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Partial Reform Equilibrium, Chinese Style

Political Incentives and Reform Stagnation in Chinese Financial Policies

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Incomplete financial reform in China is puzzling because Premier Zhu Rongji, a seemingly promarket technocrat, was largely insulated from explicitly rent-seeking pressure and leftist ideology when he carried out a massive restructuring of Chinese banks in 1997. Yet at the end of his tenure as premier, the financial sector continued to channel the bulk of savings toward the state. Given the complexity of Zhu's policies, we cannot begin analyzing them if we conceive reform as a neat, coherent policy shift. In this article, competing hypotheses of policy change are tested on Zhu's financial "reform," which is conceptualized as a bundle of discrete policies, each having different and at times contradictory impact on the economy. With this conceptualization, banking centralization, the Herculean efforts to digest nonperforming loans, and stagnation in interest rate and private banking reform can best be understood as a coherent political survival strategy.

Keywords: *China; reform; economic policy; technocrats; finance; bank*

Even when all the conditions are ripe, relatively insulated, technically competent, and well-informed technocrats may choose to forgo reform to increase their chance of political survival. Unlike the Eastern European version of partial reform, in which private rent seekers capture state policies and delay reform, partial reform in the Chinese context stemmed from central technocrats' desire to maximize political capital and retain the ability to accomplish future policy and political objectives, two strategies that

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increase their ability to survive in the uncertain world of Chinese politics. In this manner, fundamental financial reform is delayed, at least until a low-cost option can be devised to move reform forward.

In discussing this incomplete reform in China, this article touches on two central aspects of the reform literature. First, what constitutes a reform? The case of Chinese financial policies shows that reform is not a single dichotomous variable but a multitude of continuous and discrete variables that can affect the efficiency of resource allocation in a number of different dimensions. This conceptualization of reform suggests that explanatory frameworks should account for the variation in the degrees of reform in discrete policy areas rather than simply explaining why reform has taken place. Furthermore, explanatory frameworks are tasked to account for the full efficiency impact of a bundle of policies and explain why plausible policy alternatives are abandoned in the course of reform. This article shows that even within financial policy alone, reform in different areas can take place at different pace, depending on the political incentives of the technocrats. Second, this article asks whether there is a single sufficient condition for reform. In addressing this issue, the heart of this article applies previous explanations of reform to the case of Chinese financial policies and finds them inadequate in predicting the policy outcomes. Instead, an explanation based on the political incentives of key actors—the senior technocrats—is developed to predict the pattern of financial policy implementation during the Zhu Rongji Administration between 1998 and 2003. On the whole, the Chinese case reveals that the process of reform is necessarily a political one, not a simple policy exercise by insulated, beneficent social planners.

Explaining Reform

As with many concepts in political science, *reform* is a commonly used term with rather vague meaning. For the sake of convenience, I adopt Drazen's (2000) general definition of reform as "policies that enhance the efficiency of resource allocation" (p. 620). At a more specific level, the Washington Consensus outlines a list of market enhancing measures, including fiscal discipline, trade liberalization, interest rate and exchange rate liberalization, stable prices, among others (Williamson, 1990, 1994). Nonetheless, there are two issues that arise from this definition.

First, few developing countries have adopted all the policies outlined in the consensus to the full extent. If a country adopts four policies on the list, is it carrying out reform? What if a country implements six on the list? Would we consider this country reformed but not the former one? These questions highlight the multidimensionality of reform. By labeling a set of policies as reform, we risk not explaining the variation in reform implementation among the various policies in a policy bundle. Second, nearly every policy has an impact on more than just one area in the economy, and the efficiency impact of a policy remains unclear, unless we examine how a policy affects outcomes in multiple dimensions. Although some policies, including tariff reduction and interest rate liberalization, are widely recognized to increase the efficiency of resource allocation, the efficiency impact of other policies is less distinct. Rapid state-owned enterprise privatization in post-Soviet republics, for example, led to the creation of sectoral monopolies and oligopolies, which ended up lobbying the government for rent-seeking opportunities (Hellman, 1998). Although the voucher program was intended to increase the efficiency of resource allocation, it ended up introducing substantial market distortion because of the vast information asymmetry between the average voucher holder and knowledgeable insiders. Given that reform measures impact efficiency outcomes in more than one area with time, the true effect of a reform policy may not be apparent in the short run (Stallings & Peres, 2000).

For political scientists explaining a bundle of reform policies, the above conceptualization of reform gives rise to a demanding explanatory framework. First, an explanatory framework needs to explain the implementation and the failed implementation of policies in a policy bundle, instead of treating a single policy as the determining marker of a set of policies. For example, if the privatization of a sector is accompanied by government policies supporting monopoly, it remains unclear if reform has taken place. Second, an explanatory framework of reform policies should account for the net efficiency impact of a set of policies in multiple dimensions rather than just in one dimension. Returning to SOE privatization in Russia, although the new private owners of SOEs possessed stronger profit-maximizing incentive (Aslund, 1995), they also lobbied for preferential policies to maximize their profit, rendering the net efficiency impact of SOE privatization ambiguous.

Finally, an explanatory theory of policy change calls for an account of why a policy was adopted and why similarly plausible options were abandoned. In other words, the dependent variable when one analyzes policy change is not a dichotomous variable with status quo and new policy as the only two values. Besides these two outcomes, there is also a set of reasonable policy choices that are never adopted but could well have been. An explanatory account of policy change needs to explain why a policy shifts from the status quo to the new policy and why it does so instead of another reasonable option. Although the definition of a reasonable option remains vague, I show below that analysts can define reasonable options as policy alternatives that policy makers themselves consider seriously.

The 1998 financial restructuring in China serves as the perfect example of an inaccurately labeled *reform*, which in reality was a complex bundle of policies with multidimensional impact on the economy (e.g., Pei, 1998). Although Premier Zhu enacted some changes that clearly brought the Chinese banking sector closer to international standard, other policies increased the state's control over financial resources. Meanwhile, some of the most important reform measures, including the legalization of private banks and interest rate liberalization, were repeatedly vetoed by the premier. Without conceptualizing reform as a series of distinct variables, each with variegated impact and without examining abandoned policy proposals, it would be difficult to begin analyzing the Chinese case.

Alternative Explanations

Besides the political survival framework introduced later in this article, several alternative hypotheses provide plausible explanations of the financial policy outcomes in China. Yet a close scrutiny of these alternative hypotheses, most of which fall under the umbrella of the insulated technocracy framework, reveals that none of them can quite explain the complex pattern of Zhu's financial policies.

The most obvious theoretical framework with which to analyze Zhu Rongji's financial policies is the insulated technocracy framework. After all, Zhu Rongji successfully introduced significant changes to the financial system over the objection of powerful vested interests (discussed below). In the literature on technocrat-led reform, an insulated technocracy with specialized knowledge about the economy constitutes an ideal guardian of reform, because it shields the reform process from groups suffering initial losses from the reform, groups uncertain about the eventual payoffs of reform, and groups whose vested interests are harmed by reform (Przeworski, 1991; Rodrik & Fernandez, 1991; Williamson, 1994).

Even without referring to the Chinese case specifically, however, two objections arise from insulated technocracy framework. First, it seems unrealistic to assume that the insulated technocrats, even those trained in elite U.S. institutions, would have better ideas about efficiency-maximizing solutions in every policy area than other actors in society (Evans, 1995; Rodrik, 1996). Moreover, it is even more unrealistic to assume that technocrats have only efficiency in mind. Without ready knowledge about the political and careerist incentives of technocrats, one can hardly a priori predict the reform outcomes of a bundle of policies.

The proponents of a technocratic solution counters that insulated technocrats, especially those trained as economists, are clearly motivated by a desire to realize more efficient allocation of resources (Harberger, 1993). Nonetheless, studies of bureaucrats point out that their preferences arise from a complex mix of social backgrounds, career incentives, and ideology (Aberbach, Putnam, & Rockman, 1981; Schneider, 1993). Unless we assume their preference for reform in all policy areas, we would have to examine the political and private incentives facing technocrats to determine their likely policy preferences (Haggard, 2000). Indeed, several recent studies reveal that insulated technocrats are motivated by a mix of political and personal incentives when they implement policies (Grimes, 2001; Kessler, 1998; Murillo, 2002).

Indeed, if technocrats are the political incumbents, their preferences are likely to be more antireform than that of the average public. Even if we control for ideological outlooks and social background, incumbent technocrats are used to a steady stream of either economic rent or political benefits, rendering them proponents of the status quo (Krueger, 2000). In postcommunist countries, this problem is particularly acute. Technocrats often controlled the flow of vast resources under the planned economy. Thus, they are willing to change the economic system only to the extent that the new equilibrium produces just as much, if not more, benefits for them than the status quo. As the case of post-Soviet reform shows, winners in the partially reformed economic system tended to be insiders from the old regime who gained access to valuable resources at nonmarket prices (Hellman, 1998). Given the questionable assumptions about technocrats made by proponents of the insulated technocrat framework, we would do well to broaden our analytical framework beyond technocrats' education background and the level of insulation to include a wide range of political and careerist incentives facing technocrats.

The pattern of financial policy in China is undeniably affected by ideas about how a financial system should be organized (Steinfeld, 2004). Indeed, the case studies presented below highlight the intense debates between policy makers who supported policies informed both by neoliberal and statist thinking. Although ideational explanations allow us to derive a set of feasible options considered by policy makers, they often cannot specify which policy option is ultimately adopted. This especially applies to policy options that were informed by similar ideas but had vastly different distributive consequences. For example, the policy options for digesting nonperforming loans (NPLs) all called for using the market to auction off NPLs, but they had vastly different implications for government budget deficits. In this work, I recognize the role of ideas in determining a set of feasible policy choices, whereas the political survival framework provides more specific predictions about which policies within this feasible set were ultimately adopted.

An additional explanation is that despite the strenuous effort of the technocrats, they simply could not overcome entrenched opposition from ideological conservatives or from antireform interests and thus could not enact comprehensive financial reform. In the ideological sphere, the Fifteenth Party Congress in the autumn of 1997 finally put the stamp of legitimacy on private entrepreneurship, staving off a coordinated ideological attack against Zhu's policies (Fewsmith, 2001). In terms of rent-seeking interests, Chinese bureaucrats were largely insulated from direct lobbying from societal groups, because the Chinese Communist Party was a nondemocratic regime. During Zhu's tenure, some 25% of the 1997 SOE workforce, or 27.8 million SOE workers, lost their jobs, often receiving little compensation (Hurst, 2004).

To be sure, insulation from societal pressure did not imply that technocrats were free from all political pressure. Shirk's (1993) seminal work suggests that reform in China was propelled forward by reformers in the central government making a series of proreform coalitions with members of the Central Committee representing various interests. In the case of financial restructuring, had Zhu been a reform-maximizer, he could have found powerful allies for reform measures, which he ultimately rejected. For example, both interest-rate liberalization and the legalization of private banks enjoyed the fervent support of prosperous and politically powerful coastal provinces. Had Zhu's sole objective been to form a sufficiently strong coalition to implement these two policies, he could have found strong allies in local leaders. Nonetheless, there is no evidence that Zhu even attempted to form such a coalition. There, instead, is strong evidence that he made a pact with the poor regions of China to provide them with subsidized financing in exchange for their support for banking centralization.[1]

Furthermore, the delays in financial reform might have been a product of China's relatively high growth rates, which allowed technocrats to delay fundamental reform. Looking back at the 20 years of reform, China experienced three episodes of economic slowdown: 1980, 1989 to 1992, and

1999. In all three episodes, senior technocrats were perfectly content to concentrate financial power and use the central hoard of resources to spend their way out of a slowdown. Despite continual deflation after Zhu took power, he used both fiscal and monetary resources to launch an expensive and likely wasteful infrastructure, building campaign in western China. Granted, he was able to do so because of China's repressed financial system, capital control, and high savings rate. Thus, the concentration of savings in China's state banking sector furnished an important precondition of financial politics among the political elite. Nonetheless, the high savings rate alone does not explain the variation of policy implementation and could have equally furnished a cushion for committed technocrats to enact more fundamental reform.

Politicized Technocrats

The starting point of a political explanation for Zhu's financial policies is that Chinese politicians and top technocrats, who are also party elites, operate in an environment of great uncertainty. Even if they are relatively insulated from societal political pressure, they can be removed from power at any time without due process by other members of the elite. Thus, according to a rich literature on elite politics, senior Chinese leaders need to maintain their informal political influence to protect themselves against sudden challenges (Nathan & Tsai, 1995). As Huang (2000) puts it succinctly, "Decisions are made according to the vision of those who have prevailed in the power struggles rather than through the due process. . . "(p. 5) Even with the increasingly stringent retirement rules in China, top leaders have an incentive to build up informal power both for current expenditure and for postretirement influence through a network of protégés (Huang, 2000).

To ensure against possible challenges to their authority and to maintain influence, top leaders in China mobilize policy tools at their disposal to defend themselves or to unseat a rival. In the 1980s, for example, ideological conservatives launched ideological campaigns to undermine the authority of reformist leaders (Fewsmith, 1994). Because top ideologues had a network of followers in the propaganda apparatus, they mobilized these resources in the elite political struggle. Top technocrats, in contrast, have the most knowledge about economic and financial issues and the densest network of followers in the financial and economic bureaucracy in the central government. Through the distribution of fiscal subsidies, bank loans, and state fixed-asset investment, senior technocrats and their protégés heading various ministries are able to secure political support for themselves.

Given their embeddedness in the finance and economic bureaucracy, the most effective strategies for top technocrats to build up political capital comprise centralizing financial policy power and making oneself the indispensable problem solver. These two strategies complement each other and also apply to ministerial level officials in the top technocrat's patron–client network. Consolidating financial power to the central level would first enable senior technocrats to more readily use the distribution of financial resource as political bargaining chips at the Politburo level, building a support coalition through disbursing funds to the pet projects of other leaders. In China's increasingly monetized economy, where money constitutes a powerful and fungible instrument, control over banks and tax revenue becomes much more valuable to senior technocrats. Without financial centralization, provinces would garner control over financial resources themselves and would have less need to lobby their Politburo patrons to bargain for more funds from the technocrats. In Zhu's case, control over the financial sector allowed the premier to mobilize banking resources to alleviate political setbacks, such as the failed World Trade Organization negotiations and the hastening of the promotion of close protégés. One high-level interviewee (anonymous, personal communication, May 2, 2002) pointedly stated, "(Premier) Zhu values the power to distribute financial resources through loans and stock-listings, and he has used the power as chips in the political game."

Firm control over the financial sector allows senior technocrats and their followers to effectively act in the role of the problem solver, thereby accumulating "administrative accomplishments" (*zhengji*). As the postreform era experience has shown, the perceived ability to solve pressing problems greatly increases the likelihood of promotion and of retaining power. Zhu himself rose through ranks by repressing inflation in 1993 and by resolving the triangular debt problem in the early 1990s. In contrast, Premier Li Peng's authorities greatly suffered, because he had failed to rein in inflation in 1993. During his administration, Zhu and his protégés mobilized China's vast financial resources to tackle a series of problems, ranging from chronic SOE indebtedness to the decline of rural income. Delegating financial authorities to his protégés in various agencies allowed them to resolve problems and increase their chances of promotion. A senior central bank official explains this incentive in the following terms:

> Those with power over the distribution of money will do all that they can to make themselves look good, which will ensure (*baozheng*) promotion. A senior official does this by making his own policy portfolio look good. For example, if someone was in charge of agriculture, he would use his power to

> ensure that agriculture receives sufficient funding so that he would look relatively successful. Although this sort of distribution can increase society's well-being, it often does not. (anonymous, personal communication, May 14, 2001)

Because central bureaucrats have a strong incentive to deal with politically pressing issues, they tend to ignore longer term structural problems. Moreover, because their administrative accomplishments are evaluated by short-term results, they tend to concoct short-term solutions to these apparent problems. The premier's Politburo colleagues also pay little attention to the distant future. In fact, interviewees pointed out that everyone from the premier on down had a strong disincentive to carry out fundamental reforms that could potentially jeopardize short-term stability or prevent solutions to more pressing issues (anonymous, personal communications, October 10, 2000, May 14, 2001, June 23, 2001, May 2, 2002).

Given these two strategies of political survival, we can expect financial policies to take the following shape. First, one would expect the State Council to politicize policy problems to enhance central power. This is more easily accomplished after a crisis or a perceived crisis, as was the case in 1998. After the politicization of a financial problem, one would expect the top bureaucrat to adopt policies that maximize central power and maximize the apparent improvement of the situation without jeopardizing his ability to resolve other pressing issues. One would also expect senior technocrats to implement policies that minimize the short-term cost of solving problems, disregarding the long-term consequences. Policies or policy options that do not fulfill these objectives are likely to be modified or abandoned altogether. In hindsight, these are precisely the financial policies that the Zhu Administration adopted.

Outcomes of the 1998 "Reform": Four Cases

The favorable conditions at the beginning of the Zhu Administration generated great expectations of significant financial reform. After all, Zhu Rongji was heralded as a tough reformer by everyone from fund managers to the *Wall Street Journal* to U.S. Secretary of Treasury Lawrence Summers (K. Chen, 1998). With the removal of ideological barriers and a perceived crisis, all the pieces seemed to be in place for a series of long-awaited reforms. At the end of Zhu's tenure, great changes were made to centralize financial power to the State Council, which Zhu directly controlled. Beyond that, however, most of the banking resources remained in the hands of the giant state banks and were allocated to the state sector.

The policy analysis approach here compares the expected outcomes from alternative explanations with actual outcomes. The policy areas examined include financial centralization, policies addressing the enormous NPL problem, interest-rate liberalization, and the legalization of the private banks. All four areas had been under intense discussion by the policy community during or before Zhu's tenure, but only the first two policies were implemented. These four cases generate both between-case variation and within-case variation. With access to internal government debates about these policies, the analysis below further observes abandoned proposals, creating within-case variation. The political survival framework explains both why some policies were carried out zealously, whereas others languished, and why specific options within a policy area were adopted.

Banking Centralization

Banking centralization was the hallmark of Premier Zhu's financial policy. Previously, local branch managers of state banks were appointed by the local party secretary, which gave rise to rampant local intervention in the banks. 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 (Lardy, 1998). Yet careful examination reveals that Zhu's team hastily hobbled together the centralization plan when the political opportunity presented itself. Ironically, the policy with the least intellectual preparation was implemented immediately, whereas other long-anticipated policies were delayed.

As the Fifteenth Party Congress convened in the autumn of 1997, the most dynamic economies neighboring China were toppling in rapid succession. Initially, China seemed unaffected because it had effective foreign exchange control. Yet fewer than a week after the Fifteenth Party Congress at the First Plenum, General Secretary Jiang Zemin declared, "the prevention and resolution of financial risk is an important and urgent task. . ." (Zhu, 1998). His remarks were by no means empty words. Bank officials uniformly attributed major changes in banking policies to the shocking lessons from the Asian Financial Crisis. The central leadership was genuinely afraid that China would follow Indonesia's path of economic collapse and political chaos (anonymous, personal communications, October 8, 2000; October 10, 2000; October 27, 2000; December 13, 2000; April 15, 2001). Although the Politburo had reasonable cause for alarm, the new premier further manipulated the issue to centralize the banking system.

Before the Asian Financial Crisis, few at the State Council, China's cabinet, had considered centralizing the appointment authority over local bank managers from the local party committees to the central government. Instead, State Council technocrats proposed numerous alternative policy measures to deal with the growing NPL problem, including the establishment of a central commission to coordinating lending, a national system to monitor the asset-to-liability ratio of all financial institutions, and even a scheme to simply forgive interest payment owed by SOEs (Industry and Commerce Bank of China Research Group on Problems of Enterprise Bankruptcy, 1998).

But before these policies could be tested, the Asian Financial Crisis catapulted the NPL problem from a minor technical problem to the center of the regime's focus. The newly appointed premier, along with State Council technocrats, created the crisis mentality by circulating a flood of alarming internal reports on the Asian Financial Crisis among the leadership (e.g., Guangdong Branch of the People's Bank of China, 1998). In October 1997, the Central Committee and the State Council abruptly issued a stern decree to remove local branches of the state banks and the central bank from local Party committees' jurisdiction and to place them under the newly formed Central Finance Work Committee (Heilmann, 2005).

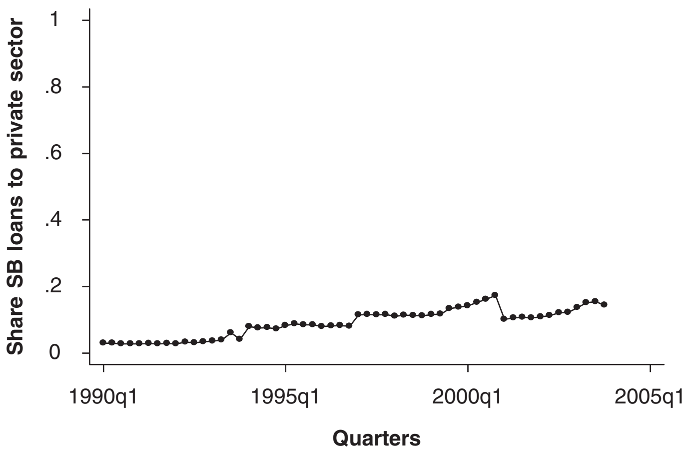
The heart of the centralization drive was the establishment of a vertical party committee system within the financial system that was insulated from the local party committees, which successfully removed local branches of state banks from the grasp of the local government (anonymous, personal communications, October 8, 2000; October 10, 2000; November 27, 2000; December 25, 2000; May 21-23, 2001; June 8, 2001). In addition to centralizing their internal command structures, the Big Four state banks also lowered the lending authority of the local branches from billions of Reminbi (RMB) to hundreds of millions of RMB (anonymous, October 10, 2000, May 22-23, 2001). 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 other policies, this could have furthered financial reform significantly, but Zhu instead mobilized the centralized banking system to achieve short-term policy goals.

The most pressing policy goal for the Zhu Administration was another SOE rescue program, which promised to get SOEs "out of difficulties" in 3 years. This was indeed an ambitious goal. For the best part of the 1990s, the Communist regime had witnessed ailing SOEs fall deeper and deeper into the quagmire of low productivity, high inventory, and high debt. Despite repeated efforts to improve SOE performance, more than 40% of SOEs were making losses (State Information Center, 1999a). By the late 1990s, the leadership had made rescuing SOEs a top priority for the regime, and financial centralization allowed Zhu to provide impressive but temporary solutions to the problem. In essence, Zhu channeled an enormous financial resources to politically connected large SOEs while denying smaller SOEs and private firms credit.

The State Council designed two major banking policies to help large SOEs—debt-for-equity swaps and interest subsidies for loans—even though these policies diminished bank autonomy. Debt-for-equity swap involved forgiving SOE debt in exchange for SOE equity. Zhu mobilized the powerful central bureaucracy, headed by the State Economic and Trade Commission (SETC), to determine which SOEs would receive this free-ride of debt forgiveness, greatly empowering the agency. Furthermore, the Zhu Administration bolstered the practice of providing subsidized loans to major SOEs. Again, central agencies, rather than the banks themselves, decided on the recipients. In 1998 alone, the state banks extended some 200 billion RMB in loans through this program, equivalent to 22% of the increase in state bank loans that year (State Information Center, 1999b). Although banks were not formally required to approve loans going toward SETC approved projects, bank managers in reality approved more than 90% of these loans because of implicit loan guarantees from powerful government agencies (anonymous, personal communications, April 15, 2000; November 27, 2000; December 25, 2000; April 21-22, 2001; June 7, 2001). Thus, rather than evaluating firms based on their commercial risk profiles, bankers continued to lend to firms based on their bureaucratic risk profile.

The net effects of these policy biases did not suggest bold reform. As Figure 1 demonstrates, the share of state bank loans outstanding to the private sector remained largely stagnant through these policy changes. Overall, the share of total loans outstanding to nonstate enterprises and to individuals increased from 11% during the first quarter of 1997 to 14% in the fourth quarter of 2003.[2] Furthermore, although the state sector lost a quarter of its workforce during Zhu's tenure, state bank loans outstanding to the state sector increased from 4.6 trillion RMB (67% of GDP) in the first quarter of 1997 to more than 9 trillion RMB at the end of 2003 (77% of GDP; China Statistical Information and Consultancy Service Center, 2004). Moreover, the Big Four state banks continued to dominate China's financial market with both lending and deposit share well above 50%.

Figure 1
Share of Outstanding State Bank Loans to the Nonstate Sector: 1990 to 2003



Source: China Statistical Information and Consultancy Service Center, 2004; Division of Statistics of People's Bank of China, 2000.

Digesting NPLs

Years of soft-budget loans to SOEs had produced a major NPL problem in China by any standard. By 2001, independent estimates place China's NPL ratio at between 40% and 45% of all loans outstanding, or some 44% to 55% of the GDP.[3] After Zhu convinced the leadership that NPLs constituted a major risk confronting the regime, he quickly devised a two-pronged strategy to deal with the problem. First, he recapitalized banks and set up asset management companies (AMCs) to digest the existing pool of NPLs among state banks. Second, he centralized the banking system and implemented strict policies to prevent the formation of new NPLs. Rather than radically transforming the Chinese banking sector, his NPL strategy primarily deferred the explicit fiscal and inflationary risk of NPLs to the future.

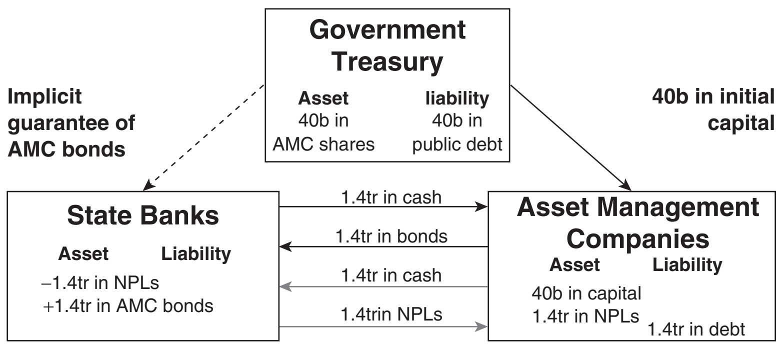
To decrease the massive pool of NPLs in China's financial system and increase capitalization in the banking system, Zhu first ordered the central government to issue 270 billion RMB of special financial bonds to recapitalize the banks. This process made explicit the government's responsibility for the creation of NPLs. Instead of banks bearing the burden of NPLs because of government policies, the burden of NPLs was transferred to the government in the form of national debt. Had this process repeated itself in subsequent years and had banks been allowed to use government injections to write off NPLs, state banks would have been on their way to being free of the "historical burden" of state intervention.

Indeed, some government experts argued for large-scale issuance of special bond to pay off NPLs, thereby making explicit the government's obligation from the outset. Proponents of this approach argued that making the government's obligation explicit would render future government bailouts more costly, increasing the credibility of this "last supper" and decreasing the moral hazard for banks (Zhan, 2000). This proposal was ultimately shelved, because it would result in a sudden surge of central deficit, which would reflect badly on Zhu and highly constrain central government spending in other areas (Er, 1999).

To accomplish the goal of digesting an enormous store of NPLs without large-scale deficit financing, a group of technocrats suggested establishing financial companies to take over the NPLs. Within this rubric, one option was to set up state-owned AMCs, which gave either bonds or stocks to the banks in exchange for bad debts. This would clean up the banks' balance sheets and separate bad debts from the banks. Finally, the government considered using private financial companies to purchase NPLs from banks at a highly discounted rate (Er, 1999). The last option was deemed undesirable because the government would still have to write off the discounted amount after the sale of the NPLs to private entities, thereby rapidly increasing the government's deficit.

The decision to set up four state-owned AMCs came fairly quickly after Zhu had become premier in 1998. On the basis of a token 40 billion RMB in initial capital from the treasury, the four AMCs issued 1.4 trillion in financial bonds to the state banks and used the funds to purchase 1.4 trillion in NPLs from the Big Four banks at face value (see Figure 2).[4] AMCs had a charter of 10 years and were tasked with recovering as much of the NPLs as possible through debt-to-equity swap and auctions. At the end of the 10-year charter, the treasury would issue bonds or inject government surplus to write off the remaining amount. Essentially, AMCs became the government's warehouses for bad debt, enabling the government and banks to keep bad debt off of their balance sheets. In this manner, state banks replaced 1.4 trillion in NPLs with 1.4 trillion in Ministry of Finance (MOF)–backed AMC bonds, thereby getting rid of some two fifth of the estimated 3.3 trillion in NPLs. Meanwhile, the MOF did not have to list the

Figure 2
Transferring NPLs from Banks to Asset Management Companies



Note: AMC = asset management companies; NPL = nonperforming loans.

1.4 trillion in special bonds on the official budget, because the MOF merely guaranteed the bonds issued by the AMCs. The AMCs, on the other hand, were saddled with 1.4 trillion in NPLs and 1.4 trillion in debt to the state banks. Although AMC officials initially resisted purchasing NPLs at face value, the opposition soon dissolved as they realized that the MOF was ultimately responsible for the pool of NPLs (anonymous, personal communication, May 14, 2001).

In the short run, all the bureaucratic interests and the political interest of Zhu Rongji gained from the transfer of NPLs to AMCs. The state banks replaced NPLs with performing assets backed by the MOF. The MOF did not have to make explicit the treasury's obligation to the public by massively issuing bonds. Although the MOF would have to deal with the remaining NPLs in 10 years, top MOF officials were mainly interested in short-term results, which served to promote their career prospects (anonymous, personal communications, May 19, 2001; June 23, 2001). The SETC gained enormous power to decide the fate of thousands of SOEs through debt-to-equity swaps. Although technocrats involved in setting up, AMCs all realized that the recovery ratio for NPLs was likely to be low (10% to 20% range) and that the treasury would have to write off an enormous amount of NPLs in the future, their main objective was to minimize the short-term burden for themselves and for the Zhu Administration (anonymous, personal communications, May 14, 2001; June 23, 2001). In fact, finding it the ideal tool, the central government increased the amount of NPLs transferred to AMCs from the originally planned 400 billion to 1.3 trillion and finally to 1.4 trillion RMB (Chang, 2001, p. 5).

The outward effect of the AMC policy was impressive (see Figure 2). Trillions of NPL disappeared from banks' balance sheets while government deficit remained at about the same level. Nevertheless, the primary net effects of Zhu's anti-NPL policies were transferring the fiscal pressure of the NPLs to the future and creating dependency on the AMCs as a convenient way of reducing NPLs. Although official announcements claimed that AMCs would recover 30% to 50% of the NPLs, Western analysts and government experts agreed that the actual cash recovery ratio is likely to be much lower (Gilley, 2000). AMCs have thus far dealt with more than 400 billion RMB in NPLs, but cash recovery as of the end of 2005 was only 154 billion RMB, or 11% of the transferred NPLs (Wang, 2005). Furthermore, as skeptics of the AMC policy had feared, instead of supplying banks a "last supper," the government continued to use AMCs to bail out banks and other financial institutions. In the middle of 2004, for example, Cinda AMC purchased a further 300 billion plus RMB in NPLs from the Bank of China, the China Construction Bank, and the Bank of Communications in preparation for their listings (Hu, 2004).

Setting the Interest Rates

Although enthusiastically implementing policies that increased the authority of the central economic bureaucracy, Zhu was much more reluctant to liberalize interest rates, which would have decreased the central government's ability to direct the flow of money. This reluctance created an enormous opportunity cost for China's economy. The rationale for setting mandatory interest rates to which all financial institutions must abide is threefold. First, the central government feared that marketized interest rates would drive banks to lend to more profitable private enterprises, depriving SOEs access to cheap capital. Moreover, mandatory interest rates on deposits prevented banks from engaging in "ruinous competition" with each other to attract deposits, which would increase the state banks' interest payments to depositors (Xie, Liu, Cheng, & Zeng, 2001). Furthermore, without an established national credit system, marketized interest rates would adversely select risky companies to apply for high-interest loans (anonymous, personal communication, May 14, 2001). Ultimately, control over deposit and lending rates constitutes a powerful monetary tool to boost short-term growth and relieve interest payments for SOEs and state investment projects (anonymous, personal communications, May 14, 2001; June 23, 2001).

Liberalizing interest rates, however, would greatly increase the efficiency of capital allocation. First, liberalized interest rates would provide banks, especially joint-stock banks, the incentive to lend to the vibrant private and joint-venture sector, creating jobs and increasing productivity. As one People's Bank of China (PBOC) researcher put it, "(mandatory interest rates) weakens the role of interest rates to guide liquidity toward sectors with high efficiency. . . ." (Xie et al., 2001, p. 29) More important perhaps for central bank technocrats, interest-rate liberalization would drastically reduce the transaction and monitoring costs for the PBOC. Under the existing system, the PBOC had to monitor more than 70 types of interest for commercial banks, 36 types for policy banks, and an additional 14 types of subsidized interests. Essentially, because interest rates were manipulated to allocate rent to regions, sectors, and policy areas, the PBOC had to ensure the proper interest rates applied to every major loan (Xie et al., 2001).

Maintaining the status quo on interest rates would have been reasonable if the policy community was in consensus about the risks of liberalization. In reality, interest rate liberalization had been a much discussed policy issue since the 1980s and enjoyed considerable support from local officials and bankers. Local officials in prosperous regions wanted liberalized interest rates to speed up the channeling of funds to the private sector (Bo, Zhao, & Liu, 1996). Bank officials felt that interest rate liberalization would foster competition between the state banks (Xie, 1995). Bankers, academics, government officials also felt that interest-rate liberalization would vastly improve the efficiency of capital allocation in China (Zhou, 2000). In sharp contrast to banking centralization, which Premier Zhu implemented immediately on taking power, he delayed significant interest-rate liberalization, despite a strong consensus across the board in favor of it. As a central bank official put it in 2001 (anonymous, personal communication, May 14, 2001), "first, it is not up to the PBOC to decide the issue. The State Council will make a decision on this, although we have already advised them to free it up." When PBOC Governor Dai Xianlong announced a definite plan to liberalize interest rates in 3 years in 2000, Zhu countermanded Dai and changed the time-frame to a vague "five to ten years" (Gilley & Murphy, 2001).

Instead of general liberalization, the State Council loosened the band around the mandatory rates for limited categories of loans. To increase rural lending, the PBOC in 1999 bestowed rural credit cooperatives greater leeway to adjust interest rates (Chan, 1999). In September of 2000, the PBOC announced that interest rates on foreign currency deposits would be set by the China Bank Association, a newly formed government directed association of bankers. In March 2002, however, the PBOC rescinded this plan for most but the largest depositors, further delaying interest rates liberalization (The Asian Wall Street Journal, 2002). At the end of Zhu's tenure, the PBOC still set a tight band around the interest rates of deposits, most short-term loans, and medium and long-term loans. Although local officials and some PBOC officials have lobbied for more than a decade on its behalf, they had little success. Thus, the central bureaucracy's strong preference for tight control over China's vast financial resources triumphed over the preferences of local governments and banking experts, causing a prolonged delay in interest rate liberalization.

Setting Up Private Banks

Since the beginning of the reform, private or quasiprivate financial institutions have formed in localities where their services were needed (Tsai, 2002). Deng's Southern Tour in 1992 further galvanized the expansion of grassroots private financial institutions. According to an estimate by a government think tank in 2004, unregulated private financial institutions had assets equivalent to one third of that held by formal financial institutions (Zhong, Ba, Gao, & Zhao, 2004). Unlike state-owned behemoths, small private banks made mostly short-term loans and had the freedom to charge and give interest equivalent to three times that at the state banks. In localities where they thrived, especially in Zhejiang, Anhui, Jiangsu, and Fujian, private financial institutions captured a substantial volume of deposits from state bank branches, forcing them to increase their deposit rates against PBOC regulations (Lu, Lu, & Hu, 1998). Individual depositors benefited from the higher interest rates provided by these institutions, and private businesses raised much-needed funds that the state banks denied them.

Undoubtedly, nascent financial institutions came with a host of their own problems. First, swindlers, sometimes with the cooperation of local government officials, concocted pyramidal schemes to defraud depositors, causing banking panics, protests, and even riots (Yu, 2001). Moreover, owners of some underground financial institutions used highly coercive means to enforce contracts, which created significant problems for the local police. Private financial institutions also served as tax shelters for individuals or businesses, especially after the implementation of the deposit interest tax in 1999. According to one estimate in 1998, depositors in private financial institutions were able to evade as much as 10 billion RMB in taxes(Lu et al., 1998). Finally, underground banks on the southeastern coast served as major conduits by which corrupt officials, businesses, and ordinary people could illegally purchase foreign currency and even set up offshore accounts (*Jinrong Shibao*, 2002).

Despite these problems, many bankers and financial experts within the government supported the legalization of informal financial institutions. Career bankers felt that legalizing private banks would increase the efficiency of capital allocation and allow the PBOC to monitor their activities much more effectively (anonymous, personal communications, November 25, 2000; June 23, 2001). Thus, from a purely bureaucratic standpoint, the central bank had an interest in legalizing these institutions. Bankers at the local level especially noted that when the center directed financial resources to SOEs, informal finance provided much needed capital to the vibrant small and medium enterprises. On the coast, at least, private banks had begun to take reputation seriously and kept a good record of paying depositors, and private businesses increasingly relied on them for financing (Tsai, 2002).

Given their record, local cadres increasingly recognized private banks as a vital and integral part of the local economy. Local PBOC officials and township cadres in Zhejiang openly praised informal credit associations and banks for their crucial role in supporting rural development. Rather than banning them, local officials supported legalizing and regulating private institutions(Cui, Li, & Wu, 2001). In 2000, when the Shanghai regional office of the PBOC decided to close down private banks in Zhejiang, local cadres mobilized their personal connections in Beijing to fight the closure. At first, the Shanghai PBOC office agreed to delay action until further investigation had been completed. In the end, however, one of the oldest and most reputable private banks, operated by the Dongfang Group in Wenzhou, was indicted for "illegally absorbing deposits" and was promptly shut down (D. Chen, 2001).

Instead of slowly allowing private banks to form, the Zhu Administration heightened the suppression of private banks. One of Zhu's first acts as premier was closing down hundreds of private and quasiprivate financial institutions that had sprung up in the early 1990s. In June 1998, the State Council promulgated Order 247, titled "Methods of Suppressing Illegal Financial Institutions and Illegal Financial Business Dealings." According to this decree, illegal financial institutions included "all institutions that are set up to absorb deposits, release loans, conduct clearance, discount notes, . . . without the approval of the PBOC"(State Council, 1998, p. 30). Although this included financial institutions operated by the local authorities, local government and police were supposed to help suppress these institutions. As the Wenzhou case reveals, implementation of this regulation was extremely difficult.

From both the technocratic and bureaucratic standpoint, the persistent criminalization of private banks makes little sense. Legalizing private banks would increase the efficiency of capital allocation, support local growth, and drastically reduce the monitoring swamp faced by the PBOC. Allowing private banks to enter the market would further increase competition and prepare Chinese banks for foreign competition. Politically, Zhu could have found powerful allies in the party to push for the legalization of private banks. Despite the high opportunity cost and the enormous monitoring quagmire of suppressing private financial institutions, Zhu hardly changed the status quo during his tenure. The status quo was maintained mainly to retain financial resources directly under the control of the central government (anonymous, personal communications, November 10, 2000; June 23, 2001). Zhu could only achieve his policy goals and expand his influence in the Politburo if he kept China's vast financial resources in the state banks.

Conclusion

Incomplete financial reform in China is puzzling because Premier Zhu Rongji, a seemingly promarket technocrat, had firm control over financial policies in 1997 with little pressure from social groups and minimal interference by leftist ideologues. Yet at the end of Zhu's 5-year term as premier, the financial sector remained dominated by the state and continued to channel the bulk of savings toward the state sector. Theories that describe reform as a neat policy bundle and theories that assume technocratic preferences for reform simply cannot account for this partial reform equilibrium. Rather, continuing gross inefficiency in the financial system can best be understood by examining the political and careerist incentives of those who decided on the policies. Although fairly insulated from societal pressure, the technocrats faced political threats from within the party. Their concern for political survival produced a bundle of policies that maximized their financial control, bolstered their administrative accomplishments, and minimized policy risks.

Although banking reform continued into the Wen Jiabao Administration, the government remained focused on painless fixes involving massive capital injections. To further diminish NPL ratios in the state banks, the new premier ordered the central bank to inject 45 billion dollars into two ailing state banks from China's enormous foreign exchange reserve. With this massive injection, the two banks, China Construction Bank and Bank of China, readied to sell a minority stake to foreign investors and small investors through listings in Hong Kong. However, most members on these two banks' boards are government officials (Shih, 2005). Ironically, although foreign investors are increasingly able to take minority stakes in state banks, domestic private investors are still unable to set up privately owned financial institutions.

Is the problem of partial reform equilibrium unique to postcommunist countries? A cursory examination of the evidence suggests that the influence of insiders on reform trajectory might be an underemphasized aspect of financial reform in Latin America. Although a rich literature provides valuable insights about the causes and process of financial liberation in Latin America, much of the discussion sees financial reform as a dichotomous variable (Boylan, 2001; Maxfield, 1993). These frameworks provide powerful explanations for financial reform, but not all policies beneficial to a healthy financial market were enacted with the same eagerness. As Mishkin (2000) points out, an important aspect of financial liberalization is the construction of regulatory capacities, which guard against moral hazard and adverse selection. Yet financial reform in many Latin American countries favored liberalization and privatization and neglected financial regulations. As a result, bankers in many cases took advantage of the arbitrage opportunity to borrow heavily from abroad and lend or speculate in domestic currencies, leading to financial bubbles and crises (Alston & Gallo, 2000; Hastings, 1993).

Instead of explaining the success of liberalization alone, a more comprehensive explanatory framework would account for both financial liberalization and the apparent lag in regulatory reform in the financial market. For example, the first round of financial liberalization in Chile benefited a small group of connected bankers enormously (Hastings, 1993; Silva, 1996). In this example, although the Western training of the "Chicago Boys" explains privatization and capital account liberalization, it does a poorer job explaining insider privatization and the lag in building regulatory structure. Instead, an explanation focusing on the Chicago Boys' close ties with the financial conglomerates does a better job of explaining these outcomes (Silva, 1996). Perhaps Olson's (1965) original observation remains valid, despite the torrent of literature claiming otherwise. Policy changes do not occur because they benefit society as a whole; they occur because a small group of actors gain enormously in the process, which gives them incentive to push policies toward the new equilibrium.

Notes

1. In November of 1997, Zhu promised western provinces that subsidized loans to western China would not be affected by the centralization (see Zhu, 1998).

2. According to the People's Bank of China categorization, nonstate lending includes working capital loans to joint-ventures set up by Hong Kong, Taiwan, and Macau firms (*sanzi*), individual enterprises (*geti siying*), joint-ventures and "other," and medium-term and long-term loans to "other." See Division of Statistics of People's Bank of China, 2000.

3. This nonperforming loan (NPL) figure represents the mean of estimated NPL by various groups. See Berger, Nast, and Raubach, 2002.

4. "At face value" means at the original amount of the loan plus accrued interest. Normally, one would never purchase a NPL at face value because of the high-risk profile of a nonperforming loan.

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