for ministers to accumulate "administrative merits" (zhengji), which, together with patronage from the top, pave the way for a bureaucrat's rise to the top of the State Council or to the Politburo. II Since the reform, cultivating the perceived ability to resolve pressing issues confronting the regime has served as an effective strategy of obtaining promotion. Zhu Rongji himself rose rapidly through the ranks by "solving" the hyperinflation problem in 1993 and the triangular debt quagmire in the early 1990s. In order to do so effectively, discretion over a policy area and the control of crucial resources, especially the banking system, become vital. In fact, Zhu solved both of these problems through manipulating various aspects of the banking sector. Thus, there is an important distinction between the motivation of top bureaucrats in China and that of their counterparts in the developed world. Whereas mid-level bureaucrats in the United States often are motivated by the autonomy and survival of the bureaus – as Wilson (1989) and Downs (1967) note -, ministers and vice ministers in China are motivated instead by their career prospects and advancement in the CCP-dominated hierarchv.

These two distinct types of preferences, one emphasizing the decentralization of money creation and the other on the concentration of policy power, form the bases of two distinct types of factions, two political strategies, and two monetary outcomes in the Chinese economy.

Two Types of Factions, Two Strategies, Two Outcomes

The two types of preferences stated earlier coincide with fairly stable factional types because of institutional features in the CCP that channel officials into distinct career paths. Cadres typically spend more than half of their careers rising through a particular *xitong*, or bureaucratic system, which is divided both geographically and functionally (Lieberthal 2004: 218). The Central Organization Department (COD) then rotates some cadres through a series of different positions across the state and the Party, whereas other cadres become specialists and rise vertically more or less in a given bureaucracy. This tendency is further enforced in the reform era when the COD began to vet cadres in the economic bureaucracies separately from party functionaries (Cui 2003: 455). As cadres in these two types of career tracks move upward, they acquire factional followers with distinct makeup.

For our purposes here, the two relevant types of factions are the generalist factions and the technocratic factions, which essentially have the two types of preferences outlined in the previous section. As can be seen in Figure 4.1, the

¹¹ Interviews in Beijing: 11/24/2000, 1/3/2001, 6/26/2001.

Lieberthal calls provincial xitong the Party Affairs xitong. See Lieberthal, Kenneth. 1995. Governing China: From Revolution through Reform. 1st ed. New York: W.W. Norton, 194–195.

leaders of both types of factions are survivors of the cut-throat climb into the Standing Committee of the Politburo, giving them considerable political power. A generalist faction is headed by a senior Party leader with extensive experience in local governments and in the Party apparatus. This career trajectory allows him to recruit followers from the provinces, the army, and central party organs during the course of his rise through the ranks (see Figure 4.1). The resulting membership composition affords generalist factions control of provinces, army commands, and central Party organs, which equip them for the competition for supremacy in the Party. Without these important linkages, it would be difficult for a leader to hold on to power for long. For the same reason, however, generalist factions are often latent or explicit rivals of each other because every generalist faction has the means of usurping power. In the 1980s, generalist factions included those led by Deng Xiaoping, Hu Yaobang, Zhao Ziyang, and Ye Jianying. In the 1990s, the key generalist factions were led by Jiang Zemin, Hu Jintao, Li Ruihuan, and Qiao Shi.

In contrast, there are narrow factions led by senior cadres who rise through a single bureaucratic grouping and ultimately are inducted into the Standing Committee. These senior leaders do not have broad connections with various segments of the CCP but instead have extensive connections with one group of agencies (Lieberthal and Oksenberg 1988: 37). In the economic arena, the most important narrow faction is the central technocratic faction, typically led by cadres who have extensive experience in the central economic bureaucracy. 13 The narrow powerbases of the technocratic factions – especially their lack of ties with army commanders – prevent them from competing for overall supremacy in the CCP. Despite having access to a relatively narrow range of resources, patrons of technocratic factions are nonetheless powerful politicians with a voice in leadership selection and access to the most sensitive information. Thus, they have the capacity to make life very difficult for the generalist factions. Chen Yun was one of the founders of the central economic bureaucracy in the 1950s and had cultivated myriad followers in various economic agencies by the 1980s (Huang 2000: 139). In the 1990s, Zhu Rongji, who only had three years of local administration, emerged as the head of the technocratic faction. With the bulk of his career in the State Council, his followers also rose up through the central bureaucracy (see Chapters 7 and 8).

Finally, although technocratic factions seem to cater to the interests of particular agencies, they in fact seek first and foremost to strengthen their own influence and not necessarily the power and influence of particular agencies per se. Commenting on bureaucratic politics in the 1970s, Swain observes that, "Individual leaders do play a crucial role as 'patrons' for general bureaucratic tendencies, but their identification with such tendency by no means prohibits them from altering their interest in the face of specific objective conditions or changes in the power structure at the top" (Swaine 1986: 15). In other words, leaders of

¹³ Other narrow factions include the Internal Security/Law Enforcement faction and the Ideology/Propaganda faction. These factions are much less important for financial outcomes.

the technocratic factions are perfectly willing to promote policies detrimental to the long-term interests of particular agencies for factional advancement.

Once factions are formed, they maintain relatively coherent membership composition because of institutional features that increase the transaction cost of recruiting faction members from another type of factions. According to Nathan, factions depend on "the hierarchy and established communications and authority flow of the existing organization..." (Nathan 1973: 44). Essentially, since both the Party and the state have established communication channels, it is easier for senior State Council officials to cultivate and maintain ties with state bureaucrats and for senior Party generalists to cultivate ties with provincial leaders, army commanders, and members of the central Party organs. The State Council holds regular meetings chaired by the premier and attended by ministers, whereas Party cadres from provincial and the central governments meet regularly during CC plenums, national conferences on Party work, and inspection trips made by Politburo members. Both the State Council and the CC have general offices that handle communication with subordinate units.

Whereas the appointments of senior State Council bureaucrats require nomination by the state, appointments of provincial Party secretaries and governors are under the strict control of the CCP Central Organization Department (Wu 1997: 142). As such, it is easier for the leaders of generalist factions to maneuver favorite underlings into provincial leadership positions than it is for them to strictly control the appointment of central ministers. Likewise, the leaders of the technocratic factions have more discretion over the appointments of ministers than of provincial cadres. For example, Jiang Zemin maneuvered many of his protégés into provincial Party secretary seats, including Jia Qingling of Beijing, Li Changchun of Guangdong, and Zhang Gaoli, who was promoted from Shenzhen to head Shangdong Province (Lam 2001; Li 2001). Likewise, Premier Zhu Rongji appointed his protégés to head the People's Bank of China, the State Economic System Reform Office, and the China Securities Regulatory Commission (CSRC) (Chen 1998a; Lam 2000). Thus, although members of the generalist factions cross over to each others' camps, a technocratic faction typically contains very few provincial officials, and few central bureaucrats become active members of a generalist faction.¹⁴

Because factional clients with two distinct sets of preferences tend to fall into two different types of factions, leaders of these two types of factions pursue two distinct financial strategies to expand factional influence and ultimately to bolster their own positions in the Standing Committee of the Politburo. For the leader of a generalist faction, his imperative is to allocate capital to the provinces. To reiterate, this strategy benefits the entire faction because the clients improve their promotion prospects while the patron obtains loyalty, signals to others his power, and increases the probability of gaining a useful ally in the Central Committee or the Politburo. As Huang (1996: 19) points out, however,

¹⁴ The only notable provincial member of Chen Yun's faction was Chen Xitong, whereas Jiang Zemin's faction included Zeng Peiyan, the head of the State Planning Commission.

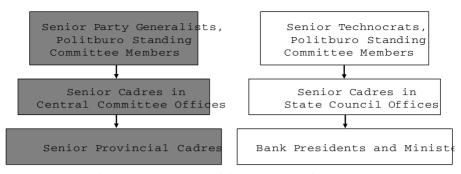


FIGURE 4.1. Membership Composition of the Two Types of Faction.

the devolution of financial control to the localities is fundamentally inflationary, as it creates a collective action problem where each province strives to maximize credit expansion regardless of its effect on overall inflation. With the decentralization of monetary control, the province that does not maximize borrowing lags behind in available funding and would still suffer the inflationary consequences of credit expansion by other provinces. To avoid this sucker's payoff, every province has strong incentive to maximize credit expansion. Likewise, if the patron of a generalist faction orders his provincial followers to refrain from borrowing, his faction's fortune would decline relative to generalist factions whose followers are maximizing credit expansion. In the meantime, every province still suffers from the inflationary consequences of overall credit expansion. Thus, between different generalist factions, there also exists a strong incentive to strictly maximize credit expansion in provinces controlled by factional followers. The pursuit of this strategy without constraint would result in high inflation.

Meanwhile, the leader of a technocratic faction strengthens his power by expanding the policy jurisdiction of his preferred ministries. In doing so, the overall aim is to wrest control over financial policies away from the provincial governments and to return it to designated central agencies. As in the case of the generalist faction, the strategy of maximizing the central government's power is mutually beneficial to the patron and to the clients. For the patron, heightened authority over the financial sector connotes greater capacity to use financial resources to bargain for political support in the Politburo. ¹⁵ Stricter control over financial resources also increases the central government's ability to provide short-term, apparent fixes to the economy, which increases the top technocrat's standing and importance in the leadership. ¹⁶ As other Politburo members perceive the head of the technocratic faction as an indispensable problem-solver, they are less likely to replace him. The strengthening of central power also gives factional followers the necessary tools with which to accumulate

¹⁵ Interview in the United States: 5/2/02. The exact location is not disclosed to protect the interviewee's identity.

¹⁶ Interviews in Beijing: 11/10/2000, 11/26/2000, 6/26/2001.

administrative merits and to obtain promotions. Increased policy discretion to ministries governed by factional followers also allows followers to benefit from distributing rent to large SOEs or to the provinces. Finally, the ability of a technocratic faction to centralize policy authority signals the continual power of that faction and deters potential challengers.

In centralizing financial policy, the leader of a technocratic faction also gains strong incentive to keep inflation in check. When financial power is centralized, the collective action problem disappears because the blame for high inflation would fall squarely on the top bureaucrat in charge of monetary policy. As Chapter 7 shows, Li Peng failed to rein in inflation in 1993 and lost his position as the dominant technocrat to Zhu Rongji. Given the concentration of responsibility, the lead technocrat must carefully weigh the benefits of credit expansion against the political damage of inflation to him personally. For these reasons, central bureaucratic control over the financial system generates less inflationary pressure than local government control of it does.

A Model of Inflationary Cycles

How do these two countervailing forces translate into inflationary cycles and inefficient allocation of capital in the reform era? In essence, although inflationary cycles are caused by the differing inflationary tendencies of the two types of factions, neither type has any incentive to improve the efficiency of capital allocation in China. A fair assumption to make on the outset is that the dominant generalist faction likely has the initial upper hand to allocate resources to the provinces at the expense of the central bureaucracy. The generalist faction's advantage stems first from its control over the appointment of government officials, including those in the central bureaucracy. The dominant generalist faction also has control over the Party's internal communication channels and the mass media. Local officials watch for central policy direction first and foremost through the internal Party communication channel (Lieberthal, Tong, and Yeung 1978). If the central bureaucracy issues regulations that contradict with the Party's decrees, local officials would obey the directives from the Party over those issued by the central bureaucracy. In fact, this phenomenon occurred quite frequently, as Chapters 6 and 7 reveal.

With the generalist factions in charge of monetary policy, any coordination to target money supply becomes impossible between the factions and between the provinces. Without the threat of an economic crisis, the most powerful generalist faction has an incentive to renege on any agreement between the factions to stabilize price level in order to allocate more credit to provinces controlled by its followers. Like Meiji oligarchs who competed with each other to build mass political parties (Ramseyer and Rosenbluth 1998), rival generalist factions scramble to grant preferential loans or lending authority to their favorite provinces, thereby undermining the central bank's credit plan in classic prisoners' dilemma fashion. Moreover, generalist control over financial policy engenders expectation of a loose monetary environment even before the PBOC

provides more funds. If local government officials sense that a generalist faction is in charge of financial policy, they would enthusiastically launch new investment projects and set up local financial institutions to make loans against PBOC regulations in anticipation of a looser monetary environment. With their factional patrons in charge, local officials have no compunction about violating PBOC decrees and exceeding the credit plan. Furthermore, expectation of a loose monetary environment and of a building boom might compel private investors to hoard building supply, which further exacerbates inflationary pressure. Through these mechanisms, the collapse of the credit plan's credibility quickly gives rise to accelerating inflationary pressure.

With rising inflation or another form of economic crisis, the dominant generalist faction is faced with three unpalatable choices. First, the leader of the dominant generalist faction can do nothing, which would end in hyperinflation or economic collapse. Although there are some strategic advantages to waiting, such as gaining information about the strength of one's rival (Alesina and Drazen 1995), the leader of the dominant faction risks dismissal or the downfall of the entire CCP regime by doing nothing. He has no wish to see either outcome, given that his faction reaps the majority of the benefits under the existing regime. Second, the leader of the dominant faction can order members of his own faction to stop intervening in the provincial banks. However, this would encourage free-riding as rival generalist factions take advantage of the self-imposed austerity to continue intervening in the banking system, thereby increasing their power relative to the dominant faction. Furthermore, on the margin, members of the dominant generalist faction would defect to rival factions because they can obtain more loans in a rival faction. Given the deleterious effects of a self-imposed austerity for the dominant faction, any claim of a selfimposed austerity would not be credible and would not be taken seriously by rival factions or by members of the dominant faction. Rapid monetary expansion would continue unabated, leading to hyperinflation.

Instead of facing these eventualities, a preferred strategy of the dominant generalist faction is to delegate monetary policy to a "neutral" faction. Although the technocratic faction is expected to make self-serving policies, its action is unlikely to change the relative balance of power between the different generalist factions. This is so because technocratic factions have an interest in making credible monetary policy through centralization, which deprives every province the authority to expand money supply, not just a subset of provinces. This prevents followers of rival factions from free-riding on the austerity measures followed by the dominant faction. At the same time, because central technocrats only have narrow support within the central bureaucracy, they are unlikely to usurp the dominant generalist's power. Under most circumstances, central technocrats, as members of the ruling coalition, are also unlikely to side with a challenging faction because the dominant generalist faction still holds control over crucial political resources. Exceptions arise when a challenging generalist, such as Deng Xiaoping in the late 1970s, is seen as having the ability to mobilize a challenge with a high chance of success. Given the narrow base of the technocrats, the dominant generalist faction is ultimately willing to accept the cost of delegating monetary policies to the central technocrats during an economic crisis when not delegating entails graver costs. Furthermore, if the economic crisis continues, the dominant generalist can shift or share the blame with the head of the technocratic faction.

In the following chapters, we will see that Deng showed a willingness to delegate financial power to Chen Yun in the early 1980s as he completed his struggle against the remaining forces of Hua Guofeng and after the Tiananmen massacre to preserve his dominance in the CCP. Likewise, Jiang conceded financial power to Zhu Rongji during the mid-1990s inflation and during the Asian Financial Crisis as he struggled to establish his own dominance in the Party over rival factions.¹⁷ The delegation of financial authorities to the technocratic faction is credible because it is costly for all generalist factions, including the dominant one, to reverse it. Once financial control is delegated to the technocratic factions, generalist factions would have to engage in costly political maneuvers to win it back.

Thus, an economic crisis provides the top bureaucrat in the Politburo an opportunity to disrupt the decentralization process and to impose a harsh regime of disinflationary measures or other remedies, most of which involve recentralizing financial power. ¹⁸ Because the central bureaucracy, which has an incentive to exaggerate an economic crisis, holds a monopoly on reliable economic information, the leaders of various generalist factions often do not heed warnings about inflation coming from the central bureaucracy until inflation has risen to alarming proportions. Conflicts over monetary policy arise between generalist and technocratic factions because while technocrats are enthusiastic about centralization, the generalists are reluctant to deprive provinces of easy access to capital. Nonetheless, when the dominant generalist perceives the imminence of an economic crisis, he ultimately goes along with these harsh measures to avoid an economic collapse.

Because local officials know that central economic bureaucrats have a strong incentive to centralize financial authority, the central bank's credit plan regains credibility when the central Party apparatus broadcasts unambiguously that financial authority has been turned over to the central bureaucrats. Furthermore, local officials know that the dominant generalist faction cannot easily retake financial control from the technocratic faction because top bureaucrats sit on the Standing Committee and have a variety of political resources. It would not be costless even for the dominant generalist faction to countermand retrenchment measures. Consequently, even local officials belonging to the dominant generalist faction realize that they can be punished for

¹⁷ Interviews in Beijing: 9/25/00, 10/10/00, 2/20/01.

¹⁸ Anti-inflationary measures included centralization of loan and investment approval, strict loan-to-deposit ratio, and work teams sent by the central government to monitor lending activities at the provincial level.

transgressing central financial decrees. In this manner, the combination of the bureaucrats' preference for centralization and their ability to retain control provides retrenchment policies a measure of credibility.

When central bureaucrats command financial policies, their imperative is to maximize control, not to increase the efficiency of capital allocation. Instead of implementing significant financial reforms, which would provide a long-term solution to the problem of inflation, the technocratic faction uses control over financial resources to enlarge the jurisdiction of the central bureaucracy. ¹⁹ In recent years, this has been done through the expansion of central regulatory authority and the strengthening of "strategic" and "pillar" SOEs, which are directly controlled by the central bureaucracy rather than by the provincial government.

The power enjoyed by the central planners, however, is not permanent. As the economy stabilizes and as growth increases, generalist factions regain the incentive and the political leverage to unlock the technocrats' grip on the financial system. The pressure to intervene in the banking system rises with economic recovery because high growth increases the demand for credit, which intensifies provincial lobbying for more credit. Also, increasing growth coupled with price stability signals to the generalist factions that the economic crisis has passed. which makes it easier for the dominant generalist faction to renege against retrenchment policies without an economic collapse. With increasing incentive and opportunity, the dominant generalist faction exerts increasing pressure on the bureaucracy to favor certain provinces in allocating credit quotas. At the beginning of the next inflationary cycle, the dominant generalist faction resets the agenda through the Party communications channels to devolve significant financial power to the provinces, especially those governed by the members of the faction. For example, the Central Committee can launch a campaign to support township and village enterprises, which requires the devolution of credit control for working capital to the provinces. This signals to everyone the end of central domination and undermines the central bank's credit plan, which sets off another round of rapid monetary expansion and ultimately inflation.

In this model, although financial power changes hands, the efficiency of capital allocation does not improve significantly regardless of who has control. If the generalists control it, local governments would allocate funds toward local developmental projects, which are a mix of growth-promoting investment and wasteful rent-seeking opportunities. Likewise, central technocrats allocate funds toward large-scale projects, which again can be wasteful on a larger scale. Because both types of factions comprise political actors with short time horizon, neither is likely to allocate funds much more efficiently than the other.

One pernicious implication of this model is that senior technocrats in fact have a disincentive to truly fix the economy, as they gain control over the economy only during a crisis. In the short run, their standing depends on an apparent

¹⁹ Interviews in Beijing: 11/10/2000, 11/24/2000.

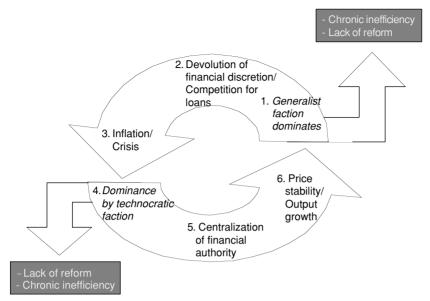


FIGURE 4.2. How Factional Dynamics Generate Inflationary Cycles.

fix of the economy. In the medium term, however, they need to plant the seeds for the next economic crisis because they know that the generalist factions would soon take their power away. Generalist factions, although wanting to stabilize the economy, still face an uncertain political environment in which they need to channel favors to faction members. As such, they engage in short-term behavior and cannot resist reclaiming control over the financial system from the bureaucrats. The reality of Chinese political economy is probably not as cynical as implied by the "rational expectation" version of this model. As we will see in Chapter 7, however, there is considerable evidence that the central bureaucracy intentionally allowed the dominant generalist faction to walk into an economic crisis in order to regain control.

Conclusion

The model outlined in this chapter builds on the existence of two types of factions, one that prefers financial decentralization and the other centralization. Because both types of factions are headed by powerful politicians inside the CCP, their struggle for control over financial resources gives rise to monetary cycles and thus inflationary cycles in China. This complex model generates many observable claims. First, this model predicts that followers of generalist and technocratic factions would distribute money in different ways. Furthermore, contrary to predictions of classical monetary theories, this model predicts a negative relationship between current inflation and future inflation because rising inflation provides technocrats the political opportunity to centralize

monetary control. Again, in contrast to monetary theory, this model predicts a short-term positive relationship between output growth and inflation, as output growth signals economic recovery, which prompts generalists to intervene in the economy. These general predictions will be tested by quantitative method in the next chapter.

These patterns also will be tested in the case studies in subsequent chapters, which reconstruct the complex political processes that gave rise to monetary cycles and reform stagnation in China. The qualitative case studies explore whether patrons of technocratic and generalist factions consistently gave different instructions to bank officials regarding monetary policies. Although this model does not predict the timing of monetary centralization and decentralization, it informs us when the structural preconditions for inflation and disinflation are present. The qualitative case studies demonstrate how these changing structural conditions drive political actors to pursue shifting strategies, causing monetary swings in China. If the preconditions for an outcome are absent, contingent factors are unlikely to induce that outcome. Finally, the case studies give readers a sense of the richness of Chinese politics, where charisma, corruption scandals, and the health of factional leaders all weave together a rich story.

Factional Politics, Distribution of Loans, and Inflationary Cycles

Several Quantitative Tests

This chapter statistically assesses the factional model in two ways. The first statistical model tests the impact of the two types of factions on provincial lending. A bedrock of this work is that membership composition of factions affects their preference for financial policies. Whereas generalist factions with substantial membership at provincial governments strive to increase monetary disbursements to the provinces, technocratic factions with members primarily in the central government have little incentive to do likewise. This starting point is not taken as given and is tested empirically. Thus, the first model examines whether factional ties give rise to the predicted effects and measures the extent to which provinces with connections with generalist factions benefit relative to provinces with no connection or with connections with technocratic factions.

The second statistical test measures the impact, if any, of the factional dynamics on inflation and lending. The factional model generates a series of predictions that counter the predictions of standard monetary theory. Thus, these counterintuitive predictions need to be tested by time series models. These findings, in combination with the qualitative findings presented in Chapters 6 through 8, provide strong empirical support for the factional model. First, the factional model predicts that high inflation systematically decreases first lending, then inflation in subsequent quarters because inflation creates a favorable political environment for technocratic factions to centralize credit, thereby lowering inflation in a later period. This prediction deviates from the usual phenomenon of inflation inertia, where high inflation in one period increases inflation in a subsequent period. Furthermore, because the pressure on generalist factions to circumvent central credit restrictions increases with economic recovery, the factional model predicts that increased output in one period augurs higher inflation in a subsequent period. Again, this prediction runs counter to the classic prediction of quantity theory, which posits a negative relationship between output growth and inflation. To determine whether these claims are consistent with empirical reality, the second section uses a battery of time series models to rigorously test them.

The Existence and the Distributional Effects of Factions

In order to test the existence of divergent factional strategy with respect to the disbursement of bank loans to the provinces, this section first develops an indicator to measure factional affiliation between provincial leaders and patrons of various factions in the center. Then, regression analysis reveals that throughout the reform era members of generalist factions indeed received significantly more bank credit than members of technocratic factions who were rotated to the provinces for stints. This pattern is robust even when a host of control variables are included and when different modeling assumptions are used.

As was pointed out in Chapter 4, factions have long been conceived of as vertical networks of mutual exchange "... motivated by the individuals' pursuit of relatively tangible and immediate incentives..." (Nathan and Tsai 1995). With this definition, one can reasonably hypothesize that membership in a given faction entails preferential distribution of resources. Put another way, although bureaucratic procedure allocates X amount of resources to a cadre, his or her informal ties with a powerful patron in the upper reaches of the Party hierarchy would appropriate X + n amount of resources, where n represents the premium of factional ties.

More specifically, the factional framework posits that different types of factions have different effects on the distribution of money and goods to the provinces. The leader of a generalist faction, who has a sizable number of followers in the provinces, exercises his power to channel more loans to provinces where his protégés serve as either governor or Party secretary because higher growth increases his protégés' chances of promotion. As previously suggested, this strategy procures various benefits to the faction and on average increases the factional leader's chance of survival. In contrast, the leader of a technocratic faction has much less incentive to do likewise, even though the economic bureaucracy has the most direct access to the banking system. Because technocratic factions are primarily composed of ministers and vice ministers in the State Council, they generally benefit more from central control over financial policies than from the distribution of additional funds to particular provinces. Although members of technocratic factions are rotated to the provinces for stints, these rotations are typically understood as temporary assignments to demonstrate these bureaucrats' readiness for leadership positions in the center. Thus, provincial growth performance does not have a significant impact on a bureaucrat's political future. In fact, members of technocratic factions serving in the provinces have an incentive to strictly adhere to State Council directives

¹ Prime examples of such individuals include Wang Qishan, the former vice governor of Guangdong, and Guo Shuqing, who served as the vice governor of Guizhou and later as the head of the State Administration of Foreign Exchange and the head of China Construction Bank (CCB). Rather than advocates of local economic development, these central bureaucrats were often sent to the provinces to deal with crises and to ensure that the province followed central edicts.

on lending in order to appease their factional patrons.² This implies that provinces headed by members of technocratic factions receive less money than provinces headed by members of generalist factions. For example, Shanghai, which had been under Chen Yun's sway during the 1980s, consistently had loan-to-deposit ratios well below that of Guangdong until Shanghai party secretary Jiang Zemin became the Party Secretary General in the 1990s (Shih 2004).

Measuring and Coding Factions

Despite the centrality of factions in Chinese politics, they are extremely difficult to observe in a systematic manner, especially in an opaque political system such as the one in China.³ Nevertheless, previous research by China scholars greatly aids the process of constructing a variable that roughly records factional ties. China scholars in general agree that factions are often based on shared characteristics between members of a faction (Dittmer 1995; Dittmer and Wu 1995; Li 1994a). Lieberthal and Oksenberg (1988:156), for example, explain guanxi wang, or networks of informal ties, in the following terms:

Bonds of *guanxi* entail mutual obligation. These bonds arise from family connections, common geographical origin, shared experience (school or military service ties), or shared loyalty toward the same patron or commander. (such as having served Zhou Enlai or Liu Shaoqi)

As outsiders, we can only observe what are commonly thought of as the bases of factions. But, as Dittmer put it, "an objective basis for an affinity does not necessarily create one" (Dittmer 1995). Despite this problem, all else being equal, we can infer that those cadres with shared ascriptive ties, including birth, school, and work, are more likely to be in the same faction than those without such ties. The implicit argument here is that shared experience or shared primordial ties between cadres lower the cost of searching for a faction leader or faction followers. For one, shared experience and primordial ties furnish marginal information about the character of another person, decreasing the risk of faction building. Socially, it is less awkward to approach someone with whom one shares common experience or primordial ties. Indeed, an internal Chinese circular outlined the precise process whereby factions are formed "...some leading cadres encourage friends, relations, fellow natives (tongxiang), classmates, old colleagues, and old subordinates to beg them for positions in the government (paoguan yaoguan)" (Editors 1998). These logical inferences serve as the foundation of the index of informal ties used here. The index focuses on possible informal ties between provincial governors and Party secretaries and members

² Huang Yasheng demonstrates this tendency in his in-depth study of investment distribution in China. He produced robust findings that local officials who had spent the bulk of their careers in the central government were much more likely to adhere to central investment policies. See Huang, Yasheng. 1996. *Inflation and Investment Controls in China: The Political Economy of Central-Local Relations during the Reform Era*. New York: Cambridge University.

³ Unlike in Japan, where membership in factions is published, Chinese factions are more covert because of party rules officially banning them.

of the Standing Committee of the Politburo. Essentially, governors and Party secretaries who share birth, school, work, or native ties with a member of the Standing Committee are presumed to be a member of his faction.

Applying this logic, I construct a panel data set that records common characteristics of provincial leaders and Standing Committee members in thirty provinces, directly administered cities, and autonomous regions between 1978 and 2004. In this data set, I code dummy variables that record a one when a province's Party secretary or governor has shared birth, work, or educational ties with a member of the Standing Committee of the Politburo and zero otherwise. Moreover, through interviews in China, I also learned that senior cadres in the Party often recruit faction members from among the provincial leaders of their native provinces. Therefore, I also code a dummy variable that records a one when a province is the birth province of a serving Standing Committee member. With these variables, as well as their derivatives, one can test whether inferred faction ties have a systematic effect on the distribution of resources in the Chinese political system.

Because these faction ties are inferred ones rather than actual ones, it puts an extra hurdle on testing the effects of factions. Because factional ties are presumed to exist given the presence of objective bases, some of the coded faction ties in reality are false positives. Similarly, actual ties in fact exist in some of the observations where faction ties are not coded. This implies a high likelihood of measurement error in these variables. Nonetheless, because the error is due to imperfect knowledge of the researcher rather than to some characteristics about China, there is every reason to believe that the measurement error is randomly distributed with respect to the error term of the final model and to the other independent variables. Given random measurement errors, the coefficients of the faction variables are likely to bias downward toward zero, creating a higher hurdle for testing the effects of the faction variables (Achen 1984). Significant coefficients for the factional variables would give us a high degree of confidence about the existence of the factional effect. At the same time, if the coefficients of the factional variables turn out to be insignificant or close to zero, we would be uncertain of the actual effect of factions.

In order to test the effects of the two types of factions, I consolidate the birth, education, work, and native ties into two factional variables: *Ties with Party Secretary General*_(it) and *Ties with Technocrats*_(it). The first variable records the putative factional ties between the serving General Secretary of the CCP and provincial officials. With very few exceptions, the General Secretary during the

⁴ Birth ties denote the coincidences in native province. Education ties record coincidences in graduating college. Work ties denote past work experience within the same unit for over half a year within two administrative steps. For example, if a provincial official served as a county level cadre of the Communist Youth League while a Standing Committee member served as the Party secretary of the CYL, the work ties variable would record a o. However, if a provincial official served as a central committee member of the CYL while the leader served as CYL Party secretary, the work tie variable would record a 1.

⁵ Interviews in Beijing: 5/12/00, 8/5/00.

reform era tended to be the head of the dominant generalist faction. Although other Standing Committee members intervened in banks occasionally as well, the rate of success was probably not as consistent. I also add Deng Xiaoping in this variable because he was the quintessential Party politician throughout much of the reform era. As Table 5.1 reveals, some 40 percent of provincial leadership between 1978 and 2004 had putative ties with the General Secretary or with Deng. 7

The Ties with Technocrats variable tracks the factional ties of Standing Committee members who were reputed to be the leaders of the central economic bureaucracy. As stated in Chapter 4, they include Chen Yun, who oversaw the planning bureaucracy throughout the 1980s and the early 1990s, his protégés Yao Yilin and Song Ping, as well as Li Peng and Zhu Rongji. These officials spent the majority of their careers in the central economic bureaucracy and built a coterie of followers who also based their careers on posts in the central bureaucracy. Although Zhao Ziyang served as premier, the nominal head of the bureaucracy, in the early 1980s, his followers were mainly provincial officials serving in Hunan, Guangdong, and Sichuan (Cheung 1998a; Wu 1997: 86). Furthermore, because of resistance from Chen Yun, Zhao was never able to build a strong network in the economic bureaucracy (see Chapters 6 and 7). As such, Zhao Zivang is considered a Party leader rather than a leader of the bureaucracy throughout this period. The mean value of the technocrat variable on Table 5.1 reveals that relative to the generalist factions, half as many provincial governments were staffed by members of technocratic factions (23 percent). This is as expected as members of technocratic factions spend the bulk of their careers in the central bureaucracy. But since they serve in important provincial positions in over 20 percent of the observations, we are able to gauge their impact on provincial level credit distribution.

The Model

The dependent variable in this model is state bank lending in every province between 1978 and 2004. Specifically, lending is operationalized as the loan-to-deposit ratio within a given province. The PBOC has targeted this ratio as a way to determine how much the local branches of the state banks could lend since the 1980s. As Lardy (1997; 1998) points out, varying loan-to-deposit targets between the provinces tantamount to an interregional redistribution of financial resources. Ma (1996) further explains that PBOC loan-to-deposit targets were often superceded because daring provincial leaders shifted funds earmarked for government priority project to support local industries, forcing the PBOC to lend more money to the local banks. These factors generate clear variation in the loan-to-deposit ratio between provinces and over time that

⁶ Interview in United States: 5/22/00; in Beijing: 11/24/00.

⁷ Because ties with party secretary is a dummy variable with values o and 1, the mean of this variable records the fraction of observations that carries the value 1.

needs to be explained. Some provinces were clearly more willing to flaunt the PBOC's credit plan.

Because we are interested in the effect of factional ties in addition to the impact of economic variables, I also control for a series of economic variables that represent four main determinants of how credit is distributed in China. They are developmental, fiscal, bureaucratic, and welfare, respectively. Controlling for these variables also serves the purpose of seeing how these criteria perform when one controls for the factional effect.

There are always good reasons to control for the level of development. In this case, lending in affluent regions is more likely to be under stricter central supervision due to the prominent role they play in the economy overall. Rapid expansion of credit as a share of deposits in affluent regions may well have a substantial effect on the overall money supply as a result of the relatively large size of the deposits in rich regions. This then would prompt stricter central monitoring. Finally, according to Lardy (1998: 88), central government uses the banking system to transfer money from affluent to poor regions, generating a negative relationship between the level of development and the loan-to-deposit ratio. To test this effect, I include the log of provincial GDP per capita between 1978 and 2004 in the equation.

The fiscal effect on loan distribution involves a province's increased ability to bargain for more financial resources if it hands over large sums of revenue to the central government (Wu and Zheng 1995). The fiscal effect is represented by the log of total revenue collected by a province in a given year. Furthermore, scholars have long argued that the distorted financial system in China allocated bank funds to places with strong SOE presence due to the legacy of the planned economy (Huang 2003: 106). Thus, money, rather than being allocated by the market or by welfare considerations, is instead allocated according to the size of the local SOE economy. To represent this effect, I include the log of SOE gross output of industry.

Finally, Lardy (1998: 15) and Pei (1998) argue that welfare considerations of the CCP regime have an important impact on the distribution of bank loan. Specifically, through an analysis of loan-to-deposit ratios among Chinese provinces, Lardy (1997) concludes that deposits from richer provinces are routinely redistributed to poor inland provinces which rely mostly on agricultural production. Moreover, bank loans are disbursed to provinces with a large SOE base, presumably to sustain the welfare of SOE workers (Lardy 1997; Pei 1998). However, the level of development and the gross output of the SOE sector might represent other causal logics, as suggested earlier. Therefore, to directly represent the welfare effect, two variables that measure the welfare needs of a province are used: percentage of population employed by SOEs and percentage of employment that is rural employment. If the signs of these two variables are positive, it would lend credence to the idea that Chinese banks

⁸ The economic data used in this model come from *Time Series-Cross-Section Database*. See Appendix for details.

Variable	Obs	Mean	Std. Dev.
Loan-to-deposit ratio	766	1.21	0.52
Ties with technocrats	808	0.23	0.42
Ties with party secretary general	808	0.40	0.49
GDP per capita (logged)	802	7.60	1.21
Total local revenue (logged)	790	1.67	1.40
SOE industrial output (logged)	786	3.25	1.43
Share of SOE employment	785	0.10	0.06
Share of rural labor force	786	0.68	0.17

TABLE 5.1. Summary Statistics of Relevant Variables

are systematically mobilized to enhance the welfare of workers and farmers. In sum, the full model has five sets of variables: faction, developmental, fiscal, bureaucratic, and welfare.

To estimate this model, I employ both ordinary least square (OLS) and panel corrected standard error (PCSE) models, the latter of which rectifies the timeseries, cross-sectional nature of the data set (Beck and Katz 1995). For the PCSE models, I further estimate the first order autoregressive error to correct the high likelihood of autoregressive shocks (Beck and Katz 2004). I also add year dummies to control for the effect of annual economic fluctuations on the error structure. For example, loan-to-deposit ratio was unusually high in 1993 for the entire country. The annual dummy variable for 1993 would absorb this effect. To demonstrate the robustness of the findings, I run the regressions with both *Ties* variables together and also separately in regressions presented on Table 5.2. Heeding Achen (2005) and Clarke's (2005) caution against "garbage-can" models, I run the PCSE regressions with only logged GDP per capita and year dummies as control variables and present the results on Table 5.3.9

These findings contain two unambiguous outcomes closely related to the heart of this study. First, they show that factional ties indeed exert a systematic effect on the distribution of bank loans to the provinces. The positive and significant coefficients of *Ties with Party Secretary General* reveal that having birth, education, work, or native ties with the serving Party Secretary General or with Deng Xiaoping on average provides an advantage of obtaining loans equivalent to 2.3 to 9 percent of the provincial deposit. In the reform era, when the total bank deposits in some provinces reached hundreds of billions of yuan, an advantage of a few percentage points easily translates to billions in additional loans. Granted, this effect is substantially diminished once we control for first-order autoregressive effects in equations 2 and 4 on Table 5.2 and in equations 1 and 2 on Table 5.3. Nonetheless, the advantage of having

⁹ Plotting the residuals of this equation over time, one finds a generally uniform distribution of disturbance over time, with the exception of 1978, where the residuals spike up. I estimated the equation without the year 1978 and found the same signs and approximately the same significant level for all variables.

TABLE 5.2. The Effects of Factional Ties on Provincial Loan-to-Deposit Ratios from 1978 to 2004^a

	r. OLS (both)	2. PCSE/AR1 (both)	3. OLS (party sec)	4. PCSE/AR _I (party sec)	5. OLS (technocrat)	6. PCSE/AR1 (technocrat)
Factional Ties with Party Secretary General	**0.09	*0.03	**0.08	*0.03	ı	I
Ties with Technocrat	(0.03) -0.003 (0.03)	(0.01)	(20.0)		0.004	-0.005 (0.03)
Developmental GDP per Capita (logged)	** -0.3 (0.03)	**-0.28 (0.02)	**-0.3 (0.03)	** (0.02)	** -0.3 (0.03)	**-0.27 (0.01)
riscai Local Tax Revenue (logged)	-0.04 (0.03)	*-0.02 (0.01)	-0.04 (0.03)	*-0.02 (0.01)	*-0.06	*-0.02 (0.01)
Bureaucratic SOE Industrial Output (logged) Welfare	**0.15 (0.03)	**0.06	**0.16 (0.03)	**0.07 (0.02)	** 0.17 (0.03)	** 0.07 (0.02)
Share of SOE Employment	**-2.46	-0.18	**-2.47	-0.2	**-2.54	0.18
Share of Rural Labor Force	**-1.33	**-0.26	**-1.33	** \(\frac{1}{2}\)	**-1.3	** -0.24 (0.07)
Rho	N = 730	0.82 N=730	N = 730	0.82 N = 730	N = 730	0.83 N=730
	r-stansnes: 15.62	wald Cnl 2: 15788.55	r-stanstics: 16.17	wald Chi 2: 18771.28	r-statistics: 15.66	wald Cn1 2: 19555-42

[&]quot;The standard error of coefficients is reported in parenthesis. Coefficients for the annual dummies are omitted in the interest of space and presentation. * indicates the probability that the true coefficient is zero given the estimated coefficient is less than 0.05, whereas ** indicates that the probability that the true coefficient is zero is less than 0.01. Data come from Time Series-Cross Section Database. See the Appendix.

	I. PCSE/ARI (both)	2. PCSE/AR1 (partysec)	3. PCSE/AR1 (technocrat)
Factional			
Ties with Party Secretary General	*0.024	*0.023	_
	(0.01)	(0.01)	
Ties with Technocrats	-0.01	_	0.0001
	(0.01)		(0.01)
Developmental			
GDP per Capita (logged)	**-0.1	**- 0.1	**-0.1
	(0.01)	(0.01)	(0.01)
Rho	0.86	0.86	0.87
	N=755 Wald Chi^2:	N=755 Wald Chi^2:	N=755 Wald Chi^2:
	2891.70	2862.36	3193.12

TABLE 5.3. The Effects of Factional Ties on Provincial Loan-to-Deposit Ratios from 1978 to 2004 (without control variables)^a

a generalist faction member in the provincial leadership remains positive and significant throughout all of the equations in which the variable is included.

Second, the coefficients of the *Ties with Technocrat* variable strongly suggest that ties with the leading bureaucrats in the Standing Committee do not yield any systematic advantage to a province in terms of obtaining loans. The coefficients of the variable remain minute and insignificant throughout all of the above equations. The difference between ties with the General Secretary and ties with the leading technocrat strongly suggests the existence of the two types of factional strategies postulated by the factional model. Whereas a General Secretary supplies factional followers in the provinces with added investment and bank loans to bolster the growth rates of the provinces over which they govern, a leading bureaucrat has little incentive to do likewise. This finding is even more striking when one considers that the leading technocrats in the State Council have more direct access to the banking system than any Party generalists, who can only exert indirect pressure.

The coefficients of the economic variables also shed important light on the political economy of China, especially given the presence of the factional variables. First, as Lardy argues, the banking system seems to systematically channel funds to poorer regions, as the coefficient for logged GDP per capita is consistently negative and significant. Nonetheless, as the results shown later suggest, this could be the product of stricter monitoring of more affluent regions rather than an active transfer of loans to less developed regions for welfare purposes.

^aThe standard error of coefficients is reported in parenthesis. Coefficients for the annual dummies are omitted in the interest of space and presentation. * indicates the probability that the true coefficient is zero given the estimated coefficient is less than 0.05, whereas ** indicates that the probability that the true coefficient is zero is less than 0.01. Data come from *Time Series-Cross Section Database*. See the Appendix.

Fiscal contribution seems to exert a negative systematic influence on the loan-to-deposit ratio, especially in the PCSE equations with autoregressions. Contrary to the expectation of the bargaining theorists, all else being equal, sending more revenue to the central government seems to limit localities' access to the banking system. This outcome, however, could be the result of collinearity between GDP per capita and fiscal contribution. As expected by scholars of the planned economy, the banking sector displays a robust tendency to allocate loans to regions with high SOE presence. Again, although autocorrelation accounts for much of this effect, even when we take autocorrelation into account, SOE output strongly predicts the allocation of bank loans.

The final factor to consider is the impact of the regime's welfare consideration on the distribution of lending. There is ample anecdotal and cross-tabulation evidence to suggest that the regime uses the banking system to inject capital to distressed and poor provinces (Lardy 1998: 15). Nonetheless, these results reveal an ambiguous picture. On the one hand, provinces with lower GDP per capita are clearly the recipients of central subsidies through the banking system. further confirming Park and Sehrt's (2001) empirical discoveries. Moreover, provinces with a heavier presence of SOEs receive more subsidies through the banking sector. On the other hand, more direct indicators of welfare, including the percentage of SOE workers in the population and the percentage of rural labor in the employed population, have on a whole a negative effect on the loan-to-deposit ratio. Although the share of SOE population exhibits extremely powerful autocorrelation, the coefficient for the variable nonetheless remains negative throughout all of the equations on Table 5.2. At the very least, this finding suggests that provinces saddled with SOE workers are no more able to attract bank loans than provinces with fewer SOE workers as a proportion of population. At the same time, a 1 percent increase in rural labor in a province brought about at least 0.24 percent decrease in loans. This finding is negative and significant throughout all of the equations on Table 5.2. Again, these findings indicate that provinces burdened with SOE workers and surplus rural labor forces are less able to obtain loans than more urbanized provinces.

Overall, the findings indicate that the distribution of loans in China is largely driven by bureaucratic and political processes rather than by purely welfare considerations. Politically, local administrators use their membership in powerful generalist factions to obtain more money. Moreover, the center retains the ability to impose tighter supervision on more affluent provinces. At the same time, provinces with larger SOE presence in terms of output are automatically allocated more loans in the remnant planned economy. Nonetheless, the regime as a whole does not seem concerned with the burdens of excessive SOE workers or surplus rural labor when they decide where to allocate bank loans. A particular telling comparison is the difference in the effect of SOE output and SOE workers. Whereas SOE output, which is an indicator of a province's bureaucratic clout in the planned economy, exerts a positive effect on lending, the percentage of SOE workers, which records the actual magnitude of the SOE employment problem, exerts a generally negative effect on lending. In a bureaucratic

economy where capital and market are both controlled by the CCP, it is not at all surprising that purely welfare considerations have little effect on the allocation of money. In fact, perversely, they determine where money would *not* go.

Factions and Inflationary Cycles

An important implication of the factional model is that the PBOC's ability to constrain inflationary pressure is intimately tied to signals the central government sends to local governments, which are dependent on inflation rates. In the absence of a major economic crisis, provincial officials, especially those with intimate ties with elite Party politicians, have no qualms about flaunting the central bank's credit plan by pressuring local financial institutions to support local investment. Without an inflationary crisis, leaders of generalist factions also have no compunction about directing more central investment to provinces governed by factional members. However, as inflation increases as a result of the expansion of credit, the credibility of the central bank actually increases because the central technocratic faction can centralize financial power in a less costly fashion during a perceived crisis. Meanwhile, the leader of the dominant generalist faction is more likely to delegate financial control to the technocratic faction in order to avoid a financial collapse. Thus, high inflation in one period increases the probability of a central reaction against lending in a subsequent period, producing disinflation.

Unlike in the Western political economy literature, what ultimately undermines the central bank's credibility is not high unemployment, which compels a Western central bank to release credit if a leftist government can intervene in monetary policy (Boix 2000; Keech 1995:71). In China, signs of economic recovery toward the end of an austerity period increase the demand for money balance from both societal agents and local government officials, who begin to lobby their patrons at the center for credit relief. ¹⁰ At the same time, economic recovery signals to everyone the passing of the economic crisis, which emboldens leaders of generalist factions to once again intervene in monetary policy. Although this tends to be a gradual process with the most powerful politicians intervening first, followed by less powerful leaders, the eventual outcome is the collapse of central bank credibility, which augurs the beginning of another inflationary cycle.

In order to test these propositions quantitatively, a time-series approach is needed. Three sets of time-series models are used to test the implications of the

¹⁰ According to Mankiw, demand for money balance, M/P, is a function of real output, interest rate, and inflationary expectation. With increase in real output, demand for money increases to catch up with increasing transactions in the economy. In the case of China, increase for demand in real balance most likely manifests in both SOE and private firms' demand for working capital loans to keep up with output. See Mankiw, N. Gregory. 1994. *Macroeconomics*. 2nd ed. New York: Worth Publishers.

factional framework. The first set of models tests whether past inflation and autoregressive shocks exert a systematic, negative effect on contemporary inflation. The second set of models also tests the retrenchment effect by examining whether past inflation has a negative effect on current lending. Presumably, high inflation in the past would result in financial centralization, which lowers the overall level of lending. Finally, the third set of models tests whether past output growth indeed exerts positive pressure on contemporary inflation. The time-series estimations here reveal that high inflation in one period suppresses first lending, then inflation in subsequent periods. This accords well with the theoretical prediction of how inflationary cycles work in China. Furthermore, high output in one period consistently triggers high inflation in a subsequent period.

The major weakness of this model is that it does not specify the time frame within which past inflation and growth affect current inflation and lending. The impact, however, is presumed to be a short-term one. That is, high inflation in one period should have a negative impact on future inflation sooner rather than later. After all, the key to China's success in reining in inflation is the central bureaucracy's ability to retake control over monetary policies before hyperinflation takes hold. Unfortunately, because of exogenous political factors described in Chapters 6 to 8, the actual takeover can take anywhere between two to six quarters. Thus, the time-series models here also aim to empirically assess the time it takes to suppress lending and inflation. Using models with various lags and a Bayesian method of choosing the most efficient model, I am able to measure the average time it takes for high inflation to suppress lending and inflation and for high growth to induce inflation.

The Inflation Models

In the first set of models, the explanatory variables are the lagged and autoregressive terms of inflation. These variables gauge the role of past inflation in bolstering the central bank's credibility. The expected sign of the coefficients here is negative, which is the opposite of the predictions generated by conventional economic theory. Both expectation theory (Mankiw 1994) and empirical findings by Fischer and others (2002) suggest a positive relationship between past and current inflation. According to expectation theory, inflation feeds on itself because it compels people to switch from cash holding to material goods, which further drives up prices. Moreover, as inflation increases, rising inflationary expectation compels societal agents to make contracts at higher prices than they otherwise would, which worsens inflation (Agenor and Taylor 1993). The dampening of inflationary pressure is usually achieved by exogenous interventions that strengthen the central bank's credibility, including exchange rate anchors, institutional changes, and inflation targeting policies (Agenor and Taylor 1993; Alesina and Summers 1993; Cukierman 1994; Mishkin 2001). The factional framework, however, predicts that factional competition over monetary policy produces a *negative* relationship between past inflation and current inflation because the probability of realizing austerity increases with rising inflation.

The effect that past inflation has on current inflation can be broken down into two elements. First, central bureaucrats constantly watch for signs of high inflation in the economy because they present opportunities to regain central control over the financial system. Thus, they establish thresholds for dangerous levels of inflation throughout the reform era, although, as Chapters 6 to 8 reveal, these thresholds are highly contested by the two types of factions. To predict when the economy might exceed these thresholds, central bureaucrats monitor fluctuations of key indicators, including lending, industrial growth rate, fixed asset investment, and cash circulation (Editors 1993a; Jin and Wang 1991; Xue 1996). If inflation exceeds a certain threshold, the central bureaucracy would earnestly begin to maneuver for a centralization drive. Although top bureaucrats are politically powerful in their own right, a high inflationary environment provides the most favorable conditions for them to wrest power from generalist factions. This mechanism creates a systematic lag effect on current inflation. In addition to the systematic element, however, inflation at times exceeds the expectation of the central bureaucrats, as in the case of 1988. When unexpected exogenous shocks such as panic buying and political intervention generate inflation that exceeds expectation, they create an extra sense of urgency that facilitates a takeover by the technocratic faction. Thus, we should also observe an auto-regressive effect on contemporary inflation. That is, we should see a negative effect of past shock on current shock.

This test uses quarterly national data from 1980 to 2001 (see the Appendix for details). The dependent variable is inflation, which is the consumer price index, $\mathrm{CPI}_{(t)}$. The independent variables include both lags of the dependent variable and the auto-regressive terms. It is unclear whether inflation is a stationary variable (see Figure 2.1). If it is not, it can lead to spurious regression. As such, I conduct the Dickey-Fuller test on unit root, which reveals that CPI might have a nonstationarity problem. To rectify this problem, I calculate the percentage change of CPI (Figure 5.1). After transforming the variable, I reestimate the P value for the new variable DCPI_(t) with the Dickey-Fuller test and find that one can reject the hypothesis that DCPI_(t) has a unit root, denoting stationarity for the new variable.

The model is estimated as an autoregressive time-series model with different lags of the dependent variable, which go back to six quarters in the past. I include two autoregressive terms for both methodological and theoretical reasons. Methodologically, plotting the autocorrelation function of DCPI reveals that the first two coefficients of autocorrelation likely exert a significant influence on contemporary inflation. There is no need to include additional

¹¹ Unfortunately, the Chinese definition for consumer price index has changed over time as the statistical bureaucracy converged toward international standards. The definition of CPI for 1980 to 1987 is "overall retail price index of consumer goods." See University of Illinois at Chicago, and China Statistical Information and Consultancy Service Center. 1989–1991. *China Statistics Monthly* 2–3 (all).

¹² Percentage change of CPI is calculated as $(CPI_{(t)} - CPI_{(t-1)} / CPI_{(t-1)}) * 100$.

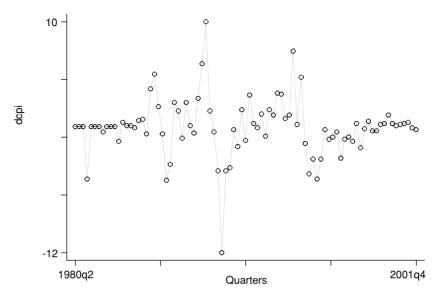


FIGURE 5.1. Percentage Change in Inflation from the Previous Quarter (1980–2001).

autoregressive terms because the autocorrelation function meanders toward zero after t-2 (Pindyck and Rubinfeld 1998: 531). Theoretically, the government is unlikely to immediately react to a change in inflation rate because high inflation is unlikely to become a clear signal to all political actors unless it persists for at least two quarters. Moreover, leaders of generalist factions are probably unwilling to cede financial authority to the technocratic faction unless it becomes clear that the economy is in crisis, which takes time. Thus, although the t-1 coefficient of autocorrelation is expected to be positive because of inflationary inertia, the t-2 coefficient of autocorrelation can be negative because unexpected inflation might increase the likelihood of a central bureaucratic takeover after one quarter.

Because the theory does not specify the number of lags, I estimate five different models with rising number of lags and use the Bayesian Information Criterion (BIC) to select the most efficient model specification. In essence, BIC is a form of corrected R², which takes into account both the goodness of the fit and the efficiency of the model by punishing a model for having too many parameters (Pindyck and Rubinfeld 1998:238; Sekhon 2003). ¹³

The findings of the inflation models are reported in Table 5.4. In the table, I present five separate second-order autoregressive (AR(2)) time-series models with different lags of the dependent variables, starting with the t-I and t-2 lags on the second column from the left and continuing to the model that includes the t-6 lag on the final column on the right. All the models presented suggest that

¹³ The formula for calculating BIC is: -2 Log Likelihood + log(N) * k, where N=the number of observations and K is the number of parameters.

TABLE 5.4. The Impact of Past Inflation on Current Inflation (AR2)^a

	Dependent Variable: $DCPI_{(t)}$, change in current inflation (%)				on (%)
	t-2 lag	t-3 lag	t-4 lag	t-5 lag	t-6 lag
$\overline{\mathrm{DCPI}_{(t-1)}}$	**1.29	**1.46	0.15	0.550	**1.35
(- /	(0.07)	(0.2)	(0.47)	(8.76)	(0.515)
$\mathrm{DCPI}_{(t-2)}$	**-0.62	**-0.89	0.11	-0.053	-0.79
	(0.07)	(0.33)	(0.43)	(1.41)	(0.76)
$DCPI_{(t-3)}$	_	0.15	-0.06	-0.015	0.24
		(0.19)	(0.14)	(0.304)	(0.55)
$DCPI_{(t-4)}$	_	_	**-0.266	-0.28	-0.33
			(0.09)	(0.197)	(0.46)
$DCPI_{(t-5)}$	_	_	_	0.11	0.36
				(2.46)	(0.33)
$DCPI_{(t-6)}$	_	_	_	_	-0.19
					(0.15)
$u_{(t-1)}$	**-o.87	**-1.02	0.3	-0.09	-0.89
	(0.11)	(0.21)	(0.46)	(0.76)	(0.52)
$u_{(t-2)}$	**-0.36	*-0.44	0.09	0.18	-0.23
	(0.1)	(0.18)	(0.48)	(4.30)	(0.47)
Bayesian	414.6	414.23	409.93	410.12	410.08
Information	n				
Criterion					
(BIC)					
	N=84	N=84	N=83	N=82	N=81
	Chi^2=344.44	Chi^2=471.62	Chi^2=70.56	Chi^2=92.25	Chi^2=353.97
	Sigma=2.3	Sigma=2.35	Sigma=2.3	Sigma=2.3	Sigma=2.3
	(0.14)	(0.14)	(0.14)	(0.14)	(0.14)

^a *denotes P > |z| is <0.05; ** denotes P > |z| is < 0.01.

inflation in the past exerts a negative impact on current inflation. In three of the five models, past inflation exercises a negative and significant influence on current inflation. In the remaining two models, inflation also produces a negative, albeit insignificant, impact on current inflation. The insignificant coefficients in the last two models likely stem from the presence of multicollinearity in the models. Looking at the BIC, it is minimized at the t-4 model on the fourth column from the left, suggesting that it has the best model specification.

In the t-4 model, inflation from four quarters ago wields a negative and significant impact on contemporary inflation. If inflation from four quarters ago increases by I percent, current inflation is expected to decline by 0.26 percent. This finding strongly suggests that despite the absence of any credible central banking institutions, the Chinese political system has an internal check against high inflation. In addition to the systematic element of past inflation, the two models presented on the second and third columns also show that the autocorrelation terms of inflation exert a negative and significant influence on current inflation. This finding suggests that unexpected inflation in the past

further dampens current inflationary pressure. However, in the t-4 model on the fourth column from the left, where the BIC is minimized, neither of the coefficients of autocorrelation seems to have any impact on current inflation. Thus, it is unclear whether unexpected inflation in the past exercises an additional negative influence on current inflation.

Overall, the findings of the inflation models strongly indicate that high inflation in one quarter triggers an internal reaction against further inflation. According to the findings above, a reaction against high inflation probably takes between two and four quarters. As subsequent chapters detail, political exigencies at times delayed the imposition of retrenchment, but the Chinese government succeeded time and again to quell inflationary expectation.

The Lending Models

Related to the inflation implication, another prediction of the factional framework is that high inflation in one quarter would lower lending in a subsequent quarter because central retrenchment first and foremost targets lending. As such, this set of models tests whether past inflation systematically suppresses contemporary lending. The dependent variable here is the total amount of state bank lending in a particular quarter. ¹⁴ As in the previous model, I first calculate the percentage change of lending from the previous quarter to ensure stationarity of the variable. I call the transformed variable D-Lending_(t). The independent variables are current inflation, as well as various lags of inflation up to the t-6 period. I use the transformed inflation variable, DCPI_(t), used in the previous model.

Plotting the autocorrelation function of D-Lending_(t) to discern the appropriate autoregressive moving average (ARMA) model specification, one finds an uncommon autocorrelation function for the state bank lending variable. ¹⁵ Although the autocorrelation of the first three lags are not significantly different from zero, the fourth, the eighth, and the twelfth lags are significantly different from zero. As such, I employ an unconventional moving average structure that uses the error term of the lag variables from t-4, t-8, and t-12 to estimate the equation. As with the inflation models, I specify five different models, each with current inflation and the different lags of inflation. Again, I use the BIC to select the best specification for the estimation.

The results of the lending models, presented in Table 5.5, report a negative relationship between past inflation and current lending. In all five models, inflation in the t-2 and the t-3 periods exhibits a negative correlation with contemporary lending. Moreover, the negative coefficients are significant in all five models, strongly suggesting that past inflation exerts a negative and systematic influence on current lending. In this case, the Bayesian information criterion is

¹⁴ State bank lending includes lending from the Big Four state banks, the PBOC, and the policy banks after they were formed in 1994. For sources, see the Appendix.

¹⁵ ARMA models have the advantage of incorporating both systematic shocks from prior values of the dependent variable and random shocks from the past.

TABLE 5.5. The Impact of Past Inflation on Current Lending (MA 4, 8, 12)¹

Dependent Variable: D-Lending_{(t),} Change in Current State Bank Lending%

	t-2 lag	t-3 lag	t-4 lag	t-5 lag	t-6 lag
DCPI _(t)	-0.03	*-0.169	0.01	0.07	0.05
	(0.15)	(0.08)	(0.16)	(0.20)	(0.2)
$\mathrm{DCPI}_{(t-1)}$	0.04	*0.2	*0.20	0.09	0.07
	(0.13)	(0.08)	(0.08)	(0.17)	(0.19)
$\mathrm{DCPI}_{(t-2)}$	-0.19	*-0.16	*-0.17	*-0.16	-0.11
	(0.16)	(0.08)	(0.08)	(0.08)	(0.23)
$DCPI_{(t-3)}$	_	*-0.28	**-0.31	*-0.3	*-0.30
-		(0.13)	(0.11)	(0.12)	(0.13)
$\mathrm{DCPI}_{(t-4)}$	_	_	0.22	0.28	0.26
			(0.15)	(0.19)	(0.18)
$DCPI_{(t-5)}$	_	_	_	-0.1	-0.14
				(0.17)	(0.2)
$\mathrm{DCPI}_{(t-6)}$	_	_	_	_	0.06
					(0.2)
$e_{(t-4)}$	**0.6	0.78	0.82	-0.8	0.8
	(0.12)	(191)	(173.1)	(1109.7)	(166.9)
$e_{(t-8)}$	*0.48	0.29	0.31	0.31	0.3
	(0.2)	(41)	(29.8)	(187.2)	(31)
$e_{(t-12)}$	*0.33	0.5	0.48	0.49	0.5
	(0.14)	(97.5)	(83.6)	(544.7)	(84.1)
Bayesian	472.15	474.1	470.4	469.6	469.2
Information					
Criterion (BIC)					
	N = 84	N = 84	N = 83	N = 82	N=81
	Chi^2=31.6	Chi^2=46.2	Chi^2=48.7	Chi^2=45.1	Chi^2=45.5
	Sigma = 3.2	Sigma = 3.0	Sigma = 2.9	Sigma = 2.9	Sigma = 2.9
	(0.19)	(287.7)	(255.8)	(1639.4)	(247.1)

^{*}denotes P > |z| is <0.05; ** denotes P > |z| is < 0.01.

minimized at the t-6 model, in which inflation from three quarters ago exerts a negative impact on current lending. According to the findings of the t-6 model, a I percent increase in inflation from three quarters ago is expected to decrease current lending by 0.3 percent.

The findings of the t-6 model match up nicely with the findings of the t-4 inflation model presented previously. The results of these two models suggest that inflation from three quarters ago lowers current lending, which in turn decreases inflation in the subsequent quarter. This causal pattern follows classical monetary theory, with the contraction in money supply quelling subsequent inflation. The findings of these two models also suggest that there is a larger time gap between inflation and retrenchment than between retrenchment and

eventual disinflation. Although high inflation on average requires three quarters to induce a reduction in lending, austerity policies that limit lending take only one quarter to stifle inflationary pressure. This statistical pattern accords with qualitative findings presented in the subsequent chapters. Essentially, generalist factions often contested the imposition of austerity policies, thus delaying retrenchment even when it became obvious that inflation had risen to an alarming level. When the generalist factions eventually signed on to austerity measures, however, they took effect fairly swiftly. As Chapter 3 explained, the CCP never lacked the institutional capacity with which to suppress inflation. Rather, postponement in inflation control was a function of elite political tension between generalist factions and technocratic factions.

The Output Models

Finally, the factional model predicts that high output in one period generates increasing inflationary pressure in a subsequent period because high output increases the pressure on generalist factions to release money into the economy. This prediction, however, is contrary to the prediction of standard economic theory. According to the quantity theory of MV=PY, there is a negative relationship between real growth and inflation, where M is money stock, V is money velocity, P is price, and Y is output. ¹⁶ On the margin, if we assume fixed money velocity, we have:

$$\Delta M_{(t)} = \Delta P_{(t)} + \Delta Y_{(t)}$$

or

$$\Delta P_{(t)} = \Delta M_{(t)} - \Delta Y_{(t)}$$

Thus, given a fixed money supply, an increase in output is expected to decrease inflationary pressure. In the case of China, however, rising output signifies escalating demand for liquidity, which increases the pressure on generalist factions to circumvent the central bank's credit plan and to allocate loans to factional followers. Increasing output also denotes an economy in recovery and prompts generalist factions to intervene in banks. Although there is likely to be a long-term negative relationship between output and inflation (Chow 1987), in the short run accelerating output signals to local government officials the end of an austerity period, which decreases the credibility of the PBOC and increases inflationary pressure.

In order to test this, I once again use a time-series model with inflation, $DCPI_{(t)}$, as the dependent variable and SOE industrial production and its lags as independent variables. I use SOE industrial production rather than GDP or export because it is the only complete quarterly series that approximates

Money velocity is the speed with which money circulates through the economy. If money velocity is presumed to be rising, then less money stock is required to maintain the same level of deflation-free economic activities.

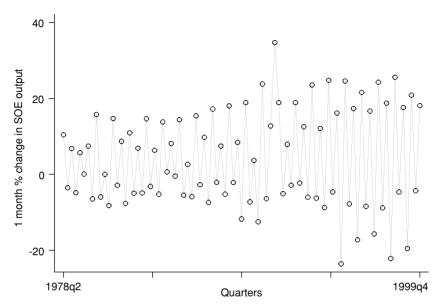


FIGURE 5.2. Percentage Change in SOE Industrial Output from the Previous Quarter: 1978–2000. Source: Data from Quarterly Database. See Appendix for detail.

output. Ideally, I would use quarterly export figures because they are exogenous to lending and inflation. However, quarterly data for export do not go back to the early 1980s. Calculating the percentage change in quarterly industrial production, however, produces a series that exhibits a high degree of seasonality. Because the series reports SOE output, the data necessarily reflect the seasonal characteristics unique to state-owned enterprises, which continued to follow planned production for much of the reform (Naughton 1996: 114, 224). As one can see in Figure 5.2, this series resembles random noise and, when regressed on inflation, produces no significant correlation with the dependent variable.

Because of the severe seasonality in this data, it is necessary to smooth out the seasonality in this series. Although there are many approaches to smooth out seasonality, I simply use the method most often used by the Chinese government, taking the percentage change from four quarters ago. This approach erases distinct features of a particular season and instead reveals changes in current industrial output from the same quarter one year ago. Because this practice is prevalent in the Chinese government, it also makes theoretical sense to use this approach of smoothing out seasonality. If Chinese government officials themselves compare output in the current quarter relative to the same quarter the previous year, a sharp rise in output relative to four quarters ago, rather than a similar increase from the previous quarter, would suggest to them a loosening monetary environment. In other words, this analysis takes seasonality into account in the same way that Chinese officials would.

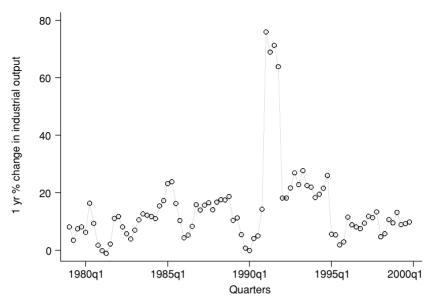


FIGURE 5.3. Percentage Change in SOE Industrial Output from Four Quarters Ago: 1978–2000.

In Figure 5.3, the seasonally adjusted series exhibits much less volatility and a more noticeable cyclical pattern. The Dickey-Fuller test on this new series reveals its stationarity. Because the dependent variable is DCPI, an AR(2) autoregressive structure is used again. Similar to the previous models, the output models regress current inflation on the various lags of the seasonally adjusted SOE output. The findings are reported in Table 5.6.

According to the findings presented in Table 5.6, there is clear evidence that output in one period exacerbates inflationary pressure in a subsequent period. Across all five models, an increase in seasonally adjusted SOE industrial output from two quarters ago systematically heightens inflation in the current quarter. According to the BIC, the model that provides the best fit is the t-2 model. In that model, a 1 percent increase in seasonally adjusted SOE output from two quarters ago is expected to elevate inflation by 0.1 percent. Although the effect is not a steep one, a significant increase in SOE output can substantially heighten inflationary pressure. As seen in Figure 5.3, a 20 percent increase in SOE output was a commonplace occurrence during the past two decades, and a rise in output of that magnitude on average increases inflation by 2 percent. This finding accords with the notion that a rapid increase in output provides the economic precondition for a decentralization campaign. Nonetheless, as will be seen in Chapters 6 to 8, many exogenous political factors also played an important role in the actual process of unlocking the bureaucrats' grip on the economy. Thus, it is not surprising that the effect of economic growth on inflation is not a strong one.

TABLE 5.6. The Impact of Past Industrial Output on Current Inflation (AR2)^a

	Dependent Variable: DCPI(t), change in current inflation (%)				
	t-2 lag	t-3 lag	t-4 lag	t-5 lag	t-6 lag
D-SOE	0.03	0.02	0.03	0.03	0.02
$Output_{(t)}$	(0.03)	(0.04)	(0.04)	(0.05)	(0.05)
D-SOE	0.07	0.08	0.07	0.06	0.06
Output (t-1)	(0.06)	(0.05)	(0.06)	(0.07)	(0.07)
D-SOE	*0.I	*0.1	*0.1	*0.1	*O.I
Output (t-2)	(0.05)	(0.05)	(0.05)	(0.05)	(0.05)
D-SOE	_	0.00	0.01	0.02	0.01
Output (t-3)		(0.07)	(0.07)	(0.08)	(0.1)
D-SOE	_	_	0.03	0.02	0.02
Output (t-4)			(0.07)	(0.09)	(0.1)
D-SOE	_	_	_	-0.04	-0.02
Output (t-5)				(0.08)	(0.08)
D-SOE	_	_	_	_	0.3
Output (t-6)					(0.08)
$E_{(t-r)}$	**1.3	**1.3	**I.2	**1.3	**1.3
	(0.11)	(0.1)	(0.08)	(0.1)	(0.1)
$E_{(t-2)}$	**-0.55	**-0.55	**-0.56	**-0.56	**-0.56
	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Bayesian	436.5	440.8	444.5	448.1	451.7
Information					
Criterion					
(BIC)					
	N=76	N=76	N=76	N=76	N=76
	Chi^2=210.8	Chi^2=210.7	Chi^2=221.3	Chi^2=221.0	Chi^2=221.4
	Sigma=3.4	Sigma=3.5	Sigma=3.4	Sigma=3.4	Sigma=3.4
	(0.26)	(0.27)	(0.3)	(0.3)	(0.26)

^a *denotes P > |z| is <0.05; ** denotes P > |z| is < 0.01.

Summary

Figuring out how much politics in China affects economic outcomes is at best an exploratory exercise. The opacity of the political system does not lend itself to careful scrutiny by outside investigators. Nonetheless, it is precisely under these circumstances that statistical methodologies can provide the most important analytical leverage with which we can pry open the black box of elite political economy. This chapter began by making the assumption that coincidences in ascriptive ties between central and provincial leaders indicate the existence of factional ties between them. If this holds true on average, then factions indeed exert a systematic influence on the distribution of scarce bank capital to the provinces. Moreover, the findings reveal two different factional strategies that accord with the two types of factions in China: generalist factions and technocratic factions.

To test the time-series effect of the factional model, this chapter posits that the perception of an economic crisis, measured as the change in inflation and the change in unexpected inflation, has a systematic impact on Party politicians' willingness to delegate financial authority to the technocratic faction. Indeed, high inflation in one quarter exerts a systematic, negative effect first on lending, then on inflation in subsequent quarters, which reflects a delayed reaction by the central government to delegate financial authority to the central bureaucracy. Delegating financial authority to the technocratic faction guarantees the end of the inflationary crisis because the faction has a strong incentive to centralize financial authority. The third set of time-series models provides evidence that increasing growth undermines the credibility of the PBOC's credit plan and creates pressure for higher inflation. This occurs as generalist faction leaders become confident that an economic crisis has passed and that the factional competition to allocate capital to the provinces can begin anew. Having tested the quantitative predictions of the factional model, the subsequent chapters examine whether one can find patterns predicted by the factional model in the complex, messy interplay between top leaders in China.

The Collapse of Discipline

The First Two Inflationary Cycles and the Fiscalization of Chinese Banks

The theory put forth here argues that the struggle to control financial policies between generalist factions, which favor decentralization, and technocratic factions, which champion centralization, gives rise to inflationary and anti-inflationary pressure, respectively. But because both types of factions exploit the banking sector to fund their respective political aims, there is a persistent failure to commercialize the banking system in China. This chapter fully demonstrates this dual logic by examining two "classic" cases of inflationary cycles: the 1978–1982 cycle and the 1983–1986 cycle, respectively.

The two cycles are essential for the main argument for several reasons. First, this period saw the first two inflationary cycles since the 1978 reform. These two inflationary cycles exhibited a "classic" pattern in which generalist factions galvanized local enthusiasm for investment through manipulating the agenda at important party meetings and through restructuring vital economic decision bodies such as the Finance and Economic Committee. Because of the latent competition between generalist factions, they competed to decentralize financial resources to provincial followers, which increased inflationary pressure. When inflation rose above a certain threshold, the central bureaucracy mobilized against the generalist factions in order to regain control over finances. Closely examining the policy coalitions that formed on investment and monetary policies in this period allows us to evaluate whether the assumptions of the theory roughly accords with political reality in China.

Equally important, the historical evidence allows us to evaluate competing explanations for monetary outcomes in China. Through detailed historical examination, we see that although factors such as institutions and ideology played a part in the monetary policy process, they were not the crucial variables determining the major shifts in monetary policy. Rather, it was the factional imperatives derived from the membership composition of the factions that drove policy preferences and political maneuvering. For example, although Zhao Ziyang was the nominal head of the central bureaucracy, his long-standing relationship with several provinces caused him to bestow more

loans and investment authority to them. His formal position could not have accounted for his behavior. A close examination of the policy preferences of the central bureaucrats informs that they were not simply the opponents of reform. In fact, Chen Yun had allied with Deng Xiaoping on a number of reform issues. They strongly disagreed with each other over the financial issue because the level of financial centralization was vital to the political strategy of each faction. These two cases also show very clearly that it was indeed high inflation that increased the political power of the central technocratic faction, and thus the credibility of the central bank's credit ceiling. In both of these cases, high inflation led to a retreat by Deng's dominant generalist faction, which allowed the central bureaucracy to harshly punish local officials for violating the central credit ceiling.

The period between 1978 and 1986 also saw a major shift in the central leadership's perception of the banking system. Rather than seeing it as the accounting arm of the state budget, the central leadership from both types of factions began to see the banking system as a separate treasury that provided an alternative source of funding for policy and political needs. In contrast to the fierce debates over the level of monetary centralization, both generalist factions and the technocratic factions agreed that the growing deposits in banks should be mobilized to serve the state. In this manner, the disciplined view of the banking system that had prevailed quickly collapsed, leaving banks completely at the mercy of administrative interventions from either the local or the central state.

Finally, particular attention is paid to this period because we have the most information about high politics and financial policies in this period. By chance, I stumbled across a two-volume set, which contains dozens of top-secret speeches by individual leaders on economic issues from that period (Document Research Center of the CCP CC 1982). Unlike publicly available speeches, these speeches reflect the divergence of opinions within the leader-ship. I also have access to all the internal banking decrees from the period, as well as a rich collection of memoirs and official chronicles of senior officials at that time. Finally, we have two extremely valuable volumes documenting the interaction between the Guangdong leadership and their patrons in the central government, which afford us a rare glimpse into the inner workings of a faction.

The Main Actors and their Factions: The Deng-Chen Dichotomy

At the end of the Cultural Revolution and the Hua Guofeng interregnum, the Chinese leadership was united on most issues. The foremost two factions at that time, led by Deng Xiaoping and Chen Yun, respectively, were mainly composed of victims of the Cultural Revolution. Chen Yun had been instrumental

¹ From 1966 to 1968, radical Red Guards and the Cultural Revolution Group coordinated to "expose" many of China's top leaders. Some, however, were merely exiled to the provinces,

in organizing the coup against the Gang of Four after Mao's death in 1976 and had also played a large part in restoring Deng Xiaoping to power in 1977 (MacFarquhar 1997: 313).² Chen Yun also sided with Deng as Deng sought to ease Hua Guofeng, a beneficiary of the Cultural Revolution and the Party Chairman at the time, out of power (MacFarquhar 1997: 319). In gratitude for Chen's support, Deng helped Chen edge out his longtime rival, Yu Qiuli, from the economic policy arena and supported Chen Yun's policy of fiscal balance and more light industrial development (Swaine 1986).³

Despite their alliance at the end of the Cultural Revolution, the two men came from very different revolutionary pedigrees. More important, their disparate career paths translated to different membership composition of their respective factions. This created divergent opinions on the issues of investment and monetary policies between the two factions.

Deng and His Faction

Deng Xiaoping began his life in the Communist Party as a young apprentice in a French factory. There, he met Zhou Enlai and Zhu De, two of the first Chinese communists, and was soon involved with the CCP (Deng 1995). On his return to China in 1926, he organized and led a series of uprisings in Southwestern China. In 1931, he led his army in southwestern China to join Mao's forces in the Jiangxi Soviet (Liu and Shen 1992). From that point on, he served as Mao's loyal lieutenant and took on a series of increasingly important command positions in the Red Army, the precursor of the People's Liberation Army. By the Chinese Civil War (1946–1949), he co-commanded the Fourth Field Army, which liberated southwestern China. He then served as the regional governor of southwestern China before going to Beijing to take up positions in the central Party apparatus.

whereas others suffered extreme torment in the hands of the Red Guards. Although Chen Yun was not formally purged in the late 1960s, he was nonetheless excluded from important decision making from 1969 to 1972. Both he and Deng Xiaoping were rehabilitated in 1972 after Lin Biao's coup. By all accounts, neither suffered the worst treatment during the Cultural Revolution. See Document Research Center of the CCP CC. 2000. Chen Yun Nianpu (The Chen Yun Chronicle). Vol. 3. Beijing: Central Documentation Publisher.

- ² In March 1977, Chen Yun made a speech at the Central Work Conference arguing that Deng had nothing to do with the Tiananmen demonstrations in 1976 and thus should be reinstated. See Ibid.
- ³ In addition to Chen Yun, Yu Qiuli was possibly the most respected authority on the economy in the late 1970s. He headed the petroleum faction in the State Council, which competed for dominance in the economic arena with Chen's faction in the late 1970s. Formally, Yu served as head of the State Planning Commission (SPC). In 1979, however, Chen Yun, with the help of Deng and Li Xiannian, created the Finance and Economic Commission headed by Chen to circumvent Yu's power. Soon after, Yao Yilin, a Chen loyalist, replaced Yu as the head of the SPC. For details of the Chen-Yu struggle, see Lieberthal, Kenneth, and Michel Oksenberg. 1988. Policy Making in China: Leaders, Structures, and Processes. Princeton, NJ: Princeton University Press, 252–255 Fewsmith, Joseph. 1994. Dilemmas of Reform in China: Political Conflict and Economic Debate. Armonk, NY: M. E. Sharpe, 58–59.

His preliberation career in the army provided Deng with an extensive network of friendly colleagues and loyal followers both in the military and in the Party apparatus, whose leaders primarily came from the army. According to Huang (2000: 384), Deng's faction at the beginning of reform included Hu Yaobang, Zhao Ziyang, Wan Li, Xi Zhongxun, Fan Yi, Hu Qiaomu, Chen Peixan, Hu Qili, Yang Shangkun, Wang Zhen, Wei Guoqing, Yang Dezhi, Geng Biao, Fang Yi, Huang Hua, Zhang Jinfu, and Qiao Shi. The key members of his factions had spent most of their careers in the central or provincial Party apparatus or in the military. Even officials such as Zhang Jinfu and Zhao Ziyang, who ended up in the State Council at the height of their careers, had spent the bulk of their careers in local administration and Party affairs. This meant that the followers of Deng's immediate clients were mostly Party and military cadres at the provinces.

Two stars in Deng Xiaoping's faction deserve special mention, as they both played an important role in the subsequent narrative on the inflationary cycles. First, Hu Yaobang, Deng's subordinate during the Civil War and a longtime leader of the Communist Youth League (CYL), owed his entire career to Deng Xiaoping (Liu and Shen 1992: 267). In 1980, with the backing of the Deng faction, Hu was elevated to the Standing Committee of the Politburo and became the General Secretary of the CCP, the highest position in the Party. Because CYL leaders tended to go into careers in local administration and Party affairs, Hu's key followers, including Hu Qili and Zhu Houze, were at that time serving in the provinces (Zong 2002: 38–39). This made him an enthusiastic supporter of a decentralized financial system. He also had a coterie of followers in the central propaganda system, including Zhou Yang, Wang Ruoshui, and Qin Chuan (Deng 2005: 266–267).

Into the mid-1980s, the relations between Hu and Deng became increasingly strained, as Hu pursued his own agendas to the neglect or even in direct contradiction with Deng's decrees (Baum 1994: 164). Hu's action follows the classic pattern of a designated successor, who tries to establish his own agenda and shore up his factional network before the passing of the current helmsman. Although perfectly rational, this strategy invites suspicion and distrust between the successor and the incumbent (Huang 2000: 18). Hu's preemptive action created a complex situation in which Deng's dominant generalist faction had to deal with an emerging generalist faction while contending with the technocrats on economic issues. The technocratic faction led by Chen Yun naturally exploited the situation fully, especially when inflation was high.

In many ways, Zhao Ziyang's path to the top tied him even more intimately to provincial leaders than Hu's career did. Zhao had joined the revolution later than Hu had and had served only as district Party secretary during World War II (Liu and Shen 1992). After the liberation, he became the right-hand man of Tao Zhu, a Party elder who governed the entire southern China. Formally, Zhao held a series of leadership positions in the Guangdong Party apparatus for much of the time before Mao's death. After the Third Plenum, Zhao was

rapidly promoted from the post of provincial Party secretary of Sichuan to the vice premier slot and eventually to the office of the premier in 1980. As the subsequent discussion reveals, despite the fact that he served as the head of the State Council, he still looked after his followers in Guangdong through a myriad of preferential policies, including devolving control over the banks and extra national priority projects. During these first two inflationary cycles, Zhao faithfully served Deng's wishes in both the economic and political arenas. After the fall of Hu Yaobang in 1987, however, Zhao became the designated successor and likewise pursued his own political agenda, which ultimately led to his downfall in 1989.

Chen's Faction

Chen Yun was another giant in the Communist Party, but he followed a very different career trajectory than Deng's. Like Deng, Chen Yun began his career in the Party as an apprentice, but it was in the Commercial Press in Shanghai rather than in France. Because of his familiarity with Shanghai workers, he specialized in union organization and underground work in "white" areas occupied by the Kuomintang (KMT) for much of the 1920s and 1930s. In 1937, Chen Yun joined the main communist forces in Yan'an and became the head of the Central Organization Department in charge of cadre promotion and evaluation. In Yan'an, Chen also began to develop his specialty in economic affairs. By the end of the Chinese civil war, Chen Yun had taken up position as the head of the Northeast Finance and Economic Committee for the newly liberated Manchuria. He remained the regime's foremost expert in economic affairs until his death almost fifty years later.

When the communists took power in 1949, China was plagued by hyperinflation because the outgoing regime had engaged in reckless currency expansion to pay for the civil war and to fill the pockets of corrupt officials. Chen Yun brought in his "change team" of communist economic officials and transformed the Chinese economy. Whereas army generals such as Deng often reminisced about battles they had fought, Chen, even in the early 1980s, looked back to the early 1950s as the height of his life's achievements. In a speech to Planning Commission cadres in 1982, Chen reminisced "the best period was from 1949 to 1956; we had a lot of problems, but we experimented and solved them all, like stabilizing prices, unifying the economy, and unifying procurement and retailing. That created socialism" (Chen 1982a: 1495). Chen Yun also was one of the very few who had dared to challenge Mao's decentralizing economic policies in 1957, although when Mao launched the Great Leap Forward in 1958, he knew enough to keep quiet (Teiwes and Sun 1997).

The innumerable problems that Chen and his colleagues solved in the early 1950s became the standard by which all subsequent Chinese technocrats were judged. Just as all Party members were expected to overcome impossible odds as the Long Marchers did, Chinese technocrats made their marks by rescuing the regime from impending crises or by solving difficult problems facing the country. This created the incentive among bureaucrats to constantly search for

the next crisis. It also induced them to hoard power over economic resources in preparation for the next crisis. In the context of factional politics, Chen worked to concentrate economic power to the central government, specifically to agencies controlled by his most loyal followers.

As Chen spent the bulk of his career in organization and economic work, members of his faction also rose predominantly through the central bureaucracy. Key members of Chen's coterie in the early 1980s included Yao Yilin, Song Ping, Chen Muhua, Bo Yibo, Li Xiannian, Jin Ming, Jiang Zemin, Li Peng, and Xu Xianggian (Chen 1982e; Document Research Center of the CCP CC 2000; Huang 2000: 364). The core members of Chen's faction had all spent the bulk of their careers in the State Council bureaucracy managing various aspects of the economy. Yao Yilin was in charge of domestic commerce for much of the Mao era. Song Ping spent much of his post-1949 career in the State Planning Commission. Chen Muhua took charge of external trade during the Mao era and became the head of the People's Bank of China (PBOC) in the 1980s. Other elders who belonged to Chen's faction, including Bo Yibo and Li Xiannian, had all spent the bulk of their postliberation careers in the State Council. Younger members of Chen's faction, such as Jiang Zemin and Li Peng, worked their way up the heavy industrial bureaucracy throughout the Mao era. Although Jiang later became the leader of the Party, he was still very much a technocrat in the early 1980s. Li Peng, whom Chen Yun forcefully promoted in the early 1980s, went on to become the head of a powerful technocratic faction.⁵

From Unity to Contradiction: The Deng-Chen Split and the First Inflationary Cycle

After the Third Plenum of the Eleventh CC in late 1978, Deng became the leader of the dominant generalist faction in the CCP, triumphing over Mao's designated successor, Hua Guofeng. Chen Yun, meanwhile, became the lead technocrat as

- ⁴ Although Huang's list (2000) includes Deng Liqun and Hu Qiaomu, they were a force of their own rather than a part of Chen's faction, whose main preoccupation was the economy. Hu Qiaomu, and to a lesser extent Deng Liqun, did not depend on Chen Yun for their promotion and did considerable work for Deng Xiaoping. Deng Liqun (2005: 404) himself claimed that he did much more for Deng Xiaoping than for Chen Yun. In contrast, Chen was in frequent contact with Yao Yilin, Chen Muhua, and Song Ping. Although Fewsmith (1994) argues that Li Xiannian opposed Chen Yun's rise to the top of the economic arena, the *Chen Yun Chronicle* records several personal meetings between Chen and Li in the early 1980s. Swaine (1986) also shows convincing evidence that Li Xiannian was in an alliance with Chen by the beginning of the 1980s.
- ⁵ In a 1981 speech to local Party secretaries on promoting young cadres, Chen Yun specifically mentioned Li Peng as an ideal candidate to promote to the ministerial level. Li Peng was promoted within a matter of weeks. See Chen, Yun. 1982e. Zai sheng, shi, zizhiqu dangwei shuji zuotanhui shang de tanhua (Remarks during the province, city, autonomous region party secretary discussion meeting). In San Zhong Quanhui Yilai Zhongyao Wenxian Huibian (Compilation of Important Documents since the Third Plenum [of the 11th Central Committee]), edited by Document Research Center of the CCP Central Committee. Beijing: People's Publisher.

head of the Finance and Economic Committee and sidelined his main rival, Yu Qiuli. In the aftermath of the disastrous Cultural Revolution, both Deng and Chen firmly agreed that restoring order and setting a firm foundation for the future were of vital importance. Thus, they worked closely with each other to address several vital issues: the rehabilitation of Cultural Revolution victims, the promotion of younger cadres, and increasing the autonomy of farmers and state-owned enterprises (Fewsmith 1994: 60).

Between 1979 and 1980, however, Chen Yun gradually realized that his drive to restore central control over fixed asset investment and to restore a balanced budget was hampered not just by Hua Guofeng's residual force, but also by Deng's faction. While Deng, Zhao, and Hu encouraged local officials to increase investment using budgetary funds and, increasingly, bank loans, Chen fought back with ineffective directives from the State Council urging restraint. Toward the end of 1980, the new leadership encountered its first perceived crisis as inflation rose to 8 percent, a level not seen since the disastrous Great Leap Forward. This allowed Chen to recentralize control over investment, slow the pace of price reform, and build up institutions that ensured some degree of central control over the banking sector.

The Beginning of the Split

At the Third Plenum in 1978, Hua Guofeng, Chairman Mao's designated successor and the proponent of the neo-Maoist theory of "Two-Whateverism," suffered a crippling defeat at the hand of the Deng Xiaoping-Chen Yun alliance (Baum 1994: 48). Yet Deng's position was not as secure as we imagine today. Until his eviction from the Politburo, Hua and his disgruntled allies in the army threatened to strike back at Deng at the first sign of trouble (Baum 1994: 122). After the Third Plenum, Deng and Chen continued to maneuver against Hua's leadership by attacking his economic program, which was designed by his chief economic advisor Yu Qiuli and centered on high-speed growth and rapid modernization through large-scale import of foreign equipment. In its place, the Deng-Chen alliance proposed a program of "adjustment, reform, rectification, and improvement" (tiaozheng, gaige, zhengdun, tigao). As later events reveal, this program was a compromise between the ideal policies of Deng Xiaoping and of Chen Yun. Deng favored reform and improvement of the economy, while Chen Yun championed adjustment and rectification, which stood for centralized control of the economy. With an internally contradictory platform, the coalition on the economy was doomed from its inception.

In the spring of 1979, both Deng and Chen adhered to the previously sealed pact. In March 1979, Chen Yun argued in favor of a larger role for the market in allocating goods (Chen 1982b). His remarks implicitly supported the Wuxi Conference in April, which explored different ways of allowing market

⁶ For details of the struggle between Yu Qiuli and Chen Yun, see Swaine, Michael D. 1986. Heavy Industrial Policy under Hua Guofeng: Bureaucracy and the Policy Process. Ph.D. dissertation, Department of Government, Harvard University, Cambridge, MA.

forces to play a larger role in the economy (Fewsmith 1994: 63). Furthermore, Chen lent his support to the household responsibility system, which allowed the legalization of the system at the September 1979 Fourth Plenum (CCP Central Committee 1982). Finally, Chen also endorsed another one of Deng's favorite projects, setting up special economic zones (SEZs) in Fujian and Guangdong (Document Research Center of the CCP CC 2000). Deng in turn reciprocated by supporting Chen's retrenchment plans in public, although he expressed dissatisfaction with the slow pace of growth in private. In a January 1979 private discussion with Rong Yiren, the most influential "noncommunist" in the regime and a former industrialist in Shanghai, Deng put a heavy emphasis on growth: "In the past we wasted too much time. It won't do if we do not (grow) faster" (Deng 2000a). Despite Deng's feeling, Chen Yun's role in Deng's re-emergence and perhaps his support for the war in Vietnam could not be easily forgotten, so for the moment, Deng remained silent about Chen's program to stifle local growth initiatives.

The fissure began to emerge in late spring soon after the formation of the Finance and Economic Committee (FEC), a superministry that coordinated the entire economy headed by Chen Yun and his loyal protégé Yao Yilin. In April 1979, the FEC convened a central work conference, attended by both central and local officials. In addition to further criticizing Yu's policies and calling for more balanced growth, the meeting also castigated local officials for expanding investment recklessly. In classic planners' fashion, over seven hundred investment projects were axed, while over 110,000 local investment projects were scaled down significantly. The proposed investment quota for 1979 fell to below 50 billion yuan from the 52 billion yuan set at the beginning of the year (Li 1982d). Li Xiannian, speaking on behalf of Chen Yun, also recommended sending work teams composed of central officials to the provinces to supervise the austerity program (Li 1982d). In July, Chen's control over the

⁷ The household responsibility system (HRS) in which farmers could sell above quota grain to an open market was first proposed after the Great Leap Forward. Despite its popularity at that time, Mao saw it as the resurgence of capitalism and put an end to it. In 1978, Deng and Chen used it as an issue to distinguish themselves from Hua Guofeng. The Third Plenum called for experimentation with the HRS, but the Fourth Plenum put the Party's formal seal of approval on the policy. See Fewsmith, Joseph. 1994. Dilemmas of Reform in China: Political Conflict and Economic Debate. Armonk, NY: M. E. Sharpe, 63–65.

⁸ Rong was in fact a member of the CCP, but it was kept a secret until his death.

⁹ The members of the FEC included Chen Yun, Li Xiannian, Yao Yilin, Yu Qiuli, Wang Zhen, Gu Mu, Bo Yibo, Wang Renzhong, Chen Guodong, Kang Shi'en, Zhang Jinfu, and Jin Ming. Although Yu Qiuli and his follower Kang Shi'en were part of this committee, they were only members. Its chairman was Chen Yun, while its secretary was Yao Yilin, and the vice chairman was Li Xiannian, who sided with Chen by supporting the formation of this body in the first place. See Li, Xiannian, and Yun Chen. 1982. Guanyu Caijing gonzuo gei zhongyang de yifeng xin (A Letter to the Central Committee concerning finance and economic work). In San Zhong Quanhui Yilai Zhongyao Wenxian Huibian (Compilation of Important Documents since the Third Plenum [of the 11th Central Committee]), edited by Document Research Center of the CCP CC. Beijing: People's Publisher.

economy was temporarily strengthened with the appointment of Yao Yilin as the vice premier in charge of the economy.

This steep reduction of investment stifled Hua's growth program and damaged Yu's support base in the heavy industrial sector, but it also took billions away from Deng's provincial supporters and potential allies at a time when their support was still needed in the final fight against Hua. The crucial province in question at this point was Guangdong Province. It was the powerbase of three of Deng's core followers: Zhao Ziyang, Yang Shangkun, and Xi Zhongxun. Zhao, a longtime leader in the province, had recently been promoted to the central government as Premier, whereas Yang, the patron of a powerful military faction, provided Deng with crucial support within the military. In addition, Deng was hoping that generosity toward Guangdong would shore up his ties with Marshal Ye Jianving, one of the few senior officials who had remained unscathed throughout the Cultural Revolution and the patron of a powerful army faction. Marshal Ye played a crucial role in the downfall of the Gang of Four and had given Deng reluctant endorsement in his struggle against Hua Guofeng at the Third Plenum (Huang 2000: 253). Deng likely hoped that generous investment money for Guangdong – Ye's native province – would finally garner Ye's support for his final drive against Hua.

Because Chen's investment reduction directly threatened his political strategy at the time, Deng soon acted to undermine Chen's program. The fall of 1979 saw an increasing chorus of complaints from the local Party secretaries against Chen Yun's austerity program. Chen and his followers in the State Council were clearly aware of grassroots frustration and tried to justify the central bureaucracy's position. In early September 1979, Chen had Vice Premier Yao Yilin reprint several State Council documents about previous retrenchments and their harmful effects on the economy and distributed them to the other Politburo members and to local Party officials (Document Research Center of the CCP CC 2000). To In a FEC meeting later that month attended by local officials, Chen drove home the lessons of these documents: "Currently, people demand a relatively fast pace of economic development, but they do not want the gallop cut short . . . We should explore a more appropriate pace of development" (Chen 1982d). In essence, Chen Yun warned Deng's faction that impatience might lead to a crisis and further reduction in investment.

Tension came to a head at an October 1979 Party meeting attended by Deng's main constituent, the Party secretaries from the provinces and major cities. At that meeting, Deng, as the head of the dominant generalist faction, unambiguously supported the local desire for high growth and investment autonomy. Deng first revealed that his disagreement with Chen Yun stemmed from the numerous specific complaints he had received from the provinces about Chen's harsh method of investment reduction. Deng echoed these complaints to Chen: "Now, there are numerous reports on the budget and the banks. There are now

¹⁰ These documents were all compiled by the Ministry of Finance and concerned the experience of the four fiscal retrenchments during the PRC's history.

many good projects that only require several hundred thousand yuan to make them work. But the budgetary and the banking system would not approve (the funds), so they languish. I am afraid this happens frequently, not rarely" (Deng 2000b). In making these remarks, Deng directly accused Chen's coterie of state planners of hoarding resources in the budget and in the banking system, stifling local economic initiatives. Deng went one step further and countermanded the State Council's earlier goal of cutting overall investment "... projects in the tens of millions range can work very quickly, so the budget and the banks should support them" (Deng 2000b). In one brief statement, local officials received the green light from the highest authority to ignore the State Council's earlier order to trim investment. Furthermore, Deng overturned the overall policy of "an appropriate pace of development" by stating that "... if we cannot have higher growth in 1982 and 1983, we are not doing a good job" (Deng 2000b). Finally, Deng urged Chen Yun to give further financial leeway to the local governments to make their own development plans (Deng 2000a).

Sensing that he was at a disadvantage, Chen beat a retreat by admitting that disagreements existed between him and Deng and that the problem should be debated further. This admission came in flowery Party language, but its meaning was clear to everyone who attended: "Great disagreements on economic work not only exist among comrades engaged in finance and economic work, but also within the Party center, and between the center and the localities" (Document Research Center of the CCP CC 2000:252). In one sentence, Chen accurately identified the different coalitions on investment and lending policy in the fall of 1979. The main cleavage on financial policy was now between Deng's faction of provincial officials and Chen's faction of bureaucrats. This first showdown between Deng and Chen revealed that they supported different investment policies because of their distinct factional bases. Furthermore, this first clash indicated that Deng had the upper hand because as the head of the dominant generalist faction, he controlled agenda setting during important Party meetings.

Chen Yun did not give up the fight entirely. The day following his hasty retreat, he threatened local officials with the specter of an economic crisis by once again recounting the horrors of inflation and budgetary imbalance in the early 50s and after the Great Leap. He might have fought Deng's agenda more, but he collapsed the next day and was rushed to the hospital, where he underwent surgery for colon cancer (Document Research Center of the CCP CC 2000). For the next few months, China's top technocrat did not have the luxury of worrying about the economy or the well-being of his faction.

In the absence of an actual economic crisis and with Chen falling ill, Deng and his provincial followers called the bureaucrats' bluff. With Deng's countermand of Chen's austerity plan, the discipline over fixed asset investment collapsed in the last quarter of 1979. Investment reached 52.3 billion yuan by the end of 1979, over 2 billion yuan above Chen's earlier goal of reducing investment to below 50 billion yuan (Department of Comprehensive Statistics of National Bureau of Statistics 1999). Because the central government

still had relatively tight control over budgetary disbursement, this new surge of investment at the local level was predominantly financed by another source: bank loans.

Deng's Triumph and the Onset of Inflation

The year 1980 began splendidly for Deng's followers. The February Fifth Plenum saw the creation of the Central Secretariat, an organization designed to run the day-to-day affairs of the Party. Deng's followers dominated it. Hu Yaobang was elected to the position of General Secretary of the Party, the highest position in the Party besides the soon-to-be-abolished post of Party Chairman (MacFarquhar 1997: 325). In the spring, Zhao Ziyang, one of Deng's favorite local officials, was promoted to vice premier before taking over the position of premier a few months later.

On the economic front, Deng further undermined Chen Yun's centralization program during the January Central Cadre Conference. In his speech at the conference, Deng stressed the importance of growth to China's position in the world: "... from the first year of the 1980s, we must not delay (*danwu*) for one day and concentrate wholeheartedly on the Four Modernization" (Deng 1982b: 400). Although Deng still valued Chen for his support in the drive against the Hua faction, he also directly criticized Chen for being too reserved when it came to the economy. Although giving Chen a perfunctory praise for restoring economic order after the Cultural Revolution, Deng also said:

On the other hand, quite a few cadres have stood on the side for a few years in the past, so their understanding of the situation was cut off. Since they have only recently returned to their jobs, even those cadres who used to hold those jobs face new problems and are unfamiliar or cannot comprehend the current situation domestically and internationally. As such, it is unavoidable that their work is a bit wanting. If we all humbly study the new situation and new problems, our work will continue to improve. (Deng 1982b)

Because Yu Qiuli and his followers had been in charge of the economy throughout much of the Cultural Revolution, the reference to those who "have stood on the side for a few years" almost certainly referred to Chen Yun and his followers, who were removed from the State Council during the height of the Cultural Revolution. Although the criticism was mild and Deng supported Chen's proposal to boost investment in light industry, it sent yet another clear signal to local officials that Deng disputed the State Council's directives to rein in investment.

Chen's faction did not simply accept defeat in the face of Deng's maneuvers to dismantle the austerity measures, but their reactions were largely ineffective. During Chen Yun's convalescence, Li Xiannian, the Vice Chairman of the FEC, continued to speak out on behalf of the central bureaucracy. In a central cadre conference on February 10, 1980, which prepared for the Fifth Plenum, Li predictably put an emphasis on readjustment rather than on reform and growth. As Chen had done earlier, Li warned that impatience could lead to "chaos," which referred to high inflation (Li 1982b). Nonetheless, Li's comments fell

on deaf ears because the economy was in fact doing fine. In a March meeting with provincial cadres, Li repeated his warning, but still had to refer to the "latent" dangers of the growing deficit and overinvestment (Li 1982c).

Although Chen's health had improved by March 1980, Deng further sidelined Chen by forming the Central Finance and Economic Leading Group to replace the Finance and Economic Committee. Rather than getting an experienced State Council bureaucrat to serve as its head, Deng appointed Zhao Ziyang, who had recently been promoted from provincial administration (The Fourth Editorial Bureau of the Central Document Research Center 1999). Although Chen Yun's protégé Yao Yilin became the vice chairman of the new organization, his power was checked by other members in the group, namely Deng's follower Wan Li, as well as Yu Qiuli and his protégé Gu Mu. With this lineup at the Leading Group, Deng in effect prevented Chen's faction from dominating economic policies. Although Yu's faction lost much of its influence in the central bureaucracy because of the declining influence of Hua Guofeng, it remained useful to Deng. As former protégés of Hua Guofeng, members of Yu's faction dared not oppose Deng because they retained their positions at Deng's pleasure. In fact, a member of Yu's crumbling faction, Gu Mu, soon became an active champion of Guangdong Province as the head of the State Council Special Economic Zone Office. Although Chen still had great influence in the vast planning bureaucracy, his power was for the moment eclipsed by the newly promoted Premier, Zhao Ziyang. This example illustrates that as head of the dominant generalist faction, Deng had the authority to fashion an institutional change that greatly weakened the formal power of the technocratic faction, especially when economic conditions were favorable.

It is instructive to examine the relationship between patrons of a generalist faction and their key provincial followers because it sheds light on the role factions played in allocating scarce financial resources to the provinces. Soon after becoming Premier in August 1980, Zhao convened a reporting meeting (huibaohui) just for cadres from Guangdong at Zhongnanhai, the central leadership compound. In reality, this was a friendly bargaining session between Zhao Ziyang, who was likely acting on behalf of Deng, and factional followers from Guangdong. The attendees of this meeting included outgoing Guangdong Party secretary Xi Zhongxun, Deng's close friend and the head of the Guangdong Military Region Yang Shangkun, Guangdong Governor Liu Tianfu, General Secretary Hu Yaobang, Deng follower and Vice Premier Wan Li, Gu Mu, and Yao Yilin. Yao was Chen Yun's only representative at the meeting.

During the course of the meeting, Governor Liu Tianfu made a series of proposals for central subsidies, and Zhao approved most of them. For example, Liu asked Zhao for control over the Bank of China branch in Guangdong, which was in charge of foreign exchange. Zhao's reply was swift:

Liu Tianfu: Now, when we deposit foreign exchange in the bank, Guangdong cannot use the funds. This is very disadvantageous toward our external economic activities. *Gu Mu*: I am in charge of solving this problem. I heard that this is not the case.

Zhao: We can do this - the Bank of China branch in Guangdong will serve at the same time as the bank for Guangdong Province and will become a provincial bank. You can write up some regulations...(Office of the Guangdong Party Committee 1986)

Now vested with the authorities of a central leader (*zhongyang lingdao*), Zhao did not hesitate to show off his power to his former colleagues. Despite Gu's reluctance, Zhao simply handed the Bank of China branch over to the Guangdong provincial government.^{II}

Other members of Deng's faction, perhaps trying to curry favors with the new Premier and Deng's close friend Yang Shangkun, also readily agreed to Guangdong's requests. ¹² For example, when Xi Zhongxun asked for more grain, Wan Li, the vice premier in charge of agriculture, simply asked, "How much do you need?" Without bargaining, Wan handed Guangdong one billion *jin* in extra grain (Office of the Guangdong Party Committee 1986). Similarly, when Governor Liu asked for central subsidies for repairing the Beijing-Guangdong railroad, Hu Yaobang quickly acceded, and Zhao added that the central government would provide subsidies to fix the local lines as well (Office of the Guangdong Party Committee 1986).

Yao Yilin, who had been sitting quietly through much of the proceedings, finally spat out a sarcastic comment on what he must have thought was a wanton exercise of factional favoritism (Office of the Guangdong Party Committee 1986):

Let's just make Guangdong into an independent country. If it wants special policies, then it should get even more independence. But now Guangdong wants more food, which we don't have. At the same time, there are not enough goods from the rest of the country to absorb all the liquidity in Guangdong.

In all fairness, the way that Deng's faction treated Guangdong demonstrated obvious favoritism. Guangdong, already one of the fastest growing destinations of foreign investment, was earning and keeping more foreign currency than most of the other provinces. At the same time, Guangdong had gained more fiscal autonomy, making it one of China's richest provinces. Although we have no record of similar bargaining sessions between Zhao and other provincial leaders, it was clear that the special relationship among Deng, Zhao, and Guangdong provided it with an enormous advantage in gaining access to funds and preferential policies. No other province at the time could have met with the premier, the party secretary general, and two vice premiers in one sitting. From the perspective of the central technocrats, the high degree of autonomy

¹² Yang Shangkun was a longtime follower of Deng. His subsequent promotion to the Central Military Commission further contributed to the "Guangdong advantage" for the rest of the 1980s.

¹¹ Gu Mu showed himself a supporter of Guangdong for much of the meeting, encouraging Guangdong cadres to act with even more autonomy. Nonetheless, Gu Mu was the head of the Export-Import Commission of the State Council, which oversaw the foreign currency operation of the Bank of China. Handing control over foreign currency to Guangdong, the source of much of the foreign currency, would have greatly diminished the power of his commission.

and preferential treatment given to Guangdong meant nothing less than a flagrant encroachment by Deng's faction into their core area of responsibility. This prompted them to look for the first opportunity to regain economic authority.

By the fall of 1980, Deng's strategy of galvanizing local support for his final drive to eliminate Hua had succeeded. In a tearful self-criticism at a November 10 Politburo meeting, Marshal Ye admitted that his support for Hua had been influenced by his "feudal" loyalty to the dying Mao, who had designated Hua his successor (Deng 2005: 170). After Marshal Ye withdrew his support, Hua was promptly demoted to vice-chairman of the Party, making way for Hu Yaobang to take over the top post. At the same time, Deng's generous investment policy toward the provinces led to a collapse of Chen's plan to rein in monetary growth. In September the previous year, Chen had planned on 25 billion yuan in fixed asset investment for 1980 (Chen 1982d). Actual investment in 1980 reached 75.8 billion yuan, three times the amount planned by Chen. The continual expansion of the money supply predictably created inflationary pressure.

The Planners Strike Back: Inflationary Crisis and Retrenchment

Although Deng had the upper hand within the Party, high inflation provided Chen Yun's faction the opportunity to highlight the one great weakness of Deng's decentralization policy, the potential for hyperinflation. After Chen's retreat in the fall of 1979, his followers in the economic bureaucracy began to lay the intellectual groundwork for centralization, but the key ingredient for reasserting central control, an economic crisis, was still missing. At the end of 1979, Xu Yi, one of Chen's followers, founded the Chinese Finance Society, which aimed at producing articles that supported more central control (Fewsmith 1994: 95). In May 1980, Chen's followers managed to publish several editorials in the People's Daily, the Party's official mouthpiece, against excessive investment (Fewsmith 1994: 99). Soon after, several key members of Yu Qiuli's faction came under attack for various policy failures (Fewsmith 1994: 100). This was likely Chen's attempt to lessen the influence of Yu's faction and, indirectly, Deng's sway, in the Finance and Economic Leading Group. However, these acts did not seem particularly effective toward Deng's faction. Local officials managed to launch or keep afloat many investment projects in 1980 with the local budget and with bank loans (Xue 1996: 365).

In November 1980, the much-anticipated inflation finally arrived. Reports of rapidly increasing prices flooded in from China's major cities. Average inflation in cities rose to 8 percent, a level not seen since the Great Leap Forward. State Council bureaucrats immediately drafted emergency notices to the Premier (Xue 1996: 363). Not having seen this level of inflation since the last great economic

This figure includes 20 billion yuan in technical innovation investment, which was used to update existing equipment and asset. It had been a minor category of investment until 1978 when both Chen and Deng agreed to increase technical innovation investment.

disaster, Deng and his faction took the price increase seriously. If the crisis spun out of control, Chen and his followers and allies who sat on the Politburo could mobilize a coalition to weaken Deng's presence in the Politburo by blaming the disaster on either Hu Yaobang or Zhao Ziyang. There also was a small chance that Hua Guofeng's residual faction – especially officers in the army – could spring back to life with a major policy failure by Deng. The Dengists knew of only one way to resolve the crisis and to preserve their factional strength – delegating economic policies, especially in the realm of investment and finance, back to the central planners.

With prices careening out of control, Chen went on the offensive at the November 28, 1980 Politburo and Party Secretariat Meeting dedicated to the economy. Specifically countering Deng's previous remarks of not wanting to delay growth further, Chen had this caustic rebut: "How much time have we wasted since the Opium War? What's the big deal with 'delaying' (danwu) another three years!" (Document Research Center of the CCP CC 2000: 262). Rather than an investment ceiling in the 50 billion yuan range, Chen called for fixing investment at 32 billion vuan for the next three years. Because of inflation. Deng had little choice but to concur with Chen's economic program of lower investment and a modest growth rate of between 4 and 5 percent. Perhaps getting back at Deng for the humiliation he had suffered in the previous year, Chen Yun rudely interrupted Deng during his remarks with sarcastic comments: "A 4 percent growth is not face-losing, nor is it a simple matter" (Document Research Center of the CCP CC 2000: 262). 14 More important for Chen, Deng announced to the Party that he completely agreed with Chen that periods of readjustment required the centralization of economic authority (Document Research Center of the CCP CC 2000: 262).

Although the November Politburo meeting decided the general thrust of the readjustment program, the vast majority of local cadres still needed convincing that the central bureaucrats were once again in charge of the economy. To send a clear message to local officials, the Central Committee convened a special work conference in the middle of December attended by Party secretaries of all the provinces. During the conference, top leaders took turns emphasizing that the central technocrats were taking control of the economy and would punish those who exceeded the investment ceiling. Chen's speech warned that "instability in the economic situation can cause instability in the political situation," the most menacing argument in the technocrats' arsenal (Chen 1982c: 803). He also announced a program of strict investment reduction, price control, and a freeze of provincial budgetary surpluses for the next few years, all unthinkable policies just a few months ago (Chen 1982c). Furthermore, he repeated his message that "delaying" for three more years was not a big loss, clearly communicating to local officials that his policies had triumphed over Deng's anti "delaying" line (Chen 1982c: 804).

¹⁴ The *Chen Yun Chronicle* quotes many of Chen's speeches, along with interruptions, but it is unclear when the speeches are quoted verbatim and when they are simply loosely paraphrased.

In his speech, Premier Zhao, who had taken charge of economic policies as the head of the Finance and Economic Leading Group, made the main self-criticism on behalf of the Deng faction. He first admitted that the 17 billion yuan budget deficit required a cash write-off from the People's Bank of China (PBOC), which contributed to inflation. Although the previous discussion shows clearly that Zhao and others in Deng's faction enthusiastically pushed for high investment, high lending, and high growth, Zhao blamed inflation on a misunderstanding: "For a period of time in the past, we did not have an adequate understanding of the latent danger in the economy..." (Zhao 1982c: 808). He even placed the blame on the Gang of Four and "leftist commandism," although the Gang of Four had been out of power for nearly four years (Zhao 1982c)!

Regardless of where he placed the blame, Zhao was on board with Chen's program of economic centralization. He announced that the central government would achieve budgetary balance, lending balance (xindai pingheng), and price stability in 1981 (Zhao 1982c: 809). Lending balance stood for a rough equality between the growth of deposits and the growth of lending, which aimed at controlling the growth of money supply. As lending became an ever larger factor in the economy, central planners increasingly relied on lending balance to maintain price stability (Bi 1987: 116). To ensure lending balance, Zhao announced that no locality could break its credit ceiling without the authorization of the PBOC and that "those who violate the rules will be punished accordingly" (Zhao 1982c: 813). In addition to these policies, Zhao also announced painful cutbacks in budgetary expenditure and a mandatory 8 billion yuan "loan" by rich provinces to repay part of the central deficit (Zhao 1982c: 811).

At the end of the meeting, Deng made his appearance to give his reluctant endorsement of the austerity program. To signal to Chen Yun that he was sincere in giving economic authorities back to the planners, Deng had two of the planners' conservative ideologue allies, Deng Liqun and Hu Qiaomu, draft his remarks at the meeting (Deng 2005: 183). These remarks sent the necessary message to lower level officials. As Zhao had done, Deng admitted that the central leadership had been divided over the pace of growth and investment and that Chen Yun's call for readjustment had been correct all along. He went on to emphasize that the main task for the next few years would be readjustment and that centralization would be the main mode of managing the economy (Deng 1982a: 828). There was now no doubt about who was in charge of the economy, although Deng exacted a small vengeance against Chen by shutting down one of Chen's central investment projects, the construction of Bao Steel in Shanghai (Chen 2005). 15

The construction of Bao Steel, a centrally controlled SOE, was a 20 billion yuan project strongly supported by Chen Yun when he served as the head of the FEC. After the launch of the austerity in November of 1980, Zhao Ziyang chaired a CFELG meeting where he and Wan Li, both Deng followers, voted to halt the Bao Steel project. When the head of the project, Chen Jinhua, appealed to Chen Yun for help, Chen Yun realized that Bao Steel was the price for maintaining

The Party and State Council machinery swung into motion after the central work conference to issue a stream of decrees that spelled out the specific elements of the retrenchment program. As was typical in the CCP policy process, the CC first distributed key remarks by central leaders to mid-level cadres (Central Committee of the Chinese Communist Party 1982a). This document conveyed the general aims of the retrenchment program. Shortly thereafter, in January 1981, the State Council issued "Decision concerning balancing the budget and strictly managing the budget," which spelled out in more concrete details how budgetary and lending balances were achieved (State Council 1982a). Essentially, the document ordered all work units to freeze new investment and lending and to wait for State Council instructions. A subsequent State Council decree centralized investment and lending related to major projects to the Planning Commission, which was controlled by Yao Yilin (State Council 1982b).

In early February 1981, the PBOC concocted its own set of specific regulations to realize the general spirit of the retrenchment, as well as the specific goals set out by the State Council documents. The PBOC document spelled out the loan ceilings and restrictions that applied to various categories of loans, as well as ways to deal with companies that had defaulted on loans (People's Bank of China 1983a). Another PBOC document specified the institution of a new reporting system which provided central bureaucrats with money supply figures every five days (People's Bank of China 1983b). Finally, throughout the year, individual banks issued even more specific regulations about how to implement the directives and goals specified by all the previous documents from the higher levels. The Bank of China regulations, for example, did not appear until July (Bank of China 1983). Regardless of the issuance of decrees, however, the tone of the policy environment had shifted, giving central agencies firm authority to halt lending and investment at the local level.

The shifting tone of economic policy environment clearly constrained the ability of factional patrons to disburse favors to followers at the provinces. On an inspection to Guangdong in August 1981, for example, Zhao took a very different stance toward local officials. First, he began his remarks by quoting Chen Yun on the importance of price stability. Rather than generously doling out preferential policies to Guangdong, Zhao stuck closely to the Deng-Chen compromise of retrenchment while continuing reform. The following remarks typified his ambivalence:

... since the end of last year, we have proposed adjustment and emphasized concentration and unity. On the whole, we are not saying that we will backtrack. Of course when this type of policies are conveyed, it immediately took effect within one quarter to concentrate (economic powers), which stabilized things. After that, Comrade Chen Yun said that we can gradually relax our grip after some consideration. On a whole, this was necessary. Of course, in some places, if things were not as rigid (*si*), it would have been better. Looking back, those places that weren't as rigid are better off today, but in the

end, if we did not put on the brakes back then, there would have been instability. (Zhao 1986c: 204)

Sarcastic remarks against Chen's economic policies were absent, replaced by a sense of helplessness toward the existing policy environment. Zhao's message to his followers in Guangdong was that although he disliked the current policy environment, Guangdong would have to adhere to central directives. Zhao even used the logic of the free-rider problem to persuade his doubtless frustrated followers of the necessities of restricting money supply: "If the entire country does what Guangdong did, there would be great problems" (Zhao 1986c: 204). Although Zhao still doled out a small amount of railroad subsidies to his longtime colleagues, he was clearly unable to give as much as he would have liked: "Look, when I come here to listen to you, I feel very good and feel that I should give you some things, but when I return to Beijing, things change immediately. My standpoint immediately changes" (Zhao 1986c: 217). Here, Zhao was likely referring to Chen Yun's wrath if he deviated from the retrenchment too much.

Zhao's circumspection reveals that Chen's participation in elite politics created sufficient credibility for the retrenchment program such that local officials believed Zhao's hands were tied in the matters of investment policy. Local officials knew that Zhao had no authority to override Chen because Chen Yun was not just a bureaucratic "agent" of the premier but a political heavyweight in his own right with a dense network of supporters and voting power in the Politburo. Even Deng, the de facto boss of the Party, had to wait for the right moment to reverse Chen's policies. As the following discussion reveals, a failed attempt to reverse Chen's policy could be costly for Deng's faction.

The Failure of Deng's Counteroffensive and Continual Retrenchment

The technocratic faction not only needed the power to initiate a centralization drive. It also needed the political resources to maintain centralization. The crux of the top bureaucrats' credibility was their ability to resist political demands from the generalists. Because local officials expected the bureaucrats to fight vigorously to retain control over the economy and, more specifically, over the money supply, they adhered to the central credit ceiling, at least until they received new information. In this instance, faced with a growing counteroffensive from Deng's camp, Chen's faction used its resources to defeat it. Without the ability to defend itself, the technocratic faction's preferred policies would not have been credible.

The seeds of the generalist faction's rebellion against bureaucratic control were planted at Zhao's August 1981 meeting with Guangdong cadres. During the speech, Zhao launched into a lengthy discussion on money supply. He noted that money supply in fact expanded by 40 billion yuan in the first quarter of 1981, the highest level seen in PRC history. Yet, inflation did not increase further as expected. Zhao wondered out loud whether this was a result of higher demand for cash in the new market economy (Zhao 1986c: 205). Objectively,

the lack of inflation in the first quarter likely resulted from both declining inflationary expectation after the December conference and the rising demand for cash. Politically, however, Zhao's analysis aimed to raise doubt about Chen's argument that rapid monetary expansion equated disaster for the economy.

The generalist faction's counteroffensive gained further momentum on July 3, 1981, when Deng spoke at a work meeting of provincial party secretaries. Rather than strictly adhering to the official retrenchment line, Deng began to raise doubts about austerity:

The speed of economic construction cannot be quick during readjustment, but we will encounter some problems if, after three years of adjustment, the economy does not grow at a certain speed. I support the perspective that we should plan for our economic construction in three-year's time. If we do not consider it now, we will not have time in three years. . . . we cannot begin too many major investment projects. Nonetheless, a coal mine with fifteen million tons of production capacity is a major project, and we should support this kind of project. Without this kind of basic construction, our speed (of economic growth) will be slow. (Document Research Center of the CCP CC 2004: 754)

Although Deng did not denounce the austerity program outright, he raised doubts about the degree of investment reduction, signaling to local officials his disagreement with Chen. In August 1981, Hu Yaobang further lent support to his patron's offensive during a meeting on propaganda and ideology. Although Hu Yaobang's remarks at the meeting mostly concerned ideological matters, he began his speech with a few cryptic remarks on the economy:

Since the Sixth Plenum, Comrade Deng Xiaoping made two important sets of remarks. The first was remarks on economic problems in his talks with Comrades Wan Li, Yu Qiuli, Gu Mu, and Yao Yilin. The record of these talks has not be edited and distributed, but I think they should be. The main point of the talks was that we should try every means to think of ways to increase growth. The economy should grow at a pace that reflects hard work. If we cannot increase growth, those of us in charge will be criticized. (Hu 1982: 1208)

This brief statement was politically salient for several reasons. First, Hu indicated that these pro-growth remarks should be "edited and distributed," meaning that they should become official policies replacing Chen's retrenchment program. Through Hu Yaobang, Deng also sent a clear warning to the central technocrats that if growth did not speed up, "those of us in charge" would get into political trouble (Hu 1982: 1208). Although this was short of an open assault on Chen's policies because the speech was heard only by a handful of officials and Deng continued to espouse the retrenchment line to foreign guests, Deng was certainly testing the water and hoping to gather enough momentum to undo Chen's policies. To the audience of local officials, they doubtless sensed that their factional patron was maneuvering to unbind the retrenchment. The process, however, did not go smoothly this time.

In the midst of rising resentment toward the retrenchment policies, Chen once again emphasized the danger of expanding money supply and inflation in a

September 1981 Politburo meeting. Sensing the shifting political tide, however, he paid lip service to Deng's emphasis on growth, but he also stressed that growth needed "a long-term plan," implying central coordination (Document Research Center of the CCP CC 2000: 280). Luckily for Chen, although overall inflation had stabilized at 2.5 percent, the price increase for agricultural goods stubbornly clung to the 6 percent level. In November, he reinforced the danger of price instability by distributing a report from the Beijing Public Security Bureau about people's dissatisfaction with rising food prices to the other leaders (Document Research Center of the CCP CC 2000: 283). Thus armed, Chen managed to veto Zhao's proposal to free up prices and to end price subsidies at the fourth meeting of the Fifth National People's Congress (Chen 1982f: 1347).

Chen Yun further undermined Deng's counteroffensive by attacking Deng's pet project, the special economic zones. Besides serving as China's economic czar, Chen Yun also headed the Central Discipline and Inspection Commission (CDIC) - the Party's anticorruption watchdog organization. Thus, he regularly received the most sensitive reports on corruption generated by the CDIC network of informants. In late 1981, he came across a series of reports on smuggling in the special economic zones in Guangdong and Fujian. Although these were minor affairs by today's standard. Chen saw the perfect opportunity to put Deng back on the defensive. He bundled several reports, titled the set "On Rampant Smuggling Activities in Some Places in Guangdong," and distributed them to Hu, Deng, Zhao, and Li Xiannian. He wrote on it that "for serious economic criminals, I think we should deal with several of them severely, give several of them serious sentences, and even execute several of the most heinous ones" (Document Research Center of the CCP CC 2000: 287). Deng and especially Zhao had likely known about these transgressions and had chosen to ignore them to protect the SEZs. Chen's action, however, forced their hands. They now had to defend the Party's honor by cracking down on smuggling in the SEZs, even if it put them at the mercy of Chen's accusations.

On January 11, 1982, the Party Secretariat held an emergency meeting on smuggling and decided to send several central leaders to coastal provinces to direct antismuggling and anticorruption investigations. ¹⁶ Chen's proposal for prosecuting the worst offenders was adopted (Central Committee of the Chinese Communist Party 1982b). In February, cadres from Guangdong and Fujian were summoned to Beijing for a harsh dressing down by Chen and his conservative ideologue allies. Chen Yun and Yao Yilin also successfully turned this meeting into an occasion to criticize Deng and Zhao for a host of economic policies, including investment and lending decentralization. Meanwhile, Zhao, who attended the meeting on behalf of Deng, did his utmost to save the SEZs.

¹⁶ Chen's original accusation focused on SEZs in Guangdong, but Deng maneuvered to dilute the charges by pointing out the problem in several coastal provinces, including Guangdong, Fujian, Zhejiang, and Yunnan. This likely reduced the political fallout of the smuggling cases for Deng.

Remarkably, Yao Yilin's speech at the meeting hardly mentioned the smuggling cases and immediately launched into an attack on the SEZs. Zhao and Yao then engaged in a tense exchange:

Yao: we can also consider whether the SEZs are a bit too big.

Zhao: No, they are not too big; we already eliminated Bao'an County.

Yao: To what extent should SEZs still have special and flexible policies? What can be done; what can't be done?

Zhao: This is a process of understanding. We might even want to give more flexibility... Even if they (the SEZs) hit a wall, they should continue. They should not quit just because they have to withdraw a bit after some period or due to some problems.

Yao: the flexible policies of the two provinces have mainly made achievements, but we should carefully study the problems. (Yao 1986a)

Because of Zhao's interruption, Yao's proposal to eliminate some SEZs were struck down, but for the remainder of his speech, Yao focused on excessive investment and money supply expansion in Guangdong. Reeling from Yao's attack on the SEZs, both Zhao and Hu Yaobang were forced to concede to Yao's point that investment and lending had to be placed under stricter control to prevent inflation (Yao 1986a). Yao's deft maneuvers turned a meeting on smuggling to one on monetary polices by tying the issues together, "I think we have to examine all of these problems together, especially the problem of excessive money supply in Guangdong" (Yao 1986a: 288). Because of Yao's threat, the CC document about this meeting released to the local cadres sent the unambiguous signal that Chen's agenda of budgetary balance, price stability, and central control over the economy remained very much the Party-line (Central Committee of the Chinese Communist Party 1986).

Outmaneuvered by Chen's antismuggling charges, Deng and Zhao had to accept Chen's economic program. In a March 1982 meeting on industry, Zhao echoed Chen's program of balanced budget, modest growth, and central control (Zhao 1982b). Even in their remarks to foreign guests, both Deng and Zhao adhered to Chen's line that rapid investment could cause instability, although Deng insisted that small scale investment could benefit the economy (Deng 1982c). Thus, the State Council retained strict control over investment and lending policies from 1982 to 1983 (Xue 1996: 370). Through political maneuvers against Deng's faction, the technocrats successfully maintained the retrenchment program. Because the technocrats had both the dedication and resources to protect their power base, economic actors in China had good reason to take the retrenchment program seriously.

"Bogaidai": The Slippery Slope toward a Fiscalized Banking System

While battles on the degree of centralization raged between the two factions, both Deng and Chen increasingly utilized the banking system to fulfill their respective political goals. For the generalist faction, banks became a useful source of funds to fuel local economic development. For the technocratic faction, the banks provided a large pool of money to tackle a host of policy problems and to keep the deficit at a low level. Despite paying lip service to

making them into "real banks," central politicians in both factions soon grew to treat banks as the second treasury. While they bickered on the level of government controlling the banks, both sides readily ordered banks to lend to their pet projects. Over time, this created a mountain of nonperforming loans.

The household responsibility system and the bonus system in state firms rapidly increased the pool of rural and urban disposable income after 1978. As a result, bank deposits also increased rapidly. Total saving deposits increased from 18 billion yuan in 1977 to 28 billion yuan in 1979 and again to 40 billion yuan in 1980 (Department of Comprehensive Statistics of National Bureau of Statistics 1999). This trend did not escape the notice of central leaders, who began to see banks as a source of funding.

The intellectual justification for using banks was sound. Given that banks had an increasing amount of funds, SOEs that generated profit should rely on bank loans for working capital and investment funds and decrease their reliance on the state budget (Liu 2000a). In this manner, the state's budgetary obligations decreased, while the increasing pool of saving was put to good use. From the outset, Chinese officials realized that banks should in theory have the autonomy to decide on loan recipients and to demand repayment from debtors. Even in 1979, the PBOC warned its officials that banks should not lend money "according to the wishes of higher level cadres" (State Council 1982c). Nonetheless, it also urged the banks to "rely on the Party at each level to fully realize the banks' work" (State Council 1982c).

Deng's generalist faction favored using the banks because they provided another source of funding for local governments to finance development. As we saw previously, Premier Zhao gave control of a major bank branch to the Guangdong provincial government to finance foreign currency needs. Turning banks into fiscal organs also allowed the local governments to circumvent the central bureaucracy, which tightly controlled the disbursement of central budgetary investment funds. As senior Party officials, patrons of a generalist faction could easily order bank managers to disburse loans to the pet projects of factional followers. For example, the Construction Bank, one of the Big Four banks in China, became a directly administered unit under the premier's office rather than a part of the Ministry of Finance. Premier Zhao Ziyang treated it as a second treasury and regularly invited senior officials from the Construction Bank to policy meetings to "arrange" (anpai) the funding for various projects.¹⁷

The central bureaucrats under Chen were not averse to fiscalizing the banks either. As Liu Hongru, one of the State Council's foremost experts on banking, wrote in 1980: "Now, the lending capital in banks is much larger than the state budget, and lending capital can turn over. Every time it turns over, lending capital doubles, which is to say that banks can use less money to do more" (Liu 2000c). In other words, the State Council could more readily meet the budgetary needs of the legion of SOEs by using banks to finance working capital needs.

¹⁷ Interview in Beijing: 12/4/2000.

Furthermore, by using bank funds, the central government's explicit deficit decreased, which improved the administrative merit of senior bureaucrats in charge of finance and investment. As Yao Yilin plainly put it in 1980, "When the budget is in trouble, banks must step in to help the budget" (Liu 2000e). Without jeopardizing the balanced budget, central bureaucrats could satisfy the capital demands of the various bureaucratic and political priorities. Finally, funding investment through loans reduced the monitoring costs of central bureaucrats who previously had no way of evaluating the effectiveness of various investment projects. As one State Council document put it, SOEs "no longer blindly compete for investment projects because they know they will have to repay (the loan) with interest" (State Council 1998c). In other words, providing loans to SOEs rather than budgetary grants could potentially increase their productivity by placing a harder budget constraint on them. Despite this initial hope, the lack of contract enforcement in China soon taught SOEs to default on their loans.

The actual process of the budget-to-loan (*bogaidai*) transformation began in February 1979. The PBOC held a meeting of its branch managers to convey the wishes of the central leadership. Still in the midst of the Deng-Chen alliance, the tone of the meeting reflected both Deng and Chen's wishes. The most important policy announced at the meeting was the budget-to-loan transformation for SOE working capital. Previously, most of the SOE working capital had come directly from the state budget in accordance to the annual plan, but banks had provided emergency working capital loans in the middle of a fiscal year. This meeting called for experimenting with a complete transformation from budgetary allocation of working capital to bank loans (State Council 1982c).

The other major policy change, one clearly favored by Deng and Zhao, was banking decentralization. Rather than having the PBOC headquarters approve all the loans, the PBOC now set a credit ceiling for working capital but allowed local bank branches to decide where the money should go. The State Planning Commission, however, retained control over the allocation of fixed asset and technical innovation loans (State Council 1982c). Again, this mixture reflected a compromise between Chen and Deng. These experimental measures were implemented in selected locations throughout 1979 and 1980, including the financing of giant central projects, such as Bao Steel (Chen 2005).

In June and August 1980, the Finance and Economic Leading Group headed by Zhao convened a series of meetings on the issue of budget-to-loan transformation. Despite the emerging division between Chen and Deng over centralization, Yao Yilin argued in these meetings that banks should fund more fixed asset investment projects, so long as they had short maturity periods and generated profit (Liu 2000e). Zhao likely endorsed Yao's proposal because Deng had already called for expanding the role of banks at a meeting in late 1979 (Liu 2000a).

The retrenchment program in late 1980 did not derail the budget-to-loan transformation experiment in the slightest. In fact, the planners made the transformation a part of the retrenchment program. In mid-November 1980, the

State Council ordered all fixed asset investment to be handled through the China Construction Bank and that all profitable ventures be financed mainly by loans (State Council 1998c). At the December work conference in 1980, both Li Xiannian and Zhao Ziyang's speeches called for a quantitative limit on the money supply but urged banks to continue providing working capital and investment funds to SOEs (Li 1982a; Zhao 1982a). The only major change was that the central government increased its monitoring and control over lending (The State Council 1982a).

The retrenchment program, moreover, exacerbated the policy bias against the banks and in favor of the state budget. During the investment boom of 1980, many local firms took out loans that could not be repaid. Rather than enforcing loan repayment, a State Council directive issued in early 1981 specified that only profit generated through production originally financed by bank loans could be used toward loan repayment. Moreover, a company was first and foremost obligated to hand in the mandated amount of taxes to the central government and to pay workers' wages before repaying banks (The State Council 1982a). As we saw earlier, central bureaucrats were fully aware that loans should be repaid, but their main concern was budgetary balance, not whether banks were solvent. Meanwhile, the State Council ordered investment projects to decrease the proportion financed by the state budget and to increase the proportion financed by bank loans (State Council 1982b). This directive was made with the full knowledge that firms were having trouble repaying banks.

Far from trying to maintain the integrity of the banking system during the retrenchment, central planners were perfectly willing to use bank funds to achieve policy tasks, much as Zhao was willing to use bank funds for local development. In 1981, Yao ordered banks to provide sufficient working capital to light industries and to provide technical upgrade funds to SOEs chosen by the State Council (Yao 1982). He made no mention of the banks' autonomy to choose the recipients of these loans. Setting a dangerous precedent for the future, Yao also ordered banks to supply funds to a group of SOEs in order to reduce triangular debt, or debt that the SOEs owed to each other (Yao 1982). Once again, this policy aimed at improving the position of the central budget. If SOEs were in the red because they did not receive payments from other SOEs. they were less able to hand "profit" up to the central coffer. With bank loans, SOEs could repay debt to each other, increasing the taxes they could pay to the central government. In an indirect way, banks were giving depositors' money to the central government. Unfortunately for the Chinese depositors, this became a popular tactic to resolve budgetary problems in the coming decades.

A Classic Inflationary Cycle: 1983-1986

The inflationary cycle that peaked in 1985 followed a classic pattern in which money supply directly increased inflationary expectation, and the decrease of money supply quickly dampened inflation. Behind the fluctuation in money supply was the oscillating political signal emanating from the center. The

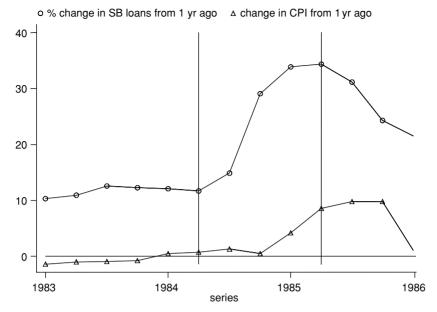


FIGURE 6.1. Percentage Change in Quarterly Lending and Change in Inflation from One Year Ago: 1983–1986. Source: Quarterly Database. See Appendix for details. Figures shown are change in inflation and percentage change in state bank lending from four quarters ago, which smooth out the seasonality of the data.

planners' tight grip on the economy was first loosened when growth far exceeded the plan in 1982 and in 1983. Deng responded by sending a series of political signals to members of his factions in the provinces to increase investment and to take their own initiatives, which culminated in Deng's trip to the south in 1984. The central bureaucrats' resistance collapsed after the trip, and local officials quickly reacted by ordering local banks to increase lending. Exactly one year later, high inflation once again forced generalist factions to hand power to the technocrats to avoid an economic disaster.

In Figure 6.1, the circle-dotted line represents percentage change in lending from one year ago, and the triangle-dotted line represents changes in inflation rate from one year ago. As the figure shows, Deng's trip to the South at the end of the first quarter in 1984, represented by the first vertical line, accelerated loan expansion in the latter two quarters in 1984, which in turn led to inflation rates some 10 percent higher than in the previous year by the second quarter of 1985. Deng's effort was greatly augmented by his two competing protégés, each wanting to garner as much local support as possible in preparation for the succession. The active decentralization of the generalists in turn prompted the central bureaucrats to clamor for more central control, which culminated in the Meeting for Responsible Cadres at the Provinces. As with the meeting in late 1980, this meeting also sent a clear signal of centralization to local officials and triggered the implementation of a series of centralization policies for finance

and investment. As seen in Figure 6.1, this meeting, represented by the second vertical line, was successful in slowing the growth of lending and in dampening inflation.

In addition to this basic pattern, this period also saw the rapid development of the budget-to-loan transformation, which made banks officially responsible for financing much of state investment. This trend persisted even after the onset of retrenchment and the discovery of a large pool of nonperforming loans, demonstrating the centralizers' willingness to take advantage of the banking system.

From Growth to Decentralization and the Impetus for Inflation

After Deng's failed attempt to unlock the planners' grip on the economy in 1981, he remained relatively subdued. In various speeches throughout 1982, Deng insisted on the course of the reform, but he did not press for further decentralization (Deng 1982c; 1982d). In a meeting with the State Planning Commission (SPC) leadership at the end of 1982, Deng said that the country should aim at doubling output twice in twenty years, a conservative pace decided at the Twelfth Party Congress in September (Deng 1993d; Fewsmith 1994). At most, Deng pressed the SPC to do its best to ensure "doubling twice" by the end of the century (Document Research Center of the CCP CC 2004: 859). The newly installed Premier Zhao likewise did not challenge Chen's policies in this period and called for a modest 4 to 5 percent growth rate in a mid-1982 meeting (Zhao 1982b: 1562).

The tide began to turn at the beginning of 1983 when the growth statistics from 1982 became available. Rather than the 4 percent growth mandated by the plan, growth registered at 8 percent. Immediately on seeing the statistics, Deng convened a meeting with "responsible cadres" from the SPC, the State Economic Commission, and the Ministry of Agriculture, three of the most important agencies in the central bureaucracy. Deng began by asking the bureaucrats why growth registered twice as high as the planned target, suggesting that they had been overly pessimistic about the economy. He then ordered the SPC to increase the planned growth rate for 1983 (Deng 1993c: 22). At this point, however, Deng was not yet ready to take economic power out of the hands of the central bureaucracy, presumably because he was afraid that another inflationary crisis would occur. At the meeting, he told the planners that he remembered the "very deep lessons of blind advance" (Deng 1993c: 22). ¹⁸

Deng's talk with the planners loosened the bureaucrats' hold on the economy as members of the generalist faction signaled to local officials the political feasibility of local growth initiatives. Just days after Deng's talk in early 1983, Gu

¹⁸ The reference to "blindness" (*mao*) did not just refer to the inflationary cycle in 1980. The term "blindness" was first coined during the economic crisis of 1956, when Mao launched a campaign to accelerate growth. Since then, the term was used by bureaucrats to describe any drive to accelerate growth that led to material shortage and/or inflation.

Mu, the head of the SEZ Office of the State Council, told cadres at the Hainan SEZ in Guangdong that "in the past few years, there was economic adjustment, but now we can put the acceleration of Hainan's development on the agenda" (Gu 1986). The timing of Gu's comment suggests a direct link between Deng's signal about higher growth and renewed optimism for Hainan's development. In February, Zhao got the planners to approve a set of comprehensive reform measures for Chongqing, a major city in Sichuan Province, where Zhao had served as Party secretary (Fewsmith 1994: 126). Again, Deng's January meeting was probably a decisive factor in this decision because Sichuan leaders and Zhao had been lobbying the planners for this since 1982.

Hu Yaobang, the Party Secretary General and Deng's designated successor, responded to Deng's signal even more strongly. In January 1983, Hu received a note from Deng urging him to look into Guangdong's complaint of overregulation by the central ministries (Document Research Center of the CCP CC 2004: 879). He immediately accused central ministries of "using the excuse of efficiency to suppress growth" and demanded higher growth (Deng 2005: 256). In February, Hu further took an inspection trip to Guangdong and visited the SEZs. In his conversation with local cadres, Hu was emboldened by Deng's note to criticize the "birdcage" - Chen Yun's theory of how the economy should be administered – and the central bureaucracy for administering "ropes and sticks" that stifled the local government (Hu 1986b). He also castigated the central bureaucracy and Gan Zivu, the vice chairman of the SPC who accompanied Hu, in front of local officials: "Comrade Gan Zivu, please say something to the central ministries. It's fine that they do not give money, but please do not give ropes and sticks... This isn't such a high demand, is it?" (Hu 1986b). Local officials who witnessed Hu's theatrics likely came to the conclusion that the bureaucracy's dominance over the economy was slipping.

Deng increased the pressure on the planners by going on an inspection trip to the Yangtze River Delta himself in February 1983. On this trip, Deng urged coastal officials to compete with each other to increase growth. At a dinner meeting with Zhejiang provincial leaders, Deng in effect forced a high-pace growth target on the province: "You know, between 1977 and 1982, Jiangsu doubled its output, so according to this pace, Jiangsu will have doubled its economy twice by 1988. Can Zhejiang realize this goal as well?" (Document Research Center of the CCP CC 2004: 888) Clearly, the answer would be yes. On his return, he had another talk with several Standing Committee members and told them that all the provinces should set their own plans (Deng 1993e). This was a shocking suggestion that would have greatly diminished the center's power and increased provincial discretion over investment and lending.

Chen Yun, who had been reminiscing about historical issues during the first two months of 1983, immediately sprang into action to put a stop to Deng's audacious suggestion.¹⁹ After an emergency meeting with his longtime

¹⁹ For example, Chen Yun discussed with Li Xiannian about whether the Western Route Army (Xilujun) had established contact with the Comintern with the Central Committee's blessing, or whether it was only doing the bidding of Zhang Guotao. He also commented extensively on an

colleague in the central bureaucracy Li Xiannian, Chen Yun decided to go after Hu Yaobang, even though Hu's action was prompted by Deng, Originally, Chen wanted to convene a small meeting to criticize Hu for intervening in State Council affairs and for violating the "adjustment, reform, rectification, and improvement" line. However, Deng worried that such a dressing down might cause Hu to tender his resignation: "what if he quits?" (Deng 2005: 256) A small meeting was nonetheless convened to discuss Hu's problems, but Chen Yun boycotted the meeting since Deng did not require Hu's attendance of the meeting (Deng 2005: 256). Two days after the small meeting, a joint meeting of the Standing Committee of the Politburo and the Central Party Secretariat, the two most powerful organs in the Party, was convened to discuss economic issues. In his remarks, Chen reiterated the correctness of the economic retrenchment and criticized Deng's suggestion of giving planning power to the localities because "the State Planning Commission needs to concentrate capital from the ministries and localities, or it would lack the means to accomplish great things (ganbucheng dashi)" (Document Research Center of the CCP CC 2000).

Chen further made an important maneuver against Deng's faction. First, he castigated Hu Yaobang and the Secretariat for getting too involved in finance and economic work: "Now you spend too little time listening to the relevant ministries, and spend 70 to 80 percent of your time talking...[You] must not be so simple-minded" (Li 2005: 800). He then proposed a clear rule to delegate economic policy implementation to the Central Finance and Economic Leading Group (CFELG), where he had a sizable presence. Beyond criticizing Hu for being "simple-minded," the joint meeting approved Chen's proposal that the CFELG henceforth served as the sole organ for economic policy coordination upon Politburo Standing Committee approval of a policy, thus setting the pattern for economic policy making for years to come (Deng 2005: 258). This institutional change greatly clarified the economic policy process and substantially weakened the generalists' influence in economic policy making. After the meeting. Chen Yun wanted to firm up his victory by disseminating the speeches at the meeting to junior officials in order to signal the continuation of retrenchment. Deng, however, vetoed the proposal to disseminate and sealed the records of that meeting (Deng 2005: 258; Li 2005: 802). Given Chen's threat to directly criticize Hu Yaobang, Deng's designated successor, Deng backed down from his decentralization drive. Nonetheless, he did not want words of his defeat spread too widely because he knew that favorable economic conditions would soon allow him to try again.

Despite behind-the-scene maneuvering by Deng's faction, central restrictions on investment funds remained in place. In July 1983, when the newly appointed Party secretary of Guangdong, Ren Zhongyi, asked Zhao for more central subsidies to finance construction projects, Zhao's reply clearly indicated the persistence of central control: "asking the province to shoulder key-point projects is

internal article on the Wuyi Uprising in Shanghai in the 1930s. See Document Research Center of the CCP CC. 2000. *Chen Yun Nianpu (The Chen Yun Chronicle)*. Vol. 3. Beijing: Central Documentation Publisher.

problematic, but I cannot over-turn the policy on my own. The SPC must first settle the bill with you" (Zhao 1986a: 70). Similarly, when Guangdong vice governor Yang Deyuan asked Zhao for more control over foreign exchange and the banking system, Zhao told him that the retrenchment would remain in place next year and that he should "make psychological preparation for it" (Zhao 1986b: 554). Again, these episodes reveal that despite his sympathy, Zhao was relatively powerless to overturn the existing policies. Moreover, these encounters demonstrate that Zhao's own preference for more investment and autonomy for his favorite provinces did not alter after he had become premier.

Chen Yun's maneuvers in 1983 only gave him a temporary reprieve. In early 1984, the economic figures from 1983 showed continual economic vigor and a thirst for capital from the grassroots level. In the last two quarters of 1983, industrial output registered a healthy 12 percent growth from the previous year, while SOE losses fell to historical lows (Fewsmith 1994: 127; State Statistical Bureau 1985). Meanwhile, the output of township and village enterprises grew by an astonishing 19 percent, complemented by a bumper harvest (Fewsmith 1994: 127). The good news on the economic front undoubtedly increased the cries for funds from the local governments, and gave Deng further political leverage to unlock the central bureaucracy's grip on the economy.

At the end of January 1984, Deng again took a trip to the prosperous provinces of Guangdong, Fujian, and Shanghai, where he exhorted local officials to "speed up growth and relax regulation a bit" (Document Research Center of the CCP CC 2004: 960). On his return, Deng called a meeting with Hu Yaobang, Zhao Ziyang, Wan Li, Yang Shangkun, Hu Qili, and Yao Yilin, a largely friendly audience. Yao was the only representative from the planners to hear Deng's latest instructions. Deng was impressed with Shenzhen's progress and wanted to give investment approval power for projects below U.S.\$5 million to all the special economic zones. Also, Deng wanted to expand the SEZ experiment to several other coastal cities, including Qingdao and Dalian (Deng 1998a). Yao, who was in charge of investment through the State Planning Commission, doubtless saw Deng's instruction as the latest political attack against central authority. Two weeks after Deng's talk, Chen held an urgent meeting with Yao Yilin, Song Ping, and senior Planning Commission cadres to discuss the implications of Deng's latest policy demands and possible responses (Document Research Center of the CCP CC 2000: 351). With the economy thriving and with relatively low inflation, however, Chen realized that he was out of cards to play. He left Beijing for Hangzhou four days later. 20

Without Chen's opposition, Deng's demand for more investment approval power at the local level and for more SEZs sent a ripple to both the local

²⁰ There is evidence that Deng forced Chen into a retreat by threatening the center's monopoly to issue currency. Before the Meeting for Some Coastal Cities, the SEZs had apparently suggested that they should issue their own currency. Chen wrote several notes (*piyu*) on this issue and strongly urged Deng and Zhao to abandon this proposal. This proposal was never adopted, but the SEZs apparently had gone as far as printing the notes. See Ibid.

government and the central bureaucracy. Days after Deng's meeting in early 1984, Hu Yaobang went on his own inspection trip to Guangdong and doled out generous largesse to the Guangdong government. Most notably, Hu allowed overseas Chinese to take out loans from the Bank of China if the loans went toward local development (Hu 1986a). He also went to the southwestern provinces to encourage them to band together toward a common developmental strategy (Li 2005: 891).

In late April 1984, Deng's call for decentralization was formalized at the Meeting for Some Coastal Cities, which was convened jointly by the State Council and the Central Committee. Besides approving special policies for fourteen more coastal cities, the meeting also had a strong agenda to devolve investment and lending power to the localities. The beginning of the meeting summary states unambiguously that "just as Comrade Deng Xiaoping pointed out, we must not contract (*shou*), but should continue to let go (*fang*)" (CCP Central Committee and State Council 1998). In the CCP's political jargon, it was nothing short of a *carte blanche* to the localities to take economic policies and local growth into their own hands. According to Xue Muqiao, a veteran central bureaucrat, the summer of 1984 saw many local officials calling for accelerated growth. Rather than the official goal of doubling the economy twice by the end of the century, local officials in many places called for "doubling three times in twenty years" or "doubling every five years" (Xue 1996: 408).

The meeting also specified several investment policies to benefit these fourteen cities. For one, all of them received the authority to approve foreign exchange investment projects below U.S.\$5 million, with Tianjin and Shanghai receiving the authority to approve projects below U.S.\$30 million.²² The meeting also ratified a resolution to allow coastal cities to spend billions of U.S. dollars "in the next several years." The meeting further decreed that the Bank of China, which specialized in foreign exchange loans, would provide "all the necessary foreign exchange" to these investment projects. Finally, since these special zones required new infrastructure, the state would allow the local government to issue bonds and would provide them with preferential loans to finance the construction (CCP Central Committee and State Council 1998). According to one of Hu's advisors, Chen Yun had anticipated the political tone of the April meeting and boycotted it. To show his displeasure, he also pledged that he would never visit an SEZ (Ruan 1995).

Chen's sentiment was understandable because these new policies greatly weakened the center's ability to control the economy. It was one thing when special policies only applied to a few outposts scattered in Guangdong and

²¹ After most major national conferences or meetings, the organizers issued meeting summaries, which signaled to lower officials of the political or policy tone at these meetings.

²² Foreign exchange investment projects refer to investment projects that required the use of foreign exchange, such as the purchase of foreign equipment. The sources of the funding included foreign investment, bank loans, bond issuance, and the local government coffer. Shenzhen and Hainan had obtained the authority to approve these projects in 1979 and 1981, respectively.

Fujian. It was another matter when the local governments in major cities all along the prosperous coast could make their own decisions about investment and lending. In compliance with the decisions made at the meeting, the central bureaucracy was compelled to enact several decentralization measures. The State Planning Commission (SPC), for example, enacted new regulations that allowed localities to approve investment projects less than 30 million yuan, up from the previous limit of 10 million. The SPC also allowed localities to approve construction projects that did not use state funding, retaining only the authority to set the overall amount of such extrabudgetary investment at the beginning of the year (State Council 1998b).

Meanwhile, Shenzhen acquired additional authority with regard to monetary policy. An experimental State Council policy enacted in May 1984 made the PBOC branch in Shenzhen a "local central bank (*bendi de zhongyang yinhang*)" (State Council 1986). According this policy, the PBOC branch in Shenzhen secured the authority to adjust the loan ceiling within a certain bound, control foreign currency transactions, approve local bond issuance, and monitor local financial institutions (State Council 1986). As the local PBOC was under the direct leadership of the local government, the local leadership obtained a powerful economic lever with which to stimulate growth.

As Figure 6.1 shows, the political ripple from Deng's southern tour and from the April meeting in 1984 unleashed local enthusiasm to increase investment and lending. The third quarter and especially the fourth quarter in 1984 saw a rapid acceleration in lending. This impetus was further fueled by a PBOC plan to peg the loan-to-deposit ratio in 1985 to the year-end level in 1984, which set off a frenzy of lending during the fourth quarter as banks tried to maximize their 1985 loan-to-deposit ratios (Xue 1996: 403). Rather than being an independent causal factor, the plan itself was a part of the drive to devolve more lending authority to the local branches of the state banks. As in 1980, the political enthusiasm generated inflationary pressure, giving the central planners the opportunity to reassert power.

Inflation and Retrenchment

At the end of 1984, currency in circulation increased by over 26 billion yuan, much higher than the planned increase of 13 billion yuan (Xue 1996: 403). At the same time, inflation climbed to almost double-digit territory. Despite these alarming statistics, the New Year edition of the *People's Daily*, the official Party newspaper, rallied for higher growth (Fewsmith 1994: 152). With the economic situation on their side, however, Chen Yun and his associates soon launched another dual-track counterattack against decentralization policies. On the first track, the central bureaucracy once again held a series of meetings with local leaders to send a clear signal of retrenchment. On the second track, Chen launched another round of smuggling investigations against the special economic zones to keep Deng politically unbalanced. If Chen and his associates did not have a political stake in centralizing or the political power to regain control, inflation would have continued its ascent.

As news of high deficit, rapid monetary expansion, dwindling foreign exchange reserve and increasing inflation flooded into the central government. The planners sprang into action. First, Chen Yun convened a private meeting with Li Xiannian and Yao Yilin to plan their strategy. Second, the central bureaucrats convened a report meeting on the economy, attended by Deng, Zhao, Yao, and Hu Qili, a core member of Hu Yaobang's faction. After hearing the bad news, Deng sensed the planners' plot to bring about another austerity period and attempted to forestall it:

In reform, we must take one step and evaluate the situation (before taking another step), but we must not lose the opportunity. It would be a shame to lose the opportunity. Although it is a risk to issue so much currency and to lose so much foreign exchange, if we look at it another way, our economic situation is on the whole stable and can support this trial. (Document Research Center of the CCP CC 2004: 1027)

Shortly after this meeting, Deng left for yet another inspection trip of Jiangsu, Shanghai, and Guangdong, during which he rallied opposition to centralization with the help of senior PLA generals, including Yu Qiuli, Wang Zhen, and Xu Xianggian (Document Research Center of the CCP CC 2004: 1030), Meanwhile, the planners convened the Conference for Responsible Comrades from the Provinces and Major Cities in February 1985, the first of several conferences convened that year to convey retrenchment policies to local officials. Because of Deng's opposition, the February Conference did not deliver the unambiguous message of centralization that Chen Yun had desired. Zhao's remarks at the conference communicated considerable equivocation: "Where we should contract, we will contract; where we need to support, we will do our best to support" (Chen 1998d). Chen Yun was annoyed with Zhao's ambiguity in wanting to "support" local investment. In Chen's remarks at a Politburo meeting right after the February Conference, he repeated Zhao's remarks and added that "I think the latter phrase can be erased. The meaning of the first phrase is enough" (Chen 1998d). The dispute, however, was not settled then.

Following the February Conference in 1985, different parts of the government sent conflicting signals about retrenchment to local officials. As a senior bureaucrat at the time observed, "Because understanding was not unified and the interests of the relevant parties conflicted, it was difficult to implement some measures immediately" (Xue 1996: 405). Furthermore, because after 1984 localities obtained much more autonomy to approve investment and had much more authority over local bank branches, even shutting off central budgetary grants to investment projects did not necessarily reduce money supply (Xue 1996: 407). As a result, although inflationary pressure did not accelerate, it remained at a relatively high level during the first two quarters of 1985. At the same time, backtracking on decentralization would have greatly reduced the pace of growth in regions headed by followers of Deng, Hu, and Zhao. Thus, Deng conveyed continuing support for high growth to local officials at a March 1985 conference: "If there are things constraining you, then I will help you think of some ways to liberate them" (Deng 1998d). Because of Deng's

tolerant attitude, the patrons of various generalist factions continued to intervene in the banking sector to increase lending in the provinces. When PBOC governor Chen Muhua reported to Yao Yilin the various special requests for funds from the generalist factions in the spring of 1985, Yao was visibly annoyed: "You can stop (the report); just give what the bank can give" (Jin 1995).

The ineffectiveness of the February conference to reduce inflationary pressure compelled Vice Premier Yao Yilin to make a personal trip to Guangdong and Fujian in an attempt to force local officials to toe the line. In his remarks to Guangdong cadres, Yao castigated local cadres for expanding money supply too rapidly, spending too much foreign exchange, and not paying banks back in a timely manner (Yao 1986b). Unlike Zhao, Yao's main concern was local compliance, not the special requests of the local officials.

During the trip, Yao also unveiled the technocrats' second track of attack against Deng's faction. For the previous two years, the Hainan SEZ in Guangdong had been importing luxury cars from abroad and reselling them at a high profit to inland provinces. In early 1985, the Central Discipline and Inspection Commission, still under Chen Yun's sway, launched an investigation of this operation. Soon after, the State Council issued a regulation forbidding all reselling activities by government units (Document Research Center of the CCP CC 2000). Without warning, Hainan's profitable import business was rendered illegal. Moreover, with a profit-making enterprise that involved tens of thousands of cars, Chen Yun was bound to find incidents of corruption. It turned out that Premier Zhao had personally approved the car operation in the first place and had given Hainan the permission to spend billions from the foreign exchange reserve without first discussing it at the CFELG (Deng 2005: 520). In this instance, Chen's main gripe against Zhao was probably not the corrupt activities of the car operation, but rather the unilateral expenditure of such an enormous sum of foreign exchange, a core macroeconomic tool for the planners. Hainan's massive import of luxury vehicles contributed to the largest drop in the foreign exchange reserve in the country's history – from U.S.\$8.2 billion in 1984 to U.S.\$2.6 billion in 1985 (State Administration of Foreign Exchange 2006). Yao's inspection trip to Guangdong allowed the technocrats to collect more evidence on the "evil teachings and deviant ways" of Deng and Zhao's Guangdong followers (Yao 1986b).

The criminalization of the Hainan car ring gravely jeopardized Zhao's political future because it was arguably a major policy failure that caused the loss of large sums of state resources. It was the type of failure over which Chen could force Zhao to resign. After Hu received his reprimand for meddling in economic affairs, this was the second time that Chen's faction had threatened a core member of Deng's coterie. Although Deng knew that Chen was in no position to take overall control of the CCP, he was certainly capable of causing enormous damage to Deng's faction. The investigation in Hainan further revived leftist criticism against the SEZs from the other elders in the Party. Deng apparently relented to the wave of criticism and reportedly said that SEZs were still an "experiment" (Fewsmith 1994: 153).

To further unbalance Deng politically, Chen had the CDIC author a report on the commercial activities of the "princelings," or children of high cadres. After reviewing the report, Chen Yun attached a comment stating that princeling participation in commercial activities should be strictly forbidden and that its continuation would "render progress in reform difficult" (Document Research Center of the CCP CC 2004: 1037). He then sent it to Deng, whose son Deng Pufang had just formed his own company earlier that year to help finance the China Association for the Disabled (He and Gao 2000: 542). Once again, Chen had backed Deng into a corner because Chen clearly had the moral high ground, even though Deng was doubtless very reluctant to squash his handicapped son's budding business career. Deng's terse reply was "agreed, we must make a decision soon," which left room for further discussion in the Politburo (Document Research Center of the CCP CC 2004: 1037). Although Deng was ultimately able to save Kanghua – his son's company – the CDIC report put him in a vulnerable position.

Under intense political pressure from the planners, Deng finally agreed to recentralize economic policies and to slow down the pace of growth. In his remarks to an Algerian delegation at the end of June, Deng acknowledged the inflation problem and signaled his acceptance of the retrenchment for "a few years" (Deng 1998b: 345). With Deng signing on to the retrenchment program, the planners convened another meeting with local officials in June 1985 to convey a unified stance on the issue. To enforce the investment and lending reduction approved during the meeting, the center also sent work teams to the provinces to monitor implementation (State Council 1987a).

The changing political environment in the middle of 1985 produced increasingly strict decrees about investment and lending from the State Council and from the PBOC. One PBOC decree forbade bank lending to all out-of-plan investment, even projects under 50,000 yuan (People's Bank of China 1987b). This policy starkly contrasted with decrees issued during the previous year, which had encouraged banks to support extrabudgetary investment. At the end of June, a State Council regulation essentially reversed the banking policies enacted during the previous year. The State Council decree states: "Banks can refuse any requests from local government that are against State Council financial regulations. The State Council will hold relevant cadres responsible (zhuijiu zeren) for harassing local banks which adhere to State Council regulations" (Office of the State Council 1987). Rather than encouraging banks to support local development, this new batch of regulations required banks to strictly adhere to the central credit plan.

However, Deng remained very dissatisfied with the state of affairs. In a July private chat with several Politburo Standing Committee members, Deng expressed his defiance: "Even if there is instability, or even great instability, we

²³ Deng Pufang became crippled during the Cultural Revolution after a failed suicide attempt in the wake of brutal Red Guard struggle sessions. He became the target of Red Guard struggle because Deng Xiaoping had been a major target of Cultural Revolution purges.

must insist on reform; otherwise, we will not have hope for the next ten years" (Deng 1998g). Had the content of Deng's talk been revealed to lower officials at the time, it would have dampened retrenchment efforts. There is no evidence, however, that Deng's private dissatisfaction was made public at the time. Besides Zhao and Deng Pufang's vulnerability, another reason for Deng's silence was perhaps Chen's acquiescence of Deng's assertion of dominance over the military. At the September Fourth Plenum, a group of veteran marshals retired from the Politburo, replaced by two Deng loyalists in the PLA, Yang Shangkun and Yang Dezhi (Baum 1994: 185). As long as Deng left economic policies alone, Chen did not oppose Deng's assertion of greater control over other parts of the Party state.

The First Wave of Nonperforming Loans

In the previous inflationary cycle and in this cycle, lending played an increasingly important role in the government's investment plans. The budget-to-loan transformation made bank loans an increasingly significant part of both local and central investment. Inevitably, the investment and lending boom in 1984, the first boom in which loans played a major role, produced the first major batch of nonperforming loans. In a pattern that repeated itself, the central bureaucracy carried out a bailout that it promised would be the last supper for banks. The threat proved to be not credible. Although PBOC regulations were issued to protect the integrity of the banks, both the central and the local governments continued to use banking resources to fulfill policy aims. Those with political clout in both the generalist and the technocratic factions simply did not have sufficient incentive to make banks into commercial entities.

The first wave of nonperforming loans (NPLs) arose from reckless local investment in 1984 and from the sudden drying up of bank funds to local initiatives. One prime example was the Hainan car ring, which could have thrived as a profitable business. But because of the crackdown, Hainan was stuck with tens of thousands of cars and NPLs to the tune of 3 billion yuan, a substantial sum at that time (Yao 1986b). The investment boom also generated NPLs in other areas. A State Council decree at that time suggests that roughly 50 percent of technical innovation loans and 20 percent of loans to township and village enterprises had become nonperforming (The State Council 1987b). Although loans in those two categories were relatively minor at that time, they likely added several billion yuan to the NPL tab.²⁴

Problems also abounded for working capital loans, the largest category of loans at that time. In late April 1985, the PBOC issued a decree to order a write-off of nonperforming working capital loans for SOEs. The write-off was

Although the precise figure for technical innovation investment loans in 1984 is not available, loans to TVEs totaled 12.6 billion yuan in 1984; 20 percent of that is roughly 2.5 billion yuan. See Division of Investigation and Statistics of the People's Bank of China. 1997. Zhongguo Jinrong Tongji: 1952–1996 (China Financial Statistics: 1952–1996). Beijing: China Finance and Economics Publisher.

in the amount of 5.5 billion yuan, a mere 1.4 percent of working capital loans outstanding at that time. Nonetheless, it was clear that the government had a rude awakening about the consequences of using the banking system. The decree stressed that this bailout would be the last one:

This is the last time that the state will take responsibility for lost capital... Capital and material losses from now on will be handled by the enterprises themselves. They can no longer suspend loans (*guazhang*) for the long run and cannot use state capital to write off debt. (Industrial and Commercial Bank of China, The People's Bank of China, and The Ministry of Finance 1987)

Needless to say, this premature commitment against bailing out SOE losses did not endure long.

In response to this wave of NPLs, technocrats in the PBOC, who were not members of the political elite, proposed both administrative measures and long-term reform to reduce NPLs. The administrative measures were a part of the retrenchment effort which essentially forbade the local government from ordering banks to lend. It also required all borrowers of fixed-asset loans to have start-up capital equivalent to 30 percent of the total investment (Office of the State Council 1987). At the end of 1985, the PBOC also organized a national inspection campaign on loans to ensure compliance to these measures (State Council 1987b).

On a longer time horizon, the technocrats at the PBOC also strove to make banks commercial entities. After vigorous lobbying, the government founded in 1984 a new bank, the Industrial and Commercial Bank of China (ICBC), to take over the PBOC's commercial lending operations in an attempt to reduce the moral hazard prevalent in PBOC commercial lending. Although this measure proved largely fruitless because the PBOC still had to lend to the state banks when they ran short of money, it nonetheless represented a significant movement toward banking autonomy. Their lobbying effort also earned them a section on financial reform in the Proposal for the Seventh Five Year Plan, which was ratified at the Party Representative Conference in October 1985. Although nonbinding, the proposal called for more autonomy for banks to set interest rates, select borrowers, and set fees (Liu 2000e).

Despite these milestones, the political logic in the communist system did not permit the optimistic wording in the proposal to become reality. Members of the generalist faction did their best to encourage local officials to intervene in the banks to obtain high growth. During the retrenchment, the bureaucrats did not hesitate to use the banks to finance various pet projects. One prime example was the subsidized loans for developing the electronic industries. In 1984, Jiang Zemin, then the Minister of Electronics, staged a special presentation of computer equipment for Chen Yun. Chen Yun was impressed by both Jiang and his equipment and requested preferential policies for electronics (Gilley 1998: 73). The State Council then set up the Leading Group on Promoting Electronics, headed by then Vice Premier Li Peng and Jiang. At the height of the retrenchment, the Leading Group drafted a policy to provide 200 million

yuan in subsidized loans to the electronic industry. The loans in this category were approved by the Leading Group rather than by the banks themselves (State Council's Leading Group on Promoting Electronics et al. 1987). Also, the State Council ordered the banks to provide funds to agricultural procurement, which had been funded by the government budget (People's Bank of China 1987a). With multiplying policy tasks, the road to banking autonomy would prove to be a long and tortuous one.

Conclusion

This chapter documented the way in which elite politics affected financial outcomes during the crucial 1978–1986 period. On the issue of monetary policy, Deng's faction of Party officials disagreed with Chen's faction of central bureaucrats on the degree of centralization in investment and lending. The struggle between the two factions created the first two reform-era inflationary cycles. Given that there was no central bank independence in China, it was the technocrats' active participation in politics that gave anti-inflationary policies credibility. Economic actors in China expected the central bureaucrats to fight tooth and nail to retain control over investment and lending, and they did. At the same time, however, leaders from both factions began to see the banking system as a useful source of funds. Because no faction had an incentive to protect the interest of the depositors, banks soon became the government's other fiscal arm.

Unlike some earlier accounts of this period, the above discussion reveals that the Deng-Chen split on economic issues began much earlier in late 1979 (Fewsmith 1994; MacFarquhar 1997). Also, the evidence presented in this chapter strongly suggests that economic policy rather than ideological concerns was the basis of the disagreement between the two factions in the early 1980s. Deng and Chen's disagreement on economic reform probably stemmed more from control than from ideological differences. Both Deng and Chen had been life-long Marxists, and Deng's stance on the spiritual pollution issue and in 1989 showed that Deng was as much a zealous guardian of the proletarian dictatorship as Chen was (Deng 2005: 346). Yet he clearly favored a more decentralized, though not necessarily a more marketized, mode of economic management. Evidence from this chapter suggests that membership composition of the two factions likely had more to do with their divergent preferences on economic issues than their ideological dispositions.

Finally, the evidence presented here supports Baum's (1994) argument that ideological cycles and economic cycles each had their distinct logic and did not necessarily coincide. Of course, the smuggling scandal at the end of 1981 and the suppression of the Hainan car ring in 1985 were critical elements in the planners' strategy of obtaining and retaining financial control. Nonetheless, these actions were motivated more by the desire to retain power than by a coherent ideological vision. The scandals would not have been useful to Chen Yun if they did not involve Deng's favorite economic experiment, the SEZs. After all,

neither the Democracy Wall Movement nor the Polish workers' protests, which caused ripples in the ideological debates, seemed to have disturbed the trajectory of the inflationary cycles. Rather, rising complaints from local officials and high inflation seemed to have played the most important role in changing the direction of monetary policies.

Deng remarked at a July 1985 private meeting that "great instability" was an acceptable price of reform. This statement was perhaps more prophetic than he would have preferred. As the next chapter shows, the next inflationary cycle indeed produced the "great instability" to test the limit of reform and his drive to decentralize the economy.

The Height of the Politics of Inflation, 1987-1996

Although the politics of inflationary cycles began in the late 1970s, the full manifestation of its dynamics did not take place until the late 1980s with the third reform inflationary cycle. The full flowering of the generalist faction's tendency to promote local financial control and the central bureaucrats' opposition to it occurred in the 1988 and in the 1993 inflationary cycles. The looming succession meant that junior generalists must firm up their own factions in preparation for the struggle after Deng's passing. This gave them impetus to devolve financial resources to their main provincial supporters. At the same time, these two inflationary cycles also reveal the dominant generalists' willingness to delegate financial authorities to the technocrats in order to preserve the status quo balance of power during crises. In the aftermath of the 1989 student protests and in 1995, Deng and his successor Jiang Zemin relied on the technocrats to stabilize the economy as they struggled to preserve or consolidate their power. Thus, the logic outlined in Chapter 4 continued to have an important impact on monetary policies in the rest of the 1980s and into the 1990s.

Examining more recent inflationary cycles also places the ideological hypothesis under rigorous scrutiny. Because debates over financial policies were tinged with ideology in the early 1980s, it is difficult to firmly reject the ideology hypothesis based solely on an examination of the earlier inflationary cycles. Into the late 1980s and the 1990s, however, the rise of a new breed of central bureaucrats, who were conversant in Western economic theory and proponents of building comprehensive market institutions, puts the ideological hypothesis to a true test. If ideology caused the underlying disagreement between the top leaders on monetary policies, the growing consensus on reform and market formation should diminish their disagreement over time. Even if there were disagreements about reform trajectories, the main division over financial policies would not have been over centralization versus decentralization because the main Western debates about financial policies did not fall in that divide. Rather than importing Western debates about financial policies wholesale, the growing economic expert community in China tailored the debate to fit the

main consumers of policy proposals, namely, the generalist factions and the technocratic factions. Despite the ideological and ideational changes and the shifts in leadership over the decade under examination, the generalist factions' preference for decentralized finance and the technocratic faction's preference for centralized finance did not diminish.

Examining these inflationary cycles also allows us to witness the persistent debates about the acceptable level of inflation throughout the cycles. This debate masked the deeper issue of which level of government should control financial resources. The generalist factions argued that society had gained a higher tolerance for inflation or that high inflation was a necessary steppingstone to reform. Their intellectual merits aside, these arguments also conveniently justified decentralized finance. In 1988, Zhao Zivang brought that argument to its logical extreme when he proposed to bring China down the road of Brazilian hyperinflation. Meanwhile, central bureaucrats in different age cohorts and with different ideological visions consistently argued that high inflation could lead to economic and ultimately political instability. The implication of this argument was of course a more centralized structure for the financial system. Over time, the generalist factions eroded the low tolerance for inflation, but the central bureaucracy repeatedly mobilized its arsenal of political tools to initiate retrenchments. If central bureaucrats did not have a stake in the political consequences of centralized finance, they would not have been such active champions of centralization and such vigilant guardians against high inflation. China would have implemented the preferred policies of the generalist factions and faced high inflation.

The parallel analysis of both monetary policy and banking policy throughout the decade is also an instructive study in contrast. Although elite factions fought over monetary control, there were no elite defenders of banking autonomy from administrative intervention. Although technocrats below the Politburo level lobbied vigorously for banking autonomy from the early 1980s, their effort produced few real results. At most, technocrats managed to include clauses supporting banking autonomy in several important policy documents, but the political elite repeatedly violated the spirit of these documents by ordering banks to lend to policy and political ends. Their actions greatly undermined the credibility of these plans and encouraged lower level officials to do the same. Local governments set up their own depository institutions or ordered the local state banks to lend to local development, foreign purchases, and bailing out local SOEs. The central bureaucrats used their control over the banking system to lower explicit deficit, finance national development, and bail out large SOEs.

Severe Tests: On the Edge of Hyperinflation and Tiananmen, 1987-1990

The years between 1987 and 1990 put both Chen Yun's faction and Deng Xiaoping's faction to the severest tests since the reform began. Zhao Ziyang, whose way to the top was opened by Hu Yaobang's removal after the 1986

protests, made even more strenuous effort to bolster his local support base in preparation for the succession. Like Hu Yaobang before him, Zhao was testing the limit to which he could establish his own agenda and factional base without directly challenging Deng. At the same time, his decentralization policies were bolstered by technical arguments from his team of economists, who argued that inflation was an acceptable price of decentralization. This would have been disastrous for Chen's faction of central bureaucrats because their powers would have been emasculated. For Chen Yun personally, hyperinflation, something he had spent much of his professional life combating, would have become a reality.

In this cycle, we once again observe the distinct logic between political cycles and economic cycles. Although the technocrats attempted to use Hu Yaobang's downfall to forestall decentralization policies, they were unable to do so because of high growth and low inflation in that period. Instead, widespread panic buying and runs on the state banks eventually convinced Deng to acquiesce to the centralization drive. To accomplish their aim, the planners had to mobilize all their resources to set a political trap for Deng and Zhao. The theory presented in Chapter 4 suggests that the technocratic faction had an incentive to create an economic disaster to regain control. In 1988, we see some evidence that the technocratic faction allowed Deng and Zhao to steer the country into an economic crisis in order to regain control. More so than the previous inflationary cycles, this case shows that China would indeed have faced high levels of inflation without the intervention of the politically powerful central bureaucrats.

The generalist factions' crisis came less than a year later when students took to the streets and protested inflation, corruption, and the uncertainties of reform. For a variety of reasons, the Party ultimately had to use its bluntest instrument to put a stop to the protest. The Tiananmen Square massacre sparked a wholesale criticism of the entire reform process. Deng used all the political resources at his disposal to stem the tide of leftist ideological attacks. In order to save the reform and his legacy, he made the ultimate bargain with the central planners. He agreed to elevate someone with strong central bureaucratic pedigree to the post of General Secretary, greatly diminishing the power of the generalist faction. Deng also signed on to a long retrenchment period of heightened central power. Contrary to previous Western accounts, however, the post-1989 retrenchment was not simply a return to the prereform days. During that period, the central bureaucracy began to reinvent and strengthen itself for the market economy. A new generation of central bureaucrats showed much greater willingness to retool the central bureaucracy to perpetuate its hold over the emerging market economy.

In terms of the money supply, this inflationary cycle did not follow the classical pattern of rapid increase in money supply generating inflationary pressure. As seen in Figure 7.1, money supply built up steadily beginning in the second half of 1986. It was inflationary expectation generated by political signals from the top that caused high inflation in 1988. As in previous cycles, it was high

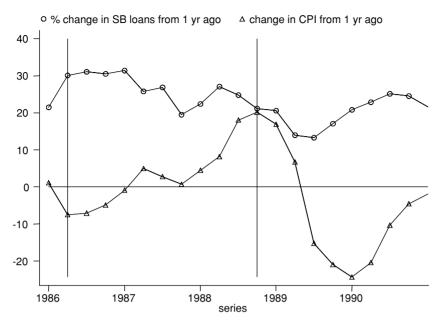


FIGURE 7.1. Percentage Change in Quarterly Lending and Change in Inflation from One Year Ago: 1986–1991. *Source: Quarterly Database*. See Appendix for details. Figures are percentage change in state bank lending and change in inflation from four quarters ago.

inflation and the resulting political reaction that ended the crisis at the end of 1988. More so than the previous cycles, we see the importance of politics in affecting inflation. The inflationary pattern in this cycle also provides further confirmation that the Chinese government was not a unitary actor. If the Chinese government had been a unitary actor, it would have more skillfully targeted money supply rather than allowed it to grow at such a rapid rate in 1986 and in 1987. Instead, the Chinese government did not react until several quarters after inflation had gotten out of control. Loan expansion remained at above 20 percent throughout 1986 and 1987, despite a couple of half-hearted efforts at soft landing. This occurred because one part of the government felt that inflation was not such a grave threat.

The Intellectual and Political Basis of the Inflation Debate

At the end of the previous inflationary cycle in 1985, Zhao mobilized a group of young economists under him to reexamine the implications of inflation. Was inflation necessarily fatal to the Chinese economy, as the planners had claimed all along? Drawing from a wide range of theoretical traditions, economists who supported Zhao's stance of decentralizing finance devised numerous justifications for allowing inflation to take off, which gradually increased the inflation tolerance of the generalist factions. By 1988, Zhao felt confident enough to ignore the planners' call for retrenchment, even as inflation crept into the

20 percent territory. Although these economists merely supplied ideas that suited Zhao's political demand, their arguments nonetheless gave Zhao the backbone to resist the planners' call for retrenchment, at least for a few months.

Because of Chen Yun's domination of the central bureaucracy, Zhao recruited a group of young economists and founded the Economic Reform Institute (ERI) to provide policy proposals independent of those generated by the traditional central bureaucracy (Fewsmith 1994: 136). When inflation reached an alarming level in late 1984, a leading member of the Institute, Zhu Jiaming, authored an article arguing that high growth required the rapid expansion of money supply (Fewsmith 1994: 140). After the center instituted retrenchment policies in 1985, scholars from the ERI issued a report contending that the cure for inflation was not centralization, but ownership reform and a freer labor market (Fewsmith 1994: 140). The appearance of these articles in the midst of the retrenchment was a means for Zhao to criticize the retrenchment unofficially. Although these justifications were ultimately ineffective in undoing the retrenchment in 1985, they served as the intellectual foundation for the fierce debate over acceptable inflation in 1987 and 1988.

In 1986 and 1987, Zhao's protégés at the ERI continued to produce work on revitalizing the microeconomy in China. It even called for the legalization of the dual-track financial system in which informal financial institutions charging market interest rates coexisted with the state banking system charging artificially low rates (Fewsmith 1994: 167). In the summer of 1986, Li Yining, an economist who became a follower of Hayek after he had studied the Hayek-Lange debate, authored an article stating that inflation was a temporary phenomenon that would disappear after ownership transformation, a politically correct term for privatization (Fewsmith 1994: 186).

Meanwhile, industrial growth in 1986 only registered at a sluggish 4.4 percent because firms lacked working capital after the retrenchment (Xue 1996: 411). Local officials and managers of firms sent a flood of complaints against the centralization policies to the central government. Sensing a possible turn in the political tide, Zhao's young economists authored several articles that called for "appropriate inflation" to revive industrial production (Xue 1996: 411). Although Gu Mu and Zhao still supported the retrenchment policies on their inspection trips in January and February 1986, the articles likely generated an elite debate about the stifling effect of the retrenchment efforts (Gu 1988; Zhao 1988). One sign of the debate was the attack on the "appropriate inflation" argument at the April National People's Congress session by an established State Council think-tank (Xue 1996: 411).

Amid the intensifying debate on "appropriate inflation," Deng scored a major victory to lessen his political vulnerability. In a January 1986 Politburo Standing Committee meeting, Deng managed to shift the main anticorruption effort to the Central Secretariat headed by Qiao Shi, a junior member of Deng's faction, and away from the CDIC, which was still under Chen Yun's influence (Document Research Center of the CCP CC 2004:1102). Although the CDIC, the CCP's official anticorruption organ, continued to conduct its own

corruption inquiries, Deng's faction could now retaliate in kind through the Central Secretariat. Chen Yun no longer had a monopoly on information about the corrupt dealings of his colleagues. Not surprisingly, one of the first cases that the Secretariat investigated involved a subsidiary of the Ministry of Aviation Industry, a heavy industrial ministry directly under the purview of the SPC (Document Research Center of the CCP CC 2004: 1106). After this, Deng appeared more emboldened to talk about high-speed development and reform in public. Hu Yaobang likewise urged local cadres in southwestern China to have "the confidence to double (the economy)" (Li 2005: 1076). To regain the initiative, Chen Yun convened a series of anti-corruption and anti smuggling conferences in the spring of 1986 (Fourth Editorial Bureau of the Central Document Research Center 1999). However, no major case broke, rendering these conferences relatively harmless to Deng.

In June 1986, the center's tight grasp on the money supply began to relax. A PBOC regulation issued at the end of June began: "While we should strive to strengthen and improve macro control over finance, we should support the national economy to grow at an appropriate speed," an attitude similar to the one proposed by the young economists earlier in the year (People's Bank of China 1987). In addition to calling for growth, the PBOC decree ordered local branches of the PBOC to provide adequate amount of liquidity to commercial banks to support working capital loans (People's Bank of China 1987). In one stroke, the credibility of the retrenchment policies was undermined because local branches of the commercial banks could lend to their hearts' content, only to draw money from the local PBOC when they ran short on liquidity. Although this rule only applied to working capital loans, SOEs were by then well practiced in using working capital loans for fixed asset investment. As Figure 7.1 shows, lending began to grow at a healthy clip from that point onward, although inflationary pressure was not apparent in 1986. As a result of monetary loosening, fixed asset investment in 1986 exceeded the planned amount by 47.7 billion yuan (Xue 1996: 415). In the mean time, Deng took an inspection trip to Tianjin to exhort local officials to "have more courage, grow faster" (Document Research Center of the CCP CC 2004: 1130). With low inflation, however, Yao Yilin could only warn local cadres to keep a "clear head" at the Planning Conference at the end of 1986 (Fourth Editorial Bureau of the Central Document Research Center 1999).

In this loosening environment, Deng's faction suffered an enormous blow when student protests in late 1986 forced Deng to abandon his designated successor Hu Yaobang. In the ideological realm, Hu Yaobang's removal introduced a conservative interregnum in which the Party cracked down on manifestations of "spiritual pollution" and "bourgeois liberalization" (Baum 1994: 206). Nonetheless, the damage to Deng personally was limited as even leftist ideologues defended Deng by saying that Hu had tolerated liberal tendencies against Deng's wishes (Deng 2005: 416). With his authorities intact, Deng managed to appoint his other loyal lieutenant, Zhao Ziyang, to the Party's top post.

Thus, from January to November 1987, Zhao gained enormous power because he held the posts of premier and CCP General Secretary concurrently.

This is not to say that the planners did not try to link Zhao's renewed drive for decentralization with the student protests. At the infamous January 12, 1987, party life meeting to criticize Hu Yaobang, Yao Yilin and Song Ping, both stalwarts in the planning bureaucracy, spoke out against Hu Yaobang on economic issues. In the case of Song Ping, he blamed "the main comrade of responsibility at the center" for sending confusing signals to local officials, causing the failure of the 1979 economic readjustment (Deng 2005: 451). Song likely used this ambiguous wording to make a veiled attack against Deng himself. Nonetheless, with the economy in good shape, the generalists were able to halt the technocrats' attempt to link the economic debates with ideological debates by issuing Central Document Number Four, which separated the two sets of issues (Fewsmith 1994: 205).

With the looming succession, Zhao wasted no time to further bolster his popularity among local officials. Almost immediately on Zhao's promotion to Party Secretary General in mid January, the Central Committee issued a decree encouraging local governments to set up their own financial cooperatives and trust and investment companies to increase investment capital in rural areas. Although local governments had been experimenting with local financial institutions to compete with the state banks, this decree legalized these informal banks "in principle" (CCP Central Committee 1998). In the runup to the fall Thirteenth Party Congress, Zhao lavished more subsidies and preferential policies on his main support base Guangdong. Zhao first allowed Guangdong to increase annual foreign exchange spending by U.S.\$200 million for the subsequent few years at a time when the Chinese foreign exchange reserve totaled less than U.S.\$3 billion. Furthermore, Zhao granted Guangdong more autonomy to approve foreign direct investment and a 100 million vuan per project limit to help with FDI projects, provided by the PBOC (Central Finance and Economic Leading Group 1988).

Unlike previous inflationary cycles, the combination of monetary expansion and rapid growth of consumer goods production generated little inflationary pressure initially. With the economy in relatively stable condition, Chen and the planners lacked the opportunity to reimpose central control over the money supply. Also, the planners might have been placated because one of their own, Li Peng, was chosen to become the new premier at the end of 1987, which deprived Zhao Ziyang the monopoly in economic policy making (Chen 1995a). Because Zhao still headed the Central Finance and Economic Leading Group (CFELG), the technocrats now argued that the decisions of the CFELG should not be binding on the State Council (Chen 1995a). Whereas the technocratic faction had argued for the supremacy of the CFELG previously, they now championed the independence of the State Council from the CFELG because Li Peng, one of their own, was appointed premier. This episode clearly demonstrates that factional considerations drove the redefinition of institutional authorities.

The Inflation Debate

The Thirteenth Party Congress in the fall of 1987 elected a new slate of leaders, which gave the technocratic faction more formal control over the economy than any time since the disbanding of the Finance and Economic Committee in 1980. Li Peng, the planner's designated successor, became Premier, whereas Yao Yilin, the veteran stalwart of the planned economy, retained his post as executive vice premier in charge of the economy. Despite the firm hold over the formal institutions that governed the economy, the planners still lacked control over the CCP's political machine, which was vital in sending political signals about economic policies to local officials. In other words, without the Central Committee's full backing, the State Council's decrees lacked authority and were not obeyed by local officials, whose compliance was crucial for monetary policies. Furthermore, Deng managed to remove Chen Yun from the CDIC and replaced him with his own protégé Qiao Shi, who had been in charge of anticorruption in the Central Secretariat. Thus, Chen Yun lost direct control over a powerful political weapon, the CDIC network that had provided him with information on the corrupt dealings of his colleagues and their families. With diminished political leverage, the technocrats could only regain power when inflation reemerged. But the dominant generalist faction did its best to redefine the bounds of tolerable inflation in order to continue decentralized finance.

The Thirteenth Party Congress provided further impetus to monetary decentralization by endorsing the great international cycle theory, which entailed the rapid growth of township and village enterprises to increase export of labor intensive goods (Fewsmith 1994: 215). After receiving Deng's blessing to "go ahead boldly, increase your pace, and grasp the opportunity" in January 1988, Zhao increased the investment approval authority of the local government and vested the Guangdong PBOC with the power to determine credit ceiling, approve the formation of trust and investment companies, and set the interest rates within a certain band (Document Research Center of the CCP CC 2004: 1223; Central Finance and Economic Leading Group 1988; State Council 1988). This was an extension of the local central bank concept first tested in Shenzhen. Despite the planners' formal control over the State Council, they were powerless to stop Zhao's continual effort to decentralize monetary control to the provinces.

Beginning in the second half of 1987, however, signs of overheating began to appear. Before the Thirteenth Party Congress, State Council economists wrote a series of reports to Zhao, warning him of inflationary pressure on the economy caused by several quarters of rapid increases in lending. At a Politburo meeting, Zhao angrily rebuked these technocrats for depicting the economy as "grave" when it was "in fact lively" and for having "pessimistic attitude that caused one to panic and lose one's calm" (Xue 1996: 415). Countering the claims of the State Council experts, Zhao said that even if demand outstripped supply in the economy, it was simply a matter of 20–30 billion yuan and that the best cure was further growth of production, not retrenchment (Xue 1996: 415). Zhao knew

that the technocrats' warnings meant the beginning of retrenchment efforts. By dismissing these warnings, he could continue his preferred decentralization policies.

This fierce debate about acceptable inflation escalated as the inflation rate climbed rapidly during the first half of 1988. Inflation, especially in major cities, entered double-digit territory, setting off a series of alarms in the State Council bureaucracy. While the State Council issued a stream of reports warning of financial chaos, Zhao's own economists also shifted into high gear to produce articles supporting "beneficial inflation" and "acceptable inflation" (Xue 1996: 416). Zhao went as far as sending a team of economists to South America to see if China could sustain a high level of inflation similar to that in Latin American countries at the time. Their conclusion, of course, was that China could in fact sustain a high level of inflation (Lam 1995). In a February 1988 CFELG meeting, Yao suggested that the Chinese economy was on the verge of collapse and that retrenchment was urgently needed. Zhao, echoing the arguments of his advisors, argued that a certain degree of inflation was inevitable and that reform should continue despite inflation (Chen 1995a). Even as inflation escalated into the 20 percent range in major cities, Deng told a delegation from North Korea that high speed growth would continue and that "upheavals" were nothing to fear (Deng 1998e). At a Politburo meeting at the end of May 1988, Zhao uttered the notorious comment that suggests how far he was willing to go: "In Brazil, prices increase 15 to 70 percent; how can people live there? – Why can't we live [with similar price increases?]" (Fewsmith 1994: 223) Although the planners were used to the inflationary preference of Zhao and Deng by that point, they must have been quite shocked by the suggestion to adopt Brazil's 70 percent inflation.

As a result of Zhao's resistance to the State Council's call for retrenchment, State Council policies to limit money supply did not have the strong language of the previous retrenchments. In any event, local officials did not comply with these decrees because they knew that Deng and Zhao disagreed with the planners. For example, the State Council increased reserve requirement from 10 percent to 12 percent during the fourth quarter in 1987, but banks continued to lend, forcing the central bank to lend more money to the banks. Essentially, the effect of increasing the reserve requirement was neutralized by central bank lending to the banks (Liu 2000d). Moreover, the PBOC's decree on the credit plan issued in March 1988 contained ambiguous provisions that called for strict adherence to fixed asset lending but flexibility in working capital lending (People's Bank of China 1989c). A June decree from the PBOC contained similar ambivalence in calling for "controlling the macro situation while revitalizing the micro situation," suggesting local autonomy in lending (People's Bank of China 1989b).

¹ A powerful tool of any central bank to control money supply is adjustment of the reserve ratio. With a higher reserve ratio, banks are obligated to place a higher percentage of deposits in the central bank, which diminishes the amount they can lend out, decreasing the money supply.

Unlike their previous reaction of acceding to the planners' call for contraction, Deng and Zhao held the line on acceptable inflation. Their resolve stemmed from several sources. First, the young economists' stream of articles about acceptable inflation shifted the debate toward higher tolerance for inflation. Whereas 10 percent inflation had brought about drastic austerity measures previously, even the planners did not harbor any illusions that 10 percent inflation would convince Deng to initiate retrenchment in 1988 (Xue 1996: 417). Moreover, Chen and the other central bureaucrats could no longer credibly threaten to abolish the SEZs because they had proved to be such enormous successes. For the moment, the planners did not have any cards to best Deng and Zhao's audacious call for 70 percent inflation. But because they had a high stake in restoring central control, they did not give up the fight. In May 1988, Chen Yun intimated his deep concern to an old friend: "I no longer manage (monetary policy), but my brain is still thinking about this problem" (Zhao 2005: 27).

The Price Reform Trap

By the middle of 1988, inflation had climbed past the 20 percent range in many places, but Zhao and Deng continued to broadcast the message of decentralization. In order to regain the policy initiative, the planners knowingly allowed Deng and Zhao to trigger an economic crisis, which resulted in another round of retrenchment. In May 1988, Deng began to call for comprehensive price reform to remove many consumer goods from the list of commodities controlled by the State Planning Commission. When Deng raised the issue at a Politburo meeting in the middle of May, the planners strenuously objected and insisted on a fivevear timeline (Chen 1995a: 191). Angry about the planners' opposition, Deng announced his desire for price reform in a series of statements to foreign guests. These remarks increased the pressure on the planners to further decentralize power and liberalize prices. Although Chen Yun had retired from the CDIC by that point, he still had great influence on the massive planning apparatus, which had enormous research and information gathering capabilities. He used these capabilities to set a political trap for Deng and Zhao in order to regain central control.

Under pressure from Deng, the Politburo decided to speed up price liberalization, but Chen and others insisted that economic policies had to be made by the State Council. Thus, Yao Yilin was put in charge of drafting a plan for price liberalization, to be discussed at the Beidaihe Meeting in August 1988 (Chen 1995a). Predictably, Yao delegated the task to the SPC, which convened a conference in June to discuss the implications of price liberalization. State Council researchers all warned that price liberalization would further increase inflationary pressure and possibly trigger panic buying and that Zhao's suggestion to provide living expense subsidies to offset the costs of inflation to households would generate even more inflation (Xue 1996: 417).² As all the participants

² Zhao first made the suggestion of inflation-indexed food subsidies in a January 1988 meeting with his staff. His staff presumably gave him several proposals, which he raised with the planners

were researchers from the planning bureaucracy, it was not surprising that they drew these conclusions, but they also happened to be right.

As inflation continued to climb in the summer of 1988, Chen Yun told Yao to organize a secret team of senior SPC officials to draft concrete plans for the upcoming retrenchment (Chen 1995a: 195). How did Chen know that retrenchment was forthcoming? State Council researchers had warned that price liberalization would translate inflation into panic buying and a run on the banks. Knowing that, Chen and Yao gambled that an announcement by the Central Committee to launch price reform would provoke panic buying and a run on the state banking system, which would create a sufficiently grave crisis to initiate austerity. Their best course of action was to put up minimal resistance to price liberalization at the next Beidaihe meeting. The planners had the best of both worlds. On the one hand, Deng and Zhao were the main proponents of price reform, so they would be held responsible if price reform ended in disaster. On the other hand, Yao and Li Peng had actual control over liberalization policies, so they could slow down the process if disaster did not strike.

When the top leadership reconvened in Beidaihe to discuss comprehensive price reform in the middle of August, Yao presented his still conservative plan for price liberalization. According to one of Zhao's aids, Zhao was dissatisfied with the pace of liberalization stated in Yao's plan and proposed a much more comprehensive and rapid liberalization pace in 1989 (Wu 1997: 529). Zhao was not entirely unaware of the risks associated with price reform. At the meeting, Zhao stated that inflation was a possible risk they all had to accept for pushing forward this reform. In order to minimize the impact of price reform, Zhao suggested a simultaneous tightening of fixed asset investment and steel production to prevent the explosion of construction projects (Wu 1997: 530).

The planners apparently changed course entirely and immediately endorsed price reform in principle (Chen 1995a). What was more, they endorsed the suggestion to "appropriately increase and adjust wages and appropriately increase subsidies to guarantee that the living standard of most workers does not decline" (Document Research Center of the CCP CC 2000). They supported something that SPC experts had told them repeatedly would exacerbate inflationary pressure, which further suggests their duplicity. At the meeting, one of the few people who spoke up against Zhao's plan for price reform was then party secretary of Shanghai Jiang Zemin, who argued that "the psychological tolerance of the people (for instability) is low" (Wu 1997: 527). As a junior Politburo member in faraway Shanghai, Jiang was likely unaware of the technocrats' plan, but his support for conservative price policies doubtless pleased Chen Yun. After receiving a final blessing from Deng on August 19, Zhao had the *People's Daily* – the official mouthpiece of the Party – announce the price reform (Wu 1997: 532). On seeing the announcement, urban residents

immediately knew that price reform meant substantial price hikes, and they lost no time going to the stores.

Although the true extent of the panic buying and the concurrent run on the banks remain state secrets, available material suggests that the run on the banks began in Nanjing and Hangzhou and quickly spread to the rest of the country (Liu 1993). Bank deposits, which had been growing at 30 percent for the past few years, suddenly declined, suggesting that massive amounts of funds were suddenly withdrawn and used for purchases (Liu 1993). On receiving reports of these incidents, Zhao immediately saw an economic and political disaster in the making. Economically, in order to meet the demands of depositors, the central bank would have to make large quantities of reloans available to the Big Four banks, which would have further exacerbated inflation. Politically, although both he and Deng were active proponents of the liberalization, Zhao knew he would take the brunt of the criticism from both his rivals and Deng's rivals. much as Hu Yaobang had taken all the blame for political liberalization. At the same time, he did not want to be the one to tell Deng that price reform had to be abandoned. Zhao's way out was to call on Yao Yilin to ask for his opinion, and Yao invariably advised retrenchment and a slow-down in liberalization (Wu 1997: 538). Zhao then contacted several Party elders, including Bo Yibo, Wan Li, Yang Shangkun, and Deng's bodyguard Wang Ruilin, and asked them to gently suggest abandoning price reform to Deng.³ Deng concurred, but he was not pleased by the development. When Wang Ruilin broached the subject with Deng, he agreed – likely because he did not want Zhao to also fall from power - but said, "I don't want to talk about this anymore (butanle)" (Wu 1997: 538).

With Deng's acquiescence, the State Council meeting on August 30, 1988, passed a stern resolution to freeze prices and limit investment and lending for the remainder of the year (State Council 1993b). On September 2, a Politburo meeting decided to pursue the goal of "correction and rectification" (*zhili zhengdun*), while delaying price reform indefinitely. The reversal of policy came less than two weeks after the price reform announcement. The Politburo meeting also gave the planners a chance to criticize Zhao and Deng for pursuing price reform and for ignoring inflationary risks. Li Peng conveyed the most direct criticism: "The reason we have to change course is that we have underestimated certain things" (Wu 1997: 538). There was little that Zhao could have said to rebut Li's charges. He did underestimate certain risks associated with price liberalization, partly because the planners had kept their analysis from him. Regardless, the failed price reform was a major blow to Zhao's prestige and to the generalists' attempt to decentralize monetary control.

³ Wang Ruilin had been Deng's trusted bodyguard for many years. In elite Chinese politics, private secretaries and bodyguards often played a much more important role than their rank would suggest because they had the most direct access to the moods and thinking of the top leaders. They were often rewarded with senior positions for their loyal service. Wang Ruilin, for example, entered the Central Military Commission.

To ensure centralization. Chen Yun launched another dual-track attack on Deng, this time targeting his son Deng Pufang, Originally started by Deng's son as a way to raise funds for the China Associations for the Disabled, Kanghua Corporation by 1988 had thoroughly exploited the Deng family name and had transformed into a corrupt business empire (He and Gao 2000: 542; Quan 1994). In the summer of 1988, an anonymous commentator penned an editorial in the *People's Daily*, the party's official mouthpiece, detailing corrupt practices at Kanghua (Quan 1994: 152). This editorial, penned by a State Council official, was obviously aimed at unbalancing Deng. At the September 2 Politburo meeting, a beleaguered Zhao defended Deng's honor by charging that someone who "opposed reform" had been spreading rumors about Deng Xiaoping and other top leaders and that these rumors were groundless. He ended his remarks with an intentional comment: "The problems with Kanghua are not the same as Deng Pufang" (Wu 1997: 540). Although Deng Pufang was never directly implicated, these accusations helped State Council bureaucrats in their main struggle to recentralize financial policies.

After the Politburo made the decision on "correction and rectification," the central planners quickly implemented the retrenchment plan they had prepared in secret. Investment and monetary centralization was a major component of the correction program. On August 30, 1988, the same day that the State Council first announced retrenchment, the PBOC rolled out its decree to freeze all lending, including working capital loans. The language of the decree left little room for ambiguity: "Whoever breaks the quota will take responsibility, and we will hold the managers of banks responsible" (People's Bank of China 1989a). Moreover, this decree pronounced that PBOC lending would be frozen at the level of 1987. Local bank managers who exceeded the credit ceiling would be punished, and they could no longer go to the PBOC for an emergency loan. Although compliance was not immediate, decrees issued by the PBOC and the State Council after the end of August left no doubt that local officials who did not adhere to the credit ceiling would be punished. This time, local officials knew the threat was credible because the Party had issued its full backing of the retrenchment.

Tiananmen

The combination of the panic buying and a potential investigation of his son frustrated Deng's call for high growth once again. Nonetheless, Deng recovered fairly quickly and was ready to loosen retrenchment policies in early 1989. In a private conversation with central leaders in February, Deng played down the economic crisis and pressed for faster reform: "A while back, there were some mistakes, but it was not a big deal. It is not worth such a big fuss... in the long term, the pace of reform cannot be too slow" (Deng 1998c: 436). Rather than simply expressing this view privately, Deng also disclosed his opinion publicly to the Ugandan president in March 1989: "Many countries in the world have higher inflation than us. If the thinking of the people unite, it will not be hard to correct" (Deng 1993a: 289). In the spring National People's Congress (NPC)

session, Zhao Ziyang vetoed a draft of Li Peng's report to the NPC delegates, which discussed the errors in economic policies in the past few years (Deng 2005: 251).⁴ Clearly, the generalists were prepared to revive decentralization.

Before generalists had a chance to revitalize the offensive against the planners, however, the former General Secretary Hu Yaobang suddenly died of a heart attack, triggering massive student protests in Beijing. For the next two months, the central government was completely paralyzed by the political crisis. Ultimately, despite Zhao's opposition, Deng and the other elders decided to use military force to end the standoff at Tiananmen Square. Even before the final bloody crackdown, the ideological debate over the causes of the Tiananmen Square protest began. Although there was an ideological debate between Deng and his ideological rivals, the planners ended up siding with Deng on the ideological debate but exacted a heavy toll from Deng in terms of centralizing the economy and choosing the successor to Zhao. This bargain between them lends further credence to the notion that disagreement over economic management. rather than ideological disputes, constituted the root of the divide between Deng and Chen. If the planners had been driven by ideological concern, they could have simply made a pact with the ideologues to turn the clock back to Mao's days. Instead, they opted to support the continuation of reform, albeit in a more centralized manner. Likewise, the dominant generalist faction trusted the technocrats enough to delegate to them enormous economic powers because it knew the technocrats did not aim to take overall control of the Party. Indeed, at Deng's weakest moment in the aftermath of the Tiananmen Square massacre, Chen Yun's technocratic faction threw its support behind Deng, thereby preserving Deng's dominance in the CCP.

As the student demonstrations intensified in the summer of 1989, Deng's position became increasingly vulnerable to criticism. This vulnerability stemmed first from Zhao's lenient stance toward the students. Twice in one decade, Deng's designated successors proved themselves incapable of defending the dictatorship of the proletariat, which seriously called Deng's credibility into question. What was worse, the demonstrators in Tiananmen Square were protesting some of the direct results of the reform: inflation, corruption, and inequality. This provided conservative Marxists ample ammunition to criticize Deng's reform program.

By the middle of May, the elders had decided to remove Zhao from the post of CCP General Secretary, and the ideological conservatives were increasingly vocal in their denunciation of the reform. Although their criticism was mainly directed at Zhao, they also criticized Deng and the reform indirectly.

⁴ The final version of the speech nonetheless contains an implicit criticism of Zhao and Deng for being "overly optimistic of the economic situation in 1987." See Li, Peng. 1993a. Jianjue guanqie zhili zhengdun he shenhua gaige de fangzhen (Resolutely implement the principles of correction and rectification and reform and opening). In *Shisan da Yilai Zhongyao Wenxian Xuanbian (A Selection of Important Documents Since the 13th Party Congress*), edited by Document Research Center of the CCP CC. Beijing: People's Publisher.

For example, Hu Qiaomu, a veteran ideologue who had plotted the downfall of Hu Yaobang, remarked: "Comrade Zhao Ziyang never flatly championed privatization, but his reforms were always tilted in favor of enterprises that had low degrees of public ownership" (Secretariat of the Fourth Plenum of the CCP Thirtenth Central Committee 2001). Because everyone knew that Deng had supported Zhao's call for developing township-village enterprises on the coast, Hu Qiaomu's comment did not just target Zhao.

With a possible reversal of the reform, Deng soon approached Chen Yun and Li Xiannian to make a pact to preserve the reform. The pact composed of elevating Jiang Zemin to the post of General Secretary, preserving the overall direction of reform, and a three-year retrenchment to "correct and readjust." The pact was apparently made between May 21 and 26, when Deng held a series of private meetings with Chen Yun, Li Xiannian and other revolutionary elders to hammer out the future of the regime (Party Central Office Secretariat 2001c). On May 21, the elders held a preliminary meeting about the successor to Zhao. At the meeting, Li Xiannian and Chen had backed Jiang Zemin, someone with a central bureaucratic pedigree who had dealt with the protests in Shanghai without shedding blood, whereas Deng had supported Li Ruihuan. someone with similar localist disposition as Zhao (Party Central Office Secretariat 2001b). By May 26 – after intense negotiations among Deng, Chen, and the other elders - Chen Yun made a short speech at the Central Advisory Committee stating that everything must be done to preserve the regime "granted to us by 20 million revolutionary martyrs who had forfeited their lives" and that Deng should remain the core of the CCP leadership (Deng 2005: 501). After Chen Yun acknowledged Deng's continual dominance in the Party, Deng reciprocated at a May 27 meeting by switching his vote to support Jiang Zemin and also by agreeing to elevate Song Ping, a veteran planner and Chen loyalist, to the Standing Committee. In return, Chen voiced his support for the continuation of reform and agreed to elevate Li Ruihuan to the Standing Committee of the Politburo (Party Central Office Secretariat 2001c). The pact was announced to the rest of the leadership at the end of May when Deng had a discussion with Li Peng and Yao Yilin, who had not attended the May 27 meeting. In his remarks to Li and Yao, Deng left no doubt as to the nature of his pact with Chen and Li: "the policies of reform and opening remain unchanged.... I've consulted with comrades Li Xiannian and Chen on this, and they both concur" (Party Central Office Secretariat 2001a). Tragically for the students on Tiananmen Square,

⁵ Based on the transcript of the Central Advisory Committee meeting on May 27 in *The Tiananmen Papers*, Deng strongly implied that he had conferred with Li Xiannian and Chen Yun before the meeting. Deng said "Comrades Chen Yun, Xiannian, and I all lean toward Comrade Jiang Zemin for General Secretary." In the *Chen Yun Chronicle*, there was only a record of Chen Yun meeting with Li Xiannian, Peng Zhen, and Wang Zhen on May 23. It is possible that Chen made his wishes known to Li, who then conferred separately with Deng after May 23. In the *Deng Xiaoping Chronicle*, Deng met with Chen Yun, Li Xiannian, Peng Zhen, Yang Shangkun, Wang Zhen, Li Peng, Qiao Shi, Yao Yilin, and Song Ping at his home on May 20 and nominated Jiang.

the pact between Deng and Chen was predicated on decisive military action to suppress the demonstrations.

The other element of the pact, the continuation of centralized control. gradually became apparent in the following days. At a Politburo meeting on June 6, Deng echoed Yao's call for reversing the economic chaos that had been unleashed because of the demonstration (Party Central Office Secretariat 2001d). On June 16, when Deng met with the new Standing Committee for the first time, he urged them to pursue reform, but also stated that "the Party central and the State Council must have the power and the authority in these (economic) affairs" (Party Central Office Secretariat 2001e). In a September 1989 meeting, Deng echoed Chen Yun's criticism of local autonomy, a reversal of his usual sentiment of encouraging local experimentation: "Comrade Chen Yun said that there are too many dukes (zhuhou, local officials), and they talk but do not decide, decide but do not act, and govern on their own. This criticism is correct" (Document Research Center of the CCP CC 2000). The pact was formalized at the Fourth Plenum in November, when the Central Committee passed the "Decision to Further Correct and Rectify and to Deepen Reform" (Central Committee of the Chinese Communist Party 1989). While affirming the goals of reform and opening, the document also called for further central control over the economy, a slower growth rate of 5-6 percent, and a threeyear retrenchment period. In order to preserve the reform and to preserve the political status quo, Deng opted to delegate financial authorities to the central bureaucrats. For the first time since the reform, the bureaucrats had free rein over the economy for a sustained period of time. Deng, however, gave the central bureaucracy barely three years to "correct and readjust."

A New Generation of Central Bureaucrats and the Southern Tour, 1991–1996

The 1989 crackdown inaugurated a three-year retrenchment period in which macroeconomic policies were highly centralized. Total central control over economic policies did not translate to a return to the planned economy era. Rather, the central bureaucracy undertook to reshape the government from micromanagers of the economy to having more macroleverage over the economy. Rather than a giant setback for reform, this important transformation also brought China closer to a fully functioning market economy. Deng, however, remained extremely dissatisfied with the bureaucrats' stifling policies because he saw the effect of a stagnating economy on the Soviet Union. As the crescendo of local complaints increased in 1991 because money supply did not provide sufficient liquidity for the rapidly growing economy, Deng decided to embark on two trips to the South to unlock the center's hold on the economy. He was wildly successful in his effort to unleash high growth, but his trips once again heightened inflationary pressure.

At the same time, the newly appointed General Secretary Jiang Zemin faced increasing threats from an array of potential challengers after Deng's passing.

The succession pressure initially motivated liang to echo Deng's decentralization drive and to channel generous financial resources to his home base Shanghai, and also to politically powerful Guangdong. As inflation climbed into dangerous territory, however, Jiang needed to prevent a slide into financial chaos while maintaining his own tenuous hold on the top post. In 1993, however, the declining health of both Chen Yun and Yao Yilin greatly diminished their ability to rein in inflation. Just as China was poised to enter the realm of hyperinflation, Deng and Chen both agreed to make an unlikely candidate the new economic tsar of China, Zhu Rongji. Although a well-known technocrat by that time, both Deng and Chen struggled in the last years of their lives to make Zhu a credible politician by giving him enormous power that surpassed even the power held by Premier Li Peng. With the rise of Zhu Rongji as a powerful technocrat. Jiang delegated financial authorities to Zhu in order to focus on the task of power consolidation in the regime. Despite the tension between the two leaders over financial and economic policies, they both recognized the need to cooperate in order to consolidate the power of the new leadership in preparation for Deng's passing.

More so than the previous cases, this case shows that the main struggle in financial policies during reform era was not an ideological one or one between status quo and reform. Even during the height of retrenchment in the early 1990s, reform did not stall completely. A different kind of reform, one which involved re-engineering central power, took place. Also, the continuation of the struggle between the two kinds of factions over monetary policies after the passing of the original revolutionary generation suggests that the factional framework presented here can be generalized to the entire reform era, not just to the Deng-Chen era.

Finally, the rise of Zhu Rongji illustrates the mechanism by which Chinese officials fall into either a generalist or a technocratic faction. For most officials, that choice came early in their careers when they entered either provincial government or the central bureaucracy. Their choice of faction was determined by the institutional location of their network of supporters. Because of his unusual career pattern, Zhu Rongji had a choice in 1992 to either side with Deng's drive for decentralization or to establish himself as the next economic tsar of the central government. He chose the latter course because of a political calculation that took into account both his support network and his desire to become the next premier.

Macro-Adjustment Power

The intellectual foundation for re-engineering the central bureaucracy to serve the market economy was formed in the 1980s. In the mid-1980s, while Zhao's economists produced treatises on acceptable inflation, researchers who worked in the traditional economic bureaucracy saw the inflationary cycles as a sign of weakening central power. Early proponents of re-engineering central power included Xue Muqiao, Wu Jinglian, and Liu Hongru. Whereas the former two were macroeconomic specialists at a State Council think-tank, the latter was a

financial specialist, who served as the vice governor of the PBOC in the mid-1980s. According to them, inflation was a product of the center's loss of control over the money supply. Although fiscal decentralization gave local government the incentive to invest and banking decentralization provided the source of funding, the central government still did not have the means to control the overall money supply. Although it retained traditional administrative measures such as the credit plan, they were ineffective toward extrabudgetary investment. Instead, the center needed a modern central bank system with effective means of controlling money supply, such as open market operations, interest rate adjustments, and reserve requirements (Fewsmith 1994; Liu 2000d; Xue 1996). Wu and Liu both trained legions of students, many of whom became important figures in the central bureaucracy in the 1990s.

The language of increasing the macro-adjustment capability of the center began to enter into the centralizers' lexicon shortly before Tiananmen. In a March 1989 speech, Li Peng urged the improvement of "our macro control and adjustment tools and means" (Li 1998). After the Tiananmen crackdown, the Fifth Plenum in November 1989 initiated the re-engineering of central authorities by calling for a stronger, more centralized PBOC, the formation of hundreds of state owned corporations directly under the center's control, and more commercial consideration for state bank lending (The Central Committee of the Chinese Communist Party 1989; Zhang 1991). Although the Fifth Plenum also decided to re-impose price control, some of the measures at the core of the retrenchment program actually brought the Chinese banking sector closer to commercialization. For example, a State Council decree required the PBOC to screen local bank managers to ensure their professional qualification (Wang and Wang 1997). Furthermore, the central bank gained more formal control over money supply when relending authorities were centralized to the Beijing headquarters of the PBOC (People's Bank of China 1989). Instead of opposing reform per se, central bureaucrats were weary of Zhao's method of blind economic and financial decentralization.

In the meantime, however, Deng was fast growing impatient with the "correction" program. In a private conversation with Kissinger in November 1989, where he uttered the famous phrase "whoever wants to turn back the clock will fall from power," Deng also said that "it is correct to strengthen the center's authorities, but this does not mean changing the reform and opening and decentralization of authorities enacted in the past" (Document Research Center of the CCP CC 2004). Unlike in the 1980s, Deng could rely on neither the General Secretary nor the Premier to launch a decentralization drive. Premier Li Peng, who never held a position in local government, obviously had no inclination to help Deng. The new General Secretary Jiang Zemin was made from a different mold than both Zhao and Hu Yaobang. Jiang had spent the bulk of his career up to that point slowly climbing the heavy industrial bureaucracy. After the reform, he became Gu Mu's deputy in the Export/Import Commission of the State Council, where he first had contact with national level leaders. In 1982, Jiang was promoted to head the Ministry of Electronics, where he impressed

Chen Yun with a computer demonstration in 1984 (Gilley 1998: 70). Jiang further bolstered his career when he became the mayor of Shanghai in 1985. In the reform era, a solid career in the industrial bureaucracy augmented by a leadership post in a major city often set the foundation for a rise to the pinnacle of the CCP leadership. Despite his four years of service in Shanghai, Jiang's network of connections with provincial leaders remained limited at that time. Although his new position as General Secretary afforded him ample opportunities to interact with local officials, he still felt obligated to adhere to the centralization line because Chen Yun and Li Xiannian had been the ones who had nominated him, not Deng Xiaoping.

As a result of Jiang's deep roots in the central bureaucracy, Jiang's public speeches stuck closely to the Deng-Chen compromise of staying on the course of reform while centralizing economic policies. For example, his remarks at the September 1991 central work conference diplomatically negotiated between Chen and Deng's lines: "If we only have the center's enthusiasm, we cannot accomplish our goals. If we only have the localities' enthusiasm, key construction projects concerning the overall national economy might be affected, and the macroeconomy might lose control" (Jiang 1998a). If the planners had chosen Jiang to curb Deng's drive to decentralize economic power, they succeeded to a considerable extent. Jiang must have known Deng's preferred policy of high growth and decentralization, but he faithfully adhered to the 1989 pact, not wanting to offend either one of his patrons.

The First Southern Tour and the Rise of Zhu

Constrained by the stranglehold of the planners' dominance, ideological attacks, and a passive General Secretary, Deng had to loosen the planners' grip step by step. Deng first tried badgering the current leadership into implementing more reform and decentralization measures. In a meeting with Jiang Zemin, Yang Shangkun, and Li Peng in December 1990, Deng stressed to the new Secretary General: "don't be afraid of taking risks. We now have a certain strength to take some risks" (Document Research Center of the CCP CC 2004: 1323). Deng also tried to unlock the technocrats' grip on the economy by giving a group of affluent coastal provinces his blessing to revolt against a State Council plan to centralize revenue via the new tax sharing system (fenshuizhi) (Fewsmith 2001: 41). However, it remained difficult to unleash reform momentum, so long as ideological conservatives continued their attacks on the reform. Leftist ideological attacks never threatened the status quo because Deng and Chen, the two dominant players in elite politics, had already agreed in 1989 to preserve the reform that had taken place up to that point. Nonetheless, the planners presumably encouraged leftists to question the reform to keep Deng on his toes. Although Li Ruihuan, a liberal and a Deng loyalist, was put in overall charge of propaganda in 1989, Wang Renzhi, an ideological conservative, controlled the Central Propaganda Department, which ran the day-to-day business of the propaganda apparatus. In that capacity, Wang Renzhi encouraged the People's Daily to publish articles that either implicitly or explicitly attacked the reform (Fewsmith 2001: 35). When Li Ruihuan objected to the publication of these articles, Wang managed to override Li Ruihuan, probably with the help of Chen Yun. In the face of Wang's blockade of the main media outlets, Li Ruihuan had to convene conferences nominally on ideology to promote the Dengist agenda of "seeking development amidst adjustment" (Li 1993b).

In order to go on the offensive, Deng had to first silence the doctrinaires. His first shot against the ideologues was fired from Shanghai on his inspection trip there in early 1991. His offensive took place in Shanghai rather than in Guangdong probably because Guangdong was too closely associated with Zhao's disobedience of the Party. An inspection trip there would have given the leftists more ammunition with which to attack Deng. Shanghai, although it was governed by a liberal cadre – Zhu Rongji – had long been associated with Chen Yun and now Jiang Zemin. The leftists would not have dared to directly attack Shanghai.

In his formal remarks to Shanghai cadres, his criticism of leftist ideologues was relatively mild, saving that they were "not used to" and were "afraid" of the reform (Deng 1998f). After he returned to Beijing, however, a series of editorials, penned by Huangpu Ping – a pseudonym – began to appear in the main newspaper in Shanghai, the Liberation Daily. 6 Unlike Deng's formal speech, these editorials, which turned out to be compilations of Deng's remarks to Shanghai cadres, attacked the leftists directly. The editorials stated that "we must prevent lapsing into certain 'new thought rigidity'" and urged cadres to "abandon any conservative, rigid, and isolated perspectives..." (Ma and Ling 1998: 172). In direct response to leftists who questioned whether the reform had a "surname of 'capitalist' or surname of 'socialist'," the Huangpu Ping editorials accused those who raised this question for "losing a great opportunity" (Ma and Ling 1998: 173). Local officials instantly recognized these articles as Deng's work. Top officials in Guangdong, Tianjin, Hebei, Beijing, and Jiangxi ordered their respective local newspapers to echo the ideas expressed in the editorials (Fewsmith 2001: 46). The central leadership was also not blind to Deng's wishes and responded by approving twenty-one special technical zones around the country to receive preferential policies (State Council 1993a). Although significant, the approval of twenty-one zones paled in comparison to the hundreds of zones that were established subsequent to Deng's Southern Tour in 1992.

Despite rising local frustration with the existing policies, the central strangle-hold on the economy remained largely in place even after Deng's trip. The key to the continual conservatism was Jiang Zemin. Unlike Zhao or Hu, who readily responded to Deng's signals with central meetings and decrees to decentralize investment powers, Jiang continued to toe the line of the 1989 compromise. Strictly speaking, Jiang was not disobeying Deng's wishes. The 1989 compromise preserved the overall course of the reform, and Jiang faithfully repeated this message in all of his remarks. Nonetheless, he stopped well short of urging

⁶ "Huangpu" refers to the river that runs alongside Shanghai and was the symbol of Shanghai, whereas "ping" was the same as the last character of Deng Xiaoping's name.

local leaders to "dare to take some risk and do something unprecedented," as the Huangpu Ping editorials had urged (Ma and Ling 1998: 91). It was difficult for Deng to broadcast political signals about decentralization without Jiang's cooperation because Deng no longer held any formal positions in the Party. Although Li Ruihuan did his best to spread Deng's message, his influence was limited by barriers erected by Wang Renzhong and by his inability to issue direct orders to local leaders, something that only Jiang could do as secretary general.

Although Deng was doubtless frustrated with Jiang, he was pleased with Zhu Rongji, Jiang's successor in Shanghai. Zhu Rongji had hosted Deng's trip to Shanghai and had ordered the local newspaper to publish Deng's editorials. Zhu's background, however, suggests that he would have been on the side of the central planners. Similar to Jiang, Zhu also climbed his way up the central bureaucracy as a cadre in the planning bureaucracy. If anything, Zhu's early career in the State Planning Commission suggests that he had stronger ties with Chen Yun than Jiang did. Despite his meteoric rise at the beginning of his career in the SPC, he became a victim of the Anti-Rightist Movement in 1957. The Central Committee had issued a quota for purging cadres, and Zhu, who had apparently voiced a mild criticism against the SPC, was sent down to the countryside for reeducation. This put his career on hold for the next twenty years (Gao and He 1998). Although many in his cohort were eventually purged during the Cultural Revolution, they all had an additional ten years at the SPC before they were purged. After the Cultural Revolution, many in his cohort and even those younger than him were quickly elevated to the center of power. Although Zhu was recognized as one of the most brilliant technocrats of his generation, his black mark from 1957 only allowed him to return as a section head (chuzhang) at the State Economic Commission, a weaker rival of the State Planning Commission that was more sympathetic to Zhao's coastal development strategy (Gao and He 1998; Zeng 1994). Although he was promoted to the mayoral seat of Shanghai in 1987, he only became an alternate member of the Central Committee at the age of sixty, which meant that he would have ended his career at the ministerial/provincial level at the Fourteenth Party Congress.

Zhu was by no means politically unambitious. Because he knew he lagged behind others in his age group, he had to pursue an unconventional strategy to climb to the top. The one gamble that paid off handsomely was publishing Deng's editorials, which helped Deng send political signals about decentralization through the back channel. Deng might have seen in Zhu a new force in the central leadership to push forward reform and decentralization. After all, Zhu had rallied for Zhao's coastal strategy in the 1980s and had openly disputed the planners' centralization policies in 1990 (Fewsmith 2001: 41). On Deng's return in the spring of 1991, he told Li Peng that Zhu had to be made a vice premier. Li reluctantly agreed but delayed giving Zhu a portfolio at the State Council. He only relented after Deng ordered him to do so through Yang Shangkun (Gao and He 1998: 370). To be fair,

resentment toward Zhu was completely understandable. By becoming a vice premier before the Fourteenth Party Congress, Zhu gained a real chance of entering the Politburo at the Fourteenth Party Congress, a rare three-step jump from an alternate in the Central Committee to the Politburo in one term. Zhu in the end exceeded even that expectation by entering the Standing Committee of the Politburo. His "helicopter" rise doubtless excited much jealousy in the State Council.

Although Deng played a crucial role in Zhu's elevation, Chen Yun also gave his blessing to Zhu's rise. His motivation, however, was less clear at the time. Chen Yun was probably annoyed with Zhu for helping Deng defeat the leftists, which lessened Deng's vulnerability. Nonetheless, Chen Yun might have also calculated that Zhu had the best chance of becoming the next economic tsar of China, replacing Chen himself. Li Peng, a long-time favorite of the planners, had become too politically vulnerable because of his dominant role in Tiananmen. Yao was getting sicker by the day. Among the other vice premiers at the time, Zou Iiahua and Li Tieving were either too incompetent or too unpopular to make viable candidates for the head of the central bureaucracy (He and Gao 2000). Having met Zhu several times in Shanghai, Chen likely knew that Zhu had been a proponent of Wu Iinglian's idea of strengthening the central government's macro-adjustment powers (Yang 2005: 266: Zhao 2005:28). Finally, although Zhu was on the periphery of Chen's coterie, he had a solid career in the central bureaucracy, which translated to a dense network of contacts at the center. Before Zhu's departure for Beijing in May 1991, Chen had a talk with Zhu and gave him the following advice: "Do not just obey your superior; do not just obey the books; only obey reality; take care to exchange, compare, and rethink" (Document Research Center of the CCP CC 2000). The first phrase presumably warned Zhu not to obey Deng's wishes completely. If Chen's endorsement of Zhu was a gamble to find his own replacement, he made the right wager. Likewise, if Deng had elevated Zhu in order to revitalize economic decentralization, he grossly miscalculated.

With Deng's order, Li Peng reluctantly handed Zhu two important portfolios, as head of the State Council's Production Office (*Shengban*) and the State Council Triangular Debt Office. Although complying with Deng's wishes, Li Peng also deliberately gave Zhu two of the most difficult policy portfolios, probably in a bid to set Zhu up for failure. A major problem facing the CCP regime in the early 1990s was mounting losses by the large and medium SOEs. Fierce competition with township-village enterprises for both input and market, high interest rates, and the inherent inefficiency of the SOEs drove SOE losses up by 89 percent in 1990 (Fewsmith 2001: 40; Lin, Cai, and Li 1998; Wedeman 2003: 94). As a result, SOEs' debt to each other, or triangular debt, had ballooned to 300 billion yuan, or a full 16 percent of the GDP in 1991. This enormous debt generated chronic cash shortage within many SOEs, forcing them to survive completely on working capital loans from the state banks. More important, the high level of debt translated to decreasing profit margins for SOEs and less remittance to the central coffer, which reflected badly on the

premier's administrative record. Both Li Peng and Yao Yilin had tried to tackle the problem, but with little success (Gao and He 1998: 331).

Zhu's solution to the triangular debt problem reflected both political and economic savvy. Zhu ordered the state banks to inject loans to the largest debtors and ordered the recipients of these funds to repay debt owed to other state enterprises and so on. By 1992, the state banking system had injected a total of 80 billion yuan to pay off 380 billion in triangular debt, a multiplier effect of 4.75 (Wang 1999: 106). Although this method of dealing with triangular debt had been used before, the scale of this bailout was much larger than the previous ones. The 1986 bailout, for example, was only 5 billion yuan (Liu 1993: 84). The downside of this method was, of course, that SOE liability to banks increased dramatically, which further exposed banks to the dilapidated SOE sector. In 1991 alone, bad debt in the state banking sector increased by 42 percent from 70 billion yuan to 104 billion yuan (Liu 2000d). Politically, Zhu's administrative record now included the grand accomplishment of decreasing the net debt of SOEs by 300 billion yuan. Although Zhu later gained the reputation as the defender of bank autonomy, he in fact established himself as a reliable technocrat at the center by ordering banks to lend to the SOEs. Without firm control over the banking system, it would have been impossible for central bureaucrats to register such impressive administrative accomplishments. For this reason, the central bureaucrats had a disincentive to promote genuine banking commercialization.

The Second Southern Tour and Inflation

If Deng had intended for Zhu to galvanize enthusiasm for decentralization, he would have been sorely disappointed. When he arrived in Beijing, Zhu began to speak the "Beijing dialect" of centralization in earnest. He did little to advance the cause of the local government. Deng once again tried to exhort the timid leadership into more daring action. In a meeting with the central leadership in August 1991, Deng stated emphatically that "while it is correct to emphasize stability, too much emphasis on it would lead one to lose the opportunity" (Deng 1993g: 368). Deng's concern with the slow pace of growth was intimately related to the collapse of the Soviet Union and the rapid rise of the other Asian countries. He told his younger colleagues that "if we do not ensure that the economy jumps to the next stage . . . we will lag behind" (Deng 1993g: 396). His remarks, however, failed to stir the leadership into launching a decentralization campaign, compelling him to go on another Southern Tour at the beginning of 1992 to finally unlock local enthusiasm.

^{7 &}quot;Bad debt" here means completely unrecoverable loans. According to Liu Hongru, "suspended loans" (*guazhang*) increased from 70 billion yuan to 104 billion yuan. Suspended loans are loans deemed to be unrecoverable by the state, which allowed the suspension of interest accrual for these loans. In Western accounting, these loans would be considered lost loans to be written off by bank capital. This suggests that nonperforming loan, a broader concept than lost loans, was considerably higher at that time.

Because of the successful effort to reduce triangular debt and strong export growth, industrial production in 1991 registered growth above 60 percent for all four quarters. As a result, local governments clamored for more policy autonomy and more funds to be made available to firms and infrastructure building (Li and Wu 1992). Sensing the right economic conditions, Deng decided to send an even stronger message of decentralization by visiting the birthplace of the reform, Guangdong Province. In January 1992, Deng took a train down to Shenzhen and Zhuhai before turning north to Wuchang and Shanghai. In those places, Deng unleashed some of the most poignant phrases in the Party's political lexicon to galvanize local officials into pursuing high growth. For example, Deng told officials in Shenzhen that "reform requires greater courage and a willingness to experiment; one cannot be like a woman with bound feet (xiaojiao nuren)" (Deng 1993f). "Woman with bound feet" was a phrase that Mao had used in 1955 to pressure local officials into pursuing rapid collectivization. Although Deng's goal was the opposite of Mao's, he conveyed a similar message urging local officials to be daring and bold. Deng also put the ideological left on the defensive by saving "we must guard against the right, but mainly we must prevent the 'left'" (Deng 1993f). During the tour, he also issued an ultimatum to Jiang Zemin, Li Peng, and perhaps even Zhu Rongji: "Whoever does not support reforms should step down" (Nathan and Gilley 2002: 151). His unmistakable warning to the leadership was that their current state of passive resistance was unacceptable.

Deng's message to the local cadres was not simply a general call for reform and opening, but a specific endorsement of high growth through inflationary financing by local governments. The following remarks, which were later publicized nationally, demonstrate Deng's preference:

If we issue a bit too much currency, or if price fluctuation is a bit too large, or if redundant investment is a bit too serious, we create some waste. But, how should we comprehensively view those five years of high-speed growth? (1984–1988).... In my evaluation, the high speed growth in those five years achieved quite a bit. (Deng 1993f)

Local officials who heard or saw the text of Deng's remarks could not but interpret it as a *carte blanche* to intervene in local financial institutions to generate high growth. These remarks also suggest that despite previous inflationary crises, Deng was willing to accept another bout of inflation to generate growth. His acceptance of inflation remained at a high level. It also shows that Hu Yaobang and Zhao Ziyang's preference for economic policies much more closely coincided with Deng's preference than Jiang's inclination. Political circumstances rather than divergence of economic opinion forced Deng to give up on Hu and Zhao.

Even after such strong language, however, Deng still encountered stiff resistance to his call for reform and decentralization. First, the mass media initially did not report Deng's trip to the south. The Xinhua News Agency only reported that Yang Shangkun had visited Shenzhen and Shanghai (Editors 1993b). The editor of the *People's Daily*, Gao Di, also tried to dilute Deng's message in the

newspaper's editorial (Lam 1995: 179). Li Peng resisted passively by admitting that the period of correction and rectification was over but stressed that growth should still "pay attention to stability" (Fourth Editorial Bureau of the Central Document Research Center 1999).

At this moment, however, Jiang finally realized that his passivity might lead Deng to abandon him in favor of one of his factional rivals. Jiang was especially alarmed by the fact that two of Deng's long-time protégés – Li Ruihuan and Oiao Shi – gave speeches to trumpet the Southern Tour before Jiang had a chance to digest the implications of Deng's remarks on the tour. On January 21 even before Deng had completed his trip in Guangdong – Li Ruihuan, the Deng lovalist who had narrowly lost out to Jiang for the top post, repeated Deng's call for more growth and reform at a national meeting of propaganda chiefs and announced that "...the task of correction and readjustment is basically over" (Li 1993c). Likewise, Qiao Shi, who by then was a Standing Committee member in charge of the entire police and anticorruption apparatus in China, proclaimed at the national law and politics meeting that "as Comrade Deng Xiaoping repeatedly emphasized, economic construction is the center of our work, and all other tasks must obey this center" (Qiao 1993). 8 Making matters worse, Yang Baibing, the ambitious younger brother of Deng's longtime friend Yang Shangkun and the head of the PLA political department, proclaimed that the army would serve as the "protective escort" of Deng's reform line (Gilley 1998: 195).

Confronted with such enthusiastic endorsement of Deng's message by his politically astute rivals, Jiang realized he also had to embrace the high-growth, decentralization agenda, or else face dismissal. At the March 10, 1992, Politburo meeting, when Yang Shangkun openly called for further reform and criticized the left, Jiang joined the bandwagon and made a self criticism about his passivity in the previous year (Fewsmith 2001: 59). Despite some grumbling from Song Ping and Yao Yilin, the Politburo meeting gave full endorsement to Deng's new decentralization effort. The spirit of the meeting was summarized in the Central Committee Document Number Two, which harshly criticized the left and called for "daring experiments" and "speeding up the pace of economic development" (Fourth Editorial Bureau of the Central Document Research Center 1999).

Even after the Politburo had finally endorsed the high-growth agenda, Deng did not let up the pressure. In May, he had another one of Jiang's rivals, Beijing party secretary and Politburo member Chen Xitong, arrange an inspection at the Capital Iron and Steel, where he complained that "(Western capitalist countries) are quite content with 2 to 3 percent growth, but for us 6 percent is not necessarily a good speed" (Deng 1993b). In direct response to Deng's request for faster growth, Jiang declared in a speech at the Central Party School in June that

⁸ An account by an anonymous insider suggests that Deng briefly entertained replacing Jiang and Li Peng with Qiao Shi and Li Ruihuan. The timing of these speeches lends credence to that account. See Nathan, Andrew, and Bruce Gilley. 2002. *China's New Rulers: The Secret Files*. New York: The New York Review of Books, 151.

"...perhaps we can go faster, toward 9 percent or 10 percent as we move forward" (Jiang 1993).9

With the political tide completely turned, the Central Committee began to issue formal decrees to give concrete shape to decentralization. Central Committee Document Four made another thirty cities special zones, along with all the provincial capitals. They would enjoy preferential policies in terms of attracting foreign investment and in launching their own investment projects (Lam 1995: 77). The SEZ Office of the State Council, which had been in hibernation through much of the previous three years, immediately dispatched three teams to coastal cities to work out decentralization measures with the local governments (Peng and Xu 1992). To further free up local initiatives, the Party ordered the State Council and local governments to review all the decrees passed during the correction and rectification period and to abolish all the inappropriate decrees (Peng and Xu 1992). In the meantime, Jiang left his technocratic past behind and began to encourage his followers in the Yangtze River Delta (Shanghai, Jiangsu, Zhejiang) to speed up growth. In June 1992, Jiang chaired a meeting on the development of the Yangtze River Delta where he urged central ministries to decentralize power to the region and his local followers to "take full advantage of the strategic importance" of the region to speed up growth (Jiang 2006c: 208). As Deng and Zhao had done in the early 1980s, Jiang further rallied his followers to support the Pudong SEZ, a bold developmental project launched by Jiang's core followers in Shanghai (Jiang 2006c: 209).

At the grassroots level, the local government heeded the generalists' call for "bold experiment" and found new ways to raise funds for local development. The most common means of raising funds was to form local trust and investment companies that paid higher deposit interest than the state banks. By April 1993, such institutions had absorbed deposits equivalent to 20 percent of the deposits held by state banks, causing a substantial decline in state bank deposits (Chen 2005: 271). In response, state banks had to raise deposit interest rates against PBOC regulations to prevent a serious run on the banks. Other means by which the local government bypassed the credit plan included using the nascent interbank market and false repurchasing agreements to raise long-term capital, rather than short-term liquidity (Pei 1998). Interbank loans used to finance fixed asset investment reached 300 billion yuan in 1993 (Wang 1999). Local governments also moved part of the budgetary fund into extrabudgetary accounts and lent out funds from these accounts to local enterprises (Chen 2005: 277).

As seen in Figure 7.2, Deng's trip and the March Politburo meeting in 1992 rekindled inflationary pressure in China during the second quarter. Unlike the previous inflationary cycles, there was no apparent spike in state bank lending, which had been growing steadily at an annual rate of around 20 percent. But

⁹ The section of Jiang's speech calling for faster growth was eliminated from the Selected Works of Jiang Zemin, which only contains a much shorter passage from the speech than the Selection of Important Documents since the Thirteenth Party Congress.

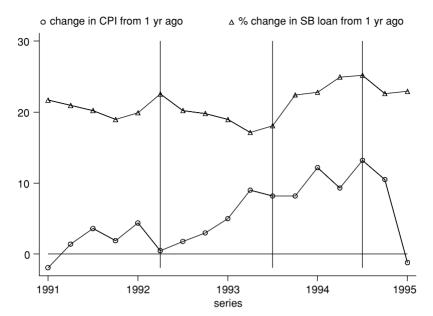


FIGURE 7.2. Percentage Change in Quarterly Lending and Change in Inflation from One Year Ago: 1991–1995. *Source: Quarterly Database*. See Appendix for details. Figures are percentage change in state bank lending and change in inflation from four quarters ago.

the destination of the loans was very different in 1992. In 1991, much of the new increases in loans went to Zhu's triangular debt write-off, whereas new loans in 1992 went toward real estate development in the coastal regions, which tightened the material bottleneck and exacerbated inflationary pressure. Moreover, as mentioned earlier, nonstate financial institutions, including semiofficial trust and investment companies and informal financial institutions, became a significant force in this inflationary cycle and accounted for much of the acceleration in money supply expansion. Although precise statistics on the growth of nonstate financial activities in this period are unavailable, one indirect indicator, the 40 percent growth of cash circulation – more than twice as high as the growth rate in 1991 – suggests a vibrant curb-side financial market.¹⁰

Although inflation remained within reasonable bounds for much of 1992, various State Council think-tanks began to produce reports warning of accelerating inflationary pressure (Liang 1994). A SPC report diplomatically pointed out that the growth of fixed asset investment was only 1.5 percent less than that at the height of the 1988 inflation (Research Team at the SPC Investment Research Center 1992). Yet not much was done to constrain the growth of money supply because the fall Fourteenth Party Congress was to decide important succession issues: whether Jiang Zemin and Li Peng would continue to

¹⁰ Annual Database; see Appendix for detail.

lead the Party and the government and whether Zhu Rongji would be promoted to the Standing Committee. No one dared to "pour cold water" on local enthusiasm for fear of losing their positions. As expected, the Fourteenth Party Congress in October gave another ringing endorsement to local pursuit of high growth. Meanwhile, inflation began to rise and broke through the 10 percent mark during the first quarter in 1993. By the end of 1993, inflation had climbed to over 20 percent, some 10 percent higher than inflation in the previous year (Figure 7.2).

The Making of a New Economic Tsar

Despite Deng's pivotal role in Zhu's promotion to the center, Zhu eventually elected to take over as the head of the technocratic faction partly because he had more resources in the central bureaucracy. Already in early 1992, there was little indication that Zhu led the crusade to lessen central domination in response to the Southern Tour. Nonetheless, Deng continued to support his favorite technocrat. In 1992, Zhu's power was further consolidated when Deng, with Bo Yibo's support, transformed the State Council Production Office into the more permanent State Economic and Trade Office and placed Zhu at the head of it (Gao and He 1998). On Deng's May 1992 inspection trip to the Capital Iron and Steel, Deng further praised Zhu for his technical ability (Fewsmith 2001: 62). Despite opposition by the ideological left of his promotion, Deng's endorsement ensured Zhu's rise to the Standing Committee at the Fourteenth Party Congress. Here, again, Chen Yun's support for Zhu's promotion cannot be underestimated. In Chen's eulogy of Li Xiannian in July 1992, Chen wrote a passage that endorsed Zhu's approach of managing the economy indirectly:

Now the scale of economic construction in our country is much greater and more complicated than before, so many effective measures in the past are no longer appropriate in the new situation of reform and opening. This means we have to work hard to learn new things and ceaselessly solve new problems. (Document Research Center of the CCP CC 2000)

Although Li Peng had also supported the move toward indirect planning, he was certainly not known as a problem-solver. Rather, Zhu's success with the triangular debt problem had established him as the foremost trouble-shooter in the central government. With endorsements from the two most important elders, Zhu was elected to the Standing Committee of the Politburo in October, leaping four steps in the Party hierarchy.

With his election to the highest ruling body in the Party and inflation rising at a rapid pace, Zhu had to make a choice about what type of official he would become. On the one hand, he could obey Deng's wishes and become a cheerleader of local economic growth. On the other hand, he could take the place of the ailing Chen Yun and become China's next economic tsar. Zhu chose the latter course probably out of two important considerations. First, looking forward to the post-Deng era, if he chose to play to the provinces, he would have had to contend with Jiang Zemin, Li Ruihuan, and possibly Qiao Shi

for the support of provincial officials. He already lagged behind them in terms of local support network because Li Ruihuan had been a longtime local official. while Jiang had maneuvered many of his followers to top provincial posts following the Fourteenth Party Congress. At the same time, he had much less competition and many more resources in the central bureaucracy. Although Li Peng still headed the State Council, he was politically vulnerable after his leading role in the highly unpopular Tiananmen Massacre. Of the other vice premiers elected at the Eighth NPC at the beginning of 1993, only Li Langing posed a possible threat to him. More important, if he became the economic tsar, he could easily draw from an established network of central officials who had worked for him previously. When he was elevated to the vice premier position, Zhu recruited former colleagues to work in the Production Office, including former SEC colleagues Zhang Yanning and Zhao Weichen (Gao and He 1998: 332). Zhu also recruited many of Wu Jinglian and Liu Hongru's students to work in senior positions at the State Council, including Zhou Xiaochuan, Lou Jiwei, Wu Xiaoling, and Guo Shuqing (Lam 1995: 342). Wang Zhongyu, Zhu's right-hand man at the Production Office, became the new head of the State Economic and Trade Commission after the Fourteenth Party Congress, giving Zhu direct control over the powerful agency.

The other possible rationale of becoming a centralizer was political ambition. Because the Fourteenth Party Congress had reaffirmed Jiang Zemin as the core of the Party leadership, it was all but certain that he would continue as General Secretary after the Fifteenth Party Congress. On the Party side, Zhu had risen as high as he could have as a member of the Standing Committee. Li Peng, however, had already served one full term as the Premier and had to retire from his post at the Fifteenth Party Congress. If Zhu established himself as an effective central administrator, he could well gather sufficient support for a bid to be the next Premier of China. It would be the ultimate fulfillment of a long and distinguished career in the central bureaucracy. In this case, both motive and opportunity combined to make the path of the top technocrat extremely attractive to Zhu.

Zhu began to reveal his anti-inflationary preference in the spring of 1993. The break came when Li Peng suffered a heart attack and was hospitalized in April, which made Zhu the acting premier. At the end of May, Chen Yun returned to Beijing to coordinate retrenchment one last time (Document Research Center of the CCP CC 2000). With Li Peng in convalescence and Yao Yilin gravely ill, Chen relied on Zhu to carry out the retrenchment. Soon after Chen's return, Zhu Rongji held an emergency meeting on the economy at the Fengtai Hotel in Beijing, where he invited numerous veteran state planners to provide him political support (Brahm 2002: 17). To the astonishment of his audience of central and local officials, Zhu first announced that the current PBOC governor Li Guixian – a Li Peng loyalist – would be removed from his post, replaced by Zhu himself. Second, Zhu issued the "Sixteen Measures" (*shiliu tiao*) to constrain inflationary pressure, anchored by strict limits on fixed asset investment, real estate development, lending, the flow of foreign exchange, and the issuance

TABLE 7.1. Members of Zhu's Faction in the late 1990s^a

Name	Position During Zhu's Tenure	Technocratic Credential
Guo Shuqing	Head of the State Administration of Foreign Exchange	Career mainly in the State Council and the PBOC, served briefly as the vice governor of Guizhou
Wang Zhongyu	General Secretary of the State Council, China's Cabinet	Headed the Production Office and SETC when Zhu was the vice premier
Lou Jiwei	Vice Minister of Finance	Master's degree in quantitative economics from the Chinese Academy of Social Sciences and a series of technocratic posts in the State Council
Dai Xianglong	Governor of the PBOC	Career mainly in the banking sector after a degree in accounting, president of the Bank of Communication, the first joint-stock bank in China
Zhou Xiaochuan	Head of the China Securities Regulatory Commission	Ph.D. in economics from Qinghua University. Served as the head of the State Administration of Foreign Exchange and president of the China Construction Bank
Xu Kuangdi	Mayor of Shanghai/ President of the Chinese Academy of Sciences	Long career as a professor at the Shanghai Polytechnic University
Wu Xiaoling	Vice Governor of the PBOC	Career mainly in the PBOC
Wang Qishan	Executive Vice Governor of Guangdong Province	Long career as a researcher in the State Council and at the PBOC. Served as the president of the China Construction Bank. The son-in-law of Yao Yilin

^a Based on the following sources: Lam (1995), Chen (1998b), and Forney and Yatsko (1998).

of securities (CCP Central Committee and State Council 1999; Li 1994b). The Sixteen Measures also called for a crackdown on illegal financial institutions and the recentralization of relending authorities to the PBOC headquarters (Chen 2000b: 553). Most astonishingly, Zhu ordered bank managers to forcefully recall all "irregular loans" to enterprises and 50 percent of such loans to nonbank financial institutions by August 15, barely two months from the time

¹¹ Relending authorities were centralized in 1989 but were apparently returned to the local PBOC after Deng's Southern Tour. The Sixteen Measures once again centralized them.

of the meeting (Zhu 1999). If Zhu's centralizing tendency had been in doubt, the Fengtai meeting conclusively put these doubts to rest.

With the premier in convalescence, Zhu worked in earnest to stifle inflationary pressure and to centralize China's monetary system. Although Zhu's replacement of Li Guixian as the head of the PBOC reflected a certain amount of enmity between him and Li Peng, Zhu also wanted a firm grasp on money supply in order to assure Chen Yun and Yao Yilin that he was up to the challenge. A clear sign of Zhu's ties with the elder planners was his choice for the vice governors of the PBOC. Zhu elevated Chen Yuan, the son of Chen Yun, to become the executive vice governor of the PBOC and promoted Wang Qishan, the son-in-law of Yao Yilin, to serve as another vice-governor (Gao and He 1998). To the multitude of local officials watching for political signals from the center, these promotions provided clear signs that Zhu had taken over from Chen as the next economic tsar of China. The question now was whether Zhu could become a credible politician who could bring about local compliance.

While Zhu was establishing himself as the head of the technocratic faction, Jiang also adapted to his role as the head of the dominant generalist faction. After Deng's threat of removing him shocked him out of his planners' mold, Jiang began to pay much closer attention to the needs of the local governments, especially given that Li Ruihuan and Qiao Shi stood ready to replace him. Since taking office, Jiang had begun to give more financial authority and central subsides to Shanghai, Jiangsu, Zhejiang, and Jilin, where his close followers headed the provincial leadership (Cotton 1996; Lin 1998). In the spring and summer of 1993, Jiang visited a string of provinces in eastern and western China. Although initially he did not work against Zhu's retrenchment efforts, he also did not stress retrenchment in his remarks to local officials. In his remarks in Xi'an, for example, Jiang began with an extensive praise of Deng's line of rapid reform and development and spent only the last part of his speech mentioning the "contradiction" in the economy (Fourth Editorial Bureau of the Central Document Research Center 1999).

As Zhu's anti-inflation stance hardened in the summer and fall of 1993, however, Jiang began actively to undermine Zhu's effort. Again, pressure from factional rival Li Ruihuan played a crucial part in Jiang's action. In the midst of rising inflation, Li Ruihuan continued to espouse high-speed growth without reservation: "any government unit or individual can only find a legitimate position, serve one's intended role, and demonstrate one's worth by insisting on, obeying, and serving the central task of economic construction" (Li 1999). With this reminder of the dire consequences of deviating from the Dengist line of high growth and decentralization, Jiang subverted the retrenchment in various ways. For one, during the discussion on what to name the Sixteen Measures, State Council technocrats originally suggested calling it a "Decision" (*jueding*), which was the harshest kind of central decree demanding absolute obedience. However, a coalition in the Standing Committee, most likely including Jiang,

vetoed it and suggested a milder "Opinion" (vijian) (Chen 2005: 273). 12 Furthermore, after the issuance of the Sixteen Measures, Jiang vetoed the SPC's proposal of holding a national conference to sternly convey the spirit of the Sixteen Measures to local leaders. Instead of showing the unity of the leadership through a central work conference, as had been the practice in previous inflationary cycles, Jiang opted to chair two separate work conferences in Dalian and Guangzhou so that local cadres could "convey to him what specific policies they would implement" during the retrenchment (Chen 2005: 272). However, the separation of the work conference completely turned the intention of the Sixteen Measures on its head. Like previous austerity plans, the Sixteen Measures contained fairly specific demands with which all local officials were required to comply. Instead of demanding uniform compliance. Jiang used the Sixteen Measures as a means of garnering local support through granting local officials individual exemptions. In September, Jiang further went on a tour of Guangdong and urged cadres to "not lose the opportunity to push forward reform and opening and to sustain high speed growth" (Editors

Given the mixed signals emanating from the central leadership, it was not surprising that the Sixteen Measures were met with stiff local resistance. In July 1993, the State Council sent out seven work teams to determine the amount of irregular loans in twenty provinces and to ensure that local banks were earnestly recalling these loans before the August 15 deadline. However, the work teams had to contend with recalcitrant local officials in many places. In one case, the local government shut down all the banks, causing depositors to stage largescale protests, which forced Zhu to give additional liquidity to the province to preserve social stability (Chen 2005: 277). In other cases, work teams could not find the provincial leadership, who were "out on inspection," which paralyzed the work teams' progress (Chen 2005:277). Furthermore, even after the issuance of the Sixteen Measures, local governments continued to pressure banks for generous loans (Zhu 1999). Strong-arm tactics had allowed Zhu to solve the triangular debt problem quickly in 1991. Nonetheless, Zhu's earlier effort with triangular debt had enjoyed Deng's support; these retrenchment measures were subverted by Jiang. According to the Hong Kong press, the PBOC was only able to collect one-third of all irregular loans by mid-August. Guangdong only recovered 40 percent of the loans, whereas Hainan collected 50 percent (Lam 1995: 123).

Making matters worse for Zhu, mixed signals from the Standing Committee also undermined the resolve of the central bureaucracy to carry out the

The final official name of the Sixteen Measures was "Opinions on the current economic situation and the strengthening of macroeconomic adjustment." According to Chen Jinhua (2005: 273), the head of the SPC at the time, there were three options on the title of the Sixteen Measures: decision (*jueding*), opinion (*yijian*), and notice (*tongzhi*). Zhu almost certainly supported "decision," as he would have wanted his policies to have the greatest effectiveness. Deng followers, including Qiao Shi and Li Ruihuan, most likely supported the mildest option of entitling it a "notice." Jiang either sided with Qiao and Li or opted for the compromise "opinion."

retrenchment. As the head of the SPC at the time put it, "most of all, I was afraid I did not understand the instructions of Deng Xiaoping well enough and might blunder.... I also could not afford to offend the 'dukes' at the local level" (Chen 2005: 265). To the multitude of besieged bankers and technocrats, Zhu could only offer words of encouragement at the July Central Finance Conference: "I know you confront pressure from two sides and criticism from three sides.... I completely understand your situation, and I express my heartfelt well-wishes" (Zhu 1999).

Zhu's retrenchment efforts suffered another major setback in February 1994 when Deng signaled a strong desire to end austerity. On his last tour to the provinces, Deng poignantly revealed this desire to the party secretary of Jiangsu: "When you develop the economy, go as fast as you can. Do not debate whether growth should be fast or slow" (Document Research Center of the CCP CC 2004). Deng likely chose that time to act because Chen Yun's health suffered a serious setback in September of 1993 and had to return to Shanghai for convalescence (Document Research Center of the CCP CC 2000: 445). Although Zhu was able to push through several measures that improved the performance of the banking system at the end of 1993, including the strengthening of the PBOC and the creation of policy banks to take over policy lending, he also was forced to release an extra 100 billion yuan into the state banking system, which generated an additional 260 billion yuan in bank loans (Lam 1995: 126; State Economic System Reform Commission Investigation Team to Liaoning 1994). As Figure 7.2 demonstrates, Deng's remarks accelerated lending and rekindled inflationary pressure for the next several quarters. The events in the fall and winter of 1993 constituted an enormous blow to Zhu's budding credibility. At the Fengtai meeting, Zhu had sternly warned local officials that the state banks could not exceed the revised credit quota, or else face Zhu's wrath (Zhu 1993). Jiang's effort to undermine the Sixteen Measures and Deng's February remarks made his threat completely empty.

The change in policy direction quickly exacerbated inflationary pressure. Although increases in lending had a lag effect on inflation, speculators saw the change in monetary policy as the beginning of another real estate bubble. According to a secret government report, speculators bought up large quantity of steel and construction material during the fourth quarter in 1993 in anticipation of another building boom, which further increased inflationary pressure (Li 1994b). The first quarter of 1994 saw inflation creeping up beyond the 20 percent mark (Wu 1994).

Despite initial setbacks for Zhu's bid to establish himself as a credible politician, 1994 saw Zhu Rongji developing into a powerful figure in his own right, which gradually increased the credibility of the anti-inflationary measures. In March, Zhu was formally designated as the stand-in Premier if Li Peng was absent. This allowed him to attend Central Military Commission meetings and other high level meetings unrelated to economic affairs, giving him access to a wide range of information beyond economic affairs (Ren 1999). Two events in the first half of 1994 provided significant boosts to Zhu's political credibility.

During an inspection tour to Heilongjiang in April, Zhu personally removed Governor Sun Weiben from power for failing to prevent workers' unrest and for his failure to rein in inflation (Jen 1994b). This episode demonstrated Zhu's no nonsense style, but it also signaled to local officials that Zhu was a powerful politician in his own right who could make major decisions on the spot. The second event involved a Hong Kong journalist named Xi Wang who had apparently quoted an anonymous PBOC official about Chinese interest rate policies. On his next trip to China, the State Security Ministry arrested him and kept him in detention without a formal charge for six months. In April 1994, he was sentenced to prison for twelve years for "stealing and probing into state financial secrets" (Leung 1994). According to Hong Kong sources, although the liberal faction within the Party had lobbied for the reporter's release, Zhu personally ordered harsh punishment for him (Leung 1994). Whether this was true or not, this rumor doubtless suggested to local officials Zhu's increasing clout as a politician instead of merely a technocrat.

As Zhu worked to establish his credibility, inflation continued to climb in the first half of 1994, reaching the post-1978 high of 27.5 percent during the third quarter. The emerging financial crisis finally prepared the way for retrenchment. In June, Zhu chaired a Seven-Province Economic Work Conference involving Hubei, Hunan, Anhui, Jiangxi, Hebei, Shandong, and Henan to enforce compliance with a host of policy issues, including monetary control (Ho 1994; Jen 1994a). He might have chosen to crack down on these provinces first because they were not economic powerhouses. If they obeyed central policies, he could then focus his attention on more independent provinces like Guangdong and Jiangsu.

Zhu's full assault on decentralized finance came at the Beidaihe Conference in August 1994. At that time, inflation in some provinces was rapidly climbing past 30 percent, and reports of panic buying began to pour into the central government (Chen 2005: 280; Ren 1994). Beyond the developing crisis, Zhu also took advantage of Jiang's need for political allies at that crucial moment to launch credible retrenchment. We can surmise from subsequent events that Zhu was a member of a pro-Jiang coalition that allowed Jiang to make three crucial maneuvers in the fall of 1994 and in 1995. First, the September fourth plenum granted Jiang the title "the core of the third generation leadership," confirming Jiang's leading role in the Standing Committee, Second, the fourth plenum also saw the promotion of Wu Bangguo and Huang Ju - two officials from Shanghai who had worked closely with both Jiang and Zhu - into the Politburo (Fewsmith 2001: 162). According to the Hong Kong press, these promotions angered officials from the other regions because they clearly showed regional favoritism (Lam 1994). Finally, in the winter of 1994–1995, a corruption investigation was launched against the Beijing city government, which ultimately led to the removal of one of Jiang's main political rivals, Beijing party secretary and Politburo member Chen Xitong (Gilley 1998: 244). Although no one openly opposed the investigation and the eventual arrest, Zhu's uncompromising stance throughout the investigation balanced against those who urged more lenience, which made it easier for Jiang to fully dismantle Chen Xitong's faction and to send a stern warning to his other rivals (Ren 1999: 31).

Although Deng doubtless gave his blessing to all three maneuvers, Jiang nonetheless needed allies in the Politburo Standing Committee (PSC) to ensure all three decisions pass PSC votes. Although Li Peng's fate was tied with Jiang because of his role in Tiananmen and junior Hu Jintao could be counted on to vote for the General Secretary, Li Ruihuan, Qiao Shi, and PLA veteran Liu Huaqing were powerful and independent figures in their own right who could potentially form an anti-Jiang coalition. This left Zhu Rongji the crucial swing vote, which could ensure Jiang's victory. Although Zhu and Jiang had been colleagues in Shanghai, Zhu's rising political authority in 1994 meant that his political support could not be taken for granted and would not have come cheaply. Still, Jiang knew that Zhu did not have the means to challenge him for ultimate power but instead demanded reign over economic policies in exchange for his support.

Thus, similar to the pacts that Deng and Chen had struck in 1978 and again in 1989, Zhu Rongji agreed to support Jiang at this crucial moment in exchange for financial centralization. At the Beidaihe Conference, Zhu made forceful arguments to the other central leaders that harsh retrenchment measures, rather than "soft-landing" policies, were needed to rein in inflation. Despite dangerously high inflation, some at the meeting – most likely either Li Ruihuan or Qiao Shi – still made the Zhaoist argument of "acceptable inflation" (Hsu 1994). With Jiang's support, Zhu ultimately prevailed in the debate, and a group of PBOC technocrats was hurriedly convened at Beidaihe to draft a series of retrenchment measures in late August. In classic planners' fashion, Zhu held PBOC branch managers personally responsible for controlling the expansion of fixed-asset lending and for cracking down on illegal financial institutions (Fourth Editorial Bureau of the Central Document Research Center 1999). Moreover, for the remainder of 1994, working capital loans could only be issued for a few uses specified by the State Council (Xinhua News Agency 1994b).

To ensure disinflation, Zhu resorted to direct administrative controls favored by his predecessors. In early September, Zhu chaired a televised conference on price control and announced stringent measures to control the prices of grain, vegetables, and meats. New measures were implemented to ensure the adequate supply of food at state mandated prices (Fourth Editorial Bureau of the Central Document Research Center 1999). Because Shanghai, Guangdong, and Beijing were known to be the major sources of inflation, Zhu held the party secretaries of these places personally responsible for the adequate supply of cheap food (Ren 1999). Zhu's retrenchment effort was further affirmed at the November 1994 Central Economic Work Conference, where Jiang told cadres that the foremost task in the coming year was inflation control. Instead of the mixed signals sent in the previous year, the leadership presented a unified front against inflation. In the spring of 1995, as anticorruption investigators swooped down on the Beijing municipal government, Zhu's centralization policy finally managed to first flatten and then reduce inflation. It is unclear what Deng thought of

Zhu's retrenchment drive. He probably gave his reluctant endorsement, as he had done several times before. His declining health in the second half of 1994 likely prevented him from doing more. It is clear, however, that the retrenchment drive in 1994, unlike the one in 1993, relied mainly on the political clout of Zhu Rongji and, to a lesser extent, Li Peng. In May 1994, Chen Yun had fallen seriously ill and did not engage in any more policy making before his death in early 1995. Yao was similarly indisposed for much of 1994 and passed away at the end of the year (Document Research Center of the CCP CC 2000: 447). Despite Chen's fast declining health, he was comforted by the fact that Zhu had made a successful transition to become China's next economic tsar. When the leadership went to the hospital to report the successes of the stabilization policies in January 1995, Chen Yun, who by then could no longer speak, expressed approval with "a grateful smile" (Yang 2005: 292).

The Continuation of the Two Tendencies

Whereas the first two inflationary cycles in the reform era mainly involved the interplay between Deng and Chen, the 1987–1990 and the 1991–1996 inflationary cycles saw the emergence of the next generation of leaders playing the roles of financial decentralizers and centralizers. While Zhao – and, to a lesser extent, Jiang – championed local causes and attempted to increase the regime's tolerance for inflation, Zhu took over from Chen in 1994 to maintain central control of monetary policies. Although Zhu's vision of central control was closer to Western notions of monetary policy, his main priority was to uphold central authority and to control inflation, as seen in his willingness to use administrative measures.

That these younger leaders fell into their respective roles could partially be explained by their factional bases. Zhao had a wide network of local supporters by the time he became premier, which made him a natural champion of decentralized finance. Although Jiang showed initial reluctance to galvanize local enthusiasm, Deng's threat to remove him and his expanding network of local supporters soon compelled him to actively support inflationary finance at the local level. On the centralizer's side, Li Peng never worked a day in the local government and became the natural successor to the planners. He filled that role marvelously during the correction and rectification phase. Zhu, in contrast, started out as Deng's designated cheerleader for renewed local enthusiasm. But as a result of political exigencies and his long career in the central bureaucracy, he ended up as China's new economic tsar. Although exogenous political factors played an important role in determining these leaders' preference for financial policies, they also were driven to a significant extent by the preferences of their main support bases. It simply made little sense in the long run to champion policies that went against the interests of one's factional support base.

The most extraordinary aspect of financial politics illustrated by these cases was that all the actors involved were powerful political figures in their own right.

Unlike the usual portrayal of technocrats who were either agents to political principals or "insulated" technocrats operating beyond the pull of politics, technocrats in China were highly politicized. In fact, these cases clearly show that it was precisely their political involvement that allowed them to balance against inflationary tendencies. If Chen Yun had not been able to blackmail Deng over the SEZ issue and with a possible corruption investigation of his son, inflationary pressure would have reached Brazilian proportion in 1988. If Zhu had not been able to provide crucial political support for Jiang's consolidation, Jiang could not have credibly delegated financial authorities to Zhu. In the absence of a politically credible centralizer, China would have experienced much higher inflation.

Elite struggle over monetary centralization, however, did not produce a similar struggle over the status of the state banks. Deng, Zhao, and Jiang all encouraged local officials to intervene in the state banking system to boost local growth. Although the central bureaucracy implemented some policies to modernize the state banking system, the new generation of bureaucrats did not hesitate to use the banking system to solve pressing policy problems. Zhu Rongji first established himself as a capable problem solver by injection 80 billion yuan in bank loans into ailing SOEs. As the next chapter reveals, even after the technocratic faction gained unprecedented power in 1997, it continued to use the banking system to fulfill various policy missions.

The Long Cycle: 1997-2006

The most recent monetary cycle in China persisted for nearly a decade. Despite a seeming lull in monetary fluctuation under Zhu Rongii, the sudden surge of lending and investment in 2002 suggests that monetary cycles are by no means artifacts of the Deng era. Even as China established a series of monetary institutions modeled after Western central banks, politics continued to play an important role in driving monetary outcomes. The central technocrats' prolonged domination over financial policy began in 1997. Unlike previous times when they had gained such control, the cause was an external shock – the Asian Financial Crisis – rather than an internal inflationary crisis. The Asian Financial Crisis gave the Chinese Communist Party (CCP) leadership a rude awakening on the economic front similar to the political shock they had received from the dissolution of the Soviet Union. The crisis, however, was more anticipated than real because foreign exchange control minimized the possibility of capital flight from China. Despite the remoteness of an actual crisis, Zhu Rongii, newly promoted to the position of Premier, mobilized the State Council research apparatus to paint a bleak portrait of the Chinese financial sector in order to centralize financial power. Jiang Zemin, not wanting to risk any instability after Deng's death, abandoned his plans to pursue energetic growth and sanctioned Zhu's centralization policies.

In the aftermath of the Asian Financial Crisis, Jiang continued to face challenges from the army and the security apparatus, which perpetuated his reliance on Zhu for crucial political support. As a result, financial centralization continued uninterrupted under Zhu. These political contingencies conspired to create the longest period of monetary stability in the reform era, despite historically low inflation. However, after Jiang finally managed to consolidate control over the regime, historically low inflation and robust growth created favorable conditions for him to renew monetary decentralization. In order to firm up his legacy in the runup to the Sixteenth Party Congress in 2002, Jiang launched the campaign for "a well-off society," a Dengist drive to stimulate local investment. This campaign exerted the familiar effect of exploding lending

and fixed asset investment, which left the new leadership with a growing economic problem. Much as Deng and Chen had done in the late 1970s, the newly appointed generalist – Hu Jintao – and the newly appointed technocrat – Wen Jiabao – cooperated with each other to establish their authorities and in the process recentralized the financial sector. This final monetary cycle reveals that the political logic first established in the late 1970s continues to exert a familiar effect on monetary policy today.

Contemporary banking policies also serve to illustrate the difficulties of reforming the banking sector in China. The favorable conditions at the beginning of the Zhu administration generated great expectations of significant financial reform. After all, Zhu Rongji was universally heralded as a tough reformer (Chen 1998b; Hajari 1998; Melloan 1998). When he became China's premier, he brought with him a "change team" of financial experts and economists to oversee the financial sector (Chen 1998a). Meanwhile, the Fifteenth Party Congress in the autumn of 1997 finally legitimized the private sector. Furthermore, China's financial elite had by then accepted the superiority of the market economy. Finally, the Asian Financial Crisis compelled the dominant generalist faction headed by General Secretary Jiang Zemin to relinquish control over the financial system. All the pieces for a major financial reform seemed in place.

The broad range of changes made by Zhu at first glance suggests a substantial departure from the past. Yet, as we evaluate the net effect of Zhu's financial policies in hindsight, it is evident that the financial sector was little more market-oriented than when he had first taken office. Although some of his efforts furthered market allocation of capital, other policies pulled China back to the planned economy. Thus, explanations that rely on his reform orientation, the capability of technocrats, or the diffusion of market-oriented ideas cannot satisfactorily account for the lack of significant financial sector reform during his administration; those conditions were all present at the beginning of his administration. According to the factional framework, central discretion over financial resources allows members of the technocratic faction to earn administrative merits through pouring funds toward perceived policy and political problems. This framework predicts policies that tend to maximize short-term improvements even if they create long-term problems. Compared to the outcomes predicted by the other hypotheses, the factional framework's predictions provide a superior fit to the actual policy outcomes in the banking sector.

Crisis and Command: Zhu's Centralization Drive

Although Zhu Rongji's credibility as the new economic tsar had been established in 1994, he continued to guard against local lobbying for decentralized finance and high-speed growth. As the inflation rate declined in 1995 and in

¹ With the exception of one veteran banker, everyone I interviewed, including central government officials, local officials, and bankers, agreed that the market economy was superior to any other economic system.

1996, local criticism against the center's restrictive monetary policies increased. Although Jiang, now the head of the dominant generalist faction, had ceded financial control to Zhu in 1994, he increasingly defended his factional interest by supporting local demand for more funds. Jiang's unwillingness to risk any instability during the crucial succession process, however, prevented him from launching an official campaign to decentralize finance. Rather than waiting for the next decentralization campaign, Zhu used the occasion of the Asian Financial Crisis to further consolidate financial centralization.

The Calculus of Succession

In late 1994, rumors of Deng's illness began to circulate around Beijing. Although Jiang remained the designated successor, his position was far from secure. Despite Chen Xitong's removal, both Qiao Shi and Li Ruihuan remained highly popular Standing Committee members, and in the case of Li Ruihuan, he was much younger than Jiang (Nathan and Gilley 2002). In this highly uncertain atmosphere, Zhu's support continued to be indispensable. As someone personally endorsed by both Deng and Chen Yun and untainted by the Tiananmen Square massacre, Zhu provided more important political support for Jiang than the politically vulnerable Li Peng could. Despite the importance of Zhu in Jiang's political strategy, he was nonetheless trying to strengthen his faction by lavishing subsidies to his regional followers.

Officially, Jiang adhered to the 1994 pact and gave public support to continual retrenchment. At the September 1995 Fifth Plenum, Jiang called for the strengthening of central authorities and castigated local governments for "considering local interest too much" (Jiang 1998b). Unofficially, however, Jiang gave every indication that he was concerned with the interest of his factional followers at the local level. Between 1994 and 1997, Jiang visited Guangdong in three separate occasions, and each time, he made a special point to visit Shenzhen, the first SEZ and a symbol of decentralized finance. Each time that Jiang was there, he called on Shenzhen cadres to continue its bold experiment and to "create new advantages to attain new heights," not a phrase that conjured Zhu's centralization policies (Chen 1995b; Shenzhen Economic Daily 1997; Xinhua News Agency 1994a).

Particularly revealing was Jiang's reaction to Guangdong's request for more financial control at a NPC session in March 1995. At the meeting, Jiang paid special homage to Guangdong by holding a discussion meeting with delegates from Guangdong, a special privilege for the province. When he heard a Guangdong official make the suggestion to "ease the present shortage of funds," the official report recorded that Jiang "nodded in approval and conscientiously jotted down notes" (Guangdong People's Broadcasting Station 1995). This episode reveals that local officials were disgruntled at Zhu's financial centralization drive, which deprived local governments of funds for new investment. Furthermore, the description of Jiang's reaction to the report, if accurate, intimates his sympathy with Guangdong's gripe.

Yet, with Deng increasingly ill and the succession looming, Jiang dared not risk an inflationary crisis by encouraging uncontrolled local lending. The Central Economic Work Conference at the end of 1996 officially announced the continuation of Zhu's retrenchment policies, despite a rapidly falling inflation rate. The official press release of the conference stated unambiguously that "the policy to strengthen and perfect macroeconomic adjustment is completely correct" (Luo, Zhao, and He 1996). The other indication of Jiang's support of Zhu was Zhu's promotion to the post of premier at the Fifteenth Party Congress. Without Jiang's approval, Zhu's final triumph would have been impossible. In the end, Jiang's cautious policies paid off. When Deng passed away in February 1997, inflation was low, providing a stable economic environment for the transition.

Asian Financial Crisis and Zhu's Preemptive Strike

Given his success in continuing retrenchment, why did Zhu seek to further centralize the banking system after the Fifteenth Party Congress? The conventional interpretation at the time was that Zhu implemented further reform as a part of a long-term plan to commercialize the banking sector in China (Chen 1998b; Lardy 1998: 18). The Asian Financial Crisis simply gave the leadership further resolve to do so. Yet, the centerpiece of Zhu's restructuring – financial centralization – had not been under serious discussion until the Asian Financial Crisis. Furthermore, Zhu's financial policies did not have a clear positive impact on the efficiency of the banking sector. Many of his policies in fact turned out to be short-sighted and involved substantial government intervention.

Available evidence suggests that the centralization drive stemmed from Zhu's desire to forestall an inevitable assault on central power triggered by a healthy economy with little inflation. An internal Party document in the spring of 1997 urged local officials to not put any more pressure on the central government to "make the cake bigger" or "give more water to the fish," both metaphors for more local access to funds (Editors 1997). Another government report suggests that local officials were ordering banks to accelerate lending despite the continuation of austerity (Li 1997b). Indeed, government economists admitted in a secret government journal that it was entirely possible that the Fifteenth Party Congress and the return of Hong Kong to China would generate another wave of reckless investment at the local level (Tian 1997). Although Jiang still gave his official support for centralization, local officials might have anticipated a decentralization drive in the near future. After all, it was the chorus of local complaints against retrenchment in 1991 that created the propitious political environment for Deng's tour to the south in 1992. If Zhu had indeed faced this political environment, it would have made sense for him to seek the first opportunity to further consolidate the center's control over the financial sector before the political tide turned. In this scenario, the Asian Financial Crisis provided the perfect opportunity.

Whatever the elite political motives, available evidence strongly suggests that the banking centralization drive of 1997–1998 was the manifestation of another

retrenchment drive initiated by the dominant technocratic faction, rather than the natural culmination of decades of banking reform. First, it was clear that the State Council research apparatus, as it had done in previous crises, played a major role in highlighting the weaknesses in the economy. Zhu's firm control over the State's Council's sprawling research apparatus enabled him to elevate nonperforming loans (NPLs) from an issue debated in the expert community to the top of the regime's agenda. State Council researchers also quickly worked out an optimal strategy for Zhu, the administrative centralization of the banking system, even though few had considered it before the crisis. Moreover, the net effect of these policies was the centralization of financial power, not the commercialization of banks.

In the autumn of 1997, the most dynamic economies neighboring China were toppling one after another even as the Fifteenth Party Congress confirmed Jiang Zemin as Deng's successor. Initially, China seemed completely unaffected. After all, China did not have capital account convertibility and thus did not face the specter of massive capital flight. Published transcripts of the Fifteenth Party Congress indeed made no mention of the Asian Financial Crisis (AFC). Yet, soon afterward, the crisis became an urgent topic of discussion for Chinese leaders behind the scene. At the first plenum – just one week after the Fifteenth Party Congress - Jiang declared that "the prevention and resolution of financial risk is an important and urgent task..." (Zhu 1998d).2 His remarks were by no means insincere. Officials and bankers interviewed uniformly attributed major shifts in banking policies in 1998 to the economic and political crises that unfolded in neighboring countries during the AFC. The central leadership genuinely feared that China would follow Indonesia's path of economic collapse and political chaos.³ As Jiang put it in the November Central Work Conference on Finance, "If our financial system is not stable, it will also affect economic and social stability" (Jiang 2006f: 71). Although the Politburo had reasonable cause for worry, the new premier also played his part in elevating the crisis to the center of the regime's focus, thus greatly facilitating banking centralization.

Although government researchers had long realized that administrative intervention in the banks would produce mounting nonperforming loans (NPLs), only a handful of financial experts were concerned about the issue. As early as the 1980s, veteran central banker Liu Hongru had warned that persistent government intervention in the banks would end in a financial crisis (Liu 2000d). In 1995, an expert at the Central Party School similarly warned that a high NPL ratio had great inflationary potential (Zhou 1995). In several government reports just before the AFC, banking experts cautioned that the government's effort to bankrupt and merge SOEs had created an enormous amount of NPLs for banks because local governments used bankruptcies and restructuring to default on bank loans (Bi 1997; Zhang 1997).

² Zhu quotes Jiang in this speech.

³ Interviews in Beijing: 10/8/00, 10/10/00, 12/13/00, 10/27/00, 4/15/01.

Despite warnings from banking experts throughout the two decades of reform, NPLs had not been an important issue at the top level before the AFC. As earlier chapters document, the government had bailed out the banking sector several times, but the NPL issue never made it to the top of the regime's agenda. Top politicians in both the generalist and technocratic factions neglected the issue even though there had been widespread runs on the banks during both the 1988 inflation and the mid-1990s inflation. During the 1993-1994 retrenchment, Zhu focused on control over the banks and limiting money supply rather than on the NPL problem. In 1996, the PBOC issued the "Lending Communicate" (Daikuan Tongce), which systematically addressed the questions of loan quality, loan classification, and NPLs for the first time (People's Bank of China 1997a). Nonetheless, the political leadership did not raise these issues at all during the Central Economic Work Conference at the end of 1996 (Luo, Zhao, and He 1996). As late as March 1997, the central government had planned to write off only 30 billion yuan in bad debt, a drop in the 3 trillion yuan NPL bucket (State Economic and Trade Commission and People's Bank of China 1997).

Not only was NPL not seen as a top priority, few at the State Council had considered centralizing the banking system administratively by removing the appointment authorities over local bank managers from the local Party committees. Instead, State Council technocrats proposed a series of other policy measures. One group of researchers proposed the establishment of a commission for coordinating investment and lending in order to ensure the efficiency of fixed asset investments (ICBC Research Group on Problems of Enterprise Bankruptcy 1998). Another popular suggestion was to reduce the center's monitoring problem and increase profitability by merging SOEs into large conglomerates along the lines of South Korean *chaebols* (1997a; 1997b; 1997c). Finally, a PBOC researcher urged the government to forgive the interest payments of a substantial portion of NPLs in order to "vitalize" (*gaohuo*) loans (Zhang 1997). Still, no one had proposed the unthinkable: the centralization of banks.

Before these policies could be tested, the AFC transformed the NPL issue from a mere accounting annoyance to a symbol of economic collapse and political instability. About to begin his tenure as premier, Zhu Rongji, along with State Council technocrats, exaggerated the threat posed by the crisis in order to increase the center's financial discretion. Because Zhu had spent the bulk of his career in the central bureaucracy, his faction resembled the one that had been led by Chen Yun, composed mainly of researchers and bureaucrats in the central government (Huang 2000: 139). Thus, he had firm control over

⁴ This researcher did not mean writing off interest payments which is *chongxiao* or *hexiao* in Chinese. Rather, he used the phrase "*mianxi huoben*," or "forgiving interest and livening principals." There is no mentioning of provisioning for the "forgiven" amount of interest.

⁵ Analysts from outside China had made the proposal to centralize the banking system. For example, see Ma, Jun. 1996. Monetary management and intergovernmental relations in China. World Development 24 (1):145–153.

the banking sector through Dai Xianglong, a protégé whom he had promoted rapidly to the head of the PBOC (Zong 2002: 510). He also retained firm control over the State Economic and Trade Commission through Wang Zhongyu and Sheng Huaren. His other followers, including Zhou Xiaochuan, Lou Jiwei, Wang Qishan, Wang Xuebing, Zhu Xiaohua, and Liu Jinbao, all held important positions in securities, banking, and the treasury (Chen 1998a; Lam 2000) Like Chen Yun, the extensive support network gave Zhu extensive research and analytical capabilities.

Zhu's crucial weapon came expectedly from within the banking sector. In the midst of the AFC, a research team at the Industrial and Commercial Bank of China (ICBC) headquarters had been preparing a research report on NPLs and redundant local investment. The report first circulated internally among government technocrats in mid-1997 before the full development of the AFC (Zhan 2000). However, its political significance rapidly increased as Asian economies went under in rapid succession. The report's findings of rampant redundant investment, nonperforming loans, and widespread liquidity problems in banks gave central bureaucrats the perfect device with which to connect what was occurring in the rest of Asia with what could happen in China (ICBC Research Group on Problems of Enterprise Bankruptcy 1998). Moreover, this report blamed China's NPL problem primarily on the local governments and on bad industrial policies made by Zhu's predecessor, Premier Li Peng.

The report was extremely successful in creating a crisis mentality among China's leadership. And to further reinforce this notion, a flood of reports from various State Council research organizations soon followed to tie the crisis with China's NPL problem (Bureau of Economic Prediction of the State Information Center 1998; Er 1999; Guangdong Branch of the PBOC 1998). The First Plenum of the Fifteenth Central Committee in September decided to give Zhu enormous discretion to change the financial system. In October 1997, the Central Committee and the State Council jointly issued the "Notice Concerning Deepening Financial Reform, Rectifying Financial Order, and Preventing Financial Risk (Guanyu shenhua jinrong gaige, zhengdun jinrong jiexu, fangfan jinrong fengxian de tongzhi)." Unlike the ineffective "Lending Communicate" issued one year earlier, this jointly endorsed document sent an unmistakable, authoritative signal about the importance of NPLs and the need for further centralization. In one fell swoop, local branches of the state banks and the PBOC were removed from local Party committees' jurisdiction and placed under the newly formed Central Finance Work Commission; hundreds of locally controlled trust and investment companies and informal private banks were closed: and strict NPL reduction quotas were imposed on the state banks (Heilmann 2005; Zhu 1998c).

To ensure compliance with these stunning announcements, Zhu, who was slated to become premier in the spring of 1998, chaired an emergency Central Finance Conference in November 1997.⁶ The conference had the main theme

⁶ The routine Central Financial Conference had already taken place in January 1997.

of "preventing financial risk" (fangfan jinrong fengxian), which meant dealing with the massive nonperforming loan problem. In his main remarks, Zhu first reminded his audience of central and local government officials that he had gained enormous latitude to make policies because of a putative national crisis. As Chen Yun and Yao Yilin had done numerous times before, Zhu instructed local officials that "if thoughts are unified (sixiang tongyi), then we can speed up work, but if thoughts are not unified, we will see winds of chaos (*luanfeng*)" (Zhu 1998d). Although Jiang attended the meeting and urged banks to continue "financial services to local development...," he nonetheless supported Zhu's drive to "... deepen financial reform, rectify financial order, and prevent and resolve financial crises" (Jiang 2006f: 74). At the December 1997 Central Economic Conference, Zhu again drove home the lesson of the Asian Financial Crisis: "This Southeast Asian financial crisis proves that our measures to prevent and resolve financial risk are timely and correct" (Zhu 1998d). Whereas earlier crises in Latin America were merely discussed among academics and bureaucrats, the AFC became a rallying cry for centralization in China.⁷

As could be expected, provincial officials were outraged by this sudden surge of central power. Zhu attempted to comfort the disgruntled local leaders: "The centralization of monetary authority does not mean that we do not trust local officials. It is just that the center and localities should each divide up our labor accordingly" (Zhu 1998d). Aside from verbal amelioration, Zhu also offered two concessions to the provinces. First, he allowed the provinces to charter more local banks to aid development (Zhu 1998d). This concession, however, was a token gesture, since Zhu had just closed down hundreds of local financial institutions and deprived local governments of control of the state banks. The other concession was a promise to use the new central power to fund the development of western provinces. At the December 1997 Central Economic Conference, he made an explicit political promise to the western provinces "... now that state commercial banks can unify allocation of capital, they are even more flexible than before, so the economic development of the central and western areas will not be affected" (Zhu 1998c). Jiang may have played a role in wrangling this concession from Zhu because he had promised western provinces a significant boost in central financial subsidies (Fourth Editorial Bureau of the Central Document Research Center 1999). Although the crisis gave him enormous leverage, Zhu bolstered support for centralization with a side-payment to the western provinces and possibly to Jiang himself. This again shows Zhu to be a savvy politician, not just a technocrat.

The centralization of the financial system was further confirmed when the ICBC report was published in *Seeking Truth* (*Qiu Shi*), the official publication of the Central Committee, days after Zhu was formally appointed premier in

⁷ Interviews in Beijing: 10/8/00, 10/10/00, 12/13/00.

⁸ In addition to Zhu's speech at the conference, interviewees also revealed that allowing local governments to charter their own banks was a partial concession to the local government. Interviews in Beijing: 2/20/01, 5/14/01.

1998. Since the journal defined the Party line in China, the inclusion of the ICBC report sent a strong signal to local officials about the Party's stance: banks would no longer serve as tools for local development (ICBC Research Group on Problems of Enterprise Bankruptcy 1998). Moreover, the report's condemnation of industrial policies under the Li Peng administration clearly demarcated the new administration from the previous one, though both pursued similar policies toward large SOEs. Indeed, the conclusion drawn in this article was not that China needed to carry out fundamental banking reform but that the central government knew the country's interests better than the local government. In contrast, a 1998 PBOC research report that chastised both central and local governmental intervention remained in the obscurity of internal circulation (Guangdong Branch of the PBOC 1998).

The heart of the centralization drive was the establishment of a vertical Party committee system within the financial system that was immune to the influence of the local Party committees. At the top of this new hierarchy sat the Central Finance Work Commission (CFWC), headed by vice premier Wen Jiabao. By all accounts, this institutional change was finally able to remove local branch banks from the grasp of the local government. Although informal influence and the giving of "face" continued between local officials and bank managers, bank managers were no longer required to respond to the wishes of the local leadership.⁹

The establishment of a Party committee system in the financial industry served as the backbone for a series of other centralization efforts. For one, PBOC provincial offices were abandoned in favor of regional offices that oversaw banking activities in several provinces. This measure was designed to elevate regional PBOC offices above the reach of provincial governments, although its actual effectiveness remains doubtful. 10 Within the Big Four banks, the establishment of a Party committee within each bank meant that their headquarters in Beijing could finally order local branches to do its bidding without local interference. In concert with Zhu's drive to lower the NPL ratio, the Big Four banks also lowered the lending authority of the local branches. Whereas provincial and city level branches had been able to authorize loans over one billion yuan before 1998, bank centralization gave headquarters the sole authority to approve loans even in the 100 million yuan to 300 million yuan range. II Moreover, banks, now armed with the full power to dismiss local managers, instituted the lifetime responsibility system to hold local managers accountable in the event of defaults. Finally, headquarters of state banks offered local branches interest slightly above deposit rate to encourage local branches to pass

⁹ Interviews in Beijing: 10/8/00, 10/10/00, 11/27/00; in Shenyang: 12/25/00; in Dalian: 5/21/01, 5/22/01, 5/23/01; in Fuzhou: 6/8/01.

¹⁰ Local officials and bank managers in Beijing reported that PBOC redistricting served only to confuse jurisdiction in bank monitoring. Others thought that creating PBOC regions was not nearly as important as establishing Party committees within banks. Interviews in Beijing: 10/10/00, 1/3/01; in Dalian: 5/22/01, 5/23/01; in Fuzhou: 6/11/01.

Interviews in Beijing: 10/10/00; in Dalian: 5/22/01, 5/23/01.

deposits up to the headquarters level (Ren 2000). The net effect of these policies was a new autonomy for the financial sector from local influence and the concentration of enormous financial resources at the central level. If combined with market-promoting policies, these changes could have furthered financial reform significantly. Instead, Premier Zhu mainly used heightened central control to achieve short-term policy goals.

The Height of Central Power and Stagnant Banking Reform

The AFC was indeed cause for alarm, although the lesson the Chinese leadership learned from it was unclear. On the one hand, Chinese leaders became even more convinced that capital control should remain in place indefinitely. On the other hand, they had a vague sense that something must be done to rectify the financial system. As his bureaucratic predecessor had done after the 1988 crisis, Zhu framed the AFC in terms of weakening central power and demanded unprecedented levels of centralization. Previous proposals concerning the NPL issue were either abandoned or incorporated into the new campaign for central power. The immense financial power Zhu amassed at the center ultimately did not bring about genuine financial reform in China. Instead, as predicted by the factional framework, short-term fixes were pursued to make the problem seem better in the near term. Zhu' policies toward the nonperforming loan problem and ailing SOEs clearly illustrate this logic. At the same time, market enhancing reform such as interest rate liberalization and the legalization of private banks. which would have substantially improved the efficiency of capital allocation, were vetoed by Zhu (Shih 2007).

Vested with unprecedented control of the banks, Zhu immediately set out to resolve the putative source of the potential crisis – nonperforming loans (NPLs). In order to generate impressive short-term results, Zhu devised a two-pronged strategy. First, he recapitalized banks and set up asset management companies to remove the existing pool of NPLs from the state banks. Second, he centralized the banking system and implemented strict policies to prevent the formation of new NPLs. Had Zhu been a reform-maximizer, his policies could have radically transformed the Chinese banking sector and drastically increased the efficiency of capital allocation in China. Evaluating it after the Zhu administration, his two-pronged strategy primarily deferred the fiscal and inflationary risks of NPLs to the future and concentrated financial resources to the central government.

In order to decrease the massive pool of NPLs in China's financial system and increase capitalization in the banking system, Zhu devised three major policies: recapitalization of the state banks, writing off the NPLs, and transferring the NPLs to asset management companies. In 1998, the central government issued 270 billion yuan of special financial bonds to banks. The government then took this money to recapitalize the same state banks which had bought the bonds. State banks gained enormously from this process as they obtained both good assets in the form of government backed bonds and higher capital ratio from

government injection. Instead of banks bearing the burden of NPLs as a result of state policies, this process also transferred the NPL burden to the government budgetary balance, transforming NPLs from implicit deficit to explicit government debt. Had Zhu allowed further issuance of treasuries to write off NPLs, state banks would have been freed of the "historical burden" caused by past state intervention.

Instead of issuing treasuries to write off nonperforming loans, however, the Ministry of Finance (MOF) continued to set the maximum write-off amount to I percent of all loans outstanding during a given year. This regulation, in place since the early 1990s, was primarily designed to control the amount of NPLs that was reflected on the budget deficit. Banks using too much to write off loans would be unable to hand "profit" over to the Ministry of Finance. Although the government briefly considered a gradual increase of this ratio at the beginning of Zhu's term, it ultimately decided against it in order to minimize explicit national debt (1998).12 What was worse, state banks had little authority over which loans to write off. Writing off loans had become a key component in Zhu's strategy to save SOEs. As such, the State Economic and Trade Commission (SETC) determined where much of the 40-50 billion vuan or so in annual write-off allotment would go. By various accounts, much of the money went to politically connected large SOEs and state corporations or to mergers that involved large SOEs (Bureau of Economic Prediction of the State Information Center 1999a; Bureau of Economic Prediction of the State Information Center 1999b).13

Because existing policy on write-offs only resolved a tiny fraction of the estimated 3.3 trillion yuan in NPLs, the Zhu administration had to devise an alternative policy to reduce NPLs (Chan et al. 2001). ¹⁴ Again, several proposals were put forth. The first proposal was to securitize NPLs into government bonds and directly sell them to the public (1997d). This proposal was eliminated early on, presumably because it required the government to publicize performance of SOEs and to decrease the pool of money going into the stock market. More important, this would have made explicit the government's obligation with respect to the NPLs. Another general policy to decrease NPL was to transform debt to state investment (*daigaitou*). Again, Zhu rejected all the proposals in this category that increased explicit deficit (1997d; Er 1999: 220).

The most promising option within the "daigaitou" category was to set up some kind of financial company to take over the NPLs. Within this rubric, one option was to set up state-owned asset management companies (AMCs) which

¹² Interviews in Beijing: 3/8/01, 4/15/01. This rule was finally abolished in 2003 when the SETC disbanded.

¹³ Interviews in Beijing: 5/14/01; 6/23/01.

¹⁴ This NPL figure represents the approximate mean of estimated NPLs by various groups. While the Chinese government has never admitted that NPL ratio was over 30 percent of all loans outstanding, foreign estimates range between 30 percent to 70 percent of all loans outstanding. A relatively conservative estimate is the one provided by Standard and Poor, which is 3.3 trillion yuan and 50 percent of loans outstanding.

gave either bonds or stocks to the banks in exchange for bad debts. This could clean up the bank's balance sheet without increasing explicit deficit substantially. Soon after becoming premier in 1998, Zhu discarded other options and instead set up state-owned AMCs to take over a massive portfolio of NPLs at face value – to be slowly digested over time. The four AMCs, Xinda, Changcheng, Huarong, and Dongfang, took over NPLs from China Construction Bank, the Agricultural Bank of China, Industrial and Commercial Bank of China, and the Bank of China, respectively. Each AMC received 10 billion yuan in initial capital from the MOF (People's Bank of China, Ministry of Finance, and China Securities Regulatory Commission 2000). On that basis, the four AMCs issued 1.4 trillion yuan in financial bonds to the state banks and used the funds to purchase 1.4 trillion yuan in NPLs from the Big Four banks at face value.

AMCs had a charter of ten years and were tasked with recovering as much of the NPLs as possible through debt-to-equity swap, bankruptcy, auctions to the private sector, and restructuring debt. At the end of the ten-year charter, the MOF would issue bonds or inject government surplus to write off the remaining amount. In this manner, state banks replaced 1.4 trillion yuan in NPLs with 1.4 trillion yuan in MOF backed AMC bonds, thereby getting rid of some two-fifths of the estimated 3.3 trillion yuan in NPLs. ¹⁶ Meanwhile, the MOF did not have to list the 1.4 trillion yuan in special bonds on the official budget, since the MOF merely guaranteed the bonds issued by the AMCs. The AMCs, by contrast, were saddled with 1.4 trillion yuan in NPLs and 1.4 trillion yuan in debt to the state banks. Although AMC officials initially resisted purchasing NPLs at face value, they soon realized that the MOF, rather than the AMCs, was ultimately responsible for the remaining pool of NPLs at the end of the ten-year charter. ¹⁷

In the short run, all the bureaucratic interests, as well as the political interest of Zhu Rongji, gained from the transfer of NPLs to AMCs. The state banks and the PBOC effortlessly swapped NPLs with performing assets backed by the MOF. AMC-issued bonds bore interest rates benchmarked to bonds issued by the policy banks, which provided banks with healthy profits. The Ministry of Finance (MOF) supported this plan because it did not immediately require the MOF to make explicit the treasury's obligation to the public by massively issuing bonds and injecting capital into the banks. Although the MOF would have to deal with the remaining NPLs in ten years, top MOF officials were mainly

^{15 &}quot;At face value" means at the original amount of the loan plus accrued interest. In a market economy, private asset management companies by definition never purchase a NPL at face value because of the high risk profile of a loan that is no longer providing the contracted amount of income stream.

When AMCs were first formed in 1998, the Chinese government only recognized NPLs to be at 20 percent. Since then, it has revised that figure. The 1.4 trillion yuan transferred to the AMCs is around 20 percent of all loans outstanding in 1998.

¹⁷ Interview in Beijing: 5/14/01.

¹⁸ Interview in Beijing: 10/19/00.

interested in providing a short-term solution to the NPL problem, which served to promote their career prospects. ¹⁹ The SETC gained control over the debt-to-equity swap (discussed later), which gave it enormous power to decide the fate of thousands of SOEs. Although technocrats involved in setting up AMCs all realized that the recovery ratio for NPLs was likely to be low (10–20 percent range) and that the treasury would have to write off an enormous amount of NPL in the future, their main objective was to minimize the short-term burden for themselves and for the Zhu administration (Bureau of Economic Prediction of the State Information Center 2000). ²⁰ In fact, the central government found AMCs the ideal policy tool and increased the amount of NPLs transferred to AMCs from the originally planned 400 billion yuan to 1.3 trillion yuan and finally to 1.4 trillion yuan (Chang 2001: 133). In this process, Zhu could claim that he "solved" a major problem while not jeopardizing the short-term fiscal balance of the central government.

In addition to dealing with the existing amount of NPLs, Zhu also implemented a series of measures to slow the creation of new NPLs. The foremost policy was the centralization of the banking system, which bereft local governments of the authority to intervene in major state banks. The hope was to decrease the amount of administrative intervention in state banks, thereby decreasing NPLs. Once the headquarters of each bank gained control over the appointment of local managers, state banks instituted strict responsibility system for managers in the event of a default. The punishment for approving a loan that ended up defaulting ranged from outright firing to wage reduction (Shenyang Branch of the PBOC 1999). In order to bring Chinese accounting more in line with global practice, the PBOC also ordered banks to use the international five-category system to classify loans. Furthermore, the Big Four banks instituted independent credit evaluation that ensured some degree of autonomy for accountants to evaluate the merit of a loan. In addition, new regulations required state investment projects to raise at least 30 percent of the required capital before applying for a bank loan.21 These new regulations reduced the possibility of lapsed interest payment in the short run. Finally, in classic planned economy fashion, Zhu issued annual NPL reduction targets to the major state banks. In 2000, for example, PBOC governor Dai Xianglong ordered the Big Four state banks to lower NPL ratio by 2 to 4 percent annually depending on the quality of their portfolios (Editorial Committee of Great Reference of Economics 2001).

These policies indeed generated impressive results. Government deficit remained at the same level while NPLs worth over 1 trillion yuan was removed from the banks virtually overnight. The central government also reduced intervention by local level rent-seekers. Within the Big Four banks, Western accounting practices were introduced, while managers were held accountable for bad

¹⁹ Interviews in Beijing: 6/23/01, 5/19/10.

²⁰ Interviews in Beijing: 5/14/01, 6/23/01.

²¹ Interviews in Beijing: 6/23/01; in Fuzhou: 6/8/01.

commercial decisions for the first time. Without a doubt, state banks made important strides toward becoming commercial entities. Nevertheless, the primary effects of Zhu's anti-NPL policies were transferring the fiscal pressure of the NPLs to the future and centralizing financial powers. Although official announcements claimed that AMCs would recover 30 percent-50 percent of the NPLs, Western analysts and government experts agreed that the actual cash recovery ratio was likely to be much lower (Bureau of Economic Prediction of the State Information Center 2000; Gilley 2000). 22 Recovering transferred asset in real estate proved to be extremely difficult. According to an internal report, the Hainan Branch of the Changcheng AMC could not locate borrowers of 40 percent of the transferred real estate related loans. For the remaining amount, real estate prices in Hainan had collapsed since the heady days in the early 1990s, allowing AMCs to recover only a small fraction of the transferred real estate assets (Ge 2001). Moreover, although debt-to-equity swaps gave AMCs shares of SOEs, they ultimately needed to find buyers for their SOE shares to repay the interest and principal of the bonds (Zhang, Ji, and Xu 2002). As of the end of 2005, the AMCs have digested over 400 billion yuan in NPLs but have only recovered some 154 billion yuan in cash, or 11 percent of the total (Wang 2005). In order to maintain interest payments on the bonds and to pay for operating expenses, it turned out that the PBOC provided 570 billion yuan in "reloans" to the AMCs (Jiang 2006a). Thus, the AMC project continues to generate liabilities for the government nearing a decade after its inception. It is hard to believe that Zhu had not foreseen the long-term outcome of forming AMCs.

In addition, both the volume of NPLs still in the banking system and the rate of new NPL creation remain unclear. After the transfer of NPLs to AMCs, the government repeatedly revised the remaining NPL ratio. In 1999, PBOC Governor Dai announced that NPL ratio was at 20 percent, suggesting that the transfer of NPLs to AMCs would have basically solved the problem (Holland 1999). In July, 2001, the Bank of China first broke rank with the official line and admitted that NPL ratio at BOC was 28.78 percent, even after the transfer of NPLs (Sito 2001). During a 2002 meeting with international investors, Governor Dai hinted that the NPL ratio among all financial institutions might be as high as 30 percent if calculated by Western accounting standard (Beijing Xin Bang Investment & Consulting Ltd 2002b). Although the massive U.S.\$60 billion (480 billion yuan) injection from China's blooming foreign exchange reserve in 2003 and subsequent transfer of a further 60 billion yuan in NPLs to the AMCs drastically reduced official NPL ratio in the state banking sector. Western analysts continue to suspect that lax monitoring and heated real estate investment in recent years generated enormous amount of new NPLs (Ernst & Young 2006; Shih 2005).

Although the centralization of the banking sector and the NPL resolution program improved some aspects of the previously crumbling banking sector,

²² Interviews in Beijing: 12/13/00; 6/23/01.

Zhu mainly mobilized financial resources to achieve another impressive administrative feat: the rescuing of China's dilapidated state sector. At the First Plenum of the Fifteenth Central Committee and at the December 1997 Central Economic Conference, Zhu articulated his goal to bring China's troubling SOEs "out of difficulties" (*tuokun*) in three years. This was indeed an ambitious goal. Despite repeated efforts to improve SOE performance since the 1990s, the official asset-to-liability ratio for SOEs in 1998 remained at an alarming 65 percent. Moreover, the ratio of SOE short-term loans to working capital was over 100 percent, which meant that SOEs completely relied on bank loans for daily operation. Meanwhile, over 40 percent of SOEs were making losses (Bureau of Economic Prediction of the State Information Center 1999a). Even these mediocre figures were likely the products of imaginative accounting. A 2000 MOF survey discovered that 99 percent of SOEs had falsified their accounts to some extent (Chang 2001).

The concentration of China's enormous financial assets at the center's disposal allowed Zhu to provide impressive, but short-term, solutions to the SOE problem. Zhu's first step was to form a subcommittee on large SOEs under the Central Finance and Economic Leading Group, the highest body of economic policies (Forney and Yatsko 1998). He then implemented a series of policies that mobilized substantial banking resources in the service of large and medium SOEs, including debt-for-equity swaps (*zhaizhuangu*), interest subsidies for technical innovation investment (*jigai lixi butie*), and closed-ended loans (*fengbi daikuan*) (Zhu 1998a). In this process, large SOEs and central ministries gained enormous amounts of financial resources and policy discretion, but it also stalled reforms in the financial sector and created enormous opportunity costs to China's economy.

As discussed earlier, the main strategy by which AMCs converted bad asset into performing asset was debt-for-equity swap, or transforming the debt owed by SOEs to SOE shares. ²³ Instead of deciding which SOEs qualified for debt-for-equity swaps themselves, AMCs received SETC "recommendations" on which SOEs could receive the privilege of the swaps. Because a debt-for-equity swap essentially gave the debtor firm a free pass to default on a loan, the policy created a "long line of Red Flag sedans" (*yilian chuande Hongqi fangche*) filled with local officials in front of the SETC's headquarters at 7:30 every morning (Zhan 2000: 199). In choosing the beneficiaries, the SETC focused on large SOEs and state corporations, as well as SOEs in the pillar industries (Zhan 2000: 203). Moreover, by all accounts, the process of picking beneficiaries was a highly politicized one in which personal connections and factional ties played a substantial role. ²⁴ Politicized or not, the discretion to essentially forgive

²³ In Western bankruptcy cases, debt-to-equity swaps are usually conducted only when the creditor feels certain that it can turn the debtor company into a profitable enterprise. The indebted company in most cases would try to fight the swap because it means giving up ownership and control to an outside party.

²⁴ Interviews in Beijing: 12/4/00, 5/14/01.

debt resided in the central bureaucracy rather than in the local government. Undoubtedly, the SETC's control over this process gave the central bureaucracy and ultimately Zhu Rongji a wealth of political capital in the Politburo.

In addition, the long-established practice of subsidizing technical innovation loans was given a further boost during the Zhu administration. The policy required large and medium SOEs to submit proposals for improving production technology to the SETC. On SETC approval of a given project, the MOF would pay for all bank interest of the approved loan until the completion of the project. In 1998 alone, 10 billion yuan in treasury bond issuance was earmarked for this purpose, which was expected to generate loans amounting to 200 billion yuan (Bureau of Economic Prediction of the State Information Center 1999b). Although banks were under no formal obligation to approve a technical innovation loan, bank managers in reality competed with each other to lend to projects that had been approved by the SETC because these loans were essentially risk-free for them bureaucratically. In other words, even if these loans became nonperforming at some point, the fact that the SETC and the MOF had approved them meant that bankers were not responsible.²⁵ Because of these incentives, banks approved over 90 percent of all loans proposed by the SETC.26

In addition to these forms of subsidies, the State Council also concocted the policy of close-ended loans, which specifically directed credit toward *loss-making* large SOEs. Under this policy, banks were instructed by the SETC to lend to loss-making SOEs that had a production line with reasonable market and profit potential. Presumably, if funds were directed at improving the promising production line rather than at wage arrears or other investment, the SOE would have a better chance of becoming profitable (Bureau of Economic Prediction of the State Information Center 1999b). Although the scope of this policy was limited, banks were nevertheless forced to lend to firms with exceptionally high levels of debt.

In addition to general policies, the State Council occasionally demanded state commercial banks to rescue certain industries. For example, in 1999, banks were ordered to "lend" to qualified loss-making SOEs so that they could repay coal fees to large state coal mines (Bureau of Economic Prediction of the State Information Center 1999b). Similar to the program to "solve" the triangular debt problem in the early 1990s, banks were unlikely to see any return on these loans. Finally, in order to ensure stability in poor regions, the State Council still occasionally ordered commercial banks to make "peace and unity loans" (anding tuanjie daikuan) to pay unemployed workers.²⁷ Although mid-level

²⁵ Interviews in Beijing: 4/15/00, 11/27/00; Shenyang: 12/25/00; Dalian: 4/21/01, 4/22/01; Fuzhou: 6/7/01.

²⁶ Interview in Beijing: 4/6/01.

²⁷ This practice was much more common in previous administrations. Respondents all agreed that direct intervention from the government was on the decline. This was a product of the local government's inability to intervene. Rather than directly pressuring banks for emergency loans, local governments had to request for intervention from the State Council, which was the only

bankers disliked these deliberate policies to help troublesome SOEs, they recognized that senior managers needed to respond to the policy demands of the premier.²⁸

In addition to specific policies, the combination of bank centralization, emphasis on risk prevention, and bias toward large SOEs created an extremely favorable environment for large SOEs and state corporations to obtain bank loans. First, under enormous pressure to maintain growth, banks lent to firms that had minimal risk in the short-run. In addition to SOEs that had received SETC or SPC blessings, SOEs or state corporations that had recently offered their shares publicly were also ideal clients for banks. Because most publicly traded state firms had undergone debt-to-equity swaps, their asset-to-liability ratios were likely low, while their short-term ability to meet interest payments was likely high. Moreover, a publicly traded company also signaled to banks that the SOE enjoyed SETC protection (Chen 2000a). Indeed, an internal decree of the Construction Bank strongly urged its branch banks to lend to listed firms because "... the listing process not only increases the capital of a company and decreases its debt ratio, it also allows the firm to raise a large amount of capital in a short time, which can invigorate our deposit base (Construction Bank of China 1998). In addition to publicly traded SOEs, banks also favored large SOEs, especially those that were on the list of "key point enterprises" (zhongdian give), because, again, lending to them entailed less bureaucratic risk for managers in the event of a default.²⁹

The net effects of these policy biases were startling. During Zhu's tenure, state owned enterprises shed a quarter of its workforce. Yet, state bank loans to the state sector increased from 4.6 trillion yuan (67 percent of GDP) in the first quarter of 1997 to more than 9 trillion yuan at the end of 2003 (77 percent of GDP) (China Statistical Information and Consultancy Service Center 2004). Anecdotal cases further suggest that bank credit was withdrawn from small SOEs and given overwhelmingly to large and medium SOEs at the city level or above. According to a 2000 survey in Hubei, the top three companies in the province, including the Three Gorges Corporation, Huazhong Electricity, and Wugang Steel, received over 17 percent of total commercial loans (Research Team of the PBOC Wuhan Branch 2001). In Chongqing, the eleven key-point industries identified by the SETC received 22 percent of new industrial loans in 2000 (Chongqing Branch of the PBOC 2000).

Despite the end of local government influence, banks instead became an integral part of the center's plan to rescue large SOEs and continued to deprive the vibrant private sector of capital. Premier Zhu compounded the private sector's capital shortage with a ban of private financial institutions which had financed much of the private sector (State Council 1998a). Finally, continual

authority that could approve emergency loans. Interviews in Beijing: 10/8/00, 11/27/00, 1/3/01; Shenyang: 12/26/00.

²⁸ Interview in Beijing: 10/8/00, 10/10/00.

²⁹ Interview in Beijing: 11/27/00; Shenyang: 12/26/00; Dalian: 5/23/01.

government control over interest rates encouraged risk-averse state banks to direct funds toward "safe borrowers," that is, major state owned conglomerates (Xie 2001). In order to maintain strict central control over the financial system, Zhu ignored repeated pleads by both local governments and banking specialists to legalize private banks and to liberalize interest rates (Tsai 2002: 208; Xie 1995).³⁰ As a result of the myriad policy bias against the private sector, state bank loans to the nonstate sector only saw anemic growth from 11 percent to 14 percent of loans outstanding between 1997 and 2003 (China Statistical Information and Consultancy Service Center 2004).³¹

Jiang Reinvigorates Decentralization

In the aftermath of the Asian Financial Crisis, Zhu enjoyed an unprecedented period of financial centralization that surpassed even the correction and rectification period after 1989. With the centralization of the banking sector, Premier Zhu seemingly rendered inflationary cycles an artifact of the past. Indeed, banking centralization in combination with a surplus economy in China produced several years of negative inflation during the Zhu administration. Local governments eager to increase the availability of credit struggled to provide sufficient funds to local enterprises because bank managers were no longer beholden to local leaders. Although institutional changes in the banking sector might have increased the cost of decentralizing financial power for generalist factions, the underlying logic driving inflationary cycles in China remained in place. Although continual political vulnerability delayed Jiang's decentralization drive until the end of his term, the floodgates of China's financial institution once again opened in the runup to the Sixteenth Party Congress in the fall of 2002, causing a rapid increase in the money supply and rising inflationary pressure by the spring of 2004.

The Woes of Centralization: Deflation

In a way, Zhu's banking centralization drive was probably more successful than he had originally hoped. Overnight, local bank branches found themselves serving new masters. Instead of taking orders from the local governments, provincial bank branches now had to adhere to lending limitation from the banks' headquarters, which in turn received their lending quotas and loan-to-deposit ratios from the PBOC. The PBOC itself made monetary policy at the behest of the premier's office. Institutionally, Zhu found himself in almost complete control over Asia's second largest banking sector behind Japan. However, this success also had a downside, especially when the country faced slowing growth, declining prices, struggling SOEs, and sluggish exports in the aftermath of the

³⁰ Interviews in Beijing: 1/3/01; Shenyang: 12/26/00; Dalian: 5/22/01.

³¹ Nonstate short-term lending includes working capital loans to joint-ventures set up by investors from Hong Kong, Taiwan, and Macau (*sanzi*), individual and private enterprises (*geti siying*), as well as township village enterprises (*xiangzhen*).

Asian Financial Crisis. Because local bankers were no longer pressured to lend by local governments, they did not lend any more than was mandated by the PBOC credit plan.

To increase money supply in 1998 and 1999, Zhu ordered the PBOC to increase allowable loan-to-deposits ratios, lower reserve requirements, and lower interest rates. However, because bank branches still had to adhere to strict nonperforming loan reduction targets, they were hardly motivated to increase lending. Growth in money supply fell from 24.8 percent at the beginning of 1997 to 17.4 percent at the beginning of 1998, and it further fell to 14.6 percent by June of 1998. Moreover, the retail price index, which first dipped below 100 in October 1997, fell to 97 in June 1998, signifying a deflation rate of 3 percent (Secretariat of PBOC Monetary Policy Committee 2000a). To prevent a further slide in prices, Zhu was compelled to order banks to increase lending every year between 1998 and 2001 (Dai 2002b; PBOC Monetary Policy Committee 2000d). For the first time since the reform, the credit plan became a floor on how much banks had to lend rather than a ceiling that limited what they could lend. Even with these concerted efforts, bank lending increased by 15 percent in 1998, a much lower figure than in previous years (Secretariat of PBOC Monetary Policy Committee 2000a).

Although Zhu mobilized the centralized banking sector to fight off slow growth and deflation, the chorus of complaints against banks' reluctance to lend (xidai) increased in 1999 (Bureau of Economic Prediction of the State Information Center 1999c). Export, which had grown a sluggish U.S.\$1.1 billion in 1998, lunged ahead and grew by U.S.\$11.1 billion in 1999 (National Bureau of Statistics 2004). Bank lending and money supply (M2), however, grew at a stagnant rate of just over 14 percent, precisely what the PBOC monetary target and credit plan had called for (Secretariat of PBOC Monetary Policy Committee 2000a). Because bankers were punished for new nonperforming loans, they were only eager to provide long-term loans to state-mandated projects and large SOEs, which carried little short-term risks. They became extremely reluctant to finance small and medium local enterprises.

With inflation at a historically low level and with the passing of the AFC, why did Jiang hesitate to launch a decentralization drive? The short answer is simply that Jiang was no Deng. Whereas Deng only relied on the technocrats' political support during two crucial periods – in the late 1970s and after 1989 – Jiang continued to face myriad challenges from within the regime even after the Fifteenth Party Congress. Although Chen Xitong's removal gave him firm control over the party, Jiang continued to struggle with control over the military and the security apparatus. In order to consolidate control over the military, Jiang relied heavily on Zhu to both act as a buffer between Jiang himself and the military and to provide the necessary funds to placate grumblings from the military. Jiang's heavy reliance on Zhu in the 1998–2000 period provided Zhu the leverage with which to delay financial decentralization.

Although Jiang was able to install several officers loyal to him in the Central Military Commission at the Fifteenth Party Congress, the children and followers

of veteran military figures continued to hold important positions in the military (Yang 2004: 117). Not only did these officers passively resist Jiang's authorities. they also ran enormous business empires involved in everything from night clubs to smuggling (Yang 2004: 128). In the summer of 1998, navy cruisers escorting smugglers engaged in a fifty-minute fire-fight with police gunboats in pursuit of smugglers, resulting in scores of injuries on both sides (Inside Mainland China 1998). The leadership was shocked by this event, but Jiang also took this opportunity to clean house in the army. In addition to launching a wideranging crackdown on smuggling along the coast, he also issued an order to ban all military and police units from engaging in business, something he had struggled with unsuccessfully since the early 1990s (Jiang 2006b). In a July emergency meeting on antismuggling attended by senior military officers, Jiang drove home the necessity of civilian leadership of the military: "If you do not obey the center, who are you obeying! If there are those who dare to go their own way and conduct their own affairs, they will have to bear all responsibilities on their own – just don't be surprised!" (Jiang 2006d: 168). Compared to the perfunctory speeches typical at party meetings, Jiang revealed the depth of his frustration with army unruliness at this meeting: "Today, I do not have a smile on my face. I am worried, and my patience is running low. So my remarks were a bit emotional. Some remarks were also very sharp, which may have shocked some of you" (Jiang 2006d).

After the meeting, the central government sent teams of investigators to trouble spots along the coast to crack down on smuggling rings and to arrest local and People's Liberation Army (PLA) officials involved in illegal activities. Instead of appointing Wei Jianxing – Standing Committee member and head of the CDIC - to lead the main investigation effort, Jiang put Zhu Rongji in charge of the frontline antismuggling operation. Jiang chose Zhu instead of Wei presumably because Wei was the protégé of Jiang's recently retired rival Qiao Shi (Lam 1999: 24). Additionally, Zhu also had an interest to see an end to smuggling because such activities took billions away from the central treasury, a main resource of the central technocrats. In October 1998, Zhu, along with his technocratic protégé Wu Yi, led a eighty-member investigation team to oversee the dismantling of massive smuggling rings based in Zhanjiang and Shantou in Guangdong Province (Office of Striking on Smuggling and Overall Rectification in Guangdong 2006; Yang 2004: 118). Jiang also took this opportunity to thoroughly undo the business empire operated by the "Guangdong Gang" children and protégés of Marshal Ye Jianying who had gained great autonomy by playing Jiang against his rival Li Ruihuan (Gao 1999: 12). Again, Zhu sent one of his protégés, PBOC vice-governor Wang Qishan – also Yao Yilin's sonin-law – to dismantle financial institutions controlled by the Guangdong faction (Brahm 2002: 78).

Although Zhu's prestige suffered in 1999 as a result of the failed WTO negotiations, Jiang continued to rely on him to oversee antismuggling operations (Fewsmith 2001: 208). In the spring of 1999, the central government decided to shut down a well-known smuggling operation based in Fujian Province that

had smuggled goods worth some U.S.\$10 billion (Pomfret 2000). By the mid-1990s, the Yuanhua Group had become an "independent kingdom" in the city of Xiamen through having thousands of local and central officials and military officers on its payroll (Straits Times 2000). Again, instead of Wei Jianxing, Jiang had Zhu and the vice director of the CDIC Liu Liying spearhead the investigations (Fewsmith 2001: 226). Why? One reason of course was that Zhu had a reputation for having an uncompromising stance against corruption. Yet, another reason may be that Jiang needed to ensure that the investigation – useful as it was in demolishing a major smuggling operation related to the PLA – would not jeopardize the career of Jiang's own protégé Jia Qinglin, who had served as Fujian governor in the mid-1990s and was then the party secretary of Beijing.

The Yuanhua case turned out to be a smashing success for Jiang's consolidation of power over the army and the police. It led to the arrests of Ii Shengde. the head of the PLA Military Intelligence, and Li Jizhou, vice minister of public security and the head of the National Anti-Smuggling Task Force, as well as hundreds of local customs, police, and administrative officials (Straits Times 2000). However, it was also widely believed that Jia Qinglin's wife and possibly Iia himself were on the Yuanhua payroll because Iia's wife had been in charge of foreign trade in Fujian during the height of Yuanhua's influence (Straits Times 2000). Despite the cloud of suspicion, Jiang went on an inspection tour of Beijing and held Jia's hand in solidarity in front of millions of television viewers, and Jia's wife also appeared on television declaring her "happy" state of mind (Fewsmith 2001: 226). After these appearances, rumors of Jia's removal or his forced divorce from his wife dissipated, and Iia was promoted to the Standing Committee at the Sixteenth Party Congress. Although Jia survived mainly because of Jiang's dominating influence in the regime, Zhu also did not press the case against Jia very hard. Had Wei Jianxing been in charge of the investigations, he may have pressed the case much harder in order to diminish Jiang's influence in the runup to the Sixteenth Party Congress.

In addition to cracking down on smuggling, Zhu also served as the lead negotiator with the PLA over compensation for divesting army businesses. Even officers loyal to Jiang only agreed to the massive divestiture of PLA businesses on condition of generous increases in the military budget (Mulvenon 2001). Likely with Jiang's support, Zhu succeeded in giving the military only modest enlargement in spending in exchange for the divestiture (Mulvenon 2001). Furthermore, Zhu handled the transfer of PLA businesses to civilian control through the SETC, Zhu's bureaucratic powerbase (Mulvenon 2001). By the end of 1998, local and central economic and trade offices had handled the transfer of over 200 billion yuan in PLA assets, and more were transferred in 1999 (Yang 2004: 137). This made the SETC an even more powerful agency, which undoubtedly provided Zhu with additional political capital.

Because of Zhu's crucial role in Jiang's effort to dominate the army, centralized finance continued into the new millennium. Nonetheless, Zhu was under increasing pressure to raise sluggish growth rate and to enhance SOE

profitability. Instead of decentralization, Zhu used even more top-down measures to affect the policy of "two prevents, one encourage" (*liangfang yisu*): prevent financial risk, prevent deflation, and encourage economic growth (Secretariat of PBOC Monetary Policy Committee 2000c). First, the PBOC issued decrees in 1999 ordering banks to raise lending to small and medium enterprises, the main victims of recent banking policies (Secretariat of PBOC Monetary Policy Committee 2000b). Furthermore, the PBOC released a controlled amount of relending funds to rural credit cooperatives to bolster rural lending (Secretariat of PBOC Monetary Policy Committee 2000c). The central government also increased liquidity in the economy through massive spending financed by bond issuances, which banks eagerly bought at no risk in lieu of making loans (Dai 2002b). Despite these measures, lending in 2000 and 2001 still saw some of the slowest growth rates since the reform (Figure 8.1).³²

A "Well-Off Society"

By 2002, however, Jiang Zemin had fully consolidated his power and was growing impatient with Zhu's strict monetary policy, especially given that the Sixteenth Party Congress was on the horizon. Because Jiang was slated for retirement in the fall Sixteenth Party Congress, he hoped for a faster pace of growth in 2002 and 2003 to seal his legacy and to ensure top positions for his followers after the congress. At the end of January 2002, Jiang used his "inspection" of Beijing as an opportunity to unleash some familiar phrases from the Dengist arsenal: "Beijing completely has the conditions to develop faster and better. I hope that Beijing grasp the opportunity, face the new challenge..." (People's Daily 2002). He also introduced the phrase "a well-off society" (xiaokang shehui) into the party's lexicon as the official slogan of the upcoming party congress.

Jiang's hand was further strengthened by the January 2002 removal of Zhu protégé and Construction Bank president Wang Xuebing on charges of corruption (Pottinger 2002). Although Wang's removal was triggered by an investigation by the U.S. Treasury Department, Jiang used this occasion to press his advantage. At the February 2002 Central Finance Conference, Zhu was forced to engage in a lengthy criticism of Wang Xuebing, which was tantamount to a self-criticism (Beijing Xin Bang Investment & Consulting Ltd 2002c). In the meantime, Jiang set about dismantling five years of centralized finance. Jiang began his remarks at the Central Finance Conference with Dengist exhortations: "In the new century, our country is entering a new developmental stage of comprehensively constructing a well-off society and speeding up of socialist modernization" (Jiang 2006e). Although paying lip-service to vigilance against financial risks, Jiang argued that the mutual dependence between banks and firms should motivate banks to lend more freely: "Only when banks fully demonstrate their financial role and increase their support of enterprises and economic development can they increase the efficiency of enterprises and improve their ability

³² Source: Quarterly database. See the Appendix.

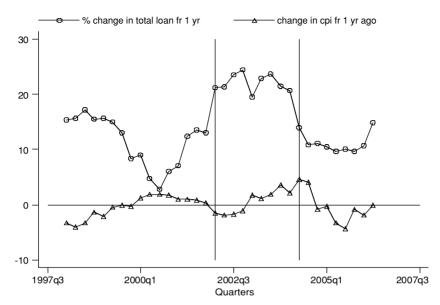


FIGURE 8.1. Percentage Change in Quarterly Lending and Change in Inflation from One Year Ago: 1997–2006. *Source: Quarterly Database*; see Appendix for detail. Unlike similar graphs in previous chapters, this graph plots total loans rather than just state bank loans. The PBOC stopped reporting loans outstanding for state banks in 2002.

to repay loans... only in this way can we realize sustained economic growth" (Jiang 2006e). As the first vertical line in Figure 8.1 reveals, this speech had an immediate effect, as growth in bank loans jumped to above 20 percent by the end of the first quarter in 2002 – the first time it had done so since the mid-1990s.

On May 31, Jiang further articulated the "well-off society" line in a speech at the Central Party School: "Development needs new thinking; reform needs new breakthroughs, and opening needs new situation" (Editors 2002). Because the students at the Central Party School were all rising political stars in various provinces and ministries, words of Jiang's speech quickly spread. Local governments in many regions immediately gathered local banking officials and urged them to "regard development as a first priority" with NPL prevention presumably a second priority (Financial Times 2002a; 2002e). PBOC technocrats also realized the political significance of the speech. Days after Jiang's speech, PBOC regional branches in Shenyang, Jinan, Wuhan, and Xi'an ordered banks within their jurisdictions to heed Jiang's speech and to simplify lending procedures (Financial Times 2002d).

As the Sixteenth Party Congress approached, local governments began to reestablish channels of communication with and policy influence over local financial institutions with the formation of financial offices (*jinrongban*). Financial offices, which were spearheaded by Shanghai and Beijing in late 1999, initially aimed at helping the local PBOC and state bank branches to limit

nonperforming loans and to enforce repayment from debtors (Wang and Wang 2003). These offices were led by the vice mayor or vice governor in charge of finance and held regular meetings with local state bankers and PBOC officials. As the political atmosphere shifted, these financial offices, which spread rapidly in 2002 and 2003, quickly evolved into forums for pressuring banks to lend to local enterprises and projects (Economic Observation News 2003). The Hebei Financial and Securities Office, for example, explicitly told banks to "change their attitude and fully support the development of small and medium enterprises and support the objective needs of local development" (Office of the Hebei Financial Securities Work Leading Group 2003). The Yueyang City Financial Office in Hunan hand-picked some forty enterprises and presented them to local state bank branches at a bank-business conference. Within two days, these enterprises signed over 400 million yuan in loan agreements with banks (Financial Times 2002c, 2003).

The November 2002 Sixteenth Party Congress fully endorsed the drive toward building a "well-off society" as the main goal of the party. Zhu Rongji, who had successfully maintained centralized financial control since 1995, ended his career with investment and lending slipping out of central control. Although the Sixteenth Party Congress saw the retirement of Jiang Zemin from the President and the Party Secretary General positions, Jiang continued to hold the powerful chairmanship of the Central Military Commission, and his core followers, including Huang Ju, Jia Qinglin, Wu Bangguo, and Zeng Qinghong, gained entries into the Standing Committee. Thus, local officials felt confident about accelerating economic growth. The developmental euphoria even pervaded central ministries. Ministry of Transportation, for example, originally had a highway construction target of 80,000 kilometers by 2020, but after the Sixteenth Party Congress, it almost doubled the target to 150,000 kilometers by 2020 (Beijing Xin Bang Investment & Consulting Ltd 2002a).

More surprisingly, even bank regulators and bankers who had focused on trimming bad debt just months earlier fully supported using financial institutions to aid local economic development. This once again demonstrates that local officials and central technocrats alike responded to the same elite political signals. Two days after the Sixteenth Party Congress, the Central Finance Work Commission (CFWC), the backbone of Zhu's banking centralization, sent out an announcement urging bankers to "guarantee that the financial sector will support the construction of the well-off society" (Central Finance Work Commission 2002). Whereas the CFWC is a party organization, even technocrats speaking at specialized financial meetings counseled bankers to increase lending to support growth (Financial Times 2002b).

When Wen Jiabao – Zhu's right-hand man who had overseen the financial sector – succeeded Zhu in 2003, the "well-off society" drive was beginning to exert a familiar effect on the economy. Both money supply (M2) and total lending had year-to-year growth of above 20 percent by the end of 2002, whereas the year-to-year growth of lending had been less than 15 percent previously (Figure 8.1). This rate of increase was sustained throughout 2003 (Figure 8.1).

Meanwhile, growth in fixed asset investment reached a ten-year high of 31 percent in the first half of 2003 (Xu and Xiao 2003). As in the early 1990s, the skylines of Chinese cities were quickly covered by building cranes, and new industrial parks, entertainment centers, shopping malls, and luxury apartments sprouted up overnight. Investment rocketed ahead despite the fact that severe acute respiratory syndrome (SARS) had spread to several major cities in China in the spring of 2003, stifling consumption and investment. Both Chinese and Western financial experts agreed that had it not been for SARS, money supply and lending would have expanded even more (Cheng and Liu 2003; Kyne and Wonacott 2003; Reuters 2003).

Because of SARS and because of China's surplus economy, inflation did not increase rapidly, although it reached its highest level for several years (Figure 8.1). In the spring of 2003, the PBOC carried out a few mild maneuvers to slow the growth of money supply, including raising reserve requirement by 1 percent and selling central-bank bills. In December, the PBOC further increased the interest rate for banks' excess reserve, again another minor adjustment (People's Bank of China 2004). Although the PBOC has moved toward more moderate adjustments as opposed to the major crackdowns of the previous inflationary cycles, the gentleness of these adjustments also reflected the lack of political will to slow lending and investment. Lending continued to grow at a rate above 20 percent into 2004.

Politics and Retrenchment

For 2004, the PBOC had optimistically hoped for a money supply growth rate of 17 percent and lending increase of 15.3 percent (People's Bank of China 2004). However, the first quarter in 2004 saw money supply growth of 19 percent, while lending grew by 21 percent. The fastest loan expansion took place in Jiangsu, Zhejiang, Guangdong, Shanghai, and Shandong, most of which were provinces governed by Jiang followers. In sectoral terms, investment grew especially fast in steel, automobile, and real estate (People's Bank of China 2004).³³ With unprecedented monetary expansion, why couldn't the central bureaucracy mobilize another monetary retrenchment?

The first and foremost reason was that inflation did not climb to alarming levels, nor was there any crisis on the horizon. Unlike the previous monetary cycles, inflation only rose to 2.8 percent at the end of the first quarter in 2004. At the same time, the rapid expansion of Chinese export lifted both growth and the foreign exchange reserve. However, this low inflation rate belied a torrential increase in fixed asset investment and reckless lending. Politically, another reason for a hesitant response to the rapid rise in money supply was an elite division over the proper monetary policy. Jiang's faction of mostly local officials did not wish to see a sudden contraction in money supply, whereas

³³ With the ironic exception of Jiangsu, Jiang's native province, Zhejiang, Shandong, and Guang-dong were all led by reputed Jiang followers, Xi Jinping, Zhang Gaoli, and Zhang Dejiang, respectively.

the central bureaucrats under Premier Wen Jiabao wanted tougher measures toward lending. The new Party Secretary General Hu Jintao also sided with Wen because local governments, particularly on the prosperous east coast, were still dominated by Jiang followers. All of this came to a head when Secretary General Hu Jintao and Premier Wen Jiabao finally mobilized a part of the central bureaucracy to crack down on lending in the eastern provinces, although their efforts were stymied by recalcitrant local officials and factional rivals in the central government.

In the summer of 2003, the new Hu Jintao-Wen Jiabao leadership attempted to leverage the popularity the new leadership had gained from successfully handling the SARS crisis to deal an early blow to the Shanghai Gang, composed of Jiang followers. However, the probe into Shanghai real estate tycoon Zhou Zhengyi, who reputedly had close connections with both past and present Shanghai officials, ground to a halt when Jiang appointed Vice Premier and former Shanghai Party Secretary Huang Ju as the leader of the investigations (Lam 2004a). Because of the failure of this early attempt at undoing the Shanghai gang, investment continued unimpeded. At the March 2004 National People's Congress meeting, Jiang Zemin, Vice Premier Huang Ju, and the serving Shanghai party secretary Chen Liangyu held a meeting where Jiang urged Shanghai officials to "continually improve the livelihood of the people ... and effectively promote development, which is the first task of a ruling party" (Ding 2004). Huang Ju, who was then the vice premier in charge of finance, also endorsed this view to a group of Guizhou officials: "Grasp the opportunity, use the opportunity, and speed up the pace of development" (Xinhua News Agency 2004a). In contrast, Premier Wen – echoing Chen Yun's cautious attitude – urged a group of Jiangsu officials to: "...start from reality, conduct affairs according to objective laws, combine enthusiasm to move forward with a knowledge of one's actual strength, and do not blindly compare oneself with others..." (Xinhua News Agency 2004a).

With April lending and investment still growing at a fast pace and inflation slowly creeping upward, Premier Wen Jiabao decided to copy a political maneuver from his predecessor; he made an example of several local leaders. The target of this exercise was Tieben Steel in Changzhou City in Jiangsu, just a few miles from Jiang Zemin's birthplace. City governments in Changzhou and Yangzhong had approved Tieben's proposed steel foundry, which required over 10 billion yuan in investment and some 6,541 mou (around 1,000 acres) of land.³⁴ A project of this size required approval from the National Development and Reform Commission (NDRC) – the offspring of SPC – as well as the Ministry of Land and Resources, but the city governments approved the project on their own (People's Daily 2004). After a Politburo meeting in which excessive investment had been the main topic of discussion, Wen launched a well-publicized investigation into this affair and punished a sleuth of city

³⁴ Instead of applying for a single 10 billion yuan project, the city governments applied for sixteen separate projects for the same foundry to get speedy approval.

and local banking officials (Xinhua News Agency 2004b). The investigation revealed that local branches of the state banks lent over 4 billion yuan to this project under heavy pressure from the local government (Wu 2004).

In concert with the Tieben crackdown, the Central Banking Regulatory Commission (CBRC), an agency controlled by Wen loyalist Yan Haiwang, issued a circular ordering banks to suspend lending in the runup to the May First holiday in order to limit investment and inflation in April. However, the elite consensus on retrenchment was tenuous. Within two days of issuing these instructions, the CBRC backtracked and claimed that the order was merely a "guidance" for banks to slow lending (Wonacott 2004). Despite elite level disputes, Wen's Tieben crackdown managed to bring year-to-year growth in lending back to below the 20 percent level by the third quarter of 2004.

The Shanghai faction, however, did not give up so easily, especially when inflation remained at historically low levels. At a July 2004 Politburo meeting, Shanghai party secretary Chen Liangyu openly disputed Wen's retrenchment policies, arguing that they would slow growth in eastern China (Lam 2004b: Wang 2004). Presumably with the backing of Jiang and Vice Premier Huang Iu. Chen went as far as to warn Wen that he would bear "political responsibility" for slowing growth with retrenchment policies (Fong 2004). Although investment and lending slowed in 2005, the lack of clear elite consensus on monetary policy saw the renewal of high speed investment at the beginning of 2006. Although lending grew at 18 percent, fixed asset investment grew by 30 percent for the first half of 2006. In Jilin, Anhui, and Henan, growth in urban fixed asset investment registered an astonishing 50-plus percent growth rates in the same period (Liu 2006). The mild monetary adjustments during the first half of the year, including increases in interest rates and reserve requirement, clearly failed to slow the torrential growth in investment. On July 25, Premier Wen held a State Council meeting, at which he announced a series of policy changes to restrict real estate investment (Xinhua News Agency 2006a). At the beginning of August, the NDRC ordered a halt of all investment projects above 100 million yuan if they violated existing regulations (China Commercial Times 2006).

As with the Deng-Chen alliance in the late 1970s, the intersecting political interests of the emerging generalist faction headed by Hu Jintao and the technocrats led by Wen allowed them to cooperate in a retrenchment campaign in 2006. For Hu Jintao, he sought to remove the residual influence of his predecessor in the runup to the 2007 Seventeenth Party Congress. Meanwhile, Premier Wen aimed at regaining central control over money supply and investment. The tactic they agreed on was a familiar one: an anticorruption sweep. Fully aware that real estate development was a great source of corruption, the Hu-Wen alliance first made an example of a few vice provincial level officials, including Vice Governor He Minxu of Anhui, Tianjin's lead procurator Li Baojin, and Vice Mayor Liu Zhihua of Beijing. All of them were accused of taking bribes in exchange for securing land for real estate developers. In August 2006, Wen Jiabao also ordered the governor of Inner Mongolia, Yang Jing,

to write a self-criticism for allowing the completion of a banned power plant (Xinhua News Agency 2006b).

These disciplinary actions turned out to be mere preamble to the main crackdown: the unraveling of a web of corruption centered in Shanghai, the powerbase of the Jiang faction. In July 2006, a team of CDIC investigators descended on Shanghai and quickly arrested the chief of the Shanghai Social Security Bureau Zhu Junyi. Zhu was the most senior Shanghai official placed under arrest since the 1980s. The investigation focused on the misappropriation of 3.2 billion yuan from the Shanghai social security fund to finance the privately owned infrastructure firm Fuxi Investment founded by entrepreneur Zhang Rongkun. Zhang bribed senior Shanghai officials to obtain loans from the social security fund, which he used to acquire shares of state-owned enterprises and leases to operate Shanghai infrastructure (Chen 2006). Following Zhu Junyi's down-fall, the CDIC team proceeded to detain a series of Shanghai officials and entrepreneurs, including Wang Chengming - the chairman of the state-owned Shanghai Electric -, Zhang Rongkun himself, Chen Liangyu's former private secretary Qin Yu, and the chairman of the state-owned Xinhuangpu Corporation Wu Minglie (Zuo 2006). Both Qin Yu and Wu Minglie maintained close ties with Shanghai party secretary and Politburo member Chen Liangvu.

With the rising crescendo of rumors about Chen Liangvu's impending arrest, he tried to save himself by vowing to thoroughly cleanse the Shanghai government of corruption (Chen 2006). However, mounting evidence against Chen Liangvu collected by the CDIC team and cooperation by a former core member of the Shanghai faction - Vice President Zeng Qinghong - ultimately forced Jiang and Huang Ju to abandon Chen Liangyu (Kahn 2006). On September 25, central investigators stunned all of China by detaining Chen Liangyu on suspicion of corruption. With the Chen arrest, both Hu and Wen's political interests were served. Much as Jiang had consolidated his control through the Chen Xitong investigation, Hu sent an unambiguous signal of his authority through Chen Liangyu's arrest. As Jiang and Huang Ju were unable to protect their Politburo-level protégé, they signaled their waning power in the face of rising Hu dominance. For Premier Wen, this arrest was a triumphant moment after suffering Chen Liangyu's humiliating criticism at the July 2004 Politburo meeting. More important, Chen's arrest signaled to local officials that they could no longer exploit the division between Hu and Jiang in order to ignore central restrictions against investment. If the center was determined enough to remove a Politburo member, it could easily remove a Central Committee-level provincial leader.

Although Chen Liangyu's downfall marked a moment of victory for the Hu-Wen leadership, past experience suggests that temporary unity augurs divergent opinions over monetary policy in the future. As Hu Jintao fills provincial leadership posts with his own followers from the Communist Youth League, he increasingly will favor decentralized finance. Meanwhile, Premier Wen Jiabao, who will likely serve another term as premier, will continue to prefer centralized

finance. There is yet little reason to believe that the factional logic of monetary swings will cease to apply to China.

Conclusion

As with previous retrenchment drives, a perceived economic crisis again gave the technocratic faction the upper hand. Although the Asian Financial Crisis was an external crisis that had little direct impact on China, Premier Zhu mobilized the State Council bureaucracy to link the crisis to China, allowing him to impose an unprecedented degree of central control over the financial sector. Although his action was not prompted by a decentralization campaign launched by the generalist faction, it sought to preempt such a campaign. As a result of the centralization policies, state-owned commercial banks finally operated as unified entities without interference from local governments. This period of centralization was further prolonged by Jiang Zemin's reliance on Zhu to aid his consolidation of power over the military through antismuggling sweeps and the divestiture of PLA businesses. Had Zhu not been a credible politician, Jiang would not have needed to rely on Zhu, and would have pursued decentralization policies sooner than he did.

With the consolidation of Jiang's power toward the end of his term as party secretary general, however, he launched a drive to decentralize financial control to the local level in order to galvanize support for his faction in the runup to the Sixteenth Party Congress. The consequence – rapid growth in lending and investment – created macroeconomic imbalance that the new leadership had to confront immediately on taking power. In order to effectively carry out retrenchment in the face of uncontrolled investment and recalcitrant local officials, the new dominant generalist faction and the technocrats formed a temporary alliance to remove Hu's rivals and to implement financial centralization.

Banking policies also exhibited a familiar pattern in the contemporary period, although China had much greater capacity to write-off banking losses. Under Premier Zhu, state banks implemented a series of measures to digest NPLs and to check the growth of new NPLs. Rather than accompanying these impressive changes with further measures, such as interest rate liberalization and the legalization of private banks, Zhu imposed planning-era lending targets and priorities on the banking sector to save ailing SOEs, which effectively decreased the efficiency of capital allocation in China, Because of the factional imperatives, he was reluctant to transform the financial sector. Premier Wen likewise left the state-dominated banking sector unchanged, except that China's ballooning foreign exchange reserve was used to write-off NPLs. The factional framework argues that top leaders in the Chinese political system endorsed policies that enhanced the power of their respective factions rather than those that promoted purely economic goals. As this chapter has shown, Chinese leaders – both generalists and technocrats – continued to pursue this primary goal into the new millennium.

Concluding Discussion

The two contingent future paths for China's economy are both embedded in its financial sector. On the one hand, extremely rapid financial deepening accompanied by relatively stable prices drives a vigorous growth trajectory that will one-day make China the world's largest economy. On the other hand, the colossal store of nonperforming loans in the banking sector augurs stagnant growth and even an economic collapse. This study argued that China's elite political dynamic has played an important role in fashioning the foundation of both outcomes.

The persistent tension between generalist factions and technocratic factions engendered a credible constraint against high inflation. On the one hand, the generalist factions comprised mainly of local officials favored financial decentralization, which increased inflationary pressure since provincial leaders competed with one another to boost investment and, thus, lending and monetary expansion in their respective jurisdictions. On the other hand, central technocrats, whose power depended on accomplishing monumental tasks for the regime, had an interest to centralize financial authorities in order to finance major undertakings. The divergent policy preferences of these two types of factions meant that each sought to take advantage of both economic and political conditions to implement their preferred financial policies.

Because party generalists commanded authorities that allowed them to set the agenda in the elite decision process, under normal economic conditions, they could enact their favored policy of decentralizing financial authorities to the provinces. However, central technocrats were powerful politicians in their own right and were able to leverage their authorities to force generalists to delegate financial control to them. High inflation or other economic crises in particular provided moments of opportunities to do so. In the reform era, central technocrats took advantage of both domestic inflationary crises and international financial shocks to accomplish their preferred outcome of financial centralization. Because the technocratic factions possessed the political leverage to sustain centralization policies, these policies were credible and sustainable. This elite

dynamic, in combination with the CCP's continual iron grip on the financial sector, saved China from the woes of high inflation. This work has demonstrated this logic through both quantitative analysis and qualitative case studies covering China's reform era monetary cycles. The results reveal a picture of elite conflicts that gave rise to monetary upswings and retrenchments.

At the same time, the pervasive influence of the CCP in the financial sector also tied the fate of banks to the ebbs and flow of factional politics and doomed the banking sector to persistent political intervention. Although particular financial outcomes or control over the banking sector were not the ultimate objectives of factional politics, the banking sector became an important means of political survival in China. With its vast store of money from increasingly prosperous depositors, the banking sector became a victim of its own success as the party leadership - both generalists and technocrats - increasingly saw banks as a bountiful source of political resource. Although the Chinese leadership willingly liberalized other sectors of the economy, the enormous pool of savings in the banking sector made it an indispensable policy and political instrument. Despite some impetus to reform the banking sector, the political elite's need for a highly fungible policy and political resource - money - led to a persistent reluctance to liberalize the banking sector beyond state control. Banking policies were made to bolster the short-term strength of both generalist and technocratic factions with little regard to long-term consequences.

The Pressure of Globalization and Reform Impetus

Although a book on the financial policies of a developing country usually includes prescriptions for needed changes, this work proposes no policy prescription. Foreign experts, international institutions, and private investors have already provided a flood of policy recommendations to the Chinese government about needed reforms in the financial sector. I doubt that I have anything to add in this regard. If anything, my advice is directed toward those who try to reform the Chinese financial system through providing consultation. This study suggests that their effort is likely to only produce cosmetic changes on the banking sector because financial policies are ultimately governed by an internal political logic that pays scant attention to external opinions. Although an exogenous economic or political shock may one day transform the Chinese financial system, the source of that shock is unlikely to be an ideational one. After all, Chinese policy makers have known all along how to commercialize the banking sector. They simply lacked the incentive to do so, and no amount of talk will change that fact.

If banking sector reform is tied to top leaders' short-term interest, what can motivate reform in China's banking sector? Increasing foreign participation in the Chinese market and the general rise of China in the world constitute important sources of reform. As foreign investment and exports become an ever larger part of China's economy, even short-sighted politicians and bureaucrats can ill afford to undermine foreign investors' confidence in the long-term

well-being of the economy (Maxfield 1997). Already, China has increased efforts to clean up the banking sector and to shore up its budget partly to assure foreign investors that China remains a stable destination of investment (Jiang 2006g). Although this concern is still balanced by the need to mobilize the banking sector to finance various policy demands, it has brought about some improvement in transparency and commercialization. It is worthwhile to note, however, that efforts to clean up the banks have mainly come in the form of massive capital injections rather than structural reform. Because of China's rising budgetary income and trade surplus, these fixes have been largely painless for all parties involved.

In the long run, foreign acquisition of minority stakes in the Big Four state banks might provide impetus for fundamental banking reform. As things stand, however, foreign investors control less than a 25 percent share of most Chinese banks. The vast majority of shares are still controlled by state holding companies or by the Ministry of Finance. Although the injection of over 2.5 trillion yuan (approximately U.S.\$325 billion) into the Big Four banks produced historically low NPL ratios, it is extremely doubtful that the state banks are in reality operating as fully commercialized entities (International Finance Times 2006). With bureaucratic masters exerting influence as major shareholders, elite politicians can continue to intervene in the banks. Meanwhile, foreign investors at most can protest the political intervention in the banks. They possess far too few shares to exercise vetoes. Although foreign pressure may generate meaningful changes in the long run, foreign investors have yet to show any willingness to confront the government over banking issues.

Reform motivated by foreign investment, moreover, has its limit because foreign investors ultimately do not rely on Chinese banks for their funds. Thus, foreign investors' demand on the Chinese government is simply that it provide a stable macroeconomic environment and not necessarily that it create a fully commercialized banking sector. Moreover, many seasoned foreign investment bankers working in China count on insider access to rent-seeking opportunities as their main sources of profit. For example, most foreign investors of China's nonperforming loan market prefer closed negotiations with the government to open auction as a means of acquiring nonperforming loans (Shih, Huang, and Lee 2005). Other foreign investment banks seek to gain a competitive edge by hiring children of past and current senior officials – the princelings – to facilitate business (Collier 2004). Rather than reforming the Chinese banking sector, foreign banks in that environment are forced to invest in political ties rather than better services.

Although some have placed their hope on China's membership in the World Trade Organization (WTO) as a catalyst for fundamental reform, the findings of this study suggest that this expectation may prove disappointing. To be sure, WTO membership will increase trade and foreign investment, which put pressure on the Chinese government to increase transparency and to maintain a certain degree of macroeconomic stability. However, the entry of foreign banks into the Chinese market by itself is unlikely to induce any significant changes.

Already, the Chinese government has decreed a number of regulations that hinder foreign banks' ability to make a profit, all of which allowable under the national treatment clause of the WTO. If the Chinese government needs to, it can decree even more regulations that make banking in China totally unprofitable for foreign banks. The major state banks can survive without any profit – and they have – but foreign banks cannot do so.

A possible source of genuine reform is increasing private sector participation in the policy process, which would increase the influence of the most significant beneficiary of banking reform. Despite the rapidly growing role of the domestic private sector in the economy, the private sector continues to have a difficult time obtaining financing from the formal banking sector. The emerging private sector, especially small and medium enterprises, would benefit greatly from fundamental reform that gives rise to a truly competitive banking sector. Unfortunately, the private sector is barely represented in the Chinese Communist Party. Since the 1980s, private entrepreneurs have lobbied the local governments to allow the formation of informal financial institutions to circumvent the confining state banking system. In fact, instances of "financial chaos" suppressed by the PBOC often were local attempts to liberalize interest rates or to form alternative financial institutions. Their influence on the local policy process, however, has not translated to a significant presence in national politics. The Sixteenth Party Congress in 2002 formally allowed private entrepreneurs to join the CCP, but it would presumably be a long time before a major private sector figure becomes a senior politician in China. If the National People's Congress (NPC) increases its power to appoint and dismiss senior officials, private entrepreneurs can potentially influence the policy process through their participation in the NPC, a much more likely venue of political participation than promotion through the CCP ranks. Closer linkage between private entrepreneurs and policy makers, however, may just produce more rent-seeking and corruption. Already, both the Yuanhua smuggling case and the Shanghai real estate scandal show that private entrepreneurs are prone to use influence over officials for private gains rather than to lobby for policy changes. Of course, this phenomenon may itself be a function of the dearth of institutional channels for interest group lobbying.

To be sure, the combination of increasingly knowledgeable banking professionals and the abundance of financial resources at the state's disposal has produced ample cosmetic changes in the financial sector. China has gone as far as mobilizing its vast foreign exchange reserve to recapitalize its ailing banks. However, in the short and medium term, there is no strong reason to believe

In December, 2002, for example, the PBOC issued a regulation limiting banks' borrowing in the interbank market to just 40 percent of domestic deposits. Although this rule applies to all banks equally in accordance to the "national treatment" clause of the WTO, foreign banks, which do not have very much yuan holding, has a much greater need for short term yuan liquidity than Chinese banks. This gives the Chinese banks an advantage over foreign banks. See Chan, Christine. 2002. Interbank rule changes give mainland banks advantage. South China Morning Post, 12/2/2002.

that the bulk of the financial sector will evolve beyond state control or that the state itself will undertake to privatize much of the financial sector. As experience from around the world tells us, fundamental change will most likely require a severe economic shock that the current system cannot handle or a major realignment of the political system.

Power in Authoritarian Regimes

In examining the political motives behind financial policies, this work has developed a fairly complete account of elite factional politics in China. In addition to explaining financial outcomes, a more general application of this framework also sheds light on power struggle in authoritarian regimes in general and factional politics in China.

The starting point of this framework is that factions divide into different types – generalist and specialist – depending on the career trajectories of the factional patron. Although this book mainly concerns the interaction between generalist factions and a particular subset of specialist factions – technocratic factions - there are in reality other kinds of specialist factions. Just as technocratic factions are mainly endowed with members and resources from the economic bureaucracy, other kinds of specialist factions are endowed with resources in their respective xitongs, or bureaucratic groupings, including propaganda, organization, internal security, and the military (Lieberthal 2004: 218). Furthermore, the various specialist factions lie on a continuum according to their ability to bargain with generalist factions. At one extreme, army factions have great bargaining power with the dominant civilian faction since they control the ultimate arbiter of power. Historically, army factions, such as those headed by Lin Biao and Ye Jianying, had great influence over the selection of civilian leaders. Yet, unless a senior army figure also had close ties with provincial leaders and senior cadres in the central party organs, army factions remained specialist factions. Nonetheless, out of all the specialist factions, an army faction has the most potential of becoming a generalist faction and of vying for ultimate control of the CCP. Chairman Mao, for one, orchestrated the purges of several army leaders, including Gao Gang, Peng Dehuai, and Lin Biao, for fear of their rising status (MacFarguhar and Schoenhals 2006). At the other extreme, the head of the education bureaucracy likely has far less bargaining power.

If one is to analyze Chinese politics from a factional perspective, the main selectorates in the system would be the patrons of the various specialists and generalist factions.² Selectorates are defined as "the set of people whose endowments include the qualities or characteristics institutionally required to choose

One also can see rent-seeking interest groups and regions as the main actors in the Chinese political system. See Shirk, Susan. 1993. The Political Logic of Economic Reform in China. Berkeley: The University of California Press, Yang, Dali L. 1997. Beyond Beijing: Liberalization and the Regions in China. London; New York: Routledge.

the government's leadership and necessary for gaining access to private benefits doled out by the government's leadership" (Bueno de Mesquita et al. 2003: 42). The dominant generalist faction constructs a winning coalition out of a mix of both specialist and generalist factions, each with their own weight in the elite selection process (Bueno de Mesquita et al. 2003: 8). For the incumbent leader – the head of the dominant generalist faction – the ability to distinguish between colleagues who can directly challenge one's power and those who cannot is likely crucial. Because specialist factions can only withdraw support, a sidepayment in the form of money, promotion, or policy concession is sufficient to maintain their support. By contrast, it is much harder to trust a generalist colleague, even if this person has shown great loyalty in the past. Unless there is some way of allowing generalist colleagues to credibly demonstrate their loyalty, an incumbent leader must live in fear of a potential coup because other generalists have sufficient connections and resources across the regime to overthrow the incumbent.

If every member of the winning coalition has the capacity to replace the incumbent, the leader is likely to live in constant fear of a coup (Wintrobe 1998: 20). Additionally, this situation would compel authoritarian leaders to pursue suboptimal policies. First, the leader would become extremely suspicious of everyone around him or her, which results in a highly repressive regime or a regime that seeks to pay off key members of the selectorate at the expense of the general economy (Bueno de Mesquita et al. 2003; Wintrobe 1998). Second, there could be a war of attrition between various factions during an economic crisis that delays fixes indefinitely (Alesina and Drazen 1995). Third, the winning coalition might dissolve as a result of a competition between its members to incorporate new social classes into the winning coalition (Ramseyer and Rosenbluth 1998). In the reform era, China has largely avoided these disastrous outcomes – at least from the perspective of the regime.⁴

The interaction between the dominant generalist faction and the technocratic faction suggests that the key to this stability is a symbiotic relationship between the dominant generalist faction and various specialist factions. For the incumbent generalist, he or she does not have to worry about direct challenges from the specialists in the winning coalition. At their worst, they would withdraw their support, but given their initial endowment, specialist factions do not seek ultimate power but instead seek to enrich their respective bureaucratic groupings. There are divergent policy preferences and clashes over policy disputes – as this work has shown – but the incumbent leader can buy specialists off with more resources and policy concessions. Although both Deng and Jiang disagreed with the central bureaucracy on monetary policy, they were willing to concede to the central bureaucracy in exchange for support during crucial

³ One can interpret the Cultural Revolution as Mao's incorporation of students and radical intellectuals into the winning coalition in order to regain absolute power.

⁴ Both Hu Yaobang and Zhao Ziyang attempted to incorporate students and intellectuals into the policy process, but they failed and were purged.

political fights against opponents from within the regime. By many indicators, Hu Jintao also made a similar pact with Premier Wen Jiabao. Thus, despite the at times fierce contests over specific policies between the incumbent generalist and various specialists, they ultimately do not seek to destroy each other. We even observe specialist factions lending support to the dominant generalists at crucial moments. In contrast, other generalists endowed with a follower network across the party and the military – even if they have shown past loyalty – are in the position to usurp the incumbent's power. The potential of a coup launched by other generalists is a constant source of worry for the incumbent generalist.

Although specialists at times cooperated with the dominant generalist only in order to secure policy autonomy, resources, and promotions, this willingness to support the dominant faction has engendered relatively stable authoritarianism in China. There is every reason to think that this dynamic also applies to other authoritarian regimes. In order for this stabilizing dynamic to take hold, a subset of senior officials must be able to signal their *inability* to usurp the power of the incumbent leader. Here, a developed bureaucracy facilitates a subset of the elite to signal their specialist role. That is, in a tinpot regime with minimal bureaucracy, every member of the junta seems a potential coup plotter because they all have similar experience in the military. In contrast, in a highly bureaucratized regime like China, the incumbent leader can more easily observe which members of the regime have dedicated their careers to specialized tasks and which members have built up extensive connections across the regime. With a specialized bureaucracy, the leader can further observe how sincere his or her colleagues are at being specialists. That is, if a self-proclaimed specialist is doing a poor job at leading a group of bureaucracies, perhaps he or she is instead spending time building connections across the regime. The dictator would then have reason to be suspicious. By being able to distinguish between generalists and specialists, the dictator can construct a more stable winning coalition composed mainly of specialist factions. The existence of specialized bureaucracies also allows a subset of the elite to invest away from general resources toward a specialization in order to credibly signal their intention to disengage from the competition for ultimate power (Spence 1973). In the Chinese case, it was clear that Zhou Enlai, who had served as party secretary general, intentionally abandoned his connections in the party in favor of cultivating resources in the economic and diplomatic bureaucracies in order to put Mao at ease of his intention.

This stabilizing dynamic can exert substantial impact on regime survivability. For one, instead of engaging in a war of attrition with rival factions during a crisis, the dominant generalist faction can safely delegate crisis management to a specialist faction, knowing that it has no design to usurp the incumbent's power. The case of financial politics in China reveals that although policy delegation can be costly for the ruler, he or she can delegate without losing power, as long as specialists receive satisfying payoffs. This on average increases a regime's ability to deal with crises and thus strengthens its survivability. With the existence of

specialist factions, rival generalist factions further have less need to incorporate new social groups into the selectorate. Rather, they can expend political capital to woo the various specialist factions. The restricted bidding provides more stability and longevity to the regime.

The distinction between generalists and specialists can also shed light on the debate in the China field about the elite political equilibrium. In Nathan's (1973) seminal article and in subsequent articulation of the theory (Nathan and Tsai 1995), he argues that the transaction costs of maintaining a faction renders total domination by a faction unsustainable. Thus, the resulting balance of power produces a code of civility among the factions. Tsou's well-known rebuttal argues that the equilibrium in elite politics in China is often total victory by the dominant faction (Tsou 1976, 1995). Thirty years after the publication of Nathan's original article, the debate persists (Dittmer 1995). The persistence of this debate is in large part a result of instances of both total domination and balance of power in the CCP's history, making it difficult to empirically assess the merits of these two claims.

Work by Huang (2000) suggests that succession politics in the CCP induced consolidation cycles in which periods of consolidation were followed by periods of competition and seeming balance of power. The problem faced by the incumbent leaders was that in order to ensure regime survival and postretirement influence, they needed to cultivate younger leaders who possessed all the qualifications of a successful leader. However, these qualities also made this person a viable threat to the incumbent leader (Huang 2000: 19). In fact, as a leader approached death or retirement, he likely faced several factions led by aspiring helmsmen. Although succession competition between several aspiring factions gave the incumbent leader more latitude to balance them against one another, he could not be sure that one of them would not preemptively take power.

This work adds to this discussion by introducing specialist factions to the latent competition between incumbent generalist factions and their aspiring successors, which are also generalist factions. The introduction of specialist factions provides a mechanism whereby the rising generalist faction can consolidate power without engaging in a prolonged struggle with rival factions. Essentially, as the succession looms on the horizon, various specialist factions must make a decision about whom to back in order to maximize the resources available to their respective bureaucratic groupings. Likewise, rival generalist factions decide on how much payoff to promise specialist factions and even other generalist factions. Again, without specialist factions, a generalist faction which wins in one round always has to wonder whether the other generalists in the winning coalition would revolt in a subsequent round. This situation would give rise to constant elite distrust and competition which may result in a balance of power. However, the existence of powerful specialist factions without design for overall control allows the victorious generalist faction to consolidate power without constantly worrying about potential usurpers in subsequent rounds. Because specialist factions only want more resources and power for their own bureaucracies, they calculate which generalist faction can maximize their expected payoff. As the outcome of the political struggle between generalists becomes clear, specialist factions bandwagon around the likely winner.

What does this understanding of elite Chinese politics suggest for China's future? This understanding of elite politics explains the relative stability of Chinese authoritarianism compared with tinpot dictatorships in other developing countries. As a result of the highly bureaucratized nature of the CCP and the state apparatus, senior leaders can specialize in a narrow set of policies and signal credibly their inability to challenge the incumbent leader. This creates a higher expectation of coordination rather than zero-sum competition in elite policy making. To the extent that the Chinese government is becoming more specialized over time (Yang 2004), it creates opportunities for senior officials to signal their "type" to the incumbent leader. Over time, as senior officials increasingly rise up through specialized bureaucracies rather than through the army, it also becomes easier for them to credibly signal their specialist roles.

For members of the revolutionary generation, it was difficult for them to signal their specialist role because the prolonged revolutionary struggle in which they partook often endowed them with a wide range of connections across the regime. Thus, Mao's wide-ranging purges of his colleagues during the Cultural Revolution in part stemmed from Mao's suspicion of the rich store of connections enjoyed by members of the revolutionary generation. With the rapid promotion of technocrats into the senior ranks of the Party since 1978, fewer senior leaders have the extensive connections necessary to compete for ultimate power. The promotion of cadres with technical background to senior positions, however, does not spell the end of elite competition. Because of factional politics, senior leaders continue to cultivate potential successors by intentionally rotating them to a wide range of local and central posts. These budding generalists eventually acquire wide-ranging connections across the regime and begin to distrust each other.

Nonetheless, the dearth of extensive revolutionary experience among younger leaders makes it easier to distinguish between generalists, who actively cultivate ties with various constituencies in the regime, and specialists who continue to manage affairs in their original *xitong*. The relatively clear identities of generalists and specialists stabilized politics in the 1990s because the incumbent could form winning coalitions with technocrats and other specialists to defeat any actual or potential threats from other generalists. Jiang Zemin formed such coalitions with Zhu Rongji and other specialists to defeat potential threats from Yang Baibing, Chen Xitong, Qiao Shi, and Li Ruihuan. In a way, Jiang's effort to defeat so many generalists paved the way for Hu's rise because Hu only had to contend with generalists who were cultivated by Jiang himself rather than a wide array of other generalists.

The stability of this dynamic may be threatened in the future by the rise of the princelings in Chinese politics. The children of revolutionary veterans and senior officials, often labeled princelings, have some of the characteristics of their parents. That is, they are endowed with a wide network of close

connections across the government, army, and the emerging corporate sector because children of senior officials often attended the same elite elementary or high schools around Beijing (He and Gao 2000). Although they do not constitute a single interest bloc, they have access to elite social networks not available to ordinary officials. Thus, even if princeling officials spend their entire careers in particular bureaucracies, such as banking, they can draw on additional political resources through their princeling connections, thus making them more ambiguous specialists. That is, princeling officials are less able to credibly signal their specialist roles because they have access to the princeling social networks. As the upper echelon of the party becomes increasingly filled with princeling officials, the incumbent leader faces a rising number of officials who, although cultivated as technocrats, have strong personal connections with a wide range of officials across the regime. Faced with increasing ambiguity about the potential threat posed by members of the winning coalition, the incumbent leader may shift more resources toward the provision of private goods in order to maintain the loyalty of those in the winning coalition. Furthermore, if the lead technocrat is seen as an ambiguous specialist due to his or her princeling connections, the leader of the dominant generalist faction may he sitate to delegate economic control to the lead technocrat in a time of crisis. More so than any other scenarios, the findings presented in this work suggest that deep distrust between the dominant generalist and the lead technocrat, leading to delayed delegation of economic control to the lead technocrat in a time of crisis, may well bring about the unraveling of the Chinese economic miracle.

Appendix on Data

The quantitative data used throughout this study are broken into three main databases: *Annual Database*, *Quarterly Database*, and *Time Series-Cross Section Database*. Because no one has attempted to construct three separate financial data sets on China, I had to draw from numerous primary sources from the Chinese government to construct these data sets. This discussion details the structure and the sources of each of the databases in turn.

Annual Database contains national level economic data from 1978 to 2006 and is a time-series data set. The data set includes data on lending, bank deposits, inflation, industrial output, fixed-asset investment, and interest rates. The main sources of this data set are:

National Bureau of Statistics. 1999. Xin Zhongguo Wushinian Tongji Ziliao Huibian (A Collection of Statistical Material for the Fifty Years of New China). Beijing: China Statistics Press.

National Bureau of Statistics. 2000. *China Monthly Economic Indicators* 2000: 1 (*January*). Beijing: China Statistical Press.

National Bureau of Statistics. 2001. *China Monthly Economic Indicators* 2001: 3 (March). Beijing: China Statistical Press.

National Bureau of Statistics. 2003. *China Monthly Economic Indicators* 2003: 2 (February). Beijing: China Statistical Press.

China Data Online. 2006. *China Yearly Macro-economy Statistics*. China Data Center, University of Michigan. http://www.chinadataonline.org.

More specific data on banks come from:

People's Bank of China. 1997. Zhongguo Jinrong Tonji: 1952–1996 (China Financial Statistics: 1952–1996). Beijing: China Financial Publisher.

Statistical Division of the PBOC. 2000. Zhongguo Jinrong Tongji: 1997–1999 (Financial Statistics of China: 1997–1999). Beijing: China Financial Publisher.

Quarterly Database contains quarterly national level economic data from the first quarter of 1978 to the fourth quarter of 2006. However, because the Chinese statistical apparatus was just recovering from the Cultural Revolution in the late 1970s, most variables are not available until the first quarter of 1980. This data set contains data on state bank lending and deposits, inflation (CPI), fixed asset investment, industrial output, agricultural output, and official interest rates. In the 1990s, quarterly data on overall money supply and total lending and deposits are also available.

The banking data available in this data set come from official sources, but valuable data on interest rates and specific categories of lending also come from Li (1994):

People's Bank of China. 1997. Zhongguo Jinrong Tonji: 1952–1996 (China Financial Statistics: 1952–1996). Beijing: China Financial Publisher.

Statistical Division of the PBOC. 2000. Zhongguo Jinrong Tongji: 1997–1999 (Financial Statistics of China: 1997–1999). Beijing: China Financial Publisher.

Li, Kui-wai. 1994. Financial Repression and Economic Reform in China. Westport, CT: Praeger.

The other economic variables in this data set were collected from the following sources:

The University of Illinois at Chicago, and China Statistical Information and Consultancy Service Center. 1989–1991. *China Statistics Monthly*.

National Bureau of Statistics. 1985–1988. Monthly Bulletin of Statistics-China. The University of Illinois at Chicago & China Statistical Information and Consultancy Service Center. 1993–97. China Monthly Statistics. Vols. I–V. Beijing: China Statistical Information and Consultancy Service Center.

National Bureau of Statistics. 2000. *China Monthly Economic Indicators* 2000: 1 (*January*). Beijing: China Statistical Press.

National Bureau of Statistics. 2001. *China Monthly Economic Indicators 2001: 3 (March)*. Beijing: China Statistical Press.

China Data Online. 2006. *China Monthly Macro-economy Statistics*. China Data Center, University of Michigan. www.chinadataonline.org

Finally, *Time Series-Cross Section Database* comprises provincial level annual economic and political data from 1978 to 2006. It covers all of China's provinces, directly administered cities, and autonomous regions, including the newly added Hainan Province and Chongqing City. The political variables in this data record the observed factional ties between a Party secretary or a governor of a province and a serving Standing Committee member (see details in Chapter 5). This requires the careful matching up of provincial officials' and Standing Committee members' biographical data throughout the entire period. Sources used to construct these factional variables include the following:

Liu, Jintian, and Xueming Shen. 1992. Lijie Zhonggong Zhongyang Weiyuan Renming Cidian (A Dictionary of Past Central Committee Members). Beijing: Chinese Communist Party History Publisher.

- Lamb, Malcolm. 1994. Directory of Officials and Organizations in China: a Quarter-century guide. Armonk, NY: M. E. Sharpe.
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- Central Organization Department, and Party History Research Center of CCP CC. Zhongguo Gongchandang Lijie Zhongyang Weiyuan Da Cidian, 1921–2003 (the Dictionary of Past and Present CCP Central Committee Members). Beijing: Party History Publisher, 2004.

Provincial level banking data come from the aforementioned *Zhongguo Jinrong Tonji* volumes published by the PBOC. Likewise, the bulk of the provincial level economic data come from the National Bureau of Statistics' *Xin Zhongguo Wushinian* and statistics published by the China Data Center, which also were used in constructing the *Annual Database*.

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- 1997b. Guojia Jingmaowei jueding jinnian de jigai zhongdian (The State Economic and Trade Commission determines this year's technical innovation keypoints). *Enterprise Decision-Making Reference (Qiye Juece Cankao)* 1997 (120).
- 1997c. Zhongyang yinhang shixing bada zhengce zhichi guoqi gaige (The central bank implements 8 policies to support SOE reform). Qiye Juece Cankao (Enterprise Decision-Making Reference) (119).
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