Dealing with Non-Performing Loans: Political Constraints and Financial Policies in China*

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ABSTRACT The stagnation in banking sector reform is puzzling given the Chinese leadership's seeming resolve to reform other sectors of the economy. This article develops a political explanation of why reform oriented central bureaucrats have centralized financial power without liberalizing the banking sector. The starting point of this explanation is that top bureaucrats value political survival as much as other members of the Politburo. Thus, they make policies based on both political and economic considerations. This framework is tested on three cases related to China's non-performing loan (NPL) problem: the politicization of the NPL problem, policies designed to slow the creation of NPLs and policies aimed at decreasing the pool of NPLs. The findings strongly suggest that political considerations play a large role in shaping financial policies in China.

Reform is crossing the river by feeling for stones (*moshi guohe*). Yet, the stones that Chinese leaders feel for are not sound economic policies but political survival. The current that threatens to topple leaders is not policy failure but political attack. To stand firm on the stones, leaders do not hesitate to move sideways or even step back away from the current. The objective is to remain standing, not necessarily to cross the river.

From a pure policy standpoint, the path of Chinese financial reform appears haphazard and does not unfold in a linear fashion towards marketization. Seen through the lenses of power politics, however, it was shaped by a series of short-term political calculations aimed at strengthening the power of individual leaders. This article demonstrates this logic through the case of Premier Zhu Rongji's policies towards the estimated 3.3 trillion RMB (US$400 billion) in non-performing loans (NPLs).[1]

The methodology employed is one of policy analysis similar to the one developed by Skocpol.[2] For all policies, I first present policy alternatives obtained through over 70 interviews and numerous internal documents. Examining a set of serious policy alternatives addresses the problem of selecting on the dependent variable prevalent in policy analysis.[3] Again relying on interviews and internal documents, I pinpoint the political and

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1. Terry Chan *et al.*, "US$400 billion needed to recapitalize China's banks," *Standard & Poor's CreditWire*, No. 4 (June 2001). This NPL figure represents the approximate mean of estimated NPL ratios by various groups, which range between 30 and 70% of all loans outstanding.

2. Theda Skocpol, *Protecting Soldiers and Mothers: The Political Origins of Social Policy in the United States* (Cambridge, MA: Harvard University Press, 1992).

3. By serious policy alternatives, I mean those proposed by a State Council organ, which should have some notion of which have a reasonable chance of succeeding.

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distributive motives behind the chosen policies. These are compared with the policy predictions of the alternative explanations to gauge the relative explanatory power of each framework. Finally, I examine the net effects of the policies and compare them with the predictions of various alternative explanatory frameworks to determine which one can most accurately predict policy outcomes. The policies I discuss fall into three general areas: the decision to politicize the NPL problem, policies aimed at stemming the creation of new NPLs and measures to digest the existing pool of NPLs.

Alternative Explanations

Previous explanations of economic reform in China centre on the diffusion of market-oriented ideas, the erosion of communist ideology and the rise of determined technocrats. According to the ideational framework, because Chinese leaders had an intrinsic desire to reform, they were willing to experiment with a wide range of reforms.[4] Set-backs stemmed from incomplete information on how to implement a particular reform, not from entrenched interests that blocked it. With the diffusion of ideas on the market economy, "mistakes" should decrease over time. In a slightly different version of the ideational model, set-backs in reform were primarily caused by the resistance of ideological conservatives in the Party.[5] According to this framework, reform should proceed smoothly after the ideologues' passing.

Shirk introduces a politically sophisticated version of China's reform path. Still assuming that Chinese leaders, especially Deng Xiaoping, preferred reform, she argues that reformers divided and conquered the anti-reform coalition by offering a subset of status quo beneficiaries selective benefits via "particularistic contracts."[6] Thus, inconsistencies in the reform path were caused by both incomplete information and the costly process of building pro-reform coalitions. Although Shirk envisages a non-linear movement towards reform, the zigzagging path would eventually turn China into a fully market economy as those in favour of the market economy overwhelm the anti-reformers.[7] Pei adds to Shirk's model by pointing out that reformers often took advantage of economic crises to carry out important reforms.[8]

Although the above frameworks come from different theoretical traditions, they all predict a general movement towards the market and place enormous faith on the spread of market oriented ideas or the rise of

4. Barry Naughton, *Growing out of the Plan: Chinese Economic Reform 1978–1993* (New York: Cambridge University Press, 1996).

5. See, for example, Richard Baum, *Burying Mao: Chinese Politics in the Age of Deng Xiaoping* (Princeton: Princeton University Press, 1994), Joseph Fewsmith, *Dilemmas of Reform in China: Political Conflict and Economic Debate* (Armonk, NY: M.E. Sharpe, 1994).

6. Susan Shirk, *The Political Logic of Economic Reform in China* (Berkeley: The University of California Press, 1993).

7. *Ibid*. p. 344.

8. Minxin Pei, "The political economy of banking reforms in China, 1993–1997," *Journal of Contemporary China*, Vol. 7, No. 18 (1998).

reform oriented elite to implement reform. These explanations have been extremely powerful in explaining the giant sea-change that has taken place in many sectors of the Chinese economy. Yet they have a harder time explaining the chronic lack or slowness of reform in certain sectors. According to these explanations, favourable conditions for fundamental financial reforms were all present at the beginning of the Zhu administration. The Asian financial crisis had placed unprecedented power in the hands of the new Premier. Zhu and his technocratic followers were heralded as tough reformers by everyone from fund managers to the *Wall Street Journal*.[9] On the ideological front, the secretary general Jiang Zemin legitimized private industries at the 15th Party Congress.[10] Furthermore, China's financial elite had by then accepted the superiority of the market economy.[11] Observers of China therefore had great expectations of what the Zhu administration could accomplish.

On the surface, the broad range of changes seems to confirm these optimistic predictions. The Big Four state banks centralized their management, drastically decreasing administrative intervention from the local government.[12] They also adopted independent credit approval, as well as the international five-category loan evaluation. As a result of these efforts, the Big Four state banks certainly look very different today from how they were at the beginning of the Zhu administration.

Despite these changes, when one examines the distribution of capital in China, two underlying indicators remain virtually unchanged. First, state banks, including both state commercial banks and the policy banks, still dominate the financial sector. As seen in Figure 1, state bank share of lending and deposits remains at essentially the same level. The seeming decline in state bank share in 2001 was the product of a new statistical grouping that moved the Bank of Communication and the China International Trade and Investment Corporation (CITIC) Bank from among the state banks to the joint-stock banks, without any actual changes in their ownership structure. Secondly, among state banks, the share of loans to the non-state sector remains at a dismally low level. As seen in Figure 2, the Zhu administration saw only tepid growth in state bank lending to the non-state sector, which hovered around the 10 per cent mark. What went to the non-state sector, even including leakage from the state sector

9. Kathy Chen, "China's economy chief plans to speed financial reform – Zhu Rongji emerges as leading candidate to take prime minister post," *The Wall Street Journal*, 23 February 1998, Nisid Hajari, "Zhu's leap forward when China's maverick economic czar takes over the government, his open, gunslinging style is certain to change the way the country operates," *Time International*, 16 March 1998.

10. Jiang Zemin, "Gaoju Deng Xiaoping lilun weida qizhi, ba jianshe you Zhongguo tese shehui zhuyi shiye quanmian tuixiang ershiyi shiji" ("Raise high the great banner of Deng Xiaoping theory and comprehensively push forth the task of building socialism with Chinese characteristics towards the 21st century"), *Renmin ribao* (*People's Daily*), 12 September 1997.

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

12. The Big Four state banks are the Industrial and Commerce Bank of China, the Bank of China, the Construction Bank of China and the Agricultural Bank of China.

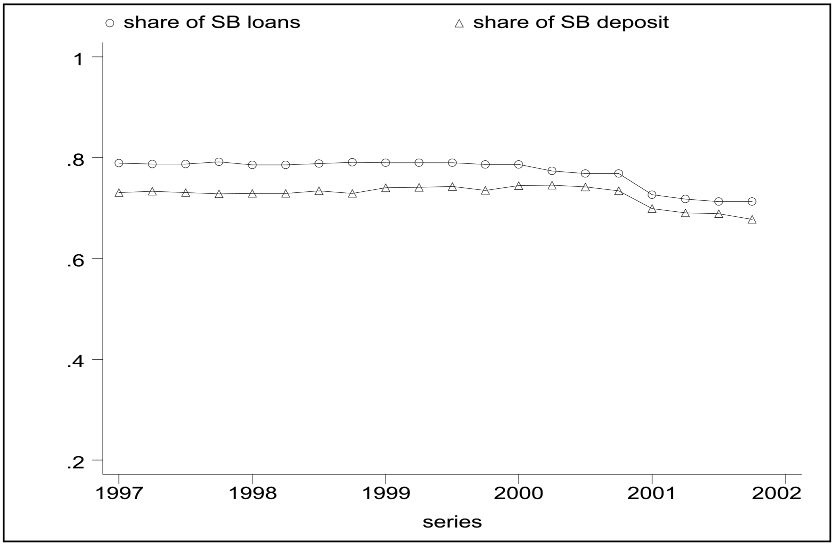

Figure 1: **Share of State Bank Lending and Deposit to Total Lending and Deposit, 1997–2001 (quarterly)**

Note:
1 = 100%.
Sources:
Division of Statistics of the People's Bank of China, *Zhongguo jinrong tongji: 1997–1999* (*China Financial Statistics: 1997–1999*) (hereafter *ZJT*) (Beijing: China Financial Publisher, 2000), National Bureau of Statistics, *China Monthly Economic Indicators 2001: 3 (March)* (Beijing: China Statistical Press, 2001), People's Bank of China, *Baogao yu tongji shuju* (*Reports and Database*) (People's Bank of China, 2003 [cited 24 June 2003]); available from http://www.pbc.gov.cn/baogaoyutongjishuju/.

to the non-state sector, in all likelihood remained well below 50 per cent.[13]

It is also unclear whether the Zhu administration made significant progress on the non-performing loans issue, the problem that motivated the new financial policies in the first place. It remains difficult for outsiders to discern whether the total volume of NPLs has decreased significantly and whether the creation of new NPLs has slowed down significantly. After the transfer of NPLs to asset management companies (discussed below), the government repeatedly revised the remaining NPL ratio. In 1999, the People's Bank of China governor, Dai Xianglong, announced that NPL ratio was at 20 per cent, which meant that the

13. According to official PBOC statistics, some 20% of all loans outstanding as of September 2003 went to the non-state sector. However, many loans to state entities end up in private hands. According to a 1999 internal report published by the PBOC, the financial system as a whole allocated around 42% of resources into the non-state sector. However, the report states that allocation to the non-state sector by the Big Four state banks remains extremely low. See Project Team at the Research Bureau of the PBOC, "Guanyu jinrong jigou dui feiguoyou jingji daikuan qingkuang de diaocha baogao" ("Research report on the situation of financial institutions lending to non-state economy"), *Jinrong tongji yu fenxi* (*Financial Statistics and Analysis*), No. 9 (1999).

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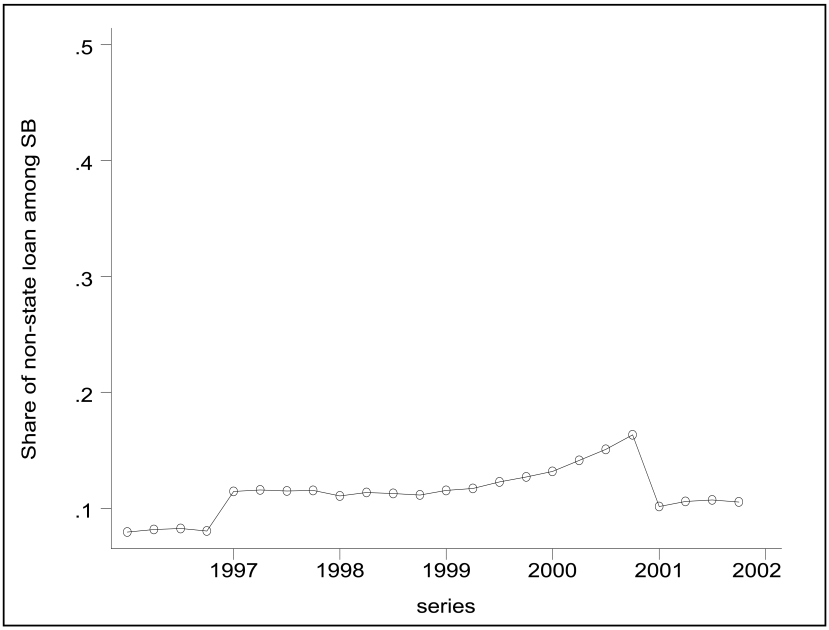

Figure 2: **Share of State Bank Lending to the Non-State Sector, 1996–2001 (quarterly)**

Note:
1 = 100%.
Source:
Division of Statistics of the People's Bank of China, *ZJT,* National Bureau of Statistics, *China Monthly Economic Indicators 2001: 3 (March).*

transfer of NPLs to asset management companies basically would have solved the problem.[14] In July 2001, the Bank of China first broke rank with the official line and admitted that its NPL ratio was 28.78 per cent, even after the transfer of NPLs.[15] Dai further revealed in November 2001 that NPLs still totalled 26.6 per cent of loans outstanding at the Big Four state banks.[16] At the beginning of 2002, the People's Bank of China (PBOC) announced for the first time that NPLs were declining. However, during a March 2002 meeting with international investors, Dai hinted that the NPL ratio might be as high as 30 per cent if calculated by Western accounting standards.[17] The constant revisions by the PBOC partially

14. Lorien Holland, "Cleaning house: China takes aim at state banks' bad debts," *Far Eastern Economic Review*, 6 May 1999.
15. Peggy Sito, "Bank of China strategy sees bad-loan ratio drop by 1.77 percentage points," *SCMP*, 9 July 2001.
16. Lester J. Gesteland, "Bad debt remains a problem for banking sector," *ChinaOnline News*, 1 November 2001.
17. In Western financial accounting, loans are classified into five categories depending on the financial health and future business prospects of the borrower. Loans in China are divided into four categories: normal (*zhengchang*), overdue (*yuqi*), congested (*daizhi*) and bad (*daizhang*), based on the time period for which loans and interest payments are overdue.

reflect the government's own uncertainty about the actual NPL level, especially during the transition towards the new five-category system to classify loans.

Bankers and government officials also admitted that there is no telling whether the NPL ratio will once again take off in the next few years.[18] As discussed below, the policy environment created after 1998 encouraged banks to provide long-term loans to fixed-asset projects, which can remain solvent in the short run but are potentially very risky in the long run. For example, a 1997 State Development and Planning Commission (SDPC) internal survey found that only 5 per cent of state sponsored construction projects could completely repay interest and principal. A full 20 per cent of these "key point" projects could repay neither.[19] More recently, a government researcher revealed that the drive to maintain 7 per cent growth had forced the government and state banks to support many second, third and even fourth rate projects with highly questionable qualifications.[20] Should a substantial portion of these long-term loans become non-performing in the future, the government will have to engage in even more deficit spending.

Two compelling alternative explanations remain to account for the stagnation in financial reform. The first is an extension of Shirk's anti-reform coalition framework while the second is an explanation of bureaucratic capture. According to rent-seeking theory, stagnation in reform is caused by the opposition of rent-seekers, or small groups that benefit from the status quo.[21] Thus, the lack of substantial financial reform during the Zhu administration might have stemmed from opposition by powerful anti-reform lobbies. In contrast to this portrayal, the State Council successfully implemented reform that substantially weakened a politically powerful group: provincial government officials. Financial centralization in 1998 deprived local officials of access to cheap credit from banks, drastically increasing their dependence on the central bureaucracy for funds. Under Shirk's framework that reformers played one group of rent-seekers against another, one would expect reformers in the State Council to eradicate the rent-seeking opportunities of another group after the defeat of the provincial officials.[22]

In reality, after financial control was taken away from the provinces, the Zhu administration left the power in the central bureaucracy, which poured funds into large SOEs and state projects. Suggestions of liberalizing interest rates and legalizing private banks, which would have given

18. Interviews in Beijing: 10 October 2000, 14 May 2001, 23 June 2001.

19. "Diaocha biaoming jinyou 5% zhongdian jianshe xiangmu ke huanben huanxi" ("Study shows that only 5% of key-point construction projects can still repay interest and principal)," *Qiye juece cankao* (*Enterprise Decision-Making Reference*), No. 124 (1997).

20. Tongsan Wang, "Predicting China's economic future and the national economic policy moving forward: 2002," paper presented at the Chinese Academy of Social Science visit to the Center for Business and Government at the John F. Kennedy School of Government, Cambridge, MA, 7 December 2001.

21. Mancur Olson, Jr, *The Logic of Collective Action* (Cambridge, MA: Harvard University Press, 1965).

22. Shirk, *The Political Logic of Economic Reform.*

the private sector more control over financial resources, were repeatedly vetoed by Zhu. The stagnation of reform was also not a product of Zhu's weakening power. Although Fewsmith points out that Zhu had lost much influence after his failure to reach an accord with the United States on the World Trade Organization (WTO) issue, he regained substantial power with the prosecution of the Yuanhua case.[23] Most interviewees agreed that Zhu had regained his status as "boss" (*laoban*) in the financial sector by late 2000.

Bureaucratic capture, which argues that bureaucratic interests dictate the implementation of financial policies, provides another compelling alternative explanation.[24] The centralization efforts in 1998 indeed brought an increase in power to the State Economic and Trade Commission (SETC), the State Development and Planning Commission (SDPC), the PBOC and the Ministry of Finance (MOF). Yet Zhu's policies also created enormous problems for some of these agencies in the medium and long term. For example, officials in the MOF well knew that transferring non-performing loans from banks to asset management companies would create enormous fiscal pressure on the MOF in the future. Despite the potential problem, top officials eagerly supported this policy because it solved an enormous problem without jeopardizing the short-term budgetary balance. Overall, when bureaucratic preferences were at odds with the promotion imperatives dominating top officials in the various ministries, the desire for more power often carried the day.

Politicians in the State Council

"No one cares what happens in the next administration" (*meiyou ren guan xiayijie de shi*), one interviewee casually remarked, as if this was the most obvious fact.[25] One often associates this mentality with political incentives in a democracy because officials in authoritarian political systems are insulated from popular pressure and thus have longer time-horizons.[26] Nevertheless, many researchers and bankers I interviewed expressed their cynicism and frustration with the short-sighted financial policies adopted by the central government.[27] From a theoretical perspective, the financial policy pattern during the Zhu administration would be much more understandable if it is assumed that the Premier's primary objective was to remain in power.

Holding on to power was by no means an easy task. As Fewsmith notes, Zhu was nearly ousted after the failure to reach an accord on the

23. Joseph Fewsmith, *China since Tiananmen: The Politics of Transition* (Cambridge: Cambridge University Press, 2001), p. 225.
24. David M. Bachman, *Bureaucracy, Economy, and Leadership in China: The Institutional Origins of the Great Leap Forward* (Cambridge: Cambridge University Press, 1991).
25. Interview in Beijing: 24 November 2000.
26. Yasheng Huang, *Inflation and Investment Controls in China: The Political Economy of Central–Local Relations During the Reform Era* (New York: Cambridge University Press, 1996), p. 326.
27. Interviews in Beijing: 24 November 2000, 3 January 2001, 14 May 2001.

WTO with the United States and after the Belgrade bombing in 1999.[28] In the spring of 2001, the policy research centre of the Central Committee, an organization reputedly under the control of Jiang's protégé Zeng Qinghong, sent out a request to all government research organizations to evaluate economic performance during the Zhu administration. According to interviewees, this kind of request, particularly from the Central Committee, was highly unusual and constituted nothing short of a challenge to the Premier himself.[29] More recently, the removal of Construction Bank president Wang Xuebing, a long-time Zhu protégé, might have been an attempt to undermine his authority.[30]

Even if Zhu had intended to be a one-term Premier all along, he had good reasons to maintain his political power until the end of his tenure. According to the rich literature on factional politics, a top Chinese leader needed to maintain his influence up to the end of his life to advance any personal or policy objectives.[31] As Huang puts it succinctly, "decisions are made according to the vision of those who have prevailed in the power struggles rather than through the due process …."[32] Thus, if Zhu wanted to maintain any measure of political influence, he would have to continue his political life beyond his formal retirement. While his post-retirement activities seem more muted than that of the other leaders in his cohort, it would be mistaken to think that he has no role in the current policy process, particularly in matters of promotion. Thus, his action in office did not just reflect his desire to establish a glowing historical legacy, but also his wish for some degree of post-retirement political authority.

What could he do in office to maximize his political influence both during and after his tenure? Two useful strategies are consolidating policy power and making oneself the indispensable problem-solver. These complement each other and serve as both an insurance against unexpected political attacks and an investment towards maintaining post-retirement influence. Consolidating financial power to the central level would first allow the Premier to use the distribution of financial resources as a political bargaining chip at the Politburo level, building a support coalition through disbursing funds to the pet projects of other leaders. With

28. Fewsmith, *China since Tiananmen*, p. 211.

29. Interviews in Beijing: 19 May 2001, 26 June 2001.

30. It is probable that Wang's removal is related to the power struggle between Premier Zhu Rongji and his predecessor Li Peng. Wang had been head of the Bank of China branch in New York. Although the Chinese government had discovered irregularities as early as 2000, Wang was merely transferred to the Construction Bank and remained in power until the US accusation. His removal was widely seen as an embarrassment to Zhu. See Hu Shuli and Gu Wei, "Zhongguo yinhang Niuyue fenhang fasheng le shenme? 'Bu anquan' he 'bu kekao' de xingwei yanxu le jin 10 nian" ("What has happened to the BOC New York branch? Unsafe and unreliable practices that lasted nearly 10 years") *Caijing*, 5 February 2002.

31. Lowell Dittmer, "Chinese informal politics," *China Journal*, No. 34 (1995), Andrew Nathan, "A factionalism model for CCP politics," *The China Quarterly*, No. 53 (1973), Andrew Nathan and Kellee Tsai, "Factionalism: a new institutionist restatement," *China Journal*, No. 34 (1995).

32. Jing Huang, *Factionalism in Chinese Communist Politics* (New York: Cambridge University Press, 2000), p. 5.

total control over financial resources, Zhu could bargain either for political support in the event of a setback, such as the failed WTO negotiations, or for the promotion of a close protégé, which would increase his post-retirement influence. One high level interviewee pointedly stated, "Zhu values the power to distribute financial resources through loans and stock-listings, and he has used the power as chips in the political game."[33] Secondly, firm control over the financial sector allowed the Premier and his followers to solve pressing problems for the regime and thereby accumulate "administrative accomplishments" (*zhengji*).

As the post-reform era experience has shown, the perceived ability to solve problems is a sure tactic to gain promotion and retain power. Zhu himself rose through the bureaucratic ranks by repressing inflation in 1993 and by solving the triangular debt problem in the early 1990s. During his administration, Zhu and his protégés gave the appearance of tackling a series of problems, ranging from chronic state-owned enterprise (SOE) indebtedness to the decline of rural income. Delegating financial authority to his protégés in various agencies allowed them to solve problems, which increased their chances of promotion. Two of Zhu's core followers, Zhou Xiaochuan and Wang Qishan, especially benefited from accumulating administrative merits during the Zhu Rongji administration. Zhou Xiaochuan's tough exercise of regulatory power at the Central Securities Regulatory Commission (CSRC) earned him a lateral promotion to head the PBOC, while Wang Qishan's role in curing "financial chaos" in Guangdong yielded a high profile promotion to the mayoral post in Beijing. This ultimately bolstered the Premier's influence both during and after his tenure.

Because central bureaucrats have a strong incentive to deal with politically pressing issues, they tend to ignore longer-term structural problems. Moreover, because their administrative accomplishments are evaluated by short-term results, they tend to concoct short-term solutions. The Premier's Politburo colleagues do not care what happens five years down the road either. In fact, interviewees pointed out that everyone from the Premier down had a strong disincentive to carry out fundamental reforms that could potentially jeopardize short-term stability or prevent solutions to more pressing issues.[34] As the examples of Hu Yaobang and Zhao Zhiyang demonstrate, signs of instability and chaos provided one's political enemies the perfect excuse to launch a political attack. For ministers, reforms that went out of control could jeopardize their chance of promotion.

Given the incentives facing central bureaucrats, what policies can the State Council be expected to adopt with regard to NPLs? First, it could be expected to politicize policy problems in order to enhance central

33. Interview in the US: 2 May 2002. The exact location is not disclosed to protect the interviewee's identity.

34. Interviews in Beijing: 10 October 2000, 14 May 2001, 23 June 2001; in the US: 2 May 2002.

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power. After the politicization of a financial problem, one would expect the top bureaucrats to adopt policies that maximize central power, maximize the apparent improvement of the situation without jeopardizing their ability to resolve other pressing issues, and minimize the short-term cost of solving the problem with little regard to the long-term consequences. In hindsight, these are precisely the policies that the Zhu administration adopted toward the NPL problem.

Crisis and Command: Politicizing NPL and the Rise of Zhu

As the 15th Party Congress confirmed the transition of power from Deng Xiaoping to Jiang Zemin in autumn of 1997, the most dynamic economies neighbouring China were toppling one after another. At first, it did not seem to affect China. After all, China did not have currency convertibility and could not fall victim to massive capital flight. Less than a week after the 15th Party Congress at the First Plenum, however, Party secretary general Jiang Zemin declared "the prevention and resolution of financial risk is an important and urgent task in our national economic work."[35] Jiang was not just paying lip service. Bank officials uniformly attributed major changes in bank policies in 1998 to the shocking demonstration effect of economic collapse followed by political chaos.[36] While the Politburo had reasonable cause for alarm, the new Premier also highlighted the issue to obtain banking centralization, finally.

Even before the Asian financial crisis, a small group of government experts had realized that years of treating banks as another government treasury had produced mounting NPLs and liquidity problems in the banking system. In 1995, for example, an expert at the Central Party School estimated that the NPL level had reached between 25 and 50 per cent of all loans outstanding, or between 21 and 43 per cent of GDP at that time.[37] Yet, the issue had only been a topic of discussion among experts rather than a top priority for the regime.[38] In 1996, the PBOC finally issued the "rules on lending" (*daikuan tongze*), which systematically addressed the questions of loan quality, loan classification and NPLs

35. Zhu Rongji, "Shenhua jinrong gaige; fangfan jinrong fengxian; kaichuang jinrong gongzuo xin jumian" ("Deepening financial reform; prevent financial risks; create a new phase for financial work"), in Document Research Center of the Chinese Communist Party Central Committee (ed.), *Xin shiqi jingji tizhi gaige zhongyao wenxian xuanbian* (*A Selection of Important Documents for Economic Structural Reform in the New Period,* hereafter *Xin shiqi*) (Beijing: Central Document Publisher, 1998). Zhu quotes Jiang in his own speech.

36. Interviews in Beijing: 9 October 2000, 10 October 2000, 13 December 2000, 27 October 2000, 15 April 2001.

37. Zhou Tianyong, "Yinhang daizhang he huaizhang shi daozhi shehui dongdang de youhuan" ("Bank overdue loans and bad loans are worries that cause social turmoil"), *Jinrong cankao* (*Financial Reference,* hereafter *JC*), No. 1 (1995).

38. Bi Zhiyong, "Guanyu zai qiye zhaiwu chongzu zhong ruhe weihu yinhang zhaiquan de tantao" ("A discussion on how to preserve bank rights in the process of enterprise restructuring"), *Jinrong yanjiu baogao* (*Financial Research Report*, hereafter *JYB*), No. 43 (1997).

for the first time.[39] Nevertheless, the political leadership did not raise these issues at all during the Central Economic Work Conference at the end of 1996.[40] Although recognized as one of the many problems confronting the regime, the NPL issue was clearly not at the top of the elite agenda.

To deal with the worsening NPL problem, a series of measures were proposed by State Council technocrats. One group of researchers suggested that the central government set up a commission for co-ordinating investment and lending to ensure the efficiency of fixed asset investment.[41] Another group suggested replacing the credit plan with a national system to monitor the asset-to-liability ratio of all financial institutions around the country.[42] Finally, a PBOC researcher urged the government simply to forgive the interest payment of a substantial portion of the NPLs without provisioning in order to "enliven" (*gaohuo*) loans.[43] No proposal seriously considered the total centralization of the banking system.[44]

Before these policies could be tested, the Asian financial crisis elevated the NPL issue from an accounting annoyance to the top of the regime's agenda. Although the crisis had been alarming, Zhu Rongji, who was due to begin his tenure as Premier, and State Council technocrats also magnified it to increase the centre's financial discretion. Just as the crisis occurred, a research team at the headquarters of the Industrial and Commercial Bank of China had been preparing a research report on NPLs and local redundant investment. The report first circulated internally among government officials in mid-1997 before the full development of the crisis.[45] However, its political significance quickly increased as Asian economies collapsed one after another. Its troubling findings of rampant redundant investment, non-performing loans and banks with chronic liquidity problems gave central bureaucrats the perfect device to connect

39. People's Bank of China, "Daikuan tongze" ("Rules on lending"), in The Office of Bank of China *et al.* (eds.), *1996 Nian jinrong guizhang zhidu xuanbian* (*Financial Regulations and Systems for 1996*) (Beijing: Finance Publisher, 1997).

40. Luo Guanxing, Zhao Ran and He Jiazheng, "Zhongyang jingji gongzuo huiyi zai Beijing zhaokai (1996)" ("The Central Economic Work Conference convenes in Beijing (1996)"), *Renmin ribao*, 24 November 1996.

41. ICBC Research Group on Problems of Enterprise Bankruptcy, "Guanyu jiejue chongfu jianshe youguan wenti de diaocha baogao" ("A research report concerning solving the problem of redundant construction"), *Qiushi* (*Seeking Truth*), No. 3 (1998).

42. Xie Hangsheng, "Guanyu quxiao xindai guimo guanli de xianshi tiaojian yu shishi buju" ("The conditions and steps in implementing the termination of management over lending quantity)," *JYB*, No. 10 (1997).

43. See Zhang Qian, "Woguo buliang daikuan de zhuangui tezheng ji 'mianxi huoben' panhuo de sheji" ("The transitional characteristics of our country's non-performing loans and designs to enliven them through 'recovering principal through cancelling interest'"), *JYB*, No. 30 (1997).

44. Analysts from outside China had made the proposal to centralize the banking system. For example, see Jun Ma, "Monetary management and intergovernmental relations in China," *World Development*, Vol. 24, No. 1 (1996).

45. Zhan Xiangyang, *Lun Zhongguo buliang zhaiquan zhaiwu de huajie* (*On the Dissolution of Bad Debt and Bad Debt Obligations in China*) (Beijing: China Financial Publisher, 2000), p. 262.

what was occurring in the rest of Asia with what could happen in China.[46] Moreover, this report blames China's NPL problem primarily on the local government and on bad industrial policies made by Zhu's predecessor, Li Peng, although Zhu himself had been actively involved in financial policies during the Li Peng administration.

To reinforce the crisis mentality, a flood of reports from various State Council research organizations followed to tie the crisis with China's NPL problem.[47] Under this barrage of information, the Politburo decided during the First Plenum to give Zhu enormous discretion to change the financial system. In October 1997, the Central Committee and the State Council jointly issued the "Notice concerning deepening financial reform, rectifying financial order, and preventing financial risk" (*Guanyu shenhua jinrong gaige, zhengdun jinrong zhixu, fangfan jinrong fengxian de tongzhi*). In one fell swoop, local branches of the state banks and of the PBOC were removed from the local Party committees' jurisdiction and placed under the newly formed Central Finance Work Committee. Hundreds of locally controlled trust and investment companies and underground banks were closed.[48]

To ensure compliance with these stunning announcements, Zhu, who was due to become Premier in the spring of 1998, chaired an emergency Central Finance Conference in November 1997 with the main theme of "preventing financial risk" (*fangfan jinrong fengxian*).[49] In his main remarks, Zhu first reminded his audience of central and local government officials that they were in the midst of a putative national crisis, which required unity and obedience to the centre.[50] This was to generate a crisis mentality, whereas previous financial crises in Latin America had merely been discussed among academics and bureaucrats.[51]

Provincial officials were clearly outraged by this sudden surge of central power. Zhu had to offer words of comfort to the disgruntled local leaders: "(the centralization of monetary authority) does not mean that we do not trust local officials. It is just that the centre and localities should each divide up our labour accordingly."[52] Besides these words, however, Zhu also offered two concessions to the provinces to stem their anger. First, he allowed the provinces to charter more local banks to help local development.[53] This was merely a token gesture because Zhu had just closed down hundreds of local financial institutions and deprived local government control of the state banks. The second concession was a

46. ICBC Research Group, "A research report."
47. See, for example, Bureau of Economic Prediction of the State Information Center, "Yao yifa zhili jinrong" ("We should rectify finance according to law"), *Caijing kuaixun* (*Headlines of Finance and Economics*), No. 18 (1998), Guangdong Branch of the PBOC, "Dongnanya jinrong weiji dui woguo jinrongye fazhan de qishi" ("The lesson of the South-east Asian financial crisis on our country's financial development"), *JYB*, No. 7 (1998).
48. Zhu Rongji, "Deepening financial reform."
49. The routine Central Financial Conference had already taken place in January 1997.
50. Zhu Rongji, "Deepening financial reform."
51. Interviews in Beijing: 8 October 2000, 10 October 2000, 13 December 2000.
52. Zhu Rongji, "Deepening financial reform."
53. *Ibid*. Interviews in Beijing: 20 March 2001, 14 May 2001.

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promise to use the new central power to fund the development of western provinces. At the December 1997 Central Economic Conference, Zhu promised that "… the economic development of the central and western areas will not be affected."[54] By doing this Zhu also made use of his new-found power to solve the perceived problem of regional imbalance for the regime.

The centralization of the financial system was further confirmed when the Industrial and Commercial Bank of China report was published in *Qiushi* (*Seeking Truth*), the official publication of the Central Committee, days after Zhu had become Premier.[55] This left no doubt about the new banking centralization policies. The article's condemnation of industrial policies under the Li Peng administration also demarcated the new administration from the previous one, although both pursued similar policies in bailing out large SOEs.

The Asian financial crisis should have alarmed the Chinese leadership because it showed that state-led growth might come at the price of financial instability. Instead of concluding that fundamental reform was needed, the State Council framed it into a crisis that demanded unparallel central power. Previous proposals on how to deal with the NPL issue were either abandoned or incorporated into the new drive for central power. As shown below, the enormous financial power concentrated at the centre ultimately did not bring a fundamental solution to the NPL problem.

Stemming the Creation of NPLs

Zhu's main strategies to stem the creation of NPLs included the centralization of the banking system, the imposition of strict NPL reduction quotas on the state banks and improved risk evaluation in the banking system. Instead of accompanying these measures with policies that gave banks more independence and made lending more market-oriented, Zhu used centralized banking power to fulfil other political goals, namely keeping large SOEs afloat and inland development. Thus, while the creation of NPLs has slowed in the short run, capital allocation in China is still largely driven by state policies.

After the First Plenum, centralization measures were quickly devised and implemented. The central government set up a separate vertical Party committee system within the financial sector which appointed and monitored bank managers. At the top of this new hierarchy was the Central Finance Work Committee headed by then vice-premier Wen Jiabao. This institutional change was finally able to remove local state banks from the grasp of the local government, although informal influence and the giving

54. Zhu Rongji, "Renzhen shiqie shiwu da jingshen; jiji luoshi guanyu jingji tizhi gaige de ge xiang buchu" ("Conscienciously realize the spirit of the 15th Party Congress; actively implement the various arrangements concerning economic structure reform"), in *Xin shiqi*.
55. ICBC Research Group, "A research report."

of "face" continued between local officials and bank managers.[56] It also served as the backbone for a series of other centralization efforts. For one, PBOC provincial offices were abandoned in favour of regional offices that oversaw banking activities in several provinces. This measure was designed to elevate regional PBOC offices above the reach of the provincial government.[57]

For the Big Four state banks, the establishment of a Party committee within each bank meant that the headquarters in Beijing could finally order local branches to do its bidding without local interference. In concert with Zhu's drive to lower the NPL ratio in China, the headquarters of the Big Four banks also lowered the lending authority of local branches from billions of RMB to hundreds of millions of RMB.[58] Finally, headquarters of state banks offered local branches interest slightly above deposit rate to encourage them to pass deposits up to the headquarters level.[59] Given strict NPL quotas, local managers were eager to let headquarters worry about making loans.

Zhu also set harsh targets to lower the ratio of NPLs and ordered state banks to implement responsibility systems so that managers who authorized loans could be punished with wage reduction and employment termination.[60] PBOC governor Dai Xianglong further specified this policy by ordering the Big Four banks to lower NPL ratio by 2 to 4 per cent annually depending on the quality of their portfolios.[61] The net effect of these policies was a new autonomy for the state banks from local influence and the concentration of enormous financial resources at the central level. Efforts were also made to bring state banks more in line with international practice in risk assessment and loan classification. These changes, if combined with market-promoting policies, could have engendered fundamental reforms in the financial system.

Despite new policies that moved the banking sector towards commercial independence, interviewees unanimously pointed out that the underlying logic of the state banking system was still one of following commands from the central government. Bankers took credit risk seriously simply because the centre had issued a quota, not because they truly cared about profitability. If Zhu's command was withdrawn or if the

56. Interviews in Beijing: 8 October 2000, 10 October 2000, 27 November 2000; in Shenyang: 25 December 2000; in Dalian: 21 May 2001, 22 May 2001, 23 May 2001; in Fuzhou: 8 June 2001.

57. Local officials and bank managers in Beijing reported that PBOC redistricting served only to confuse jurisdiction in bank monitoring. Others thought that creating PBOC regions was not nearly as important as establishing Party committees within banks. Interviews in Beijing: 10 October 2000, 3 January 2001; in Dalian: 22 May 2001, 23 May 2001; in Fuzhou: 11 June 2001.

58. Interviews in Beijing: 10 October 2000; in Dalian: 22 May 2001, 23 May 2001.

59. Ren Derong, "Dangqian huobi zhengce chuandao shouzhu de biaoxian, cheng'en, yu duice" ("The manifestation, causes, and solution to the blockage to current monetary policies"), *JC*, No. 6 (2000).

60. Zhu Rongji, "Deepening financial reform."

61. "Guoyou yinhang shangshi san nian zhinei meixi" ("The chance for state banks to list shares publicly within three years is minimal"), *Jingji da cankao* (*The Great Reference of Economics*, hereafter *JDC*), No. 4 (2001).

political wind changed, bankers would immediately lapse back to carefree lending.[62] Meanwhile, the Zhu administration mobilized the centralized financial apparatus to fulfil a host of policy objectives.

After the Big Four banks centralized, they became an integral part of the three-year programme to get SOEs out of difficulties (*san nian tuokun*). First, the policy of subsidizing technical innovation loans required large and medium SOEs to submit proposals for improving production technology to the SETC. After approval, the MOF would pay for the interest of the loan until the completion of the project. In 1998 alone, 10 billion RMB in bond issuance was earmarked for this purpose, which was expected to generate 200 billion RMB in loans.[63] Although banks were under no formal obligation to approve a technical innovation loan, bank managers in reality competed with each other to lend to these projects because SETC and MOF approval freed them from being held responsible in the event of default.[64] Because of these incentives, banks approved over 90 per cent of all loans proposed by the SETC.[65]

Second, the provision of close-ended loans (*fengbi daikuan*) specifically targeted loss-making large SOEs. Under this policy, banks were instructed by the SETC to lend to loss-making SOEs that had a production line with reasonable market and profit potentials. Presumably, if funds were directed at improving the promising production line rather than at wage arrears, an SOE would have a better chance of becoming profitable. The State Council also occasionally demanded that state commercial banks rescue certain industries. For example, in 1999, banks were ordered to "lend" to qualified loss-making SOEs so that they could repay fees owed to large state coal mines.[66] Although this policy benefited both large SOEs and state coal mines, banks were unlikely to see any return on their "loans."

The combination of bank centralization, emphasis on risk prevention and bias towards large SOEs also created an extremely favourable environment for large SOEs and state corporations to obtain bank loans. Under enormous pressure to maintain growth at 7–8 per cent, banks lent to firms that had minimal risk in the short run, including large, strategic SOEs and state corporations that had recently offered their shares publicly.[67] Since most publicly traded state firms had also undergone debt-to-equity swaps, their asset-to-liability ratios were likely to be much lower. Indeed, an internal decree of the Construction Bank strongly urged its

62. Interviews in Beijing: 10 October 2000, 10 November 2000, 27 November 2000, 14 May 2001, 19 May 2001; in Dalian: 22 May 2001, 23 May 2001.

63. Bureau of Economic Prediction of the State Information Center, "Duoxiang zhengce chutai youxiao tuidong guoqi tuokun mubiao de shixian" ("Many policies implemented to effectively realize the goal of state-owned enterprises getting out of difficulties") *Zhongguo hongguan jingji xinxi* (*Chinese Macroeconomic Signals*, hereafter *ZHJX*), No. 38 (1999).

64. Interviews in Beijing: 15 April 2000, 27 November 2000; Shenyang: 25 December 2000; Dalian: 21 April 2001, 22 April 2001; Fuzhou: 7 June 2001

65. Interview in Beijing: 6 April 2001.

66. Bureau of Economic Prediction, "Many policies."

67. "Bu lan dai ye bu xi dai" ("Do not lend freely but also do not lend too little"), *ZHJX*, No. 9 (1998).

branch banks to lend to listed firms for this precise reason.[68] More importantly perhaps, these companies enjoyed the protection and support of the SETC.[69] Thus, rather than evaluating firms based on their commercial or liquidity risk profiles, bankers lent to firms based on their *bureaucratic* risk profiles.

The Zhu administration also effectively mobilized the banking sector to fulfil another "campaign promise," the financing of the Go West Campaign. Since the 15th Party Congress placed a high priority on developing western China, bureaucrats at the State Council have viewed it as a way to build up their own "administrative accomplishments" (*zhengji*). PBOC governor Dai, for example, personally promised to "actively oversee" (*jiji ducu*) state commercial banks to lend to state-directed infrastructure projects in the region.[70] He also promised to finance the mergers of loss-making SOEs in the west with profitable ones in the east.[71] By the end of 1999, over 1.5 trillion RMB in loans have gone to western China. This was a 16 per cent increase from 1998, or twice the national rate for loan expansion. Bankers gladly complied with the policy pressure because they were much less responsible in the event of default. In fact, state banks and even joint-stock banks routinely sent representatives to the SDPC to bid for state priority projects in western China.[72]

Finally, in order to ensure stability in poor regions, the State Council still occasionally ordered commercial banks to make "peace and unity loans" (*anding tuanjie daikuan*) to pay unemployed workers.[73] While mid-level bankers disliked these deliberate policies to help troublesome SOEs, they recognized that senior managers needed to respond to the policy demands of Premier Zhu.[74] The combination of these central lending initiatives gave rise to a rapid increase in long-term fixed asset investment loans (Figure 3).

The centralization of the banking system gave Premier Zhu much more power with which to fulfil political objectives. At the same time, it slowed the creation of new NPLs in the short run because fixed asset loans to large SOEs and state construction projects tended to have longer maturity dates. Since most of these entities were also supported by direct

68. Construction Bank of China, "Guanyu jiaqiang dui gufenzhi gaizao qiye jinrong fuwu de tongzhi" ("Notice on strengthening financial services to firms that have undergone share system transformation"), in Construction Bank of China (ed.), *Zhongguo jianshe yinhang guizhang zhidu xuanbian: 1997* (*A Selection of Regulations and Systems for the China Construction Bank: 1997*) (Beijing: Economic Science Publisher, 1998).

69. Chen Qiang, "Fei guoyou touzi de xianzhuang, zhang'ai ji duice jianyi" ("The current situation and obstacles to non-state investment and suggestions of policy responses"), *Jingji yuce fenxi* (*Economic Prediction and Analysis*), No. 39 (2000).

70. "Jinrong jiang da li zhichi xibu kaifang lidu" ("The financial industry will whole-heartedly support the force for the development of the west"), *JDC*, No. 7 (2000).

71. Bureau of Economic Prediction of the State Information Center, "Jinrong jiang cong liu fangmian zhichi xibu" ("Finance will support development of the west in six ways"), *Caijing kuaixun* (*Headlines of Finance and Economics*), No. 17 (2000).

72. Interviews in Beijing: 27 October 2000, 10 November 2000, 27 November 2000, 3 January 2001.

73. Interviews in Beijing: 8 October 2000, 27 November 2000, 3 January 2001; in Shenyang: 26 December 2000.

74. Interview in Beijing: 8 October 2000, 10 October 2000.

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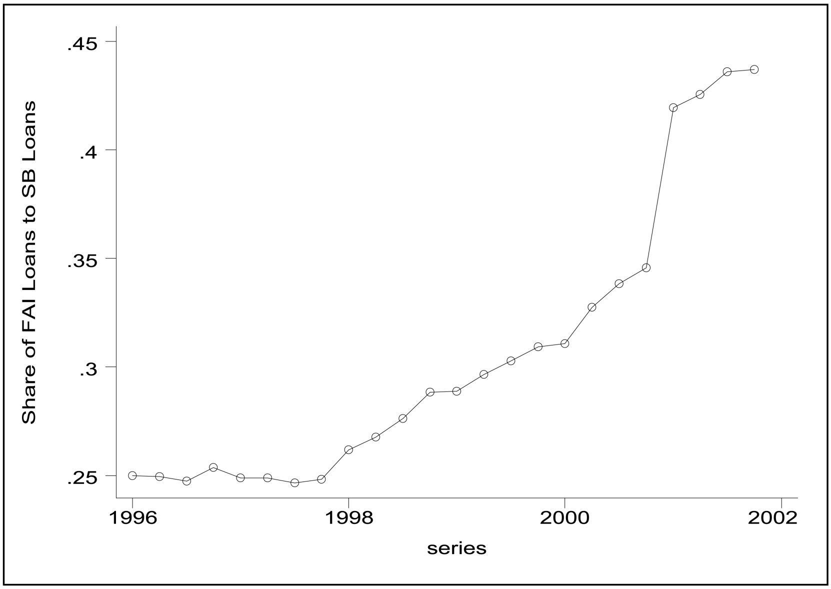

Figure 3: **Share of Fixed-Asset Loans as % of Loans Made by State Banks, 1996–2001 (quarterly)**

Note:
1 = 100%.
Source:
Division of Statistics of the People's Bank of China, *ZJT,* National Bureau of Statistics, *China Monthly Economic Indicators 2001: 3 (March).*

fiscal subsidies from the central government, they were likely to be able to sustain interest payments for the first few years. In the long run, however, it is unclear whether NPLs will continue to haunt the banking sector. Firms which benefited from Zhu's *tuokun* programme are probably taking central aid for granted, creating a moral hazard problem. Already, one report found that large SOEs in Hubei were using around 10 per cent of received bank loans to speculate in China's highly volatile stock market.[75]

Recently, an unconfirmed source reported that when the PBOC carried out a limited investigation of loans over 100 million RMB made in 100 branches of the state commercial banks at the end of 2001, it found an astounding 57.28 billion RMB in NPLs, most of which were generated through recent loans to large SOEs and state construction projects.[76] This bodes extremely ill for the future of the Chinese banking sector. Never-

75. Research Team of the PBOC Wuhan Branch, "Dui Hubei sheng xin fafang daikuan qingkuang de diaocha" ("An investigation on new loans in Hubei province"), *JC*, No. 2 (2001).

76. Beijing Xin Bang Investment & Consulting Ltd, "Si da yinhang 570yi daikuan cheng daizhang, zhongyang zhengjing" ("57 billion in loans from Big Four banks became NPLs; the centre is shocked"), *Xinbang caijing qingbao* (*Xinbang Financial Intelligence*), 4 June 2002.

theless, at the moment, the official rate of NPL generation has slowed down; large SOEs, flushed with cash, were generating operating profits; billions were pouring into western provinces as construction loans.

Dealing with Non-Performing Loans

Besides devising policies to slow down the creation of NPLs, Premier Zhu also devised ways to decrease the enormous pool of existing ones. After taking office, Zhu immediately devised a two-pronged strategy to deal with the problem. First, he recapitalized banks and wrote off a small part of the NPLs. The main effort, however, was setting up asset management companies (AMCs) to take over NPLs from state banks. It is now clear that the emphasis on AMCs was intended to minimize explicit fiscal deficit in the short run and to defer the NPL problem to the future.

In 1998, the central government issued 270 billion RMB of special financial bonds to banks. The government then took this money to re-capitalize the same state banks which had bought the bonds. State banks gained enormously from this process as they obtained both good assets in the form of government backed bonds and higher capital ratio from government injection. Instead of banks bearing the burden of NPLs due to government policies, the NPL burden was transferred to the government in the form of debt. Had this process repeated itself in subsequent years and had banks been allowed to use government injections to write-off NPLs, state banks would have been on their way to being free of "historical burden."

Instead, however, the MOF continued to set the maximum write-off amount to 1 per cent of all loans outstanding during a given year. This regulation, in place since the early 1990s, was primarily designed to control the amount of NPLs that was reflected on the budget deficit. Banks using too much to write-off loans would be unable to hand "profit" over to the MOF. Although the government briefly considered a gradual increase of this ratio in 1998, it ultimately decided against it in order to minimize explicit national debt.[77] Making matters worse, state banks had little authority over which loans to write-off. Under the *tuokun* programme, the SETC distributed much of the 40–50 billion or so RMB in annual write-off money to politically connected large SOEs and state corporations.[78]

Because existing policy on write-offs only resolved a tiny fraction of the estimated 3.3 trillion RMB (37 per cent of 2000 GDP) in NPLs, the Zhu administration devised an alternative policy to reduce NPLs.[79] Again,

77. Interview in Beijing: 8 March 2001, 15 April 2001. "Jinnian jiang zhenzhong chuli chongxiao daliang yinhang huaizhang wenti" ("[The government] will conscientiously deal with and write-off large amount of bad debt in banks this year"), *ZHJX*, No. 19 (1998). This rule finally changed in 2003 when the SETC disbanded.

78. Interview in Beijing: 14 May 2001; 23 June 2001. Bureau of Economic Prediction, "Many policies implemented."

79. Chan *et al*., "US$400 billion needed."

there were several proposals. The first would securitize NPLs into government bonds and directly sell them to the public.[80] This was eliminated early, presumably because it required the government to publicize SOE performance and to decrease the pool of money going into the stock market. More importantly, it would drastically increase the budgetary deficit. Another proposal called for the transformation of debt to state investment (*daigaitou*). Government researchers recommended various solutions within this broad category. For one, the central government could directly issue bonds to state banks and use the capital to purchase NPLs from state banks. It could then convert NPLs into state shares, thereby digesting the NPLs.[81] This proposal, however, would also immediately transform NPLs into explicit budgetary deficit. If the government issued bonds to the state banks to buy NPLs, it in effect transferred NPLs from the banks' balance sheet directly to the government's balance sheet. A second solution involved conducting debt-to-equity swap within banks and setting up asset management departments within banks to oversee companies as shareholders. However, it was felt that this solution would further tie banks to the fate of SOEs, encouraging them to lend more to failing SOEs.[82]

The most promising option within the *daigaitou* category was to set up some kind of financial company to take over AMCs which gave either bonds or stocks to the banks in exchange for bad debts. This would clean up the bank's balance sheet and separate bad debts from the banks. Finally, the government considered using private financial companies to purchase NPLs from banks at a highly discounted rate.[83] The last option would also require the government to inject huge sums of money into banks to write-off the discounted amount after the sale of NPLs to private entities. Again, the necessity of injecting large amounts of government money and thereby increasing explicit deficit made this option extremely unattractive to the Zhu administration.

The decision to set up state-owned AMCs came fairly quickly after Zhu had become Premier. By the middle of 1998, the State Council had decided to set up AMCs to absorb NPLs at face value and to recover as many NPLs as possible. The four AMCs, Xinda, Changcheng, Huarong and Dongfang, which took over NPLs from China Construction Bank, the Agricultural Bank of China, Industrial and Commercial Bank of China, and the Bank of China respectively, each received 10 billion RMB in initial capital from the MOF.[84] On that basis, the four AMCs issued 1.4 trillion RMB in financial bonds to the state banks and used the funds to

80. "Zhuanjia fenxi: 1997 nian jinrong fengxian you shei lai chengdan" ("Expert analysis: who will bear the financial risk in 1997"), *Qiye juece cankao* (*Enterprise Decision-Making Reference*), No. 130 (1997).

81. Er Jianmin (ed.), *Guojia jinrong anquan baogao* (*A Report on the Financial Safety of the Country*) (Beijing: Central Party School Publisher, 1999).

82. Er Jianmin, *A Report*, p. 221.

83. *Ibid*.

84. The People's Bank of China, Ministry of Finance and China Securities Regulations Commission, "Guanyu zujian Zhongguo Xinda zichan guanli gongsi de yijian" ("Opinion concerning the formation of Xinda Asset Management Company"), in Zhan Xiangyang (ed.),

purchase 1.4 trillion in NPLs from the Big Four state banks at face value.[85] AMCs each had a charter of ten years and were suppose to recover as many of the NPLs as possible through debt-to-equity swap, bankruptcy and restructuring debt. At the end of the ten-year charter, the MOF will issue bonds or inject government surplus to write-off the remaining amount. In this manner, state banks replaced 1.4 trillion RMB in NPLs with 1.4 trillion RMB in MOF-backed AMC bonds, thereby getting rid of some two-fifths of the estimated 3.3 trillion in NPLs. Meanwhile, the MOF did not have to list the 1.4 trillion in special bonds on the official budget, since it merely guaranteed bonds issued by the AMCs. The AMCs, on the other hand, were saddled with 1.4 trillion RMB in NPLs. Although AMC officials initially resisted purchasing NPLs at face value, the opposition soon dissolved as they realized that the MOF was ultimately responsible for the pool of NPLs.[86]

After purchasing NPLs, the main strategy by which AMCs converted bad asset into performing asset was debt-for-equity swap, or transforming the debt owed by SOEs to share ownership for AMCs. Instead of deciding which SOEs qualified for the swap themselves, AMCs received SETC "recommendations." Because a debt-for-equity swap drastically reduced a company's debt level, eager SOE managers and local officials waited in a "long line of Red Flag sedans" in front of the SETC for the privilege.[87] In choosing beneficiaries, the SETC focused on large SOEs and state corporations, especially those with personal connections and factional ties.[88] This policy configuration undoubtedly gave the central bureaucracy and ultimately Zhu Rongji a wealth of political capital in the Politburo.

In the short run, every bureaucratic interest, as well as the political interest of Zhu Rongji, gained from the transfer of NPLs to AMCs. The state banks and the PBOC were happy to replace NPLs with performing assets backed by the MOF. AMC-issued bonds bore interest rates bench-marked to bonds issued by the policy banks, which increased bank profitability significantly.[89] Bankers could therefore claim increasing profit as their administrative accomplishment. The MOF supported the plan because it did not immediately have to make explicit the treasury's obligation to the public. While the MOF would have to deal with the remaining NPLs in ten years, top officials were mainly interested in

footnote continued

Lun Zhongguo buliang zhaiquan zhaiwu de huajie (*On the Dissolution of Bad Debt and Bad Debt Obligations in China*) (Beijing: China Financial Publisher, 2000).

85. "At face value" means at the original amount of the loan plus accrued interest. In a market economy, private asset management companies by definition never purchase a NPL at face value because of the high risk profile of a non-performing loan.

86. Interview in Beijing: 14 May 2001

87. Xiangyang Zhan, *On the Dissolution of Bad Debt*, p. 199.

88. Interviews in Beijing: 4 December 2000, 14 May 2001. State Economic and Trade Commission and People's Bank of China, "Guanyu shishi zhaiquan zhuang guquan ruogan wenti de yijian" ("Opinion on certain problems on the implementation of debt-equity swap"), in Zhan Xiangyang, *On the Dissolution of Bad Debt*.

89. Interview in Beijing: 19 October 2000.

providing a short-term solution to promote their career prospects.[90] The SETC, an agency under Zhu's strict control, gained control over the debt-to-equity swap, which decided the fate of thousands of SOEs. In fact, the central government found AMCs the ideal policy tool and increased the amount of NPLs transferred to them from the originally planned 400 billion to 1.3 trillion and finally to 1.4 trillion RMB.[91] In this process, Zhu "solved" a major problem and gained an enormous amount of political capital without jeopardizing the short-term fiscal balance.

Despite the short-term success of the AMC programme to reduce NPLs, rescue SOEs and reduce fiscal pressure, a main outcome was to transfer fiscal pressure to the future. While official announcements optimistically claimed that AMCs would recover 30–50 per cent of the NPLs, Western analysts and officials involved in setting up AMCs agreed that the actual ratio is likely to be 10–20 per cent.[92] Recovering transferred asset in real estate proved to be extremely difficult because of collapsing real-estate prices in some localities.[93] Moreover, while debt-to-equity swap gave AMCs sufficient preferred shares to pay interest on their bonds, they ultimately needed to find buyers for their shares of SOEs to repay the principal of the bonds.[94]

AMCs have thus far dealt with over 500 billion RMB in NPLs, but cash recovery as of the end of 2003 was only 99 billion RMB, or 7 per cent of the total.[95] Attempts to sell NPLs to foreign institutional investors yielded a return of 6 per cent, and the most recent offering of NPLs by an AMC failed to attract sufficient bidders even after the assets were greatly discounted.[96] Despite these troubling indicators, State Council officials were not perturbed because they knew that the main objective of the NPL policies was to minimize short-term burden for the Zhu administration.[97] The next administration would have to take care of itself.

Conclusions

China's opening to the global economy and increasing participation of Western-trained economists and managers in its financial system have

90. Interviews in Beijing: 23 June 2001, 20 May 2001.
91. Gordon Chang, *The Coming Collapse of China* (New York: Random House, 2001), p. 133.
92. Interviews in Beijing: 13 December 2000, 23 June 2001. Bureau of Economic Prediction of the State Information Centre, "Zichan guanli gongsi qianjin lu shang kunnan duo" ("Asset management companies will face many difficulties in the road ahead"), *Caijing kuaixun*, No. 42 (2000).
93. Ge Chong, "Hainan sheng fang dichan daikuan xianzhuang ji panhuo duice" ("The current situation with real estate loans in Hainan and responses to enliven it"), *JC*, No. 2 (2001).
94. Zhang Wenkui, Ji Min and Xu Duo, "The effect of debt-to-equity swap on corporate governance structure and an analysis on its prospect," *China Development Review*, 13 January 2002.
95. Andrew Collier, "Asset managers take 5 years to recover 36pc of bad loans," *South China Morning Post*, 20 January 2004.
96. Karen Richardson, "Chinese banks' bad loans draw increased scrutiny," *Wall Street Journal*, 15 January 2004.
97. Interviews in Beijing: 14 May 2001, 23 June 2001.

laid more stones that lead to the distant shores of a marketized financial system. Yet, the swift political current demands that bureaucrats in charge of China's economy act as politicians and devise a rational strategy to remain standing. In the highly uncertain political environment in China, that strategy involves hoarding financial authority and devising policies that give short-term fixes to pressing problems. Elite power politics makes fundamental reforms that bear the risk of instability unpalatable to everyone. As a result, the domination of the state in the financial sector continues beneath a series of cosmetic changes.

The logic underlying this article is by no means novel in the field of political science. A number of studies suggest that politicians' short-term concerns constitute major obstacles to reform.[98] Nevertheless, short-term political concerns typically are not used to explain economic policies in high-growth countries in East Asia.[99] Within the China literature, this article suggests a reform logic which departs from the conventional view of the Chinese government, that it has a strong interest in carrying out incremental reform that leads to complete marketization. While previous frameworks do well in explaining instances of reform or decentralization, the power framework does better in explaining centralization and reform stagnation. Rather than negating the previous explanations of Chinese reform, this work suggests that a more general framework is needed to explain both the successes and failures of reform across various sectors. This task requires a time-series, cross-sectoral analysis to pin down the causal mechanism.

One preliminary observation is that the central bureaucracy is increasingly abandoning specific policy authorities in favour of more fungible powers. Whereas complex rules made by the ministries used to govern many aspects of firm behaviour, tightening central control over taxation and monetary policies now arguably gives the central government just as much leverage over major firms, while drastically reducing its monitoring costs.[100] Politically, also, rather than making complex preferential policies to specific provinces or sectors, the top technocrats can now simply give either fiscal subsidies or bank loans to the target recipients. Again, since money is fungible, the top technocrat can earn political credit without making substantial institutional investment. For example, the Open up the West Campaign's massive injection of funds through the budget and the banking system stands in stark contrast to preferential treatment of Guangdong in the 1980s, which involved a mix of investment and complex industrial and fiscal policies.

Moreover, the concentration of fiscal and financial power in a few

98. See, for example, Ann Krueger, *The Political Economy of Policy Reform in Developing Countries* (Cambridge, MA: MIT Press, 1993), Adam Przeworski, *Democracy and the Market: Political and Economic Reforms in Eastern Europe and Latin America*, *Studies in Rationality and Social Change* (Cambridge: Cambridge University Press, 1991).

99. The exception is Kang's work on Korea. See David Kang, "Bad loans to good friends," *International Organization*, Vol. 56, No. 1 (2002).

100. Zysman makes a similar observation about industry policy in European countries. See John Zysman, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change* (Ithaca, NY: Cornell University Press, 1983), p. 76.

central agencies also provides the top technocrat with a virtual monopoly over the allocation of state resources. In other words, the concentration of rent allocation authorities in a few agencies under the Premier's direct control makes it much harder for other Politburo members to play a direct role in allocating rent. They become more dependent on the top technocrat, which gives him much more political leverage over the rest of the Politburo. Thus, reform in the financial sector might be a victim of the central bureaucracy's simplification strategy. While a top technocrat is willing to liberalize other sectors of the economy, the enormous pool of savings in the banking sector renders it an indispensable policy and political instrument. In China's increasingly monetized economy, financial and fiscal institutions become even more crucial in the elite political calculus.