1

Introduction

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

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

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

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

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

Not Quite a Miracle

Since China launched its economic reform nearly three decades ago, the rest of the world has watched in astonishment as it grew rapidly from a poverty-stricken and isolated state to a country poised to take over from Japan as the premier economic powerhouse in Asia. A number of studies have attempted to explain China's seemingly miraculous growth.[1] The goal of this study is not to provide yet another account of China's spectacular growth. Rather, it seeks to explain two important financial outcomes intimately tied to China's long-term growth trajectory: inflation and the efficiency of capital allocation. As Chapter 2 explains, an important precondition of China's spectacular growth has been its rapid financial deepening accompanied by relative price stability compared with many developing and postcommunist countries. China's ability to constrain inflation is puzzling, given that it has no institutional credibility against government intervention in monetary policy. With a dominant presence in the banking sector, the CCP can intervene in monetary policy at any time to achieve a host of political and policy objectives. Added to this mix is the at times severe elite rivalry, which has a tendency to engender suboptimal economic outcomes (Alesina and Drazen 1995; Rosenbluth 1989: 287). Indeed, China has witnessed repeated episodes of rapidly rising inflation in the two decades of reform. Yet none of them has exploded into hyperinflation, as has been the case in many developing and postcommunist countries. This study provides an account of how elite political tension provided credibility to monetary policies under certain conditions, thereby preventing hyperinflation from taking place.

However, the miracle is not all that it seems. A study of the Chinese financial system cannot possibly ignore China's enormous store of NPLs, estimated at around 50 percent of China's gross domestic product (GDP) in 2001.[2] Chapter 2 also discusses how this pool of bad loans potentially can inflict serious consequences on China's long-term growth trajectory. The buildup of this harrowing debt stems directly from the persistent failure to reform China's lumbering banking sector, which continues to serve as an instrument of state policies. Given China's apparent success in reforming many sectors of the economy, why has reform in the banking sector lagged so far behind? This study makes the argument that the same political dynamic that constrains China's inflation also precludes fundamental banking reform.

[1] See, for example, Naughton, Barry, 1996. *Growing Out of the Plan: Chinese Economic Reform 1978–1993*. New York: Cambridge University Press; Shirk, Susan. 1993. *The Political Logic of Economic Reform in China*. Berkeley: University of California Press; Qian, Yingyi, Barry Weingast, and Gabriella Montinola. 1995. Federalism, Chinese style: the political basis for economic success in China. *World Politics* 48 (1):50–81; Oi, Jean Chun. 1999. *Rural China Takes Off: Institutional Foundations of Economic Reform*. Berkeley: University of California Press.

[2] Nonperforming loan ratio is the ratio of total loans that are lapsing in timely interest payment or payment of principal. According to U.S. financial accounting, loans are classified into five categories depending on the financial health and future business prospects of the borrower: normal, special mention, substandard, doubtful, and loss. The last three categories of loans are considered nonperforming. Loans in China have long been divided into four categories: normal (*zhengchang*), overdue (*yuqi*), congested (*daizhi*), and bad (*daizhang*), which mostly are based on the time period for which loans and interest payments are overdue. In the Chinese system, the last three categories are considered nonperforming.

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

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

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

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

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

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

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

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

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

At the same time, because top leaders of both generalist and technocratic factions face persistent political threats, they are reluctant to forego the use of a vast supply of funds provided by the banking sector. Party leaders can bolster factional support by giving followers access to bank funds for local development. Rather than reforming the banking system when they control it, bureaucrats also see the banking system as a rich source of funds to build up impressive administrative records, which make them indispensable to the regime and permit them to increase or retain power. As a consequence, the leader of a technocratic faction provides only short-term improvements to the financial sector and pursues a strategy of maximizing central control over the financial system, which increases the power of his faction and his personal standing in the Politburo. Because top leaders do not have an interest in truly reforming the banking sector, proposals for reform are either vetoed or diluted, and direct and indirect interventions in the banking system continue unabated.

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

The State, Bureaucracy, and Financial Outcomes

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

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

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

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

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

In light of the financial problems across Asia in the late 1990s, as well as unsuccessful reform in many Latin American countries, we have to ask whether the ghost of Weber has blinded us from closely examining the actual motives of bureaucrats and central bankers. Even highly insulated bureaucrats in a professional bureaucracy have an interest in getting promoted, and financial resources constitute a powerful policy tool that can quickly bolster one's administrative accomplishments and thus speed up promotion (Grimes 2001; Kessler 1998; Schamis 1999; Silva 1997). At the same time, technocrats who control credit allocation gain little from the efficient allocation of capital (Kang 2002). If government officials have the incentive to manipulate state-controlled financial resources to gain a political or career advantage, does it matter if the state is completely insulated from societal forces? Even if politicians and bureaucrats have no career ambitions, without a stake on the returns of the investment, they would hardly bother to allocate capital efficiently.[3] Closer scrutiny of the careers and political incentives of bureaucrats and bankers allows us to make realistic predictions about their preferred policies and whether these policies are likely to generate real reform.

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

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

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

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

Inflationary Cycles and the Impetus for Reform in China

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

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