

Elite Decision-Making in China's Financial Sector: A Quasi-Market Analysis

Victor Shih

Assistant Professor of Political Science, Northwestern University

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How are financial policies made in China? What motivates policy-makers? This paper presents a quasi-market model for financial decision-making in which multiple agencies headed by power-maximizing ministers propose a range of policy options on multiple issues to spark the interest of power-maximizing elite policy consumers. If a senior leader or elite decision body sponsors a policy, then the lead agency that proposes that policy would enjoy elite attention and heightened formal power. A market analysis of financial policy-making suggests an impetus for persistent policy innovations, a strong preference for rapid fixes, a tendency to disregard long-term consequences of policies, and prolonged jurisdictional competition between agencies involved in the financial sector.

Introduction: a “Market” View of Financial Policy Making

The policy-making process in China at times seems like a black box from which one surprise after another springs forth. For example, foreign investors and, indeed, Chinese academics were generally surprised by the use of the foreign exchange reserve to recapitalize the Big Four state banks in early 2004. This confusion stems partly from the assumptions we make about the Chinese policy process. In democracies, we have an easier time observing the driving forces of policy formulation. Politicians who seek offices or re-elections must formulate policies that maximize their electoral prospect, either by appeasing voters or powerful lobbies.¹ In the absence of democratic pressure, it remains unclear what the driving forces of policy-making are, in China and elsewhere. The naïve assumption that Chinese policy-makers create policies “for the good of the country,” is simply unsustainable because it can only explain policy success. Policy failures and stagnation are then attributed to mistakes, incomplete information, or external shocks. In fact, myriad studies of policy-making have shown leaders in a wide variety of settings are perfectly capable of initiating bad policies on their own.² This paper attempts to demystify policy-making in China by making some simple assumptions about the incentives of Chinese leaders and bureaucrats.

¹ There is an enormous literature in this vein in the study of American politics. But the notion that politicians are “vote maximizers” began with the following works. Anthony Downs, *An Economic Theory of Democracy* (New York: Harper, 1957), David R. Mayhew, *Congress: The Electoral Connection, Yale Studies in Political Science; 26* (New Haven: Yale University Press, 1974).

² See, for example, Alberto Alesina and Allan Drazen, “Why Are Stabilizations Delayed?” in *Monetary and Fiscal Policy: Volume 2, Politics*, ed. Torsten Persson and Guido Tabellini (Cambridge, MA: MIT Press, 1995), Robert H. Bates, *Markets and States in Tropical Africa: The Political Basis of Agricultural Policies, California Series on Social Choice and Political Economy* (Berkeley: University of California Press, 1981), Frances McCall Rosenbluth, *Financial Politics in Contemporary Japan, Studies of the East Asian Institute* (Ithaca: Cornell University Press, 1989).

To further complicate policy-making in China, a bewildering alphabet soup of agencies and individuals are involved in even very basic financial policy-making. This paper seeks to provide a structure for understanding financial policy-making in China through the usage of a simple quasi-market model of policy-making. This model is likely more useful as a heuristic to organize the important players in financial governance than as a tool to predict policy outcomes. Nevertheless I briefly outline some policy and theoretical implications of this quasi-market model of financial policy making.

For the purpose of this analysis, all government organizations involved in the financial arena are divided into “consumers” and “producers.” The consumers are elite policy makers or policy-making groups that make executive decisions about major financial policies. Producers are ministerial-level organizations that can both implement policies and provide policy alternatives to senior policy-makers. Both consumers and producers are presumed to be power-maximizing, meaning that they wish to rise as high in the CCP hierarchy as possible. Consumers are Politburo Standing Committee members who wish to retain their positions and to expand their influence in the Standing Committee. Producers are ministerial officials who aim to enter the Politburo. Note this assumption is different from the typical assumption of the budget-maximizing bureaucracy.³ Unlike the prototypical Weberian bureaucracy, there is no hard distinction between bureaucrats and politicians among senior policy-makers, since they are all

³ William Niskanen, *Bureaucracy and Representative Government* (Chicago: Aldine Press, 1971), Barry Weingast and Jeffrey Banks, "The Political Control of Bureaucracies under Asymmetric Information," *American Journal of Political Science* 36, no. 2 (1992).

eligible to enter the Politburo Standing Committee (PSC), which is the ultimate locus of power in China.⁴

In this market for financial policy-making, high-level consumers are monopsonists, for whom producers - the various ministries - must compete with one other for “contracts.” Thus, this market is imperfect in the sense the elite consumers can artificially suppress the “price” that they pay. If we believe that the main currency in the government is power and prestige, then senior leaders are high net-worth individuals who reward producers with fame and promotion of their policies. Power and prestige, however, are suboptimal metrics for conveying price signals as they do not express themselves in easily observable units. Moreover, the market suffers from fundamental contract enforcement difficulties since the complexity of elite politics does not always allow consumers to pay producers the expected reward for services. The contract enforcement problem is partially alleviated by the realization of exchange between consumers and producers. That is, the producer automatically gains prestige and a bolstered resume when an elite consumer adopts the policy proposal put forth by a particular producer. Thus despite the imperfections of this “market,” this framework provides a useful first-cut into the analysis of financial policies in China by decoupling and clarifying the incentives of the various actors involved in the policy process.

In the analysis below, I will first describe the makeup, incentives, and organization of both groups of actors (ie, producers and consumers). I will then describe how these groups of actors fit into the overall policy process in China. Finally, the paper

⁴ Victor Shih, "Dealing with Non-Performing Loans: Political Constraints and Financial Policies in China," *The China Quarterly* (2005).

concludes with a discussion on policy and theoretical implications of the framework presented.

Consumers

Because China remains a one-party authoritarian regime, the ultimate consumers of policy are not the citizenry, but rather the top leaders of the Chinese Communist Party (CCP). As senior leaders, they have a collective interest in maintaining power and individual incentive to maximize their own prestige and standing. Therefore, these CCP leaders have a stake in promoting financial policy innovation and ensuring the success of some of these policies, although elite political competition has a tendency to slow down radical policy innovations. To this end, senior leaders seek policies they believe would produce the most desirable political and economic outcomes. However, as in any consumer market, this does not preclude producers from shaping consumer preferences through aggressive marketing campaigns. Factional politics further complicate the picture (e.g., one has an incentive to promote bad policies in an area controlled by political rivals), but for the sake of focus this paper will not address this aspect of policy-making.

The ultimate consumer of policies in China is the Politburo Standing Committee (PSC) composed of the top nine or so senior leaders who vote on all major decisions in China, an important point often ignored by the Western press. When the PBOC, for example, announced currency revaluation, it was not announcing a decision made by the PBOC, but rather one made by the PSC. Each member of the PSC is assigned a group of portfolios in which to specialize. Generally, PSC members who also serve as the premier

or the vice-premier in the State Council (SC) are in charge of economic portfolios, which include state-owned enterprises (SOEs), transportation, energy, finance, agriculture, fiscal affairs, and fixed-asset investment, among others.⁵ Although the member of the PSC who controls the finance portfolio (currently Vice-Premier Huang Ju) has considerable agenda-setting power in PSC discussions on financial issues, he cannot unilaterally make decisions on major policies and needs PSC votes to approve them. Specifically, although the PSC member in charge of finance can bring issues to the attention of his PSC colleagues, the party secretary general, who chairs most of the PSC meetings, can choose to discuss or set aside an issue, and even if an issue is voted on, his colleagues can approve or reject a proposal. Although it remains difficult for outside observers to determine what constitutes an “important issue,” decisions that potentially have significant impact on the overall economy, including interest rate liberalization, the revaluation of the RMB, and the listings of major state banks, are likely subjects to PSC votes.

The incentive of this group of senior leaders is extremely complicated, but if we abstract away from factional struggle, it becomes somewhat manageable. Collectively, the PSC has an interest to see that growth continues at a healthy pace in China because they know that a large part of the Chinese Communist Party’s (CCP) legitimacy rests on growth. Thus, without considering vested interests and factional conflicts, they are in general opened to financial innovations that can promote growth. Individually, each PSC member would like to make his or her own portfolio as successful as possible to increase individual standing in the PSC and to establish a policy legacy. Failure in a policy area

⁵ Kenneth Lieberthal, *Governing China: From Revolution through Reform*, 1st ed. (New York: W.W. Norton, 1995).

results in the humiliating prospect of being deprived of a particular portfolio, although PSC members are rarely removed from power for policy failure alone. For example, former Premier Zhu Rongji underwent the humiliating experience of being removed from the state-owned enterprise (SOE) portfolio for the perceived failure to galvanize local SOEs.⁶ PSC members' individual desire to operate successful portfolios thus introduces considerable complication to financial policy. Because money affects every policy area, a financial policy that prevents a PSC member from maximizing the success of his portfolio would likely generate opposition to the policy.

A recent example of this logic occurred when Party Secretary General Hu Jintao voted in favor of the revaluation of the RMB over the probable opposition of Premier Wen Jiabao. Despite the heated rumors of revaluation throughout much of 2004 and early 2005, the Chinese government repeatedly stated its intention to preserve the status quo exchange rate.⁷ Besides not wanting to reward speculators, one major factor for the reluctance to reevaluate stemmed from Premier Wen's desire to maintain strong employment momentum and to protect farmers. In an interview just days before the revaluation, the vice-director of the Head Office of the Central Finance and Economic Leading Group (discussed below) Chen Xiwen stated that revaluation would encourage grain import and harm Chinese farmers.⁸ As Chen Xiwen was a close advisor to Wen on rural policies, his comments likely reflected Wen's perspective. As the Premier of China, Wen's main portfolio is the overall health of the economy. Moreover, since the

⁶ Hairen Zong, *Di Sidai (the Fourth Generation)* (Hong Kong: Mirror Books, 2002), pp. 184.

⁷ See Li Yu, "Huilu Biange Shiji Chengshu? Yingxiang Jihe (Is the Opportunity to Reevaluate Mature? What Will Be the Impact?)," *Zhongguo Zhengquanbao (China Securities News)*, 4/29/2005 2005.

⁸ Cary Huang, "Yuan Rise 'Would Hurt Grain'," *South China Morning Post*, 7/4 2005.

beginning of his tenure, Wen has made rural economy a high priority in his administration.

In the mean time, the People's Bank of China, a producer, had aggressively lobbied the PSC for revaluation, even going as far as inviting a group of foreign economists to debate the issue.⁹ Although PBOC began to call for revaluation as early as 2003, this marketing campaign did not sway the PSC until the spring or summer of 2005, probably due to the objection from Wen and others.¹⁰ We are reasonably certain that the PSC finally voted in favor of revaluation due to Secretary General Hu Jintao's support. As he had the agenda setting power in PSC meetings, it would have been unimaginable to approve such an important shift without his blessing. Why did he support revaluation in July? One likely reason is that he wanted to appease the Americans before his impending (and delayed) trip to the US in September 2005. As the party secretary general, he led the Central Leading Group on Foreign Affairs, which gave him ultimate discretion over China's foreign affairs. Up to the end of 2004, Hu Jintao's role in foreign affairs had been shadowed by his predecessor, Jiang Zemin, who had served as the Chairman of the Central Military Commission (CMC).¹¹ With Jiang's formal retirement from the CMC at the end of 2004, Hu finally could build up his foreign policy credibility. However, meeting angry congressmen and disgruntled administration officials over China's currency would have made a disaster of Hu's trip. It is very likely that he supported the revaluation camp out of the desire to make his main portfolio, foreign affairs, a success.

⁹ James Areddy et al., "Behind Yuan Move, Open Debate and Closed Doors --- Two-Year Saga Included Secret and Staged Meetings, Weeks of Quiet Diplomacy," *the Wall Street Journal*, 7/25 2005.

¹⁰ The precise date of the PSC vote on revaluation is unknown, but it is highly unlikely that the final vote took place before April of 2005. Ibid, "China Sources: Politics to Outweigh Mkt on Yuan Rate," *Market News International*, 7/25 2005.

¹¹ Willy Wo-Lap Lam, "A House Divided: Contentious Politics within the Ccp," in *China Brief*, ed. Jamestown Foundation (Washington, DC: Jamestown Foundation, 2004).

Besides the PSC, enormous power is vested in the Central Finance and Economic Leading Group (CFELG), which was first founded in the early 80s to preside over economic affairs. The CFELG is typically chaired by the Premier of China, while its members typically include vice-premiers in the State Council with economic portfolios, as well as ministers of essential agencies, including the People's Bank of China, the National Development and Reform Commission (formerly State Planning Commission), the Ministry of Finance, and the Central Securities Regulatory Commission.

As an elite decision body, the CFELG serves three important functions in the policy process. First, in the economic arena, the CFELG sits just below the PSC and can unilaterally make decisions on important issues that do not pertain to the entire economy. For example, the CFELG routinely allocates fiscal and financial subsidies to various sectors and localities by issuing orders to the ministries.¹² Second, CFELG has since its formation been an important forum for senior leaders to debate about major economic policies before moving them to the PSC for final votes. For example, both the 1988 price reform and the 1994 tax centralization were debated vigorously in the CFELG among senior party leaders specializing in economic affairs.¹³ Thus, in some ways, the CFELG constitutes a more powerful organ for financial and economic policies than the PSC because a consensus is often reached in the CFELG before an issue is moved to the PSC for a vote.¹⁴ The CFELG affords elite specialists in the economy greater influence over

¹² See, for example, State Planning Commission et al., "Guanyu Fuchi Sanxian Qishiye Tiaozheng Jige Youdai Zhengce Wenti De Tongzhi (Notice on Question on Adjusting Preferential Policies to Support Third Front Industries)," in *1986 Nian Jinrong Guizhang Zhidu Xuanbian (a Selection of Financial Rules and Regulations in 1986)*, ed. The Office of Bank of China, et al. (Beijing: Finance Publisher, 1986).

¹³ Guoguang Wu, *Political Reform under Zhao Ziyang (Zhao Ziyang Yu Zhengzhi Gaige)* (Hong Kong: Pacific Century Institute, 1997), pp. 553, Dali L. Yang, *Beyond Beijing: Liberalization and the Regions in China* (London; New York: Routledge, 1997), pp. 101.

¹⁴ Again, the fiscal centralization of 1994 was likely such an issue. In a speech on fiscal centralization, then Vice-Premier Zhu Rongji stated that the main debate on the issue took place at the CFELG rather than the

economic policies than specialists in other areas in the PSC. Furthermore, the CFELG has its own research apparatus that advises senior leaders on various policy options. It also has the authority to “sub-contract” research to various other government agencies. Finally, although CFELG does not command its own policy implementation capabilities, it often coordinates policy implementation to ensure squabbling ministries and recalcitrant local governments carry out policies with the proper zeal.¹⁵

At about the same level as the CFELG is the State Council (SC), China’s cabinet. The SC is headed by the Premier and holds regular meetings attended by vice-premiers and ministers. Members of the SC overlap with both PSC members and CFELG members to a considerable extent (see Table 1), and in recent years, we find the SC mainly rubber-stamping the decisions of the PSC and of the CFELG in the economic arena. However, there was a period in the 80s when the CFELG was controlled by Premier Zhao Ziyang, while the SC was mainly controlled by planning stalwarts such as Yao Yilin and Chen Yun.¹⁶ Under this situation, SC considered different policy alternatives than the CFELG and at times countermanded the decisions of the CFELG.¹⁷ Although this dichotomy is unlikely to arise again, we cannot rule out the possibility. Unlike the CFELG, however, the SC obviously has enormous research and policy implementation abilities, which will be explored below.

PSC. See Rongji Zhu, "Zhengdun Caishui Jiexu, Yansu Caijing Jilu, Qianghua Shuishou Zhengguan, Jiakuai Caishui Gaige (Rectify Order in the Budget, Restore Strictness in Budgetary Discipline, Strengthen Management of Taxation, Speed up Fiscal Reform)," in *A Selection of Important Documents for Economic Structural Reform in the New Period (Xinshiqi Jingji Tizhi Gaige Zhongyao Wenxian Xuanbian)*, ed. Document Research Center of the Chinese Communist Party Central Committee (Beijing: Central Document Publisher, 1993).

¹⁵ Kenneth Lieberthal and Michel Oksenburg, *Policy Making in China: Leaders, Structures, and Processes* (Princeton, NJ: Princeton University Press, 1988).

¹⁶ Joseph Fewsmith, *Dilemmas of Reform in China: Political Conflict and Economic Debate* (Armonk, N Y: M E Sharpe, 1994).

¹⁷ Xiaonong Chen, "Decision and Micarriage: Radical Price Reform in the Summer of 1988," in *Decision Making in Deng's China: Persepctives from Insiders*, ed. Carol Lee Hamrin and Suisheng Zhao (Armonk, NY: M.E. Sharpe, 1995).

Beyond these permanent elite bodies, temporary leading groups are often formed to tackle specific problems in the financial arena. When former Premier Zhu wanted to suppress money supply and to centralize monetary policy in 1993, for example, he formed the Central Leading Group on Financial Reform.¹⁸ Zhu also formed the Central Finance Work Committee to oversee the centralization of the banking system in 1998, but it was abolished after centralization was accomplished.¹⁹ After Wen Jiabao took office in 2003, he revitalized momentum to reform state-owned banks by forming the Leading Group on State Bank Share-Holding Reform (LGSBSR). Although similar organizations existed during Zhu's tenure, they were much less powerful organizations headed by the governor of the PBOC Dai Xianglong, a ministerial official.²⁰ The new organization is headed by Vice-Premier and PSC member Huang Ju, which confers LGSBSR much more authority than its predecessors. LGSBSR has the specific missions of restructuring and listing all four of the state-owned banks. Because of the enormity of the task, its members include the new governor of the PBOC, Zhou Xiaochuan, who runs the head office, as well as the heads of the China Banking Regulatory Commission (CBRC), the Ministry of Finance (MOF), and the China Securities Regulatory Commission (CSRC).²¹

This organization most likely consolidates proposals from the various producer organizations on different stages of bank listings (recapitalization, share-holding restructuring, listing) and packages them for PSC or CFELG votes. For example, while the decision to inject capital from the foreign exchange reserve to recapitalize the Bank of

¹⁸ Zhu, "Zhengdun Caishui Jiexu, Yansu Caijing Jilu, Qianghua Shuishou Zhengguan, Jiakuai Caishui Gaige (Rectify Order in the Budget, Restore Strictness in Budgetary Discipline, Strengthen Management of Taxation, Speed up Fiscal Reform)."

¹⁹ Sebastian Heilmann, "Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry," *China Quarterly*, no. 181 (2005).

²⁰ Chenbo Wang, "Guoyou Yinhang Shangshi: Yichang Jiannan De Tizhi Gaobie (the Listing of State Banks: A Difficult Farewell to the System)," *Xinwen Zhoukan (News Weekly)* 2003, no. 44 (2003).

²¹ Ibid.

China (BOC) and the China Construction Bank (CCB) likely required PSC approval, there is every indication that LGSBSR first selected this proposal for a PSC vote. The LGSBSR sits between the consumers and the producers in that a producer organization, the PBOC, plays an important leadership role in the organization. Zhou Xiaochuan, the governor of the PBOC, runs the daily affairs of the LGSBSR, and he has clearly leveraged his position to favor policy proposals put forth by the PBOC. For example, the formation of Central Huijin Company to serve as majority shareholder of the newly restructured BOC and CCB greatly benefited the PBOC.²²

Although the LGSBSR cannot unilaterally decide on issues of national importance, it likely has enormous authorities over narrow questions pertaining to banking reform. For example, Vice-Premier Huang Ju presumably has the final say over selecting the strategic partners for BOC and CCB. As long as Huang is perceived to be following proper procedures in selecting the strategic partners, it is unlikely that other members of PSC—not even the Premier—would intervene in these decisions. Indeed, when Bank of America Chairman Kenneth Lewis went to Beijing to finalize its strategic position in the China Construction Bank (CCB), he first met with Huang Ju at Zhongnanhai before signing the agreement with CCB Chairman Guo Shuqing.²³ In a similar vein, the Leading Group probably has the final say on the exact amount of recapitalization, the shareholding patterns of the restructured banks, and the lead underwriters and strategic partners of the IPOs.

²² The Huijin Company, because of the composition of its senior management and the usage of the foreign exchange reserve, which is controlled by the PBOC, serves more or less as a PBOC subsidiary. Victor Shih, "Beijing's Bailout of Joint-Stock and State-Owned Banks," *China Brief* 5, no. 18 (2005).

²³ *Diyici Woshou: Jianghang Shandian Lianhun Meizhou Yinhang (the First Handshake: The Lightning Marriage between Ccb and Bank America)* (sina.com, 2005 [cited 6/27 2005]); available from <http://finance.sina.com.cn>.

Table 1: Main Consumers of Financial Policies ²⁴

<i>Organization</i>	<i>Members</i>	<i>Authorities</i>
Politburo Standing Committee (PSC)	<p>Hu Jintao (President, Party Secretary General) Wu Bangguo (Chairman of the National People's Congress) Wen Jiabao (Premier) Jia Qinglin (Chairman of Chinese People's Political Consultative Conference) Zeng Qinghong (Vice-President) Huang Ju (Vice-Premier) Wu Guanzheng (Chairman of the Central Disciplinary and Inspection Committee) Li Changchun (Chairman of the Leading Group on Spiritual Civilization Construction) Luo Gan (Chairman of the Politics and Law Committee)</p>	Ultimate authority over all issues of national significance
Central Finance and Economic Leading Group (CFELG)	<p><i>Chairman:</i> Wen Jiabao <i>Vice-Chairman:</i> Huang Ju <i>Members:</i> Wu Yi (Vice-Premier) Zeng Peiyan (Vice-Premier) Hui Liangyu (Vice-Premier) Hua Jianmin (State Councilor) Ma Kai (Minister, National Development and Reform Commission) Jin Renqing (Minister of Finance) Zhou Xiaochuan (Governor of PBOC) Li Rongrong (Chairman of the State Asset Supervision Administration Commission)</p>	<p>Sets agenda for PSC votes and hosts debates on economic issues</p> <p>Makes final decisions on minor economic issues</p> <p>Makes decisions on the distribution of fiscal and monetary subsidies</p>
The State Council (SC)	The Premier and all of the vice-premiers are also members of the CFELG	Similar to CFELG authorities
Leading Group on State Bank Share-Holding Reform (LGSBSR)	<p><i>Chairman</i> Huang Ju <i>Vice-Chairman</i> Hua Jianmin <i>Head of the Office</i> Zhou Xiaochuan <i>Members</i> Jin Renqing Liu Mingkang (Chairman of the China Banking Regulatory Commission) Shang Fulin (Chairman of the China Securities Regulatory Commission) Other possible members include the vice-governor of PBOC Wu Xiaolin and the head of State Administration of Foreign Exchange Hu Xiaolian.</p>	<p>Sets agenda for CFELG and PSC votes and hosts debates on issues pertaining to banking reform</p> <p>Makes ultimate decisions on narrow issues related to banking recapitalization, restructuring, and listing</p>

²⁴ Sources: the *People's Daily* website (<http://www.people.com.cn/>), Zhenhua Li, "Huang Ju, Zhou Xiaochuan Zuozhen Gugai Lingdao Xiaozu (Huang Ju and Zhou Xiaochuan Takes Charge of Share-Holding Reform Leading Group)," *21 shiji jingji baodao (21st Century Economic Report)*, 11/18 2003.

Beyond the above “consumers,” there are other agencies and organizations that make decisions on financial policies. For example, the PBOC itself makes voluminous regulations every year, but they are either highly technical decrees or are the fine-tuned extensions of more general policies decided by the aforementioned groups. In terms of financial policies of national or sectoral significance, the above organizations constitute the final arbiters.

Producers

The main producers of policies in China include the major State Council ministries and directly administered units, all of which are at the ministerial level. These agencies tend to be large entities with policy implementation capabilities, provincial and local branches, and a substantial administrative and research staff. Therefore, all producers also serve a consultative role in the policy process. As ministers, the heads of producer organizations can all be seen as ambitious politicians hoping to rise higher in the hierarchy, with the ultimate aim of entering the PSC and becoming the premier of China. To achieve these aims, senior officials in these producer ministries mobilize their organizations to compete with each other for major policy “contracts,” which bolster their administrative accomplishments and increase their promotion prospects. This competition is exacerbated by the ambiguous jurisdiction between these agencies, which gives considerable room for producers to encroach upon the jurisdiction of rival agencies.

Producer agencies in the financial sector can be divided into two groups: more powerful full-service providers and less powerful regulators. Full-service providers have

both enormous regulatory capacities, as well as control over a significant source of funding. The latter resource is important because it allows full-service providers to supply comprehensive policy solutions to policy consumers. As discussed below, the People's Bank of China (PBOC), the Ministry of Finance (MOF), and the National Development and Reform Commission (NDRC) all command a wide range of powers and resources. Their importance is reflected by the fact that their ministers are all full members of the CCP Central Committee, an elite body composed of the 200 or so of the most powerful officials in China. Furthermore, they all sit on the CFELG. In contrast, regulatory agencies, including the China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), and the China Insurance Regulatory Commission (CIRC), can only provide regulatory services that are often only a part of a package of financial policies. Politically, the current ministers of these regulatory agencies are only alternate members of the Central Committee, a half a step below full Central Committee members in the party hierarchy. These chief regulators are also not represented in the CFELG. Thus, although the formation of these regulatory agencies seemingly suggests a gradual movement toward an institutionalized financial regulatory framework, these regulators have found their authorities constantly challenged and diminished by the full-service providers.

In the financial arena, the most powerful and influential agency is the People's Bank of China (PBOC), which has enormous agenda-setting and executive authorities in monetary policy, financial regulation, and increasingly in personnel control. The PBOC's giant presence in the financial sector is a relatively new phenomenon. For much of the 80s, the State Planning Commission (today's NDRC) served as the main executor

of monetary policy through the implementation of the pervasive plan. Money supply, most of which came either from the state investment plan or the cash plan, was subsumed as part of the national or local production plan.²⁵ Beginning in 1992, when Zhu Rongji took over as vice-premier in charge of finance, the PBOC began to take a much more active role in formulating monetary policies. Nonetheless, the PBOC's dominance in monetary policy is by no means complete today. For example, the monetary policy committee, an advisory body that makes recommendations to the SC and CFELG, is composed of PBOC, MOF, CSRC, and NDRC officials.²⁶ The final arbiter of major shifts in monetary policy, most likely the CFELG or the PSC, additionally accepts recommendations on monetary policies from many agencies besides the PBOC.

Nonetheless, the PBOC in recent years has consolidated control over monetary policy as the number of monetary instruments it administers rose. When monetary policy composed of just the cash and investment plan, it was well within the Planning Commission's reach to directly influence monetary policy. However, as fixed asset investment became a declining share of the money supply and as the PBOC developed a growing arsenal of monetary instruments, its voice in the monetary policy process increased. In the past decade, the PBOC developed a host of monetary instruments, including open-market operations, reserve requirements, interest rate adjustments, asset-liability management, and PBOC bonds. Although the PSC and the CFELG still have

²⁵ Chuanzhi Fei, "A Comparison of the Lending and Monetary Adjustments During Several Major Economic Adjustment Periods since the Founding of the Country (Jianguo Yilai Jida Jingji Tiaozheng Shiqi Huobi Xindai Tiaokong De Bijiao)," *Financial Reference (Jinrong Cankao)* 1995, no. 5 (1995).

²⁶ PBOC Monetary Policy Committee, "Zhongguo Renmin Yinhang Huobi Zhengce Weiyuanhui Hui Zhidu Ji Qi Zuoyong (the Meeting System and Its Use for the PBOC Monetary Policy Committee)," in *Zhongguo Renmin Yinhang Huobi Zhengce Weiyuanhui Huiyi Jiyao (a Summary of Meetings of the PBOC Monetary Policy Committee)*, ed. PBOC Monetary Policy Committee (Beijing: China Finance Publisher, 2000).

ultimate say over monetary targets, the PBOC's command of these instruments provides the agency with enormous leverage over the exact implementation of monetary policy.

The PBOC's role in financial regulation has declined in recent years with the formation of the China Securities Regulatory Commission (CSRC), China Insurance Regulatory Commission (CIRC), and the China Banking Regulatory Commission (CBRC). Nonetheless, financial regulation remains a contested area between the PBOC and the other agencies. In 2003, for example, Premier Wen shifted all banking regulation duties to the CBRC, which resulted in the transfer of many PBOC departments to the CBRC. Although Governor Zhou Xiaochuan ultimately failed to prevent the split, he successfully argued that money laundering and counterfeiting are monetary phenomena that should fall under PBOC supervision. This is significant because the anti-laundering portfolio affords the PBOC and the State Administration of Foreign Exchange great latitude with which to examine the books in all financial institutions, not just in banks.²⁷ In addition, because the PBOC is charged with "overall financial stability," it continues to audit the books and to collect internal data from every kind of financial institutions.²⁸

The most contested arena in the financial sector, one that the PBOC has fought pitch-battles with rival agencies to command, is political control. The core of political control is the authority over personnel appointment. Before 1998, the PBOC shared appointment power in the financial sector with the local party committee and the Central Organization Department. Under Zhu Rongji, most appointment power in the financial

²⁷ State Administration of Foreign Exchange, "Jinrong Jigou Da'e He Keyi Waihui Zijin Jiaoyi Baogao Guanli Banfa Shishi Xice (the Fine Points of Implementing the Reporting System for Large or Suspicious Foreign Exchange Transactions in Financial Institutions)," ed. State Administration of Foreign Exchange (2004).

²⁸ Author's interviews with PBOC officials.

sector was centralized to the Central Finance Work Committee (CFWC).²⁹ In this period (1998-2003), the PBOC retained considerable influence over the appointment of bankers since several senior members of the PBOC also served in the CFWC. With the formation of the CBRC, however, the PBOC found itself deprived of most of its appointment power. With the formation of the CBRC, PBOC only retained the authority to appoint regional governors of the PBOC itself, while the Central Organization Department (COD) and the CBRC took over appointment of senior bankers.³⁰

In 2004, however, the PBOC won back substantial amount of appointment authority by injecting massive funds into China Construction Bank (CCB), Bank of China (BOC), Industry and Commerce Bank of China (ICBC), and Bank of Communication (BOCO), thereby gaining “ownership” of these banks through a subsidiary, the Central Huijin Company. Although the PBOC has injected “reloans” (*zaidaikuan*) into distressed financial institutions since the 80s, these injections were considered policy loans, and recipients were under some obligation to repay them. With the formation of the Central Huijin Company, however, the PBOC acquired an investment vehicle with which to obtain equity control over a wide range of financial institutions. Through the Huijin Company, the PBOC injected funds from the foreign exchange reserve and from central bank loans into banks and even brokerages. In the spring and summer of 2005, for example, the PBOC successively announced that Central Huijin Company would recapitalize Galaxy Securities (Yinhe Zhengquan), Southern Securities (Nanfang Zhengquan), Huaxia Securities, Shenyin Wanguo Securities, and

²⁹ Heilmann, "Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry."

³⁰ Ibid.

Guotai Jun'an Securities, all of which were illiquid state-owned securities firms.³¹ These injections have made Huijin the majority shareholders of these companies and thus have transferred substantial appointment power to Huijin. Undoubtedly, the PBOC's access to the fledging foreign exchange reserve and base money affords the PBOC with a substantial comparative advantage in offering comprehensive policy solutions to consumers. This in turn facilitates the expansion of the PBOC's authorities.

Following the PBOC, the Ministry of Finance currently constitutes the most influential full-service provider in the financial sector. Its influence stems from the MOF's traditional role as the "investor" (*chuziren*) of major financial institutions in China. Although its "investor" status has been eroded in recent years, it continues to control a large slice of the financial sector. Furthermore, as the issuer of treasury bonds and the agency in charge of the National Social Security Fund, the MOF carries a loud voice in any debate on the national economy. Finally, MOF's accounting and tax policies have a large impact on the bottom line of financial institutions in China.

Since the formation of the Big Four state banks in the 1980s, the MOF has served as the "investor" in these banks, giving the agency primary claimant status over the profits of these banks. Granted, this nominal status did not afford the agency power to make unilateral decisions on major issues relevant to the banking system. Final decisions were still left to consumer organizations. Nonetheless, as the chief investor, the MOF made regulations that determined how much capital the Big Four banks could use to write-off bad debt.³² Although the PBOC had long lobbied for higher write-off

³¹ Ming Liu, "Chongzheng Quanshang, Huijin Jianyin Zai Xingdong (Huijin and Construction Investment Are Acting to Restructure Brokerages)," *Jingji Ribao (Economics Daily)*, 8/11/2005 2005.

³² Bank of China, "Guanyu Zhuanfa Caizhengbu 'Guanyu Tiaozheng Yinhang Daikuan Daizhang Hexiao Shenpi Quaxian Wenti De Tongzhi' De Tongzhi (the Bank of China's Notice Concerning Distributing the

allowance, the MOF successfully resisted increasing the write-off allowance until three years ago.³³ In 1998, the MOF scored another major “contract” in becoming the “investor” in the four asset management companies (AMCs) set up to digest the Big Four state banks’ non-performing loans (NPLs). By injecting 40 billion RMB in start-up capital to the four AMCs, MOF obtained “investor” status over these entities and gained regulatory oversight over the AMCs’ NPL recovery ratios and their annual budgets.³⁴ Currently, the governance over the AMCs is highly complex, with MOF taking charge of the annual recovery ratios and expenses, the CBRC monitoring the acquisition and sale of NPLs, and the CBRC and the Central Organization Department sharing power over appointing senior AMC officials.³⁵

Increasing constraints faced by the national budget, however, have eroded the MOF’s ability to offer comprehensive solutions in the financial arena, thereby diminishing its influence. After the transfer of 1.5 trillion RMB in NPLs to the AMCs in 1998, the government realized that a mountain of NPLs—around 30% of all loans outstanding-- remained in the banking system, even though the 1998 transfer supposedly solved much of the problem.³⁶ Given the enormity of the problem, senior bankers were not optimistic about the speedy write-off of NPLs and the prospect of listing state banks

Ministry of Finance's 'Notice Concerning Adjusting the Banks' Authority to Evaluate and Write-Off Bad Debt')," in *1994 Nian Jinrong Guizhang Zhidu Xuanbian (Financial Regulations and Systems for 1994)*, ed. The Office of Bank of China, et al. (Beijing: Finance Publisher, 1995).

³³ Chuanzhi Fei, "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, no. 8 (1995).

³⁴ Ministry of Finance, *Jinrong Zichan Guanli Gongsi Buliang Zichan Chuzhi Kaohe Banfa (Method of Evaluating Recovery Ratios of Asset Management Companies)* (www.law-lib.com, 2001 [cited]).

³⁵ Author’s interview

³⁶ Beijing Xin Bang Investment & Consulting Ltd, "Dai Xianglong Admitted in Public for the First Time That Npl Level in the Financial System Is as High as 30%," *Xinbang Caijing Qingbao (Xinbang Financial Intelligence)*, 3/28/02 2002.

in the near term.³⁷ The central budget, stretched to the limit by Zhu Rongji's SOE revitalization program and the Go West investment drive, was in no shape to issue more bonds to recapitalize the banks.³⁸ At the same time, banks did not have the capacity to purchase more AMC bonds. In 1998, the Big Four banks "sold" 1.5 trillion RMB in NPLs to the four AMCs at face value. In order to raise the 1.5 trillion to pay banks, the AMCs sold MOF-backed bonds to the banks that had sold them the NPLs. Having recently acquired 1.5 trillion in AMC bonds, the banks simply could not buy more AMC bonds without substantially slowing lending. Thus, the policy tools at the MOF's disposal were simply incapable of speeding up the recapitalization of the banking sector.

It would be up to another producer, one with the means of rapidly recapitalizing the banks, to provide the leadership with a policy solution. Even in May of 2002, the then PBOC governor Dai Xianglong stated in an internal speech that the state should only recapitalize banks by 4% of its core capital. The banks themselves should use annual profit to slowly write-off NPLs and to build up capital to the required 8% level.³⁹ This plan was apparently too slow for the new governor of the PBOC and for the new set of policy consumers, i.e. Premier Wen Jiabao and Vice-Premier Huang Ju. At the same time, the foreign exchange reserve was reaching historical heights, surpassing the 300 billion USD level at the beginning of 2003. In a speech in mid 2003, the new PBOC

³⁷ Lili Wang, "Zhongguo Yinhang Ye Ruhe Yu Guoji Jiegui (How Can the Chinese Banking Sector Catch up to the International Financial Sector)," in *Zhonggong Zhongyang Dangxiao Baogao Jingxuan (the Best of Central Party School Reports)*, ed. Central Party School Editorial Department (Beijing: Central Party School Publisher, 2003).

³⁸ Some 300 billion RMB in treasury bond was issued between 2000 and 2003. See Victor Shih, "Development, the Second Time Around: The Political Logic of Developing Western China," *Journal of East Asian Studies* 4 (2004).

³⁹ Xianglong Dai, "Dui Zhongguo Jinrong Zhuyao Wenti De Sikao (Thoughts on the Main Problems Facing Chinese Finance)," in *Zhonggong Zhongyang Dangxiao Baogao Jingxuan (the Best of Central Party School Reports)*, ed. Central Party School Editorial Department (Beijing: Central Party School Publisher, 2003).

governor Zhou Xiaochuan expressed that his first policy priority was “the systematic reform of the banking system, including dealing with NPLs, recapitalizing banks, transforming company structure, as well as speeding up share-holding transformation and listing.”⁴⁰ Meanwhile, researchers within the PBOC began to view the foreign exchange reserve as a possible source of bank capital. According to a PBOC official involved in the decision, the PBOC saw many advantages in using the rapidly growing foreign exchange reserve: minimal impact on budget deficit, decreasing revaluation pressure, minimal impact on money supply and inflationary expectation, and rapid recapitalization.⁴¹ Zhou Xiaochuan and Huang Ju were apparently impressed by this reasoning and pushed the proposal to the CFELG and the PSC, which approved it. As discussed before, the decision to use the foreign exchange reserve through the Huijin Company gave the PBOC enormous new powers in the financial sector.

Despite recent setbacks, the MOF’s presence remains formidable. MOF continues as the sole investor in the Agricultural Bank of China and a 50% owner of the Industry and Commerce Bank of China. Moreover, the MOF is well represented on the board of the Huijin Company, although its influence suffered after the arrest of senior MOF official and Huijin board member Xu Fangming for suspected corruption.⁴² MOF also retains an enormous influence over the stock market through the 166 billion RMB

⁴⁰ Xiaochuan Zhou, "Zhongguo De Huobi Zhengce, Jinrong Rizhi Gaige Yu Chixu Jingji Zengzhang (Chinese Monetary Policy, Financial System Reform, and Sustainable Growth)," *Zhongguo Jinrong Banyuekan (Chinese Financial Bi-monthly)* 2003, no. 14 (2003).

⁴¹ Guoping Xu, "Guoyou Duzi Shangye Yinhang Gufenzhi Gaige Ji Guojia Zhuzi De Lilun Shiji Yiyi (the Theoretical and Practical Meaning of the Shareholding Reform and State Recapitalization of the State Commercial Banks)," *Guangxi Nongcun Jinrong Yanjiu (Guangxi Agricultural Finance Research)* 2004, no. 1 (2004).

⁴² Haiyan Hu, "Zhongyang Huijin Gongsi Jinrong Bantu Qiemi (Unveiling the Secret Design of the Central Huijing Company)," *Zhongguo Qiyejia (Chinese Entrepreneur)*, 7/7 2005.

(year-end 2004 figure) National Social Security Fund (NSSF).⁴³ Under current regulation, the NSSF can directly or indirectly invest between 1/3 and 1/2 of its assets into the stock markets, which currently have total market capitalization of 3.7 trillion RMB (year-end 2004 figure).⁴⁴ Finally, the MOF determines all accounting rules and taxation policies, both of which have enormous influence on the profitability of financial institutions.

Beyond these two agencies, the National Development and Reform Commission (NDRC), the off-spring of the once-omnipotent State Planning Commission, constitutes the third full-service provider in the financial sector. Despite its retreating influence in recent years, the NDRC has fought fierce rear-guard battles to maintain its formidable, if narrow, power in the financial sector. The NDRC today continues to enjoy enormous distributive and regulatory authorities over financial resources.

Since the First Five-Year Plan in the early 50s, the Planning Commission has played a dominant role in distributing investment and bank funding to various sectors and localities. Although its investment approval authorities have steadily declined as enterprises and banks gained increasing autonomy from the plan, the NDRC continues to formulate five-year and ten-year guidance plans, which still play a significant role in sectoral development in heavy industrial sectors dominated by SOEs and in the construction of major public work projects. The continual existence of the plan gives NDRC a significant voice in the formulation of national economic policies. Its minister sits on the CFELG, and it is represented in the monetary policy committee.

Despite increasing SOE autonomy, the NDRC still controls approval power for large-scale fixed-asset and technical innovation investment projects, especially if they

⁴³ National Social Security Fund, *Nssf 2004 Annual Report* (NSSF, 2005 [cited 9/2 2005]); available from <http://www.ssf.gov.cn/enweb/Column.asp?ColumnId=39>.

⁴⁴ Internet Securities Inc., "Isi Financial Market Statistics," (ISI Industry and Company Database, 2005).

require state funding. It also retains the authority to approve major public work projects that use state funding or funding from international development agencies.⁴⁵ Because of these authorities, the NDRC is the lead agency in charge of coordinating regional development policies, chief among them are the Go West Campaign and the Northeast Revitalization Plan. These plans involve the expenditure of an enormous amount of state investment financed by bond issuance, and the NDRC plays the politically salient role of distributing an immense amount of state funding. Government investment projects greatly affect the banking sector because both policy and commercial banks lend generously to finance these investment projects. Therefore, NDRC decisions affect the usage of a significant slice of bank deposits. The Go West campaign, for example, used up some 600 billion RMB in new loans between 2000 and 2003, compared with the 300 billion in new loans made in western provinces between 1997 and 2000.⁴⁶ Banks willingly lent to these state investment projects because these loans were guaranteed by the government, but they nonetheless had to comply with NDRC policies mandating low interest rates, speedy approval, and extremely long repayment schedules.

Besides the considerable authority of distributing fiscal and monetary resources, the NDRC's traditional power in price control accords it surprising clout in various aspects of the financial industry. For example, the NDRC, rather than the CBRC, makes regulations limiting the prices that asset management companies can pay sub-contractors performing auditing and legal work.⁴⁷ Its traditional power further bestows the NDRC

⁴⁵ NDRC website: <http://www.ndrc.gov.cn/jj/default.htm>

⁴⁶ Shih, "Development, the Second Time Around: The Political Logic of Developing Western China."

⁴⁷ State Planning Commission, "Guanyu Guifan Jinrong Zichan Guanli Gongsi Shougou Yu Chuji Buliang Zichan Guochengzhong Zhongjie Fuwu Shoufei Youguan Wenti De Tongzhi (Notice Concerning Fees Paid by Asset Management Companies to Intermediary Service Providers in the Course of Buying or Selling Non-Performing Assets)," ed. www.lawstar.com (Beijing: www.lawstar.com, 2001).

the authority to regulate service fees charged by banks.⁴⁸ The NDRC even formulates regulations limiting the regulatory and penalty fees charged by other regulatory agencies such as the CSRC and the CIRC.⁴⁹

Finally, although the NDRC no longer commands the banking system as the accounting unit of the national plan, it continues to fight for—and win—authorities, even as its jurisdictional expansion goes against the overall direction of financial reform. Because the NDRC traditionally coordinates the entire economy, it retains the authorities to determine the overall scale of stock issuance and enterprise bond issuance in conjunction with the CSRC. It also has the authority to approve the issuance of enterprise bonds denominated in both RMB and in foreign currencies.⁵⁰ In another example of its continual clout, the NDRC in 2004 issued a decree to forbid banks from lending to businesses engaged in the production of “backward” products, a list that was generated by NDRC technocrats. PBOC and CBRC branches across the country were required to work with local NDRC units to implement this policy.⁵¹ Although the PBOC and the CBRC were doubtless unhappy about this intervention, especially given that it came in the midst of impending bank listings, the State Council apparently found the NDRC the appropriate agency to carry out this arcane policy. In sum, despite its much

⁴⁸ China Banking Regulatory Commission and National Development and Reform Commission, "Shangye Yinhang Fuwu Jiage Guanli Zhanxing Banfa (Temporary Method of Regulating Service Fees in Commercial Banks)," ed. www.chinalawinfo.com (Beijing: www.chinalawinfo.com, 2003).

⁴⁹ State Planning Commission and Ministry of Finance, "Guanyu Chongxin Heding Zhengquan Shichang Jianguanfei Shoufei Biaozhun Ji Youguan Wenti de Tongzhi Jijiege (Notice Concerning Reassessing the Regulatory Fees Schedule for the Equities Market)," *Zhengquan Shibao (Securities Times)*, 2/14 2003.

⁵⁰ State Council, "Guojia Fazhan He Gaige Weiyuanhui Zhuyao Zhize Neishe Jigou He Renyuan Bianzhi Guiding De Tongzhi (Notice on the Main Responsibilities, Internal Organization, and the Rosters of the National Development and Reform Commission)," ed. www.chinalawinfo.com (Beijing: www.chinalawinfo.com, 2003).

⁵¹ National Development and Reform Commission, People's Bank of China, and China Banking Regulatory Commission, "Guanyu Jinyibu Jiaqiang Chanye Zhengce He Xindai Zhengce Xietiao Peihe Kongzhi Xindai Fengxian Youguan Wenti De Tongzhi (Notice Concerning Strengthening the Coordination between Industrial Policies and Lending Policies and Controlling Lending Risks)," ed. www.chinalawinfo.com (Beijing: www.chinalawinfo.com, 2004).

diminished influence, the NDRC's traditional claims over economic management and its connection with former NDRC cadres who are now high-ranking party members have given the agency a strong foundation on which to maintain a substantial foothold in the financial sector.

Among the three regulatory agencies, the China Banking Regulatory Commission (CBRC) probably has the most bureaucratic clout as it regulates the enormous banking sector. It was first formed in 2003 out of the former CFWC and parts of the PBOC. Since its formation, its chairman Liu Mingkang, formerly the president of the Bank of China, has jealously guarded the CBRC's main mission of monitoring bank performance in China. In particular, the CBRC enforces liquidity, capital adequacy and non-performing loan targets on all depository institutions in China, including state banks, joint-stock banks, foreign banks, credit cooperatives, and investment companies. Because these targets all have monetary implications, the CBRC indirectly participates in monetary policy. Taking over the regulatory departments of the PBOC, the CBRC commands a vast local network of offices that regularly audit local branches and national headquarters of all depository institutions. It is also the main agency in charge of formulating specific policies that ensure China's compliance with the WTO in the financial sector. For example, it determines the specific operation requirements for foreign banks in China and approves the expansion of foreign bank branches.

Besides routine monitoring of financial institutions, the CBRC is also responsible for preventing, investigating, and halting financial corruption and fraud. Here, the CBRC's authorities are more diluted. Although the CBRC has the data and expertise with which to uncover financial fraud, many cases of fraud are uncovered by audits

conducted by the local or national auditing office. The uncovering of these cases is greatly embarrassing to the CBRC because it calls to question the agency's ability to effectively monitor banks. At the beginning of 2005, for example, the National Audit Office discovered that asset management companies (AMCs) regularly reported more staff than they had in order to receive higher subsidies from the MOF.⁵² This revelation doubtless discombobulated the CBRC leadership because the CBRC conducted two audits on the AMCs every year. In addition, because senior bankers are party officials with vice-ministerial rank, the Central Disciplinary and Inspection Committee (CDIC), the party's anti-corruption watchdog, often takes control over corruption cases involving senior bankers. For example, the CDIC took charge of the investigations of Wang Xuebing and Zhang Enzhao, both former Presidents of the China Construction Bank.⁵³

The CBRC's regulatory authority is further diluted by the existence of disciplinary committees and supervision committees in all major financial institutions. Because major financial institutions in China are either wholly or partially state-owned, they all have party committees with propaganda, organization, and discipline and inspection (anti-corruption) sub-committees. In addition to reporting to the party secretary of the institution, who often serves concurrently as the chairman of the board, the discipline and inspection committee (DIC) also reports to the DIC at a higher level and ultimately to the CDIC. Due to the traditional weakness of the courts in China, many important tip-offs and allegations continue to flow through the CDIC network rather than

⁵² Qingxin Ding and Wei Wu, "Shenjizhe Zaici Quanmian Shenji, Sida Zichan Guanli Gongsidi Midu Daiqie (the Auditors Conduct Another Comprehensive Audit; the Puzzle of the Four Asset Management Companies Awaits Uncovering)," *21 shiji jingji baodao (21st Century Economic Report)*, 4/13 2005.

⁵³ Xinhua News Agency, *Zhongjiwei: Duiyuan Jianhang Hangzhang Wang Xuebing Wenti De Shencha Jieguo (Cdic: The Investigation Results on the Former President of the Ccb Wang Xuebing)* (2002 [cited 9/8 2005]); available from <http://www.people.com.cn/GB/jinji/34/166/20021106/859961.html>.

through the judiciary system or through the CBRC. Because of the pervasiveness of corruption in China's financial institutions, the State Council and the CFWC in 2000 further ordered the formation of 15 independent boards of supervision in the 15 largest financial institutions in China.⁵⁴ Even after the disbanding of the CFWC, these boards of supervisions remain in place in the major financial institutions to supervise their work. Because of the existence of a wide array of monitoring institutions, the CBRC merely controls the most technical and in many ways the least important aspects of financial supervision.

Nomenclature power, or the authority to appoint and remove officials, is perhaps the most sought-after authority in any authoritarian country. In the banking system, the turf war over appointment has been extremely fierce. Although the Central Finance Work Committee temporarily put a stop to the dispute by consolidating appointment power, its demise in 2003 renewed the inter-agency scuffle over it.⁵⁵ In 2003, the Central Organization Department (COD) acquired the authority to appoint all senior-level bankers at the 10 largest financial institutions, while the CBRC obtained appointment power over the CEOs of the four asset management companies, the China Merchant Bank, and the Minsheng Bank.⁵⁶ In addition, the CBRC conducts professional qualification evaluations on all candidates for bank presidents and vice-presidents, including candidates for senior positions in foreign institutions operating in China.⁵⁷ Despite this formal division of power, the PBOC soon gained significant *de facto* appointment

⁵⁴ Xinhua News Agency, "State Appointed Board of Supervisors Placed in 16 Financial Institutions," *Xinhua Domestic Service*, 8/21 2000.

⁵⁵ Heilmann, "Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry."

⁵⁶ *Ibid.*

⁵⁷ author's interview

authorities through Zhou Xiaochuan's appointment to the head office of the LGSBSR. Zhou's influence is further reinforced by Huijin's share-holder control over the restructured banks. With the combination of both party and share-holder power, Zhou's office obtained the authority to approve candidates for all senior positions in banks that plan to list on the stock market.⁵⁸ Even after listing, senior management in majority state-owned banks, including the ICBC, BOC, and the CCB, will continue to operate under the purview of LGSBSR through Central Huijin Company.

Besides the CBRC, two agencies, the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Agency (CIRC) regulate the activities of the securities and insurance industries respectively. Although these agencies nominally possess great latitude over the securities and insurance industries, their authorities are in reality constrained by rival agencies, especially the PBOC and the NDRC.⁵⁹ In the securities industry, the CSRC has grown from a weak advisory body with little real power to a plenipotentiary agency in the industry. Nominally, it now has the authority to regulate the stock exchanges, all securities companies, and mutual funds. It also approves the appointment of senior management in the exchanges and in all of the major brokerages and mutual funds. Finally, it regulates all transactions related to securities.⁶⁰ Yet, this power is constrained by the NDRC's continual control over the overall scale of stock and enterprise bond issuance, the PBOC's ownership of several important securities companies through Huijin, and the Central Organization Department's appointment

⁵⁸ author's interview

⁵⁹ China Banking Regulatory Commission, China Securities Regulatory Commission, and China Insurance Regulatory Commission, "Zai Jinrong Jianguan Fangmian Fengong Hezuo De Beimanglu (a Memorandum of Understanding Concerning the Division of Labor and Cooperation in Financial Regulation)," ed. www.chinalawinfo.com (Beijing: www.chinalawinfo.com, 2004).

⁶⁰ Stephen Green, "Equity Politics and Market Institutions: The Development of Stock Exchange Governance in China, 1984-2003," in *Working Papers*, ed. Royal Institute of International Affairs (London: RIIA, 2004).

power over senior CSRC and state-owned brokerage officials. Moreover, many brokerages are still owned by local governments, which use their appointment power to pressure brokerages into underwriting the listings of highly indebted SOEs.⁶¹ Finally, with the Ministry of Finance's drive to consolidate extra-budgetary fees into the central coffer, the CSRC lost control over independent sources of funding and thus is deprived of considerable autonomy.⁶²

The agency's fortune also suffered due to the sluggish performance of the stock market in the past few years. In 2001, the CSRC attempted to stimulate the market by promoting the circulation of state-owned shares, which were previously held exclusively by government entities, but it was met with a steep market crash as investors expected a sudden surge of stocks into the market. The market crash resulted in a sudden halt of the circulation program and the disgrace of senior CSRC officials.⁶³ Unlike the PBOC, the CSRC does not have control over a substantial supply of funds, which would have allowed it to "rescue" the market. Although the CSRC is currently engaging in another round of share circulation reform, it is proceeding with caution and is sharing the risk with the State Asset Supervision Administration Commission (SASAC). It is also reliant on the PBOC and on the MOF to inject funds into distressed brokerages and to maintain market capitalization during this transition period.

⁶¹ Stephen Green, "Better Than a Casino: Some Good News from the Frontline of China's Capital Market Reforms," in *Asia Programme Working Paper*, ed. Royal Institute of International Affairs (London: RIIA, 2003).

⁶² People's Bank of China and Ministry of Finance, "Guanyu Jiang Bufen Xingzheng Shiyexing Shoufei Naru Yusuan Guanli De Tongzhi (Notice Concerning Consolidating Some Administrative Fees into Budgetary Control)," ed. www.chinalawinfo.com (Beijing: www.chinalawinfo.com, 2002).

⁶³ Stocks in China are divided into state shares, legal persons shares, and listed shares, the former two categories are not bought and sold in the open market. This situation has led to a stagnation of the stock market due to investors' expectation of non-circulated shares flooding the market and investor weariness over the lack of shareholder control. See Green, "Better Than a Casino: Some Good News from the Frontline of China's Capital Market Reforms.", Stephen Green, "The Privatisation Two-Step at China's Listed Firms," in *China Project Working Paper* (London: Royal Institute of International Affairs, 2004).

The China Insurance Regulatory Commission is in many ways the weakest policy producer discussed in this paper. Formed only in 1998 as a vice-ministerial organization, it did not become a ministerial-level agency until 2003.⁶⁴ Before its formation, the Chinese insurance industry was under the supervision of the PBOC and the MOF. After its formation, the CIRC acquired enormous discretion over market entry, allowable investment strategies, and pricing and benefit structure of policies in the insurance industry. Like the CBRC and CSRC, the CIRC also has approval power over senior management in the entire industry, including foreign firms operating in China.⁶⁵ Nonetheless, like the CSRC and CBRC, it shares appointment of senior CIRC officials and top management in major state-owned insurance companies with the Central Organization Department.⁶⁶ Moreover, because of its junior status, CIRC defers to more established agencies on a number of other issues. For example, the Ministry of Finance continues to regulate accounting and auditing standards of insurance companies, and MOF tax policies on the insurance industry have a large impact on the bottom-line of insurance companies. The PBOC, although it supposedly handed the bulk of the regulatory authorities to the CIRC in 1998, continues to require insurance companies to make regular reports to the PBOC under the guise of maintaining financial stability.⁶⁷

The jurisdiction of the CIRC is under threat of further erosion. In June 2005, the MOF asserted its “investor” status by accusing state-owned insurance companies of

⁶⁴ "Baojianhui Shengwei Zhengbuji Zhongguo Baoxianye Jianguan Shengji (Circ Is Elevated to Ministerial Level; the Regulation of Chinese Insurance Industry Is Elevated)," *guoji Jinrongbao (International Finance Journal)*, 3/26 2003.

⁶⁵ China Banking Regulatory Commission, China Securities Regulatory Commission, and China Insurance Regulatory Commission, "Zai Jinrong Jianguan Fangmian Fengong Hezuo De Beimanglu (a Memorandum of Understanding Concerning the Division of Labor and Cooperation in Financial Regulation)."

⁶⁶ "Baojianhui Shengwei Zhengbuji Zhongguo Baoxianye Jianguan Shengji (Circ Is Elevated to Ministerial Level; the Regulation of Chinese Insurance Industry Is Elevated)."

⁶⁷ People's Bank of China, "Baoxianye Jianguan Zhibiao (Targets for Monitoring the Insurance Industry)," ed. www.chinalawinfo.com (Beijing: www.chinalawinfo.com, 1998).

having “imperfect governance structure.”⁶⁸ In a proposed change of the insurance industry, the MOF laid out a plan that would allow the MOF to send board members directly to the five major insurance companies, impose performance targets on senior management and the management of major subsidiaries, and require state insurance companies and their subsidiaries to report major policy changes to the MOF for approval.⁶⁹ This proposal drew a heated response from the insurance companies and from CIRC.⁷⁰ If the MOF succeeds in asserting its “investor” rights, the nascent CIRC will lose a large part of its authorities to the MOF.

Although the agencies discussed above by no means exhaust government entities that are involved in the financial sector, these agencies all devote a substantial part of their energy in the financial sector. The discussion above briefly touched on other agencies peripherally involved in the financial sector, including the National Audit Office, the State Asset Supervision and Administration Commission, and the National Social Security Fund. In examining the PBOC, MOF, NDRC, and the three regulatory agencies, a clear pattern emerges. Those agencies with secured access to a large pool of funds, including the PBOC, the MOF, and to a lesser extent the NDRC, can much more aggressively bid for “contracts” from policy consumers. The prime example of aggressive bidding is the PBOC’s proposal to recapitalize banks over-night using the burgeoning foreign exchange reserve. Because of the attractiveness of this option for policy consumers, the PBOC was able to implement its preferred policy, which bestowed

⁶⁸ Ke Sun, "Caizhengbu Qianhua Chuziren Jianguan Wuda Baoxian Gongsì Yuequan Daoyi (Debate on Whether the Mof Has Exceeded Its Authority by Strengthening Investor Regulation over the Five Major Insurance Companies)," *21 shìjì jingjì baodào (21st Century Economic Report)*, 7 2005.

⁶⁹ Ibid.

⁷⁰ "Qianyi Guoyou Baoxian Gongsì Chuziren Jianguan (a Brief Discussion of Monitoring by the Investor of State Owned Insurance Companies)," *Zhongguo Baoxianbao (China Insurance News)*, 8/3 2005.

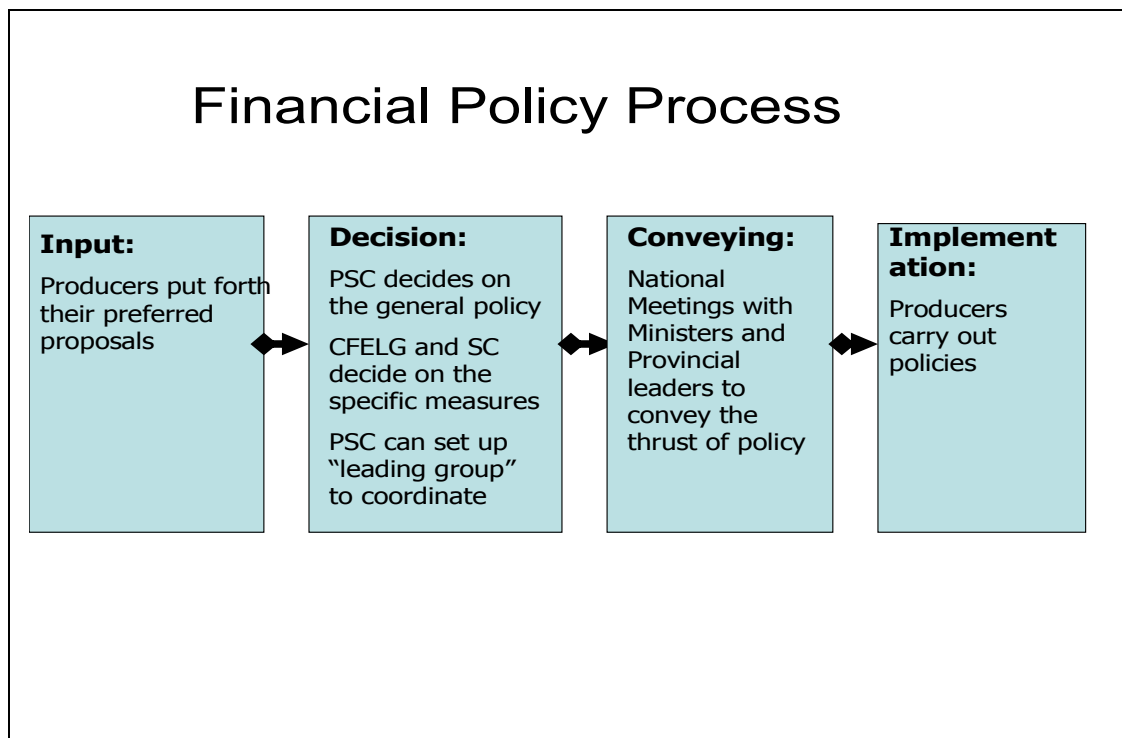
enormous share-holder power on the agency. Similarly, it looks as though the MOF will succeed in its quest to assert investor control over major insurance companies over the objection of CIRC. Thus, although China appears to have a well-structured regulatory framework for its financial industry, the three regulatory agencies are in fact increasingly at the mercy of more resourceful bureaucratic brethren.

Table 2: Producer Agencies

<i>Agencies</i>	<i>Leader (concurrent positions)</i>	<i>Major Authorities</i>
People's Bank of China (PBOC)	<i>Zhou Xiaochuan</i> Head of Office, LGSBSR Member, CFELG Member, CCP Central Committee	-Formulate Monetary Policies -Recapitalize distressed financial institutions (FIs) with PBOC loans or foreign exchange reserve -Participate in appointment of FI management as "investor" -Prevent money laundering and counterfeiting
Ministry of Finance (MOF)	<i>Jin Renqing</i> Member, LGSBSR Member, CFELG Member, CCP Central Committee	-Monitor FIs as "investor" -Recapitalize FIs with bond issuance -Determine accounting and tax policies for FIs
National Development and Planning Commission (NDRC)	<i>Ma Kai</i> Member, CFELG Member, CCP Central Committee	-Formulate investment plans and industrial policies to channel bank loans -Determine the overall amount of stock and enterprise bond issuance -Regulate the fees charged by financial regulators and banks
China Banking Regulatory Commission (CBRC)	<i>Liu Mingkang</i> Member, LGSBSR Alternate Member, CCP Central Committee	-Monitor liquidity, capital adequacy and NPL ratios of depository institutions -Appoint senior management of FIs (AMCs) -Approve appointment of senior bankers -Prevent fraud and corruption in the banking sector -Approve the commencement and expansion foreign bank operation in China
China Securities Regulatory Commission (CSRC)	<i>Shang Fulin</i> Member, LGSBSR Alternate Member, CCP Central Committee	Regulate the stock exchanges, all securities companies, and mutual funds -Approve the appointment of senior management in the exchanges, major brokerages, and mutual funds. -Regulate all transactions related to securities -Approve QFIIs and QDIIIs
China Insurance Regulatory Commission (CIRC)	<i>Wu Dingfu</i> Standing Committee Member, the Central Discipline and Inspection Committee Alternate Member, CCP Central Committee	-Regulate market entry, allowable investment strategies, and pricing and benefit structure of policies -Directly appoint senior management in state-owned insurance firms. -Approve appointment of senior management in the entire industry, including foreign firms operating in China -Approve entry and expansion of foreign and joint-venture insurance firms

Policy Process

Figure 1: Financial Policy Process



Under the market framework, the policy process has four distinctive steps (Figure 1). The “market” aspect of policy-making mainly enters into first two steps. In the policy proposal or input stage, a plethora of producer agencies and government think-tanks propose policy choices in response to an economic crisis, to a salient issue raised by a consumer, or to a long-term problem in the financial sector. At this stage, there is considerable room for the producers, who are often specialists in the economy or in the

financial sector, to influence the preference of the consumer, who are often not financial experts. An important audience for producers' marketing campaign at the initial stage is the vice-premier (VP) in charge of finance. Because finance is the main responsibility of this VP, he or she has a stake in maximizing the success, or at least the apparent success, of this portfolio. This VP has a high incentive to "shop" for policy proposals that either resolve a grave crisis confronting the financial sector or proposals that affect apparent reform of the financial sector.

The policy "shopping" process produces both positive and negative consequences. On the positive side, the incentive to maximize portfolio success provides a constant impetus to financial policy innovation at the elite level. Reform policies abandoned by one administration will be taken up by a subsequent VP in charge of finance. On the negative side, however, the VP in charge of finance cares little about the actual long-term impact of a set of policy innovations. His or her main objective is only to maximize the apparent, short-term success of financial policies. Knowing this consumer preference, producers provide proposals that maximize short-term results, even if they come at the expense of long-term functioning of the economy.⁷¹ The liberal mobilization of the foreign exchange reserve to recapitalize banks might turn out to be one such policy.

If a policy producer manages to attract the attention of the VP in charge of finance or another elite consumer, this consumer would sponsor a particular policy in the CFELG or in the PSC. At this point, the policy bidding process is by no means over. As other PSC or CFELG members consider the impact of a given policy on his or her own policy portfolio, competing producers can provide alternative policy options to the original

⁷¹ Premier Zhu Rongji's NPL policy is a prime example of this short-sightedness. See Shih, "Dealing with Non-Performing Loans: Political Constraints and Financial Policies in China."

proposal. They are also likely to contact their elite patrons to lobby for the adoption of alternative policies. Members in high-level executive bodies ultimately must engage in intense bargaining to settle on a set of policies.

A recent case of this complex policy bidding process took place in 2002 and 2003 when officials at the CFWC and the State Council Development and Research Center called for the establishment of an independent agency to regulate the banking sector.⁷² Obviously, the PBOC strongly resisted this proposal and soon mounted a fierce campaign against this move. The PBOC cleverly made a wide range of alternative proposals, ranging from the consolidation of all financial regulation under the PBOC to the establishment of an independent regulatory agency under the leadership of the PBOC. For a time, the PBOC succeeded in persuading the out-going Premier Zhu Rongji to delay regulatory reform and to settle on internal regulatory changes within the PBOC.⁷³

After Zhu stepped down from the PSC in September 2002, however, policy consumers shifted position entirely. The new Premier, Wen Jiabao, appeared strongly in favor of splitting up the PBOC, partly because his long-time protégé Yan Haiwang had served in the CFWC. After replacing Zhu at the PSC in September of 2002, Wen immediately had Yan Haiwang convene a team of experts from various agencies to draft a concrete proposal on the new regulatory agency.⁷⁴ To prevent the PBOC from delaying

⁷² Xiao'an Qian, "Jianli Zhongguo Tongyi De Jinrong Jianguan Tizhi De Gouxiang (a Proposal for Building a Unified Financial Regulatory System in China)," *Caijing Kexue (Finance and Economic Sciences)* 2002, no. 1 (2002).

⁷³ "Gongjian Buweinan- Jinrong Jianguan Xiaolu Buduan Tigao Yinhangye Huanjing Dada Gaishan (Do Not Be Afraid to Attack a Strong Target- the Efficiency of Financial Monitoring Improves Ceaselessly, and the Banking Sector Greatly Improves)," *Jinrong Ribao (Financial Daily)*, 12/30 2002.

⁷⁴ In September of 2002, Wen still served as vice-premier, but because he had replaced Zhu in the PSC, he obtained de facto control over policy-making from that time. Wen was formally appointed as the Premier of China by the National People's Congress in March of 2003. Xiangwei Wang, "The Man to Watch as China's Banking Sector Comes of Age," *South China Morning Post*, 1/11 2003.

the drafting process, Wen even excluded PBOC officials from the team.⁷⁵ Despite active counter-proposal making by the PBOC, it ultimately failed to persuade the new Premier to suspend policy innovation.

Once a particular proposal is formally adopted by either the CFELG or by the PSC, the lead agency, often in conjunction with experts from a group of government think-tanks, would convene to hammer out a concrete proposal. If an adopted policy is particularly complex, such as the listing of the Big Four state banks, a central leading group headed either by a vice-premier or the premier would be created to formulate and coordinate the policy. A leading group is formed on complex issues because State Council ministries all hold the same rank, and rival agencies at times refuse to follow the decrees of their competitors. Thus, a leading group headed by a senior party official ensures efficient coordination between agencies of the same rank.⁷⁶ Some policies, such as the formation of the CBRC, require formal approval by the National People's Congress (NPC), although the NPC has seldom rejected major financial policy changes proposed by the State Council. Other policies, such as the revaluation of the RMB, require only formal announcements by the PBOC or other implementing agencies.

After a policy is adopted, there is a unique step in the Chinese policy process, which can be labeled as "conveying." Conveying comprises a series of rituals to ensure that relevant agencies understand the new policy and feel compelled to carry it out. Usually, a major policy is announced at either a special meeting (if urgent) or at an annual economic or financial work meeting. Provincial leaders and ministers are all

⁷⁵ Beijing Xin Bang Investment & Consulting Ltd, "Yinjianhui De Yanjiu Xiaoguo Caizhengbu Ji Yanghang (the Planning for the Cbrc Goes around the Mof and the Pboe)," *Xinbang Caijing Qingbao* (*Xinbang Financial Information*), 1/19 2003.

⁷⁶ Lieberthal and Oksenburg, *Policy Making in China: Leaders, Structures, and Processes*.

required to attend these meetings. The Party Secretary General and the Premier take turn exhorting the attending officials the importance of the new policy. The reason for these meetings is that thousands of new regulations cascade down to both central agencies and local governments every year, and central and local officials find it difficult to recognize the top policy priorities of the leadership. If the Secretary General and the Premier both emphasize the importance of a policy, lower-level officials would know that failure to carry out this policy might bring about administrative sanction. For minor policies, the lead agency or the leading group usually sends the new policy to the State Council or to the Central Committee so that these powerful organizations can issue these decrees as their own decrees. This step increases the authoritativeness of the decrees.

In the final step of the policy process, the lead agency singly or in conjunction with other agencies carries out the new policy. Changes to the status quo often create both winners and losers, as well as give rise to new conflicts of interests. These conflicts often cannot be resolved by rivaling agencies or competing local governments themselves. Many of these conflicts find their way upward to the leading groups, the CFELG, or even to the PSC for adjudication.⁷⁷ A set of policies that fail to affect any meaningful changes or result in disastrous outcomes leads to the disgrace of the lead agency, as well as the elite sponsor of the policy. Policy failure also leads to another round of policy bidding by various agencies.

Implications

⁷⁷ Ibid.

The assumption of power-maximizing elite consumers and producers of financial policies has important implications for policy outcomes in China. First, as stated previously, power-maximizing policy consumers prefer policies that enhance the success of their individual portfolios to the fullest extent possible. Their time-horizon, however, are short and medium-term rather than long-term. In response to these preferences, policy producers are likely to offer policies that make big splashes in the short-run, but might produce trivial or harmful consequences in the long-run. Related, ministers in charge of producer agencies do not necessarily have the interest of their respective agencies in mind, since they are power-maximizing. They are perfectly capable of supporting policies that confer to them a high degree of elite appreciation in the short-run, but create enormous problems for their agencies in the long-run. Moreover, because it pays to be the main producer of financial policies, agencies have strong incentives to engage in fierce competitions to control important areas of financial policies. Granted, there are bounds for such competition, as each producer has its own comparative advantage. Fourth, because full-service providers, including the PBOC, the MOF, and the NDRC, each has control over a major source of funding and formidable regulatory capacities, they are expected to encroach upon the jurisdiction of weaker regulatory agencies, including the CBRC, the CSRC, and the CIRC.

Theoretically, the market model of policy making provides an alternative explanation of the policy cycles in the Chinese financial sector. That is, the government is expected to implement a bundle of new policies at the beginning of a new

administration and to slow down policy innovation toward the end of an administration.⁷⁸ While this phenomenon is often seen as a “demand” side issue in that elite policy consumers prefer to initiate policy innovations at the beginning of their tenure. This model, however, suggests a “supply-side” reason for the policy cycle. In essence, the “worth” of a contract at the beginning of the consumer’s tenure is higher than at the end because the worth of elite attention and the prospect of promotion for a producer are much higher at the beginning of the consumer’s tenure. Producers know that if they implement a policy to the satisfaction of the consumer at the beginning of his tenure, the consumer still has time to reward them with expanded jurisdiction, elite attention, and promotions. At the end of the consumer’s tenure, however, ministers know that new policy initiatives would not necessarily help their promotion prospects in the next administration under new leaders, thus giving them fewer incentives to propose new policies. Thus, the high tide of new policies at the beginning of a leader’s tenure has as much to do with the “demand” for new policies stemming from elite politics as it has to do with “supply” side factors like producers’ promotion prospects.

The market view of policy-making in China by no means provides a comprehensive, or even an accurate, view of policy-making in China. For one, the market view cannot account for inter-elite bargaining over financial policies. The heterogeneity of elite preferences for financial policies likely introduces intractable complexity to the analysis of decision-making in the PSC and in the CFELG. In essence, actors in these executive organs bargain with each other and “trade” on issues both across time and across issue areas. An added layer of complication is introduced if we consider

⁷⁸ A party secretary general and a new premier are chosen either once every five years or once every ten years, depending on the age of the leader. Premier Zhu Rongji, for example, only served a five-year term as the Premier due to his advanced age, but Wen Jiabao is expected to serve a ten-year term.

the existence of rival factions in the PSC and in the CFELG. In addition to the goals of regime survival and the success in one's portfolio, members of the PSC must also consider the impact of a given policy on the relative distribution of power between rivaling factions. Factionalism also affects whether elite consumers would favor the proposals offered by a particular producer if the producer agency is headed by someone in his faction. It remains unclear how elite policy-makers balance all three of these considerations in deciding financial policies. In the end, policy making everywhere is complex, and no single framework can account for every aspect of policy-making. We can only develop different frameworks that compete with each other to explain policy outcomes.