

NEOLIBERAL DEVELOPMENTALISM:
STATE-LED ECONOMIC LIBERALIZATION IN CHINA

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Mi Ji

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Mi Ji, Ph. D.

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On the question of state-market relations, the neoclassical economic view regards a minimal state as essential for economic growth. The statist view in political economy studies, on the other hand, stresses the active role of the state in promoting economic development. Both views tend to treat “state” and “market” as opposing forces: A developmental state is associated with industrial planning and active interventionist measures to “govern the market”, whereas market-conforming liberalization is usually seen as a sign of the state’s retreat in the face of globalized market forces. My study of economic reforms in China, however, indicates that a state may pursue market-conforming liberalization to advance its developmental goals.

This dissertation seeks to account for the logic behind the apparent anomaly of state-market relations in the course of China’s economic reform through examining the reform processes of key economic sectors. The study pays special attention to the historical and institutional contexts where reforms took place and evolved and uses institutional change and the ensuing socioeconomic dynamics to explain the course and outcome of the reforms. It argues that administrative decentralization in China changed the Chinese state’s internal

structure and in turn adversely affected the central state's autonomy and policy enforcement capacity. To regain state authority and control, central policy makers resorted to market-conforming liberalization. Rather than the state intervening in the market or the state giving way to market forces, this process entails the Chinese state's effort to re-create a developmental state through the creation of a liberal market.

BIOGRAPHICAL SKETCH

Mi Ji was born in Beijing, China. She received her Bachelor of Arts degree from Foreign Affairs College (now China Foreign Affairs University) in Beijing, China in 1993 and her Master of Arts degree from Cornell University in Ithaca, New York in 1999. In 2000, she went to Fontainebleau, France to study in the MBA program at INSEAD, and was awarded a Master of Business Administration degree in 2001.

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LIST OF ABBREVIATIONS

BOC (Bank of China)

CCB (China Construction Bank)

FTCs (Foreign Trade Corporations)

ICBC (Industrial and Commercial Bank of China)

MOF (Ministry of Finance)

MOFERT (Ministry of Foreign Economic Relations and Trade)

MOFTEC (Ministry of Foreign Trade and Economic Cooperation)

PBC (People's Bank of China)

PCBC (People's Construction Bank of China)

RCCs (Rural Credit Cooperatives)

SEZs (Special Economic Zones)

SOBs (State-Owned Banks)

SOEs (State-Owned Enterprises)

TICs (Trust and Investment Companies)

UCCs (Urban Credit Cooperatives)

CHAPTER ONE

INTRODUCTION

Since 1978, China has followed a distinctive path of economic reform and liberalization. Over the years, China has maintained an average annual growth rate of 9.7%.¹ The reform years have witnessed a transition from a command economic system to a market one. By the mid 1990s most of the agricultural and industrial consumer prices were free of government control; and the scope of mandatory production planning fell to only 5% from 95% of total industrial output prior to reform. Meanwhile, the Chinese economy has been internationalized. Its total trade increased by 24 times in the past two decades.² Having emerged from its previous seclusion and isolation, China ranked as the 3rd largest trading nation in the world in 2004.³ In 2003, China surpassed the United States to become the largest recipient of foreign direct investment with a total FDI inflow of US \$54 billion.⁴ Institutionally China formally joined the WTO in 2002, committing itself to free trade and further liberalization of its domestic economy.

Underlying the dramatic changes that have happened in China are three major processes: development, marketization, and liberalization. China's economic takeoff is often regarded as another successful example of late development. Yet compared with earlier "late developers"

¹ Source: State Council Development and Research Center.

² Zhu Rongji, "Report on the outline of the Tenth Five-Year Plan for national economic and social development at the 4th session of the 9th National People's Congress, March 5, 2000.

³ Source: State Council Development and Research Center.

⁴ UNCTAD. *World Investment Report*. 1994.

such as Japan, Korea and Taiwan, China has faced different international and domestic conditions. Whereas the favorable political conditions of the Cold War allowed the latter countries to pursue an export-led strategy while keeping their domestic markets relatively protected, the internationalization of the Chinese economy has coincided with the trend of globalized trade and finance. Internally, China's drive for economic development since 1979 has been accompanied by the transition from a planned economic system to a market one. The question for the Chinese government, therefore, is not only about the relative position of the state vis-à-vis the market, but also about creating a market in the first place. On a more general level, China's economic transformation is part of the nation-states' experience with globalization. In China, as in many other developed and developing countries, the national economy has undergone the process of liberalization.⁵ What is special about the Chinese experience is that the processes of economic takeoff, marketization and liberalization have been taking place almost simultaneously rather than sequentially as is the case with most NIEs and developed economies. The Chinese experience itself, therefore, provides an opportunity for observing and assessing the effect of the interactions of these processes. Unraveling the logic of the reform experience in China may also serve as a starting point for further comparisons and investigations along one of the three dimensions of development, market transition and liberalization.

⁵ For liberalization in developing economies, see Alex. E. F. Jiberto and Andre Mommen (1996); Will Martin and L. Alan Winters eds. (1995); Rob Vos, Lance Taylor and Ricardo Paes de Barros (2002). For deregulation and liberalization in developed economies, see Steven Vogel (1996); James Malcolm (2001); Louis W. Pauly (1998).

This study focuses on the Chinese experience itself and starts with a few intriguing questions that the three intertwining processes have posed to China scholars and political economists: Whereas the Chinese reform has been generally described as following an incremental approach, how does the Chinese government eventually take the decisive step towards full marketization and liberalization of its economy? What factors caused the Chinese government to prefer a relatively hands-free approach to an active interventionist one in fulfilling its growth objectives?

The Chinese reform has been a story of growth. During the reform years, the Chinese state has focused on “economic construction” and taken economic growth as its primary policy objective. Accordingly, people tend to view the Chinese state as a socialist developmental state and expect it to assume an active role in “governing the market”. Indeed, at the onset of the reform the Chinese state was in full command of the economy through micro management. Even today, the state still has a strong presence in market activities. Yet over the years the Chinese state has shown an increasingly determination to decouple itself from the market. Whereas some East Asian developmental states such as Japan and Korea sought to promote economic growth through industrial planning, sector-specific interventions, export promotion and import protection,⁶ China appears to be more disposed to conform to a

⁶ See, for example, Chalmers Johnson (1982), Robert Wade (1982), Alice Amsden (1989), Frederic Deyo (1987).

liberal economic order than its East Asian predecessors at the comparable stage of economic development.⁷

China's embracing the world market is not without its costs. While China's export-oriented companies look forward to benefiting from this liberal order introduced to China through the country's WTO accession, other domestic players are exposed to sharply increased competitions from the international market. In the short to medium term, full scale liberalization is likely to have an adverse effect upon social equality, widen the gap between rural and urban areas, and exacerbate unemployment.⁸ What prompted the Chinese government to commit itself to a liberalization strategy despite negative domestic repercussions that could pose threats to its economic security and social political stability?⁹ What was the rationale behind the Chinese state's policy choice and the country's reform trajectory?

The Logic of China's Economic Reform: Competing Explanations

Existing studies of Chinese reforms have had very different interpretations of the logics behind the reforms and equally different evaluations as to where they were heading to. Susan Shirk, in *The Political Logic of Economic Reform in China*, argues that China's reform has followed a political rather than economic logic. The sequencing of

⁷ According to Nicolas Lardy (2002), the decade prior to China's WTO accession already saw China's deep integration with the world economy. Not only were its trade and inward FDI expanded at a rate unmatched by other East Asian NIEs and developing countries in general, it also became a major overseas investor; with systematic efforts to remove tariff barriers in the 1990s it had the lowest level of tariff protection among all developing nations.

⁸ See Shaoguang Wang (2000), Huang Jikun, Chen Chunlai (1999) and Nicholas Lardy (2002) for evaluations of short term and medium term costs of China's WTO entry.

⁹ See Gordon Chang (2001) for pessimistic forecasts about a liberalized China.

the reform and the mode of institutional transformation are determined by competitions among individual political leaders as well as among various bureaucratic interests. More often than not, reform measures are adopted out of consideration for appealing to a certain constituency rather than for economic benefit and efficiency. She concludes, based on such observations, that reform in China will be fragmented and incomplete, as the political logic has prevailed over the economic one. Under this view, full-scale market-conforming liberalization is not the likely outcome of China's reforms.

Another view, however, argues for the merit of China's gradualist approach and describes the reform process as Pareto-improving and leading the country smoothly from plan to market. Barry Naughton observes that the dual-track approach in China ensures that the entire system does not collapse overnight while market elements grow over time and force state sectors into competition. The process is analogous to deregulation reforms in developed market economies where selective entry ensured that change is initiated and competition increased with a minimum of disruption. Under this economic logic, China will "grow out of the plan" towards a free and market economy.¹⁰

A third view sits somewhere in-between. Andrew Wedeman observes that the gradualist reform was not rolled out as a smooth evolutionary process as the "growing out of the plan" view portrays. Rather, China did fall into the pitfalls of partial reform as incremental change unleashed a wave of rent seeking and gave rise to local protectionism.

¹⁰ see Barry Naughton (1995); "China's Transition in Economic Perspective" in Goldman and MacFarquhar (1999).

According to Wedeman, however, such rent seeking and local protectionism ironically served to fulfill what formal reform failed to achieve as they crippled the state's ability to control price, thereby forcing de facto price reform and undermining the institutional foundations of the planned economy.¹¹ In other words, the apparent chaos and disorder resulting from fragmented authority and unbridled rent seeking undermined the institutional foundations of a planned economy, freeing the artificially fixed prices and moving the economy towards its market equilibrium point.

Naughton's growing-out-of-plan argument provides an economically coherent explanation of the logic of incremental reform. By portraying the reform process as one of smart design and smooth evolution, Naughton demonstrates how a dual-track and apparently incomplete reform approach was crafted to produce economically optimal outcomes. However, Naughton's sophisticated account of the economic processes in China seems to provide an ex post facto explanation of the logic of China's economic reform. It is true that the Chinese economy has emerged out of plan and that the dual-track system has been giving way to a standardized market system. However, at the onset of the reform policy-makers hardly had a clear picture of how the market is going to outgrow the plan. In fact, it was amid disputes over different models and occasionally suspected power struggles that the path of reform has been blazed.

Shirk's study, on the other hand, explores the political rather than economic logic underlying the reform process. Under Shirk's account,

¹¹ Wedeman (2003): 1-22.

the reform process was slow and partial not by design but as a result of political compromises made between different political actors. Shirk's model captures well the dynamics of the decentralization era, revealing the tension within the decentralized structure and the actual politics behind the apparently incremental change. With a rational-choice institutionalist approach, however, Shirk largely treats institutions as rules of the game within which individual political actors engage in repetitive rounds of political bargaining and calculations. The historical evolution of state institutions and the possible impact of institutional change on the nature of politics were left under-explored. As a result, Shirk's model can hardly explain the reform outcomes since 1992 when the Chinese government committed itself to building "market economy with Chinese characteristic." In the 1990s, market conforming reforms in crucial economic sectors, and privatization in the name of reforming state-owned enterprises was finally put on the agenda. By the time China acceded to the WTO, doubts about the thoroughness of the Chinese reform were largely gone. To account for the new developments, Shirk resorts to ad hoc explanations citing factors ranging from political diplomatic considerations such as China's intention to beat Taiwan in the GATT/WTO accession race and its need to obtain permanent MFN (later PNTR) status through GATT/WTO membership to transnational factors such as pressures from the international market and possible collaboration between domestic pro-liberalization sectors and international business interests.¹²

¹² Susan Shirk (1994): 55-56. Susan Shirk's (1993) analysis of the logic of China's economic reform is largely based on a rational-choice institutionalist approach. Whereas later on she argues that there are reasons to expect China's economic reform

Like Shirk, Wedeman also treats the stalled reform of the late 1980s as a political liability of incremental change rather than an intended move on the part of the central government to prepare the country economically for the next round of bolder reforms. Yet in his account the political evils of the partial reform such as rent seeking and local protectionism turned out to be a blessing in disguise as they eventually “dissipated the rents that vested bureaucratic interests had sought to defend”.¹³ Underlying the dismal political competition and rent-seeking was an economic law that drove the market towards its equilibrium point. The central government launched a new round of top-down reform just to “bring regime policy back into line with economic reality”. Wedeman’s study provides rich detail and contextual analysis of central-local political-economic struggles under the decentralized planning system. The ultimate explanation Wedeman offers, however, is one imbued with a neoclassical economic logic, showing how market-oriented transformation was self-generated from political setback and stalemate of the previous round of reform. Yet it appears to have understated the complexity of the new round of market-conforming reforms. The reform initiative of 1992 entailed a series of marketization and liberalization measures of which price reform was only one objective. Local dynamics could have provided a momentum for change. But pending a strong initiative and decisive measures from the central government, it is hard to imagine that “the

to go forward (1994), she admits that developments since the 1990s cannot be explained by her earlier model of central-local political interactions. (Shirk, Talk on China’s Economic Reform at Peking University November, 2005)

¹³ Wedeman, op. cit.: 22.

economic reality” of a national market and a more open economy could be born out of regional segregation and rivalry. The question of rationale and motivation for change is left ambiguous in Wedeman’s account.

This study builds on Shirk and Wedeman’s analyses of central-local politics in the decentralization era and pays special attention to the historical and institutional contexts where reforms took place and evolved. In fact, Wedeman argues that rent seeking by local governments that were numerous and scattered had a different institutional effect than rent seeking by powerful oligarchs as was the case in Russia. In this way, he goes one step further than Shirk to explore the effect of earlier reform measures on latter rounds of reform. However, Wedeman’s treatment of institutions is still similar to Shirk’s, i.e., institutions are seen as the rules of the games under which rational players seek to maximize their payoffs. The Chinese reform, however, has not only been a process of the state or societal actors making rational calculations and moves under system constraints, but also one of institutional change, which primarily concerns the change to the internal structure and organization of the state. Changes in institutional structures would eventually change the rules of the game for actors involved and reset the course of reform at the subsequent stage. The outcomes of China’s economic reforms and the country’s overall developmental trajectory need to be understood and explained in this light.

My argument is that administrative decentralization in China changed the Chinese state’s internal structure and in turn adversely affected the central state’s autonomy and policy enforcement capacity.

State autonomy is premised upon the coherence and cohesiveness of the state's bureaucratic structure and is defined as the ability of the state to achieve relative independence from the demanding clamor of special interests (whether class, regional or sectoral).¹⁴ As economic authority was delegated to provincial governments and profit-sharing schemes between the central government and provincial authorities were introduced on a regional particularistic basis, bureaucratic coherence and cohesiveness required for an autonomous state were weakened, which eroded the ability of the central state to enforce its development and growth strategies. To regain control, central policy makers realized that it was necessary to reassert state autonomy and they attempted to do so through marketization and decoupling the state from microeconomic activities. Rather than the state intervening in the market or the state giving way to market forces, this process, to a certain extent, entails the central government's effort to re-create a developmental state through the creation of a market.

Such an explanation requires a historical institutionalist analysis of the Chinese state and its relationship with the market. Under historical institutionalism, the state is treated both as an actor and as an organization. As an actor the state makes rational moves based on incentives given by institutional constraints. As an organization, however, the state's organizational attributes are historically grounded and constructed. The actual incentives and interests that motivate state

¹⁴ Leftwich (1995): 408; Nordlinger (1987): 361. For discussions on state autonomy and state capacity, also see Michael Mann, "The Autonomous Power of the State: Its Origins, Mechanism and Results." in John A. Hall, ed. (1986); Peter Evans (1988); Joel S. Migdal (1989; 2001); Migdal, Kohli and Shue (1994); Atul Kohli (2004).

actions, therefore, are endogenous to the institutional structure of which the state is a part. A close examination of the changes in the Chinese state's organizational structure during the reform era and the ensuing socioeconomic dynamics may help us identify the sources of institutional incentives and state interests and delineate the logic of the Chinese state's liberalization initiatives.

State-Market Relations in Modernization and Development

Exploring the logic behind the Chinese economic reform and the Chinese state's policy choices requires us to examine the relationship between state, market activities and economic development. Treating the state as a collection of interest-maximizing individuals may lead to negative evaluations over the state's ability to pursue consistent developmental goals. Treating the state as an autonomous bureaucratic organization, on the other hand, leads statist scholars to stress the state's ability to promote economic development through active intervention in market activities. This latter approach, however, takes state autonomy for granted and overlooks the fact that the degree of state autonomy is largely determined by its organizational attributes, which vary across different institutional structures that are historically shaped. In exploring state-market relations, the statist approach needs to be informed by a historical institutionalist analysis in order to uncover the logic behind a state's choice of approach to the market.

State, Market and Economic Growth

The relationship between "state" and "market" has always been a central issue for discussion in the studies of political economy.

Neoliberal/neoclassical economic doctrines regard *a minimal state* as essential for economic growth.¹⁵ In general, scholars applying the logic of neoclassical economics to political economy studies paint the state as a negative factor in market activities and economic development. State intervention beyond this minimal role induces rent-seeking activities, distorts market operations and hinders economic development. The desire of office holders to obtain and perpetuate abnormal rents makes it illogical for them to behave in ways that are consistent with the common good.¹⁶ Underlying this view is the treatment of the state as an aggregation of individual utility maximizers. According to Anne Krueger, competition for entry into government service is, in part, a competition for rents.¹⁷ Once in office, self-interested politicians and bureaucrats seek to reward and retain their supporters by directly distributing resources to them or intervening in market activities in their favor. This, however, is achieved at the expense of economic efficiency and proper functioning of the market. Accordingly, this economic view of politics, sometimes called neo-utilitarianism,¹⁸ proposes that the state's sphere should be reduced to the minimum so as to allow market mechanism to work wherever possible.¹⁹

¹⁵ See Douglass North, (1981): 20.

¹⁶ For the theory of rent seeking, see T. N Srinivasan (1985); and James Buchanan, Gordon Tullock, and Robert D. Tollison (1980); Charles K Rowley, Robert D. Tollison and Gordon Tullock, eds. (1988). For rational choice analyses, see Margaret Levi (1988, 1997) and Robert H. Bates (1981, 1988).

¹⁷ Anne Krueger (1974): 293.

¹⁸ See Peter Evans (1995):22-25.

¹⁹ Neo-utilitarianism's negative assessment of the state's role in economic activities derives from both neoclassical economics and the new institutional economics; the latter amends the neoclassical economic view by incorporating institutions into economic analysis. However, institutions are treated as a set of constraints on behavior in the form of rules and regulations and the state is seen as nothing more

One problem with this view, however, is that the very depiction of the state as a collection of rent-seeking and interest-maximizing individuals makes the minimal state that is conducive to economic development logically impossible to realize, as there is no reason to believe that politicians and bureaucrats would forgo personal wealth and privileges for the welfare of the economy. Moreover, this is not only a logical problem. In reality we have seen many instances of state-led liberalization or deregulation programs. If the state is nothing but a bunch of self-interested individuals who benefit the most by keeping their rental havens, these state-initiated efforts would be virtually inexplicable. The process and outcomes of the Chinese reform, for example, pose such an empirical problem. If the first decade of the Chinese reform can still be explained as redistribution of political and economic benefits among central and local politicians, the state's push for economic liberalization in the second decade of the reform era is indeed an anomaly to the neo-utilitarian expectation of state behavior.²⁰

In contrast to this "reductionist" view of the state, there has been an academic tradition of treating the state as an institution insulated from societal interests. The early roots of the "statist" tradition can be found in Max Weber's "bureaucratic state". The Weberian state is antithetical to the neo-utilitarian depiction. Weber believes that modern bureaucratic state distinguishes itself from pre-bureaucratic forms of state with its ability to rise above individual interests. Bureaucrats with defined and specialized roles find their interests fulfilled by carrying out

than an organization for reducing the transaction costs of economic activity. (Douglas North 1981, 1984, 1990).

²⁰ See fn 12.

their assigned duties and contributing to the goals of the state apparatus. The existence of such a bureaucratic apparatus is necessary for providing and maintaining the order required by the capitalist market.²¹

Weber's conception of the state is recaptured by various institutional arguments about the role of state involvement in assisting and improving market operations. Studies about modernization and development, for example, rest upon the conviction about the relative autonomy of the state vs. the society. These studies, however, go beyond the Weberian state that provides a stable environment for private capital to argue for a more interventionist role of the state in promoting economic development. Alexander Gerschenkron, in studying "late development" of Europe, argues that in countries where private economic networks are underdeveloped, the state had to play the role of "investment banker" in financing industrialization so as to acquire production technologies and catch up with already industrialized countries.²² Albert Hirschman's observes that for "late late" developers of the Third World, what is in shortage is not only capital, but the "ability to invest", i.e., "the ability to make and carry out development decisions." The state, therefore, had to go one step further: It had to lead and induce entrepreneurial activities so as to "channel existing or potentially existing savings into available productive activities."²³

A more recent statist enterprise is the study of developmental states of East Asia. Chalmers Johnson first used the concept of capitalist

²¹See Max Weber (1968):54.

²² Alexander Gerschenkron (1962): 12-22.

²³ Albert Hirschman (1958): 35-36.

developmental state to describe the Japanese state. The notion was then used by other scholars like Robert Wade, Alice Amsden and Frederic Deyo in their studies of East Asian NIEs.²⁴ A common characteristic of these studies is that they set out to explain the successful growth stories of East Asian countries. What they find is that a highly autonomous state with a strong commitment to economic development has been the major force shaping capitalist development in those countries. The East Asia Model under their accounts, therefore, is one of active participation by the state in promoting economic growth through industrial planning, sector-specific interventions and careful control and negotiation of international ties.²⁵

Whereas Gerschenkron and Hirschman's studies focus on why states need to intervene in promoting economic development, studies of East Asian developmental studies seek to explore the causality between "state intervention" and "economic growth". The former arguments are more historically contingent whereas the latter ones seem to be looking for a more generic explanation about state market relationship. This, however, makes the arguments in the latter category vulnerable when empirical situations turn against them. For example, when Asian economies were struck by the Asian Financial Crisis, many critics see the root of the problem as lying in the non- "market-conforming" nature of government regulations and unnecessary and unhealthy

²⁴ See Chalmers Johnson (1982), Robert Wade (1990), Alice Amsden (1989), Frederic C. Deyo, ed., (1987).

²⁵ For general literature on state-centric political analysis since the rise of statism in the late 1970s, see Peter Evans, Dietrich Rueschemeyer, and Theda Skopel, eds. (1985); Bob Jessop. (2001); Gianfranco Poggi (1978); Stephen Krasner (1978, 1984); Howard Lentner (1984); Peter Hall (1986); Forrest D. Colburn (1988); Linda Weiss and John Hobson (1995).

government-business collaborations. The very model that had been used to account for the “miracles” now was put under fire. Whether state intervention should be blamed for causing or worsening the crisis remains a question to be explored. But obviously the East Asia model cannot account for all success cases. In China, for example, high growth rates have accompanied market-conforming reforms.²⁶ The government appears to be keener in leveraging the country’s existing comparative advantage to participate in free trade rather than pursuing active industrial planning and interventionist policies. Why could China reproduce the economic miracle of its East Asian neighbors without replicating their model? A more modest and yet more relevant question is: why didn’t the Chinese state choose to emulate its East Asian predecessors given their cultural affinities as well as China’s tradition of state control over the economy?

In this regard, the Gerschenkronian and Hirschmanian approaches are closer to getting the answer: By putting states and markets into specific historical and comparative contexts, they see state-market relations not merely as independent variables accounting for growth, but as outcomes to be explained as well. ²⁷

²⁶ For a review of China’s market-conforming reform in the 1990s and efforts to comply with the WTO requirements, see Nicholas Lardy (2002: Chapters 1-3, 5). Lardy observes that before China joined the WTO, the Chinese government had already taken drastic reforms in many economic sectors. Average tariffs were lowered by 2/3 and import quota and licenses were reduced by 80%. Market-conforming enterprises restructurings were taken in traditionally state-dominated industrial sectors such as textiles, construction materials, nonferrous metals, steel, chemicals, petroleum, railway, mining, etc. Price reforms were completed for most industries except for a few key products and services such as postal service, natural gas, electricity, etc.

²⁷ Historical institutional analysis generally treats state-market relations or state policy outcomes as dependent variables to be explained by historically determined institutional structure. See, for example, Peter Katzenstein, ed. (1978); John Ikenberry (1988); John Zysman (1994); Thelen and Steinmo, “Historical Institutionalism in

State Structure, State Autonomy and State's Approach to the Market

When the paths of development are seen as historically contingent and a state's approach to the market is treated as an outcome to be explained, domestic institutional structure becomes a major explanatory variable to be investigated.

Both Gerschenkron and Hirschman see the state's approaches to the market as deliberate choices aiming at promoting industrial growth. However, they are in the first place, determined and confined by the preindustrial situations of late developing countries. The actual role of the state in promoting development, therefore, may vary from country to country. The internal workings of different political regimes, combined with different timings of industrialization, lead to different paths of development.

Other authors have also investigated into the origins and rationale of various types of state-market relations. Gary Hamilton and Nicole Biggart, for example, challenge the argument that views the development of East Asian NIEs as following a single model. They compare the cases of Japan, South Korea and Taiwan and find out that contrary to the usual depiction of East Asian development as characterized by the intervention of strong states, the role of state and its relationship with business varies from country to country. And such varied state-business relations, according to Hamilton and Biggart, should be seen in a much larger context, as flowing from the attempt on

Comparative Politics," in Steimo, Thelen and Longstreth eds (1992); Paul Pierson (1996, 2004); Kathleen Thelen, "How Institutions Evolve: Insights from Comparative Historical Analysis" in James Mahoney and Dietrich Rueschemeyer (2003).

the part of the political leaders to legitimize a system of rule in the society. And to do so they focus on the cultural historical origins of the organization of the state and the state's relations to the society.²⁸

Peter Evans goes one step further in *The Embedded Autonomy* by exploring not only the rationales behind developmental state's different approaches to the market, but also the prerequisites and conditions for a state to effectively pursue its developmental strategy. Evans judges that the debate about how much states intervene have to be replaced with arguments about different kinds of involvement and their effects, as in the contemporary world state involvement is a given. However, according to Evans's analysis the form of state involvement is not a matter of choice but institutionally determined. Evans observes that the Weberian bureaucracy that is coherent and cohesive cannot be taken for granted in reality and state structures, which are not generic but vary across countries instead, define the range of roles that the state is capable of playing.²⁹ The key, therefore, is to identify differences in ways states are organized and then connect these differences to variations in states' approaches to the market.

Similarly, Atul Kohli's study of states and industrialization in the global periphery also explores the institutional foundations of states' approaches to the market. Kohli argues that states that are able to effectively pursue their developmental goals are characterized by

²⁸ See Gary Hamilton and Nicole Biggart (1998) and Orru, Marco, Nicole Biggart and Gary Hamilton (1997).

²⁹ Peter Evans (1987: 10-12).

cohesive politics, i.e., by centralized and purposive authority structures that often penetrate deep into the society.³⁰

For both Evans and Kohli, the emphasis of their study is not on how a Weberian bureaucratic state promotes growth and development, but on evaluating the degrees of proximity of state structures in reality to the ideal-type Weberian state and the corresponding effects on these states' relationship with the market.

Moreover, both Evans and Kohli hold that state autonomy does not preclude linkages between the state and the society. Evans argues that to formulate and implement development programs to reach developmental goals, the states need to be embedded in a concrete set of social ties that binds the state to society and provides institutionalized channels for the continual negotiation and renegotiation of goals and policies. This is what he calls "the embedded autonomy". Kohli observes that cohesive-capitalist states have usually carved out a number of identifiable links with society's major economic groups and devised efficacious political instruments. In this sense, state autonomy is less a matter of organizational insulation from the society than of bureaucratic capabilities to maintain policy independence.

By looking into the differences in state structures and their effects on state autonomy, Evan's, Kohli's as well as Hamilton and Biggart's studies offers a promising analytical perspective with which to investigate the logic behind the variations of states' approaches to the market.

³⁰ Kohli (2004): 10.

By the same token, treating the state as a historically grounded institution and analyzing the effect of institutional change on state interests and actions may help us uncover the rationale behind the apparent anomaly of state-market relations in China and solve the puzzle as to why China was able to move away from the political equilibrium of partial reform to embrace full-scale market-conforming liberalization.

From Decentralization to Liberalization: The Chinese State's Pursuit of Autonomy

Examining the characteristics of China's state structure and its evolution during the reform era may help us uncover the logic behind the apparent anomaly of state-led liberalization in China. Cross-country studies mentioned above compare institutional structures spatially to account for differences in states' approaches to the market across countries. This study, on the other hand, examines China's domestic institutional structure temporally to explore the underlying reasons behind the changes in the state's policy outcomes. At the core of this analysis, therefore, is structural change. Whereas study of stable structures is more concerned about general patterns and continuities of state behavior in historical and institutional contexts, an investigation of structural change is more concerned about the state's specific policy choices and its decisions. In a sense, it is a situational analysis where politics kick in and where decisive action can "change history".³¹

³¹ Peter Gourevitch (1986).

When we ground our understanding of the Chinese reforms on an analysis of the characteristics and changes of the country's state structure, the apparent puzzle of state-led liberalization becomes explicable. Seen in this light, market-confirming reforms and liberalization measures were not byproducts of deals struck between politicians seeking political rents, nor did they indicate the state's subservience to free market forces. Rather, they stemmed from the state's quest for autonomy.

The pre-reform Chinese state has been regarded as a socialist developmental state. If a developmental state is characterized by cohesive politics, that is, by centralized and purposive authority structures that often penetrate deep into the society³², theoretically speaking the organization of the Chinese state meets this criterion. Under the party-state system, the state is in a sense omnipresent through the state's vertical administrative apparatus and the party's supervising mechanism. Each ministry has its "party members' group". Each local government - from provincial level down to district or township level -- has its party committee. And each work unit has its party branch. These party committees and branches are composed of the core administrative members of the governments or organizations. Party secretaries at each level supervise the operations of their organizations and are accountable to party committees of the higher level. Through the party's network, the state reaches virtually every corner of the society. The state apparatus is composed of both the central state and its policy enforcers along the pipelines of the party

³² Atul Kohli (2004: 10).

system, which include local governments at different levels and even administrative authorities at the grassroots level. This institutional structure gave the state strong mobilization power when the country was under centralized control. The will of the central state was enforced through these channels down to the bottom of the society.³³

The actual organization of the Chinese state, however, has been marked by both integration and segmentation ever since the Great Leap Forward of the late 1950s. Vivienne Shue observes that amid decentralization and recentralization attempts during the 1950s and 1960s the Chinese administrative organization evolved into a system characterized by institutionalized tension between central and regional authorities, i.e., between the vertically linked state ministries and regionally or horizontally based local planning committees. Whereas the state apparatus was undeniably highly integrated, local-based offices had an inclination to pursue the interest of their own areas and when necessary, against the demands of the vertical state apparatus.³⁴ In the economic sphere, given its small and spatially concentrated industrial base, Chinese planners allowed tightly centralized industries to coexist with loosely planned and coordinated rural economy, which strengthened the vertical segmentation of the periphery and encouraged the model of self-reliant, comprehensive, but locally bounded economies.³⁵

The apparently omnipotent and omnipresent state apparatus that penetrated deep into the society was therefore intersected by

³³ For an overview of the party-state relations, see Shiping Zheng (1997).

³⁴ Vivienne Shue (1988: 53-56)

³⁵ *ibid*: 59-69

horizontally-based local authorities and interests. Whereas during the Maoist era, the state tolerated localism and saw in localist motives “one of the more important mobilizable forces for balanced economic progress”³⁶, under the new scheme of administrative decentralization during the reform era, the central state’s policy enforcement capabilities were seriously weakened as localist pursuits were reinforced by new economic incentives. Although decentralization measures successfully revitalized the Chinese economy, they also magnified the problems inherent in the organization of the Chinese state.

Decentralization of the early 1980s was not the first time the central government attempted to delegate economic planning authorities to provincial localities.³⁷ However, it was unprecedented in the fact that comprehensive revenue sharing packages were introduced between the center and provincial authorities on a regional particularistic basis, which gave provincial administrative authorities considerable discretionary power in raising and allocating revenues.³⁸ At the provincial and sub-provincial levels, local states grew significantly as the downward transfer of property rights and fiscal responsibility prompted local governments to expand their organizations and staff.³⁹ For almost all economic sectors ranging from trade to tourism, local administrative offices were set up to supervise the sectors alongside locally based ministerial offices.⁴⁰ Forces to “intersect the vertical lines

³⁶ *ibid*: 63

³⁷ In this study local authorities mostly refer to administrative offices at the provincial level.

³⁸ See Richard Baum and Alexei Shevchenko in Merle Goldman and Roderick MacFarquhar (1999: 334-335) and Shaoguang Wang in Walder (1995:87-113).

³⁹ Richard Baum, Alexei Shevchenko, *op.cit.*: 339.

⁴⁰ World Bank (1995)

of ministerial authority designed to link the center and localities” as observed by Shue were stronger than ever.

In the meantime, the dual-track price system was adopted in many industries and sectors and market mechanism began to function in the above-plan portion of the economy, whereas region-based fiscal arrangements reinforced vertical segmentation of the economy and resulted in market fragmentation and local protectionism.

Given regional particularistic fiscal incentives and geographically segmented market dynamics, not only were local governments at the provincial and sub-provincial levels more motivated than ever to pursue local interests but they were also equipped with more means and resources than ever before to do so. Generally speaking, local authorities have engaged in microeconomic activities as profit-seeking entrepreneurs, competitive developers or protective patrons.⁴¹

China scholars have observed that at the basic local level there is a growing trend toward the fusion of political and economic power as local governments directly took part in entrepreneurial activities or even reorganized themselves into profit-making commercial corporations.⁴²

⁴¹ Baum and Shevchenko have developed a typology of local states in China, which includes entrepreneurial states, developmental, clientelist and predatory states. Baum and Shevchenko argue that predatory states can be institutional in nature, involving excessive exactions by local officials on behalf of their cash-starved state agencies. Bernstein and Lu (2003), however, attribute predatory behaviors to decentralization of state power; the state is unable to control subordinate agents and their excessive extractions at lower levels. Evans (1987) and Kohli (2004) define predatory states as states totally captured by societal interests that lack the ability to prevent individual incumbents from pursuing their own goals. With this definition in mind, the existence and practice of local predatory states constitutes evidence of the erosion or loss of autonomy on the part of the Chinese state. Since the focus of study here mainly concerns how local states engage in local industrial activities (either through local developmental policies or direct entrepreneurship), the predatory state type is not examined here.

⁴² Ibid: 339; Nan Lin(1995: 301-354); Walder (1995); Blecher (1991).

At the provincial and municipal levels “incorporation” of the entire government is rarely seen. Yet there are cases of the government’s partial “spin-off”. In a study of the real estate management and commerce departments in Tianjin, Jane Duckett shows that individual bureaus of the Tianjin government during the reform era are directly involved in profit-seeking and risk-taking business through setting up new business ventures by investing bureau funds in the same way as private entrepreneurs or the managers of economic firms. Duckett differentiates this state model from the model of local developmental state and sees state entrepreneurialism as evidence of the state’s voluntary adaptation to the market. Yet seen in a wider perspective, however, such spin-offs and the associated activities may well pose a problem to central administrators. As Duckett describes, those incorporated state units begin to identify themselves with the industrial and sectoral interests that they are supposed to supervise and regulate and some of them even become industrial leaders. As links in the central state’s policy enforcement mechanism, however, these units, having acquired a dual identity, may welcome central initiatives that will improve their market positions but are likely to obstruct those that threaten their profitability and privileged positions in the market.⁴³

Other scholars have studied and presented cases of local developmental states during the reform era.⁴⁴ Local agents are developmental when they are oriented towards increasing economic output and productivity

⁴³ See Christine Wong “Material Allocation and Decentralization” in Perry and Wong eds. (1985). My interviewees at the MOFTEC (now Department of Commerce) also saw new trading corporations set up by local governments as participants and facilitators of interregional arbitrage that went against state policy in the 1980s and early 1990s.

⁴⁴ For example, Blecher and Shue (1996) and Jean Oi (1999).

while they themselves are not connected to particular enterprises within the sphere of their administrative jurisdiction.⁴⁵ However, under geographically bounded fiscal and sectoral preferential policies and given price distortion and the scarcity of resources, it is natural for these local developers to compete against other localities in order to maximize economic gains for their own areas, which makes their behavior hardly differentiable from protectionist and clientelist patron other than the fact that they are protecting and striving for benefits for the locality as a whole rather than for particular corporate interests.⁴⁶ Although at the local level these governments may well maintain their role and image as promoter of higher-order goals for both the state and the society, on the national scale their role as policy enforcement agents of the central state becomes problematic as they calculate and behave increasingly as principals on behalf of local interests.⁴⁷

Decentralization measures, therefore, brought significant changes to China's domestic institutional structure. The old system of high degree of centralization compensated by managed localism was transformed into one with strengthened local offices and fiscally

⁴⁵ Baum and Shevchenko. *op. cit.*

⁴⁶ The difference between a developmental state and a clientelist state, according to Baum and Shevchenko, is that the former is concerned about increased output/productivity and is not connected to enterprises whereas the latter is the other way around. Jean Oi (1999), for example, describes how local developmental states engage in competitive and protectionist practices to maximize economic gains for their localities.

⁴⁷ Oi (1999:196-197). It can be reasoned that the competitive and protectionist tendency of local developmental states in the decentralization era was determined by regionally differentiated and segmented fiscal incentives that put such local states into a zero-sum game against other localities or even the central government. In areas where the economic structure was less affected by the wave of reform and opening up, local states may well promote the higher-order developmental goals without being overly parochial in its relationship with the central state. See for example Blecher and Shue (1996).

weakened center. More than ever, the empowerment and expansions of horizontal authorities crosscut or even obstructed the vertical pipelines that reached from the center to the grassroots. In many cases officials on the vertical system assigned to supervise a specific area also tended to identify themselves with the interests of the locality.⁴⁸ As a result, the coherent and cohesive bureaucratic apparatus that was required for an autonomous developmental state was being weakened and compromised.

To regain control, the state did not resort to administrative recentralization as it had done before during previous rounds of decentralization in the 1950s and the 1960s. Recentralization of this type would mean a rollback of the reform program upon which the Chinese state had built its legitimacy and creditability in the post-Mao era.⁴⁹ Such attempts would also encounter strong resistance from local governments and the wider society that have on the whole benefited from the reform initiatives.⁵⁰ The central state, instead, sought to reassert central authority through further decontrolling the economy. By disentangling itself from microeconomic activities, the central state aimed to remove the sources of rent, restore bureaucratic

⁴⁸ Vivienne Shue observes that even in the pre-reform era, some cadres in vertically linked bureaus may have stood to advance their own careers by promoting the interests and performance levels of the locality in which they happened to be assigned. This kind of situation, however, was more typical during the reform era, as economic interests kicked in to tie cadres on the vertical links directly to the localities they were assigned to. Pending systematic evidence, my interviews with managers at the headoffices and municipal branches of major state-owned trading corporations and commercial banks confirmed this point.

⁴⁹ See Wang Gungwu in Jonathan Unger ed. (1996); Nicholas Lardy (1998). Also see Andrew Wedeman (2003) for the irreversibility of the reform program.

⁵⁰ See Susan Shirk (1994).

coherence and cohesiveness of the state apparatus and regain the autonomy needed for effective management of the economy.

Reforms of Foreign Trade and Banking: Decentralization and Liberalization in Two Critical Sectors

To examine how changes in China's domestic institutional structure and the ensuing political dynamics shaped state-market relations and to explore the logic underlying the trajectory of the country's economic development and its integration with the world economy, I chose my cases of observation at the sector level at the outset of my research. A sector here is broadly defined as a domain of economic activities. My preliminary research included literature surveys on foreign trade (commodity trade), foreign direct investment, banking, insurance, and telecommunications, all of which were crucial sectors for China's WTO accession negotiations that have been put under media spotlight. Following my research trips to China in 1999 and 2000, I chose the sectors of foreign trade and banking finance for intensive case studies.

First of all, the cases of foreign trade and banking meet the requirement of unit homogeneity and therefore provide good basis for possible comparison and contrast.⁵¹ These two sectors are self-contained units for studying the effect of institutional changes on reform outcomes. The development of specific service industries such as insurance and telecommunications were tied to China's WTO accession deals and were part of the liberalization outcomes. They could only be explained, therefore, by looking at the process of the foreign trade

⁵¹ See King, Keohane and Verba (1994: 91-94) on the criteria for unit homogeneity.

reform as a whole. Similarly, foreign direct investment was a new economic element that the government introduced during the reform era and the sector itself was a product rather than a target of reform. The institutional context for studying decentralization and liberalization was lacking in the FDI case. The reform processes of the foreign trade sector and the banking sector, on the other hand, were largely independent of each other. Institutionally, both sectors experienced the initial administrative decentralization and the eventual move towards liberalization. Each of them provides a relatively complete and standalone context for observing the behaviors and interactions of actors at different levels and for exploring possible patterns underlying the reform process.

Moreover, both the cases of foreign trade and banking are of critical empirical significance. Not only were both sectors at the intersection of domestic reforms and the “opening up”, they were also the focal points of macroeconomic and microeconomic policies. Reforms of foreign trade and banking system usually entailed important macroeconomic adjustments whereas microeconomic effects of reform measures on industries and regions were themselves epitomized in these two sectors. Studying these two sectors and examining the relationships and interactions between the central state, provincial authorities, societal and market forces may help one go beyond sectoral logic towards a more generalized explanation about the logic of economic liberalization in China.

Furthermore, the selection of these two cases allowed me to observe the effect of key variables and processes while controlling for the effect

of other factors. The reform of the foreign trade sector pioneered China's economic internationalization. Even at the decentralization stage of the reform, international actors began to participate in China's foreign trade activities through establishing export processing and production facilities in China under the auspices of preferential FDI policies.⁵² The reform of the banking sector, on the other hand, proceeded in a relatively closed setting and the presence of foreign players in banking activities was minimal. The presence of international actors in the foreign trade case and, relatively speaking, the lack of participation by such actors in the banking case provided ground for assessing whether a domestic institutional analysis could consistently explain the logic of China's economic liberalization across cases.

Finally, whereas institutional change as the intended key explanatory variable was present in both cases, the reform processes of the two sectors demonstrate a certain degree of variations with regard to the specific mode of institutional restructuring. In both cases the institutional transformations began with administrative decentralizations, which aligned the provincial governments more and more with local interests as economic incentives kicked in. However, decentralization in the foreign trade sector was carried out with regional-particularistic arrangements with regard to foreign exchange retention, whereas decentralization in the banking sector on the other hand entailed a more straightforward redistribution of power between

⁵² Most of FDI in China, especially in the early years of the reform, were greenfield facilities engaging in processing trade. According to Song Hong, the share of processing trade in China's exports has been more than 50%. And the share of Foreign-Funded Enterprises in China's exports has also been more than 50%. (*Executive Intelligence Review*: July 22, 2005).

the center and localities. Accordingly, interactions among different players displayed different dynamics in the two sectors.

In the case of foreign trade, the central government had originally intended to set up a decentralized but planned system of trade. But local interests, vying for privileges in trading rights and revenue retention, created a market of inter-provincial “internal imports and exports”, which seriously hampered the state’s ability to implement its foreign trade plans. In an attempt to reassert its authority, the central government resorted to market-conforming reforms, which finally led to the liberalization of the trade authority. In this course, provincial and sub-provincial governments as well as business interests largely supported the moves. As the dual exchange rate system was removed and foreign exchange became more accessible, the incentive for smuggling across provinces was reduced. Localities instead became increasingly interested in improving the efficiency of their import and export activities and making necessary adjustments on the basis of cost and benefit calculations. The measures the central government took to standardize and liberalize trade practice coincided with their needs. In this sense, the central state, local authorities and business interests were on a “joint project” for a more thorough reform of the trading system.⁵³

As for reforms of the financial sector, the central government wanted to create a banking system that was distinguishable and separate from the fiscal authority but at the same time located within

⁵³ The “band wagon” effect of regionally differentiated decentralization measures on further reforms is also discussed by David Zweig (2002) and Dali Yang (1997).

the state planning framework. Resembling the credit-based “late development model”, such a system would serve as an instrument of state’s industrial policy. Yet under decentralized politics, representatives of the “state” at different levels have acquired different incentives. The newly commercialized banks found themselves subject to administrative orders and making loans not on commercial basis, but out of consideration for departmental/local interests. Loans and credits flew to state-owned enterprises that had no ability to generate adequate returns. Banks themselves were virtually insolvent. The overall economy suffered from “overheating” from time to time as local governments tried to obtain credit for their enterprises “above the quota”, which caused over expansion of credit. Whereas trade decentralization had unexpectedly created dynamic, though primitive, markets for the state to regulate, decentralization of the banking sector turned self-interested local states into entrepreneurs, each seeking its own “industrial policy” by drawing funds from the central government’s account.⁵⁴ Moreover, the twisted relationship between banks, governments and enterprises posed obstacles to reforms in other crucial sectors such as reforms of the state-owned enterprises. The central government found it neither effective nor possible to solve such problems through issuing administrative directives. To regain control the state needed to decouple itself from microeconomic activities and become an autonomous regulator and macroeconomic player. Only

⁵⁴ The “entrepreneur” here is used in Hirschmanian sense and refers to local governments’ role in making investment decisions and channeling funds into industrial projects. Such decisions can be made for either developmental or entrepreneurial purposes.

market-oriented banking reform and liberalization could help it reach such an end. Despite resistance from vested interests, the state went ahead to pursue this course, beginning with the reform of the central bank modeled after the Federal Reserve, recapitalization of state-owned banks, and increase of foreign bank participation to boost competition. And with China entering the WTO, a schedule has been finally set for full-scale liberalization of the banking sector.

Overall, both cases, each from a different angle, argue against the view that treats reform outcomes as political deals struck between central and local actors. According to this view reforms in China were being carried forward as local officials gave pressures to certain central leaders who otherwise preferred status quo. The reform coalition was not stable, however. As soon as further reforms would touch their vested interests, both central and local leaders would be loath to change.⁵⁵ But the cases of foreign trade and banking shows that in either a “real economic sector” where most local parties benefited from the decentralization or in the financial area where the costs of the reform were borne and resistance to further changes stronger, it was the central state that took the initiative to set the course for further reforms. And the changes did not occur along the line of decentralization and recentralization but took a decisive turn towards market-conforming liberalization instead.

In the next two chapters, I will explore in full detail the processes of reforms in these two sectors respectively. Transformations in the two sectors share a similar logic: The central government’s decentralization

⁵⁵ Shirk (1994); “The Politics of Industrial Reform” in Perry and Wong (1985).

initiatives changed the organizational dynamics of the Chinese state, which exerted an impact on the sector's reform trajectory in the subsequent period. In both cases the final policy outcome was liberalization. But contrary to the conventional belief that such an outcome is a sign of the state giving in to global market forces, the cases show that such an outcome largely arose from the need of the central state to reassert its autonomous control over the society and the fragmented markets. Meanwhile, as decentralization played out differently in the two sectors, different institutional dynamics ensued, which helps account for the differences in the speed of liberalization and in the actual methods employed in liberalization processes.

Economic Liberalization and Ideological Justification

Whereas the two empirical cases provide evidence as to what motivated the state to pursue liberalization and how liberalization helped the state redress the problems it had been faced with, they naturally beg another question: Given the fact that the Chinese central state's autonomy was seriously eroded due to administrative decentralization, why was it able to rally domestic support and enforce economic liberalization? I will explore answers to this question by looking at the role of ideology in policy legitimation and enforcement process.

In the wake of the Cultural Revolution, the Chinese government led by Deng Xiaoping positioned economic revival and development as the country's top priority in order to save the country's economy from the verge of bankruptcy and to regain political credibility of the communist

party. The reform process in China was filled with political struggles. Oppositions to reform policies were often expressed not as direct objections to the reform programs the government initiated but as disputes and confrontations in the ideological sphere. Facing party conservatives' resistance to reform initiatives on the ground of socialist orthodoxies, Deng and the reformist government positioned market as a neutral tool to promote economic growth and enhance national strength, thereby appealing to the nationalist aspiration for national glory⁵⁶. Subsequently, the Chinese government presented the liberalization program as a natural extension of the plan-to-market transition and combined the rhetorical power of neoliberal economic doctrines and a nationalist end goal to justify its liberalization move.

At the core of the analysis is the concept of economic nationalism. Economic nationalism as I discuss in this study has two analytical attributes. First, the concept is defined in terms of purpose or objective rather than specific policy approaches.⁵⁷ Secondly and relatedly, the purpose or objective here denotes social consensus rather than state policy goals. Studies on economic nationalism have shown that states could counter-intuitively pursue liberal economic policies for nationalist purposes.⁵⁸ In the Chinese case, however, nationalism was not necessarily the motivating force behind the state's liberalization initiative. As argued above, the Chinese government pushed for

⁵⁶ See Jonathan Unger ed (1996), Wang Gungwu (1996) Wei-Wei Zhang (1996), Maria Hsia Chang (2001) Peter Hays Gries (2004) for discussions on the rise of nationalism during the reform era and its relationship with the economic reform program.

⁵⁷ On this point I share Derek Hall's view about defining economic nationalism as goals rather than policies. See Derek Hall in Eric Helleiner and Andreas Pickel (2005): 119.

⁵⁸ *ibid.*

economic liberalization in order to reassert state authority and control. In this course, Chinese leaders and official media tweaked neoliberal economic principles to be in line with an economic nationalist end goal. At this level the story is largely rationalist as economic nationalism was invoked to serve the state's practical end. On the other hand, however, economic nationalism was not merely a legitimating tool whose content was supplied by the specific context of political struggles over competing policy preferences,⁵⁹ but was an expression of social consensus shaped and informed by historical memory and experience. In fact, it was the social criteria against which expedient ideological discourses like neoliberalism were adjusted and repackaged.

In Chapter 4, I will explore origins and attributes of Chinese nationalism and its role in China's modernization process, examine the rhetorical compatibility between nationalist economic goals and neoliberal/neoclassical discourses, and demonstrate how the Chinese state exploited such rhetorical compatibility to legitimize the liberalization drive and facilitate its enforcement.

Research and Documentation

In gathering my evidence, I began my research with both primary and secondary literature. The former include government reports, publication of policy guidelines, published speeches of political leaders, official statistics issued by relevant state departments, national and provincial yearbooks. The latter include press reports, periodicals, and scholarly publications in both English and Chinese that range from

⁵⁹ Maya Eichler in Helleiner and Pickel (2005):72-74.

studies of foreign trade and banking and of reform politics, central-local relations and state-society relations in general to policy oriented studies conducted by state-sponsored research institutes and centers in China. Analysis based upon these sources of information was supported and reinforced by interviews with a number of “key informants” conducted prior to China’s entry to the WTO. In 1999 and 2000 I made a couple of research trips to Beijing, China where I interviewed a number of ministerial officials and managers from state-owned corporations and banks, out of which 16 interviews were finally used for this study.⁶⁰ The interviewees included section-level heads at the Ministry of Foreign Trade and Economic Cooperation (now Ministry of Commerce) and the People’s Bank of China, and managers at both the headquarters and the Beijing municipal branches of three state-owned commercial banks, as well as managers at three state-owned specialized trading companies and one major conglomerate.

Although the number of interviews may be too small to offer any systematic evidence, they provided insider views and perspectives on the impact of decentralization and liberalization on those organizations and individuals concerned. Interviews with managers from the major state trading companies and state banks, in particular, allowed me to gain insight into the reach of the state at the micro corporate level and the changed role and identity of former state policy enforcers during the reform era. In the past those managers were virtually government officials, as their corporations were indeed part of the state’s

⁶⁰ Interviews with managers at the People’s Insurance Company of China and officials at the Beijing Telecom Bureau were not counted as eventually the insurance and telecommunications sectors were not included in this study.

administrative arms. As reforms were rolled out, these organizations were “commercialized” and managers found themselves increasingly responsible for the profits and losses of their companies. Juxtaposed between the central state and the growing sectoral interests and subject to the leaderships of both vertical and horizontal authorities, their experiences helped me gain a concrete understanding of the nature and dynamics of institutional changes in these particular sectors.

China’s reform experience entails the three interrelated processes of development, marketization and liberalization and speaks to the central theme of political economy studies – the relationship between the state and the market. As a late developing country, China has demonstrated a greater propensity to liberalize its economy than most East Asian NIEs at the comparable stage of economic development. While international conditions in an age of globalized trade and finance have obviously impacted the Chinese government’s economic policy making, this study argues that an understanding of the rationale and timing of economic liberalization needs to be grounded in the context of the Chinese state’s institutional change. By adopting a hands-free approach towards the economy and decoupling the Chinese state from microeconomic activities, the central government in China sought to redress the socioeconomic consequences of the previous round of institutional reform and to regain policy autonomy and effective control over the economy. A statist analysis of the Chinese state’s options and choice in economic development and transition, therefore, is compatible with a liberal economic outcome. The case of China’s economic liberalization,

in this sense, provides a new piece of empirical evidence for the statist claim about the pattern and nature of state-market interactions in the greater research project of state-market relationship under economic globalization.⁶¹

⁶¹ See, for example, Ikenberry (1988) and Vogel (1996), which argue that more state control and regulation can result from economic deregulation and liberalization.

CHAPTER TWO

FOREIGN TRADE REFORM

One of the most conspicuous and profound changes that have taken place in China over the past two decades is the transformation of the foreign trade sector. Before reform, foreign trade was one of the most centrally controlled sectors in the economy. Twelve specialized national import and export corporations under the supervision of the Ministry of Foreign Economic Relations and Trade (MOFERT) monopolized the entirety of foreign trade of the country.¹ The Chinese economy was semi autarkic, with foreign trade making up less than 10 % of its total GNP.² China ranked 36 of the world's trading nations, its imports and exports accounting for less than 1% of the world's total.³

Since the introduction of foreign trade reform in 1979, the foreign trade sector has experienced fast growth and total transformation. Between 1978 and 2002, China's annual growth rates of imports and exports amounted to 14.7% and 15.7% respectively, whereas average GDP growth rate was around 9.7% per annum for the same period.⁴ In 2004 China surpassed Japan to become the 3rd largest trading nation in the world, its foreign trade totaling more than US \$ 1 trillion. China's economy has become highly dependent on trade. In 2003 its

¹ The MOFERT was later renamed as MOFTEC (Ministry of Foreign Trade and Economic Cooperation). In 2003, MOFTEC, the State Economic and Trade Commission, and the State Planning Commission were merged to form the Ministry of Commerce.

² Sources: *China's White Paper on Foreign Trade and Economic Cooperation* (1999); Ministry of Commerce: Import and Export Statistics.

³ David Wall, Jiang Boke and Yin Xiangshuo (1997): 110-111; *China Daily* (November 27th, 2003).

⁴ Source: Ministry of Commerce: Import and Export Statistics.

trade dependence reached 60%, whereas top trading nations such as the US and Japan only have a trade dependence of around 20%.⁵ Although scholars suspect that China's trade dependence in recent years may have been overestimated due to an undervalued RMB exchange rate or an underestimated GDP growth rate, or a combination of both, China's economic openness and heavy involvement in world trade have become an undeniable or even alarming fact for a country with a huge domestic market.⁶

China's excellent trade performance has earned it second place worldwide after Japan in foreign exchange reserve, its foreign exchange reserve amounting to \$ US 610 billion in 2004 (See Figure 2.1. for a graphical portrayal of China's foreign reserve between 1979 and 2003). And according to China's official report, the country enjoyed a \$ US 80.3 billion trade surplus with the US.⁷ The surge of China's trading power reminds one of the earlier versions of economic miracles in East Asia in the last century, where Japan and East Asian NIEs such as Korea and Taiwan achieved economic takeoffs through an export-led growth strategy. At first sight, the Chinese experience bears a great deal of similarity to the other East Asian nations'. Even Chinese newspapers often describe China's opening up as following "a strategy of developing export-led outward-looking economy".

⁵ Figures are based upon press releases by the State Council Press Office in 2003 and 2004, and UN Project LINK data.

⁶ See discussions about China's trade dependence in Zhang Jun, "Review of the Chinese economy in 2003," *Jiefang Ribao* (January 3rd, 2004)

⁷ The US claims that its deficit with China was as high as US \$162 billion, which includes trade with mainland China and transit trade through Hong Kong.

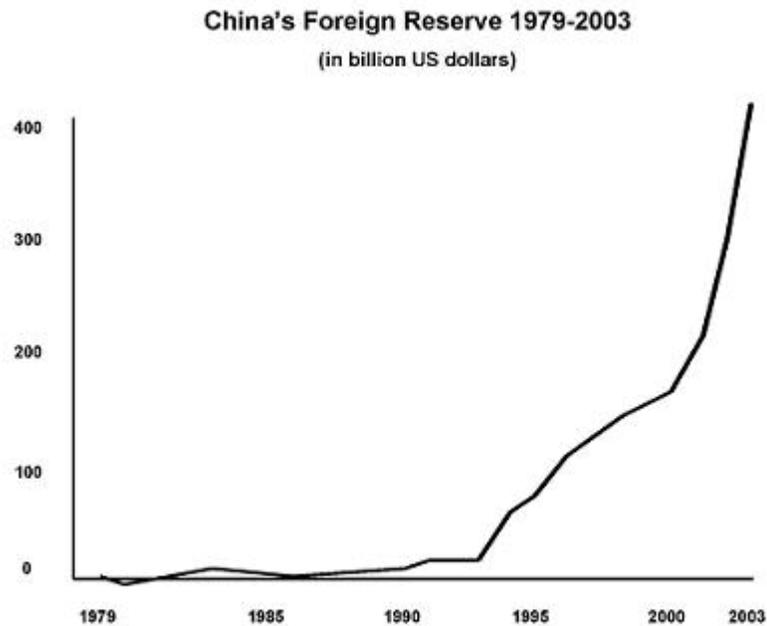


Figure 2.1. China's Foreign Reserve 1979-2003

Data Source: State Administration of Foreign Exchange Control

Under closer examination, however, China has displayed different dynamics from the East Asian earlier movers when it comes to foreign trade practice and performance. The East Asian experience is characterized by sector-specific interventions, export promotion and centralized policy making on trade and industry issues.⁸ In contrast, China's authority for foreign trade policy making during the reform era has been dispersed across several agencies. Its foreign trade policy is generally not linked with industrial assistance to specific domestic sectors.⁹ Its imports have grown together with exports and in many

⁸ See Robert Wade (1992): 270-320.

⁹ World Bank (1994): 133-134.

years China was even running a trade deficit¹⁰. Finally, China's high rate of trade dependence as mentioned above indicates that its economy is more open than its East Asian neighbors at the comparable stage of economic development.

What then is the logic behind China's foreign trade reform? Given the tradition of planning and control in its pre-reform economic system, why did China choose a "liberal" approach over a "governed market" approach of East Asian NIEs? Given the fact that China had secured, through the Uruguay Round of the GATT talks, most of the benefits for those sectors where the country enjoyed a "comparative advantage"¹¹, why did the Chinese state resort to full-scale trade liberalization, which would inevitably expose many of the country's ailing domestic sectors to international competition?

One explanation for China's policy choice is that China was pushed by external pressures to pursue trade liberalization. Such pressures came from several dimensions. Firstly, by 1994 China was under the pressure to conclude its GATT talks in order to automatically become a founding member of the WTO.¹² A second and more specific concern was Taiwan's bid for GATT/WTO membership. Susan Shirk argues that China sought to rejoin GATT/WTO because it wanted to join the organization ahead of Taipei to fulfill its national pride. Thirdly, Securing GATT/WTO membership would also allow China to rid itself of

¹⁰ See Appendix 2-1: China's Imports and Exports Since 1978.

¹¹ See Nicolas Lardy (1994), Hong Kunlian and Hong Keren (1994), Gu Weiping (1994), Ren Quan and Sheng Baoliang (1994), Shao Wangyu (1995), Zhang Yao (2003) for reviews of the Uruguay Round of the GATT talks and China's rights and obligations as a developing country.

¹² Wang Yaotian and Fu Ming (1994):24. Also see Li Xiaogang (1994): 23-24.

the annual review of its MFN status by the US government.¹³ These political diplomatic concerns weighed more heavily on the state's political scale than economic considerations.

While all these factors may have impacted China's WTO accession process, the external pressure argument tends to evaluate China's decision to liberalize its economy as one move in a short term political game rather than in the context of the 15-year long persistent efforts of domestic restructuring¹⁴. It was true that in 1994 the Chinese government set a goal for the country to rejoin GATT before January 1st, 1995 in an attempt to secure the WTO founding party status for China. Such a move, however, was mainly intended to obtain the opportunity to formally conclude the deals that had been struck between China and GATT members during the Uruguay Round.¹⁵ In other words, the Chinese government was not forced to liberalize its economy under the pressing need of joining the GATT/WTO. Rather, the attempt to join the GATT/WTO by the 1995 deadline was a logical step in advancing its opening-up strategy. Moreover, if China's decision to liberalize its economy was motivated by the expedient concern for WTO founding membership, we would expect to see China drop or reduce its effort for

¹³ Susan Shirk (1994: 70-72).

¹⁴The entire GATT talks lasted for 15 years. China decided to rejoin GATT in 1986. The negotiations were on and then off in the early years. On December 15th, 1993 the Uruguay Round of the GATT talks was concluded. China set its objective for rejoining GATT before January 1st, 1995 in order to become a founding party of the WTO. It took another 8 years, however, before China was finally admitted to WTO in 2001.

¹⁵ See Wang Yaotian and Fu Ming. *op. cit.*; Liu Ke (1994): 23. And according to Ren Quan and Sheng Baoliang (*op. cit.*), China contributed to the final successful conclusion of the Uruguay Round by reducing tariffs on over 800 items of agricultural goods and over 5000 items of non-agricultural goods and by opening up a selected number of service industries. For all Uruguay Round agreements to take effect, they would have to be signed by the contracting parties of the WTO.

WTO accession after its failure to rejoin GATT at the end of 1994. The reality, however, shows that China continued to pursue WTO membership after 1995 and intensified its effort to comply with WTO standards by voluntarily and substantially lowering tariff levels and speeding up domestic reforms.¹⁶

Besides, the claim that China's liberalization efforts are driven by political diplomatic considerations such as Taiwan's WTO membership and Sino-US bilateral trade relations tends to interpret China's national interests too narrowly. In fact, the issue of WTO entry was a security issue for China in the sense that negative repercussions could pose serious threat to the country's political stability and the legitimacy of the communist rule.¹⁷ Pessimistic writers were talking about the possible "collapse" of China in the aftermath of its WTO entry.¹⁸ Moreover, challenges and costs associated with the WTO accession were not only looming ahead in the medium and long run, but also were imminent in the short term. According to Lardy, the comprehensive and deep commitments China made to economic liberalization since 1995 far exceeded those of the contracting parties of the WTO. Domestic

¹⁶ For example, at the APEC meeting in Osaka in 1995, China declared a unilateral cut of tariffs on more than 4000 lines of imports and abolishment of import licensing and control over a variety of commodities under 170 tax codes; Long Yongtu, then Minister Assistant of MOFTEC pledged that the promises China made at APE apply to its WTO negotiations. See Wang Wei (1995). The Chinese government also intensified its effort to reform the foreign trade regime and other relevant areas such as allowing foreign enterprises to engage in foreign trade activities in China, granting national treatment to foreign products and enterprises, further reforming the foreign exchange control system, etc.

¹⁷ During the 1990s, many Chinese scholars conducted studies on economic security, evaluating the negative repercussions of globalization and China's WTO accession to China's economy and social stability. See, for example, Xia Shen (1996); Wang Zhaocai et al (1998); *Lingdao Juce Xinxi (Information for Decision-makers Magazine)* (1998)

¹⁸ See Gordon Chang, *The Coming Collapse of China* (2001).

restructurings required by these commitments would inevitably incur high costs in many economic and social areas in the short term.¹⁹ In other words, Chinese political leaders were not trading long term risks for short term political gains. China's determined efforts to pursue economic liberalization require an explanation that goes beyond citing the few political diplomatic concerns to answer why the Chinese government chose to do so despite the high stakes involved.

Another possible explanation for China's liberalization is that domestic players in favor of internationalization and liberalization may have overshadowed those inward-looking players in influencing policymakers' decision making process.²⁰ This guess, however, is not consistent with the reality in China. China's WTO preparations and negotiations followed a highly centralized process. During the talks domestic firms had minimum information about the terms of the agreements and the likely impact upon various industrial sectors. It was always the central government that set the general directions and pushed the talks through difficult circumstances.²¹

This study attempts to explain the logic behind China's trade liberalization in the historical and institutional context of the reform of the country's foreign trade system. Like reforms in other areas, China's foreign trade reform has been described as following a gradual and

¹⁹ See Lardy (2002), Chapters 1 and 3.

²⁰ See Jeffrey Frieden and Ronald Rogowski "The Impact of the International Economy on National Politics: An Analytical Overview" in Helen Milner and Robert Keohane (1995) for an argument about how internationally competitive sectors in the domestic economy push for liberalization.

²¹ According to Susan Shirk (1994:73), trade talks were defined as foreign policy issues: the Foreign Ministry, MOFTEC, the Bank of China, the tourist administration, and the SEZ office met and made recommendations directly to senior CCP leaders, thereby bypassing the industrial ministries. Also see Xia Huasheng (1999).

incremental approach. Nevertheless, as far as state strategy is concerned, “gradualism” merely tells part of the story. This term tends to depict a picture of coherent, continuous as well as incremental change. A closer look at different stages of China’s foreign trade reform, however, suggests that trajectory of reform was far from predetermined at the outset. Nor were steps of the reform truly even and incremental.

Rather than consistently pursuing a strategy of trade liberalization, foreign trade reform in China started with administrative decentralization. It was only when China intensified its efforts to rejoin GATT (later WTO) in the early 1990s that market conforming measures were underway. As part of the decentralization program, trade decentralization was intended to redistribute power between the central state and provincial governments as well as between the center and departments in charge of different industrial sectors. The principles behind trade practice largely remained unchanged from the era of central planning: exports were regarded as means to acquire foreign exchanges needed for “domestic economic construction”. Some scholar commented that trade decentralization along administrative lines on a particularistic basis would cause the central and local political authorities to develop an interest in perpetuating an incompletely marketized system. And “without any transformation of communist political institutions, achieving a more universal foreign exchange and trade regime will be more difficult than carrying out the initial measures.”²² Evidently, the outcome of the trade reform diverges from this prediction: Full-scale market-conforming reforms have

²² Susan Shirk op.cit.:53-54.

replaced the incomplete and particularistic approach, while communist political institutions remain intact. Meanwhile, as I will show this chapter, the central government initiated and led the liberalization drive rather than simply bringing policy back in line with economic reality.²³ The driving force behind China's market-conforming move was political rather than economic.

In examining the process of China's foreign trade reform, I divided the reform into three stages. The first stage was from 1979 to 1987. During this period, the Chinese government broke the central state's monopoly on foreign trade by delegating foreign trade authority to administrative organizations at the provincial level. Like reforms in other areas that were carried out since 1979, foreign trade decentralization started from experimental zones and was gradually rolled out across the country. The Chinese government at this point regarded export activities as a means to acquire foreign exchange and its foreign trade strategy remained to be one of import substitution. The second stage of reform spanned between 1987 and 1991. The central government enforced a contracting system to divide responsibilities between the center, foreign trade units, and localities respectively. With a regional particularistic arrangement, the central government intended to align its foreign trade strategy with its overall strategy for regional and industrial development. In 1991, however, the central government decided to abolish the strategy of regional differentiation in foreign trade,

²³ See Andrew Wedeman (2002) for an argument that sees market-oriented reforms of the 1990s as driven by the law of the market underlying regional tension and rivalry.

and since then China's foreign trade reform entered the phase of market conforming liberalization.

Key to this process was the fact that decentralization of the trade regime changed the internal structure of the state as local governments increasingly acquired a "dual role" – state policy enforcer on the one hand and local interest sponsor on the other. In a sense, the bureaucratic autonomy of the central state was being eroded as the coherence and cohesiveness of its policy enforcement mechanism was weakened by administrative decentralization and as horizontal authorities intersected the vertical linkages of the central state apparatus²⁴. In order to regain central authority and policy autonomy, the central state resorted to market-oriented liberalization to decouple the state apparatus from microeconomic activities and thereby restore bureaucratic coherence and cohesiveness. Meanwhile, decentralization prepared institutional basis and support for the liberalization program as liberalization measures coincided with the need of local governments and business interests who had been vying for greater trading privileges and foreign exchange retentions under the particularistic decentralization program. Trade liberalization became a "joint project" that the central state, local authorities and the society pursued.

An examination of China's state structure and its changes needs to start with its party-state system. As explained in the introductory chapter, theoretically the reach of the central state is in a sense omnipresent through the party-state's administrative apparatus. Party committees are present from central level ministries, provincial

²⁴ See Introduction for discussions on this point.

governments to village and township governments and grassroots work units with the lower level committees to higher level ones. The state apparatus is composed of both the central state and its policy enforcers along the pipelines of the party-state system, which include local governments at different levels and even administrative authorities at the grassroots level. With this institutional structure, state capacity was strong. The will of the central state was enforced through these channels down to the bottom of the society, giving the impression of a “strong state”. When administrative power was decentralized, however, local administrations’ agenda tended to diverge from the central government’s. China has had a history of central-local friction and the so-called warlordism, where central authority was weakened and local powers asserted themselves. But the very feature of the party-state institutions further compounded this problem: the central state was relying on the party-state apparatus to enforce its policies, including decentralization measures, whereas local administrative entities at the provincial level and below that were part of the state apparatus were increasingly concerned about “parochial interests”, which led to distorted effects of state policies, as the newly empowered horizontal authorities intersected the central state’s vertical policy enforcement network and eroded its policy autonomy. The dynamics of foreign trade reform in China needs to be understood in this light. ²⁵

²⁵ In the next few sections when I study the process of reform, I will sometimes use “the central state”, “the central government” almost interchangeably.

Foreign Trade Decentralization Phase I (1979-1987)

The initial focus of China's economic reform was on internal development, with an emphasis on revitalizing the agricultural sector and import-substituting industries. The main purpose of the reform was not to abolish the planning system, but to improve its operation and efficiency. As Deng Xiaoping observed in 1978, too much concentration of economic management power at the center was not providing incentives for localities, enterprises and individuals to improve the profitability and efficiency of economic activities.²⁶ To re-instill vigor into the economy, a decentralization program was rolled out after the 3rd session of the 11th plenum of the CPC central committee. Foreign trade was one of the many economic areas the program covered.

Foreign trade was once the most centrally controlled economic sector in pre-reform China. All import and export activities were strictly directed by state plans. The prices and quantities were determined at the domestic level without reference to supply and demand conditions in the international markets. The state purchased goods from domestic producers and sold them abroad through its specialized trading companies. Altogether twelve specialized national trading corporations (national FTCs) monopolized all foreign trade transactions of the country under the supervision of MOFERT. At the provincial level, foreign trade bureaus and branches of national trading corporations were there to enforce plans and orders set by MOFERT and national trading corporations. They themselves, however, did not have any autonomous power in the business of foreign trade, as even the slightest

²⁶ Deng Xiaoping (1993):150-152

change of the trade plan required the approval of the higher authorities. The main purpose of exporting activities was to obtain foreign exchanges needed to finance strategic imports such as grain and industrial materials. The overall size of foreign trade was small. And an overvalued domestic currency created a bias towards imports and against exports.²⁷

When the “reform and opening up” policy was adopted in 1979, priority was given to reforms in the rural sector. Industrial development strategy remained largely unchanged, with an emphasis on heavy industry. Foreign trade reform, as part of the “opening up” efforts, was intended to complement domestic economic construction by increasing foreign exchange earnings needed for purchasing advanced equipment and technology. In fact, decentralization of foreign trade authority was not an entirely new policy. Back in the Great Leap Forward period, the Chinese government had already made such an attempt. In 1959, the central government decentralized foreign trade planning authority to localities while keeping the financial authority in foreign trade under central control. The initiative was cancelled in the subsequent retrenchment period of 1963-1965, as under the decentralized planning system localities across the country competed with each other to shoot for higher foreign trade targets, driving the overall foreign trade plan of the country out of control.²⁸ The new decentralization initiative in the reform and opening up era was not very much different from the 1959 program in the sense that it was still decentralization along

²⁷ For descriptions of the pre-reform foreign trade system, see Yin Jinqing (1998): 20-33.

²⁸ Ibid: 24.

administrative lines.²⁹ Foreign trade authority was granted to provincial and sub-provincial governments, not individual enterprises. And the planning mechanism remained intact. Yet this time the Chinese government, drawing lessons from the past, started the reform from selected “experimental” regions. And the decentralization program gave more emphasis on profit sharing between the center and the localities in the hope of making the latter more responsible for their planning activities. These arrangements, on top of decentralization of foreign trade authority enforced through the existing state apparatus, created unexpected dynamics in the foreign trade sector.

The Process of Decentralization

Between 1979 and 1983, the central government took some initial steps to delegate foreign trade authority to localities. Geographical decentralization was undertaken on an experimental and particularistic basis. Four Special Economic Zones (SEZs) – Shenzhen, Zhuhai, Shantou, Xiamen – were set up to engage in export-oriented activities. Special arrangements were made with the SEZs to ensure their access to imports and foreign exchange so as to boost their export industries. The center granted Guangdong and Fujian, SEZs' hosting provinces, expanded rights to conduct foreign trade. The two provinces were allowed to set up their own import and export corporations and carry out their own foreign trade plans. The center also allowed SEZs to retain 100% of the foreign exchanges they gained from exports and the two

²⁹ For the characteristics of the 1959 decentralization program, see Vivienne Shue (1988).

hosting provinces to retain 30%.³⁰ Before long, “municipalities directly under the state control”, namely, Beijing, Shanghai, and Tianjin, were also allowed to set up their own FTCs and were granted partial authorities to plan their foreign trade activities.

This new scheme was hardly market-oriented: domestic producers continued to be denied direct access to international trade; import & export activities continued to be subject to trade plans, albeit under a more decentralized authority. The arrangement nonetheless gave unprecedented incentives for the SEZs and their hosting provinces to expand foreign trade activities as now they could use their earnings from exports to finance imports needed for projects of local economic construction.

The rapid improvement of economic performance of the SEZs and their hosting provinces, especially Guangdong that resulted from preferential policies in trade, investment, and taxes drew envy from the other provinces and encouraged the central government to further roll out the decentralization program. In 1984, China declared that it was going to open 14 coastal cities to enforce its “coastal development strategy”, signifying the state’s determination to step further on the course of reform and opening up.³¹ Soon, throughout the country, more and more local FTCs were set up or “spun off” from national FTCs. Similarly, government ministries and departments in charge of specific

³⁰ See the State Council, “Regulations on Issues Regarding Developing Foreign Trade and Increasing Foreign Exchange Income” (1979) and State Council, “Provisional Regulations on Tax Reduction and Exemption for Special Economic Zones and the 14 Coastal Cities (1984).

³¹ Hainan Island, which was then part of the Guangdong province, was assigned as an open economic area with a status similar to the SEZs.

industrial sectors established their own FTCs. In 1984 and 1985 alone, 400 new FTCs were approved by the state. The state also granted trading rights to selected industrial units, thus breaking the monopoly of specialized trading companies over import and export activities.³²

As more and more provinces, industrial departments, and their own FTCs engaged themselves in the foreign trade business, they were eager to export to obtain foreign exchange without paying heed to the profits and losses of their export activities – anyway the state would finance the domestic currency losses associated with exporting activities. The central state, under increasing financial problems, saw the solution to this problem in separating the administrative authorities from economic entities and establishing connections between industry and trade so as to remove the price wedge between domestic and international prices.³³

To achieve these objectives, the state introduced *the foreign trade agency system* in 1984. Under this arrangement, FTCs served as intermediaries between producers and users abroad. They passed the international prices to domestic producers/users and charged a commission fee for each transaction. Domestic producers were encouraged to form “free associations” with FTCs and accept international prices. FTCs, on the other hand, could hope to make profits out of such transactions and therefore rely less on state subsidies and move towards independent accounting.

The system, however, didn’t work as well as the state had expected. Under the agency system, FTCs and domestic producing units were

³² Yin Jiqing. *op. cit.*: 39.

³³ Interviewee 1 (MOFTEC); Also see David Wall et al (1997), Yin Xiangshuo (1998): 101.

supposed to form alliances in researching the international markets and negotiating with foreign importers and exporters. It was expected that the producing units would reveal their production costs to FTCs whereas FTCs would share the information concerning costs for obtaining foreign exchange. In reality, however, both FTCs and the producing units were reluctant to share the information. Given that foreign exchange was “scarce resources” under the Chinese system of import and export control, both FTCs and domestic producers attempted to maximize their margins in foreign trade transactions and their interests virtually went against each other. Rather than forming alliances with producers, getting transparent on foreign exchange costs and playing an intermediate role to charge a commission fee, most FTCs chose to continue purchasing goods directly from factories and then exporting them on their own account. ³⁴

Characteristics and Consequences of Decentralization Phase I

The first phase of decentralization shattered the monopoly of the state and national FTCs over foreign trade. Between 1979 and early 1987, over 2,200 new FTCs were set up, which included 500 plus specialized FTCs, over 300 FTCs subject to ministerial or departmental leaderships, and more than 1200 local FTCs. Over 200 industrial production units were granted the rights to conduct foreign trade. ³⁵

The planning system was also loosened and partially transformed. The foreign trade plan became more export driven, with a target for export fixed, and import activities to be planned within the foreign

³⁴ Liu Xiangdong (1998): 224.

³⁵ Sources: MOFTEC, State Economic and Foreign Trade Commission.

exchange constraints implied by the export target. The export plan was divided into two parts: the command plan and the guidance plan. The command plan specified export targets in quantitative terms and applied only to specific products.³⁶ The guidance plan only set value targets for provincial governments to reach. It was up to provincial authorities to determine how to reach them. In 1986, around 60% of exports were subject to the command plan and 20% to the guidance plan, the remaining 20% being “above plan” exports.³⁷

What was not changed during this period was an overvalued domestic currency. Before reform China held an exchange rate that overvalued its currency and biased against export. After reform began, the Chinese currency continued to be overvalued, although there was a tendency towards devaluation. At the onset of the trade reform, an Internal Settlement Rate (ISR) was introduced for trade transactions. The rate was higher than the official exchange rate and was intended to alleviate the adverse effect of overvalued currency upon export trade. The ISR system was abolished in 1985 after the official exchange rate was brought in line with the ISR. The unified exchange rate, however, still overvalued RMB yuan.³⁸ In the meantime, foreign exchange trading rooms were allowed to be established, first in Guangdong, and then in the major commercial cities of other provinces, where enterprises, upon authorization, could buy and sell foreign exchange entitlements at the “swap rate”.³⁹ Overall, RMB remained overvalued throughout the 1980s,

³⁶ Yin Xiangshuo. *op.cit.*: 91-92.

³⁷ World Bank (1994): 25.

³⁸ See Yu Yongding and He Fan eds. (2004): 56-70.

³⁹ Yin Xiangshuo. *op.cit.*: 111-117. Also see David Wall et al. (1997)

which kept the cost of exports high and structurally incurred losses for the producers and FTCs. The state, instead of confronting the problem of distorted exchange rate upfront, continued to cover FTCs' domestic losses through providing fiscal subsidies, as during this period, the main objective of promoting export activities was to obtain more foreign exchange to finance import. Even after the state began to adopt "Coastal Developmental Strategy" and opened more areas along the Southeastern coast of China to the outside world, this focus on domestic economy remained unchanged. In 1986, the then Prime Minister Zhao Ziyang, known as China's radical reformer, said that "the Chinese economy, generally speaking, should be built upon its domestic market... In coastal areas where conditions permit, outward-looking economy should be gradually developed so as to generate more foreign exchange for the state."⁴⁰

Yet an administrative incentive to boost export, coupled with a continued import substitution oriented practice on export subsidies and exchange rate, produced an unintended effect nationwide. As the number of enterprises with foreign trade rights increased, and the scope of commodities under the guidance plan expanded, provincial and departmental FTCs were competing for sources of exportable goods. Domestic prices for such goods were driven high, as different localities and departments, port cities and inland provinces competed against each other. In the international market, the situation was just the opposite: FTCs and enterprises with direct trading rights were in price

⁴⁰ Zhao Ziyang's comments on foreign trade reform on his trip to Guangdong Province (1986). Sheng Bin describes the foreign trade strategy of this period as "import substitution compensated by export orientation." Sheng Bin (2002): 175.

wars against each other to get their goods sold. The result was “raised procurement prices at home, slashed prices abroad, outflows of profits, and reduced bargaining power with foreigners on the part of the state.”⁴¹ All FTC losses were to be compensated by state subsidies. In 1986 alone, losses of FTCs financed by the central government amounted to about RMB Y 25 billion, more than 2% of China’s gross national product.⁴²

While volumes of export increased, overall foreign exchange reserve did not expand significantly during this period and the figure even went negative in some of the years. On the one hand, the major components remained to be low value added raw materials, as the focus of the provincial governments was on exchanging goods for hard currency, rather than on linking foreign trade with industrial policy and development strategy. On the other hand, with an overvalued domestic currency, and loosened control on foreign trade, imports flowed in to accommodate the surge in domestic demand. Decentralization based on geographic particularism further compounded the problem: SEZs and provinces with preferential treatment took advantage of their expanded trading rights to import manufactured goods, mostly consumer goods, and resold them in the domestic market.⁴³ While the state was covering their losses in exports, local FTCs in these zones and provinces were making money through “internal imports”, which was virtually an illegal practice under China’s import and export control of that time. Local governments, however, were ready to cross the lines in pursuit of

⁴¹ Interviewee 1. Also see Shirk (1994): 49. Wedeman (2003) contains detailed discussions concerning inter-regional “warfare” between domestic producers.

⁴² World Bank (1994): 26.

⁴³ See Susan Shirk in Perry and Wong (1985: 211-213).

economic profits. The most notorious case was the Hainan Scandal in 1985. As an open economic area, Hainan was granted the freedom of arranging its own imports. Officials in Hainan made huge profits by reselling imported vehicles to provinces where imports of automobiles were not allowed. By the time their misconduct was discovered by the center, they had already spent US \$1 billion importing automobiles and other consumer durables.⁴⁴

As China's foreign exchange reserve was severely depleted by frenzied import activities, the central government initially took actions to freeze the foreign exchange retention program, which could mean an end to the decentralization drive.⁴⁵ Just as the central government did in the aftermath of the Great Leap Forward, the state could resort to recentralization to restore the authority of the center and tighten control over foreign trade. But this time in the new era, reform and opening to the outside world had become China's "basic national policy". Decentralization was being carried out in many economic areas. Foreign trade decentralization as well as preferential treatment of foreign direct investment had become symbols and indicators of the opening-up policy. Backing off from such an initiative could undermine the creditworthiness of the reform package and the legitimacy of the central state. Rather than permanently taking back foreign trade rights from localities, therefore, the central government soon determined to redress the problems by "deepening" its reform efforts of trade

⁴⁴ Lardy (1992): 56.

⁴⁵ Shirk (1994), and my interview with managers at Sinochem.

decentralization.⁴⁶ The key, therefore, was to create a mechanism whereby companies and government organizations continue to have the incentive to expand exports but will not do so at the expense of the central state. And this ushered in the next round of foreign trade reform.

Foreign Trade Decentralization Phase II (1987-1990)

In view of the problems arising from the first round of foreign trade decentralization, the central government decided that the primary task at hand was to give the right incentive to export activities so as to build the much needed foreign exchange reserve. The center realized that the chaotic situations in the foreign trade area had resulted in part from self-interested activities of provincial and sub-provincial governments and assertion of departmental interests under a decentralized trade regime. Enterprises, FTCs and government organizations did not care about the cost efficiency and profitability of foreign trade operations because they were not held responsible for their losses and were even encouraged for that.⁴⁷ The crux of the problem was that while the central state had designed the decentralization program and expected it to be enforced through every link on the state apparatus, part of the state apparatus was affected and transformed by decentralization. As governments at the provincial level and below became motivated than ever to pursue local interests, their role as state policy enforcer became problematic. How to redefine their role so that state initiatives would not be compromised and state interests would not be infringed upon was a

⁴⁶ 13th session of the CPC national assembly, "Speed up and deepen reforms of the economic system."

⁴⁷ Interviewee 2 (MOFTEC).

critical question that the next step of the reform needed to address. To this end, the central government was seeking a mechanism to legitimize the pursuit of local interests while at the same time specifying their obligations to the center. The contracting system that the state had applied to many economic areas since reforms and opening up appeared to be a promising solution. This was still a solution along administrative lines under the framework of “planned commodity economy” rather than a market conforming one, although more economic incentives were introduced into the system to reshape the dynamics between the center, FTCs and localities.

As I will describe below, the central state, in adopting the contracting system, started with “tiao-tiao” contracting and then shifted to “kuai-kuai” contracting. The former involved more active efforts on the part of the central government to “rescue” central state interests from local interests by specifying obligations of state-owned FTCs and major industrial enterprises to the center, whereas the latter indicated a more formal acknowledgement of local governments’ newly acquired role.

“Tiao-tiao” Contracting

Beginning in 1987, the central government invoked the contracting system within the “foreign trade institutions” which comprised of the MOFERT, its subordinate specialized FTCs, and other industrial and trading companies subject to the state trade plan. Since the contracting system was enforced vertically along departmental lines, it was called “tiao-tiao” contracting, or “strip by strip” contracting. Under this system, the MOFERT was the general contractor signing contracts with

the state, in which three major targets were specified: *foreign exchange earnings, export costs, and the ceiling of domestic currency losses against which state subsidies were to be provided.*

The MOFERT in turn signed contracts with the headoffices of specialized FTCs and industrial companies, specifying targets for the companies to reach. The latter then subcontracted the targets to their branches to fulfill. Whatever the companies earned above the quota were to be retained and divided up between the headoffices and the branches. The contracting system left out provincial governments and their newly created FTCs. But provincial branches of specialized national FTCs that had become “independent economic entities” during the previous round of decentralization were now bound by performance contracts with the national headquarters. So were branches of national industrial companies with direct trading rights. The state hoped to strengthen the foreign trade system’s ability to generate foreign exchange and promote exports through realignment of interests along different “strips”. While local governments and FTCs would still be prone to the pursuit of parochial interests at the expense of the center, the contracting system would hopefully keep the core organizations accountable to the center, not through direct orders, but with a profit-sharing regime. Along each “strip”, specialized FTCs, industrial companies and their branches were to form an artery where foreign exchange earnings flowed steadily to the center rather than diffused and lost in local governments’ import drives. ⁴⁸

⁴⁸ On foreign trade contracting, see Yin Jiqing (1998): 51-53; *Jingji Yanjiu (Review of Economic Research)* (1996): chapter 4. Liu Zhenya (1998): 5-12.

Meanwhile, the center supplemented the tiao-tiao contracting with tax rebate policy for exports. While tax rebate was an internationally accepted practice for export promotion, it was new to the Chinese foreign trade system. Before its introduction, the Chinese government's export subsidies took the form of direct fiscal allocation of funds to localities and government organizations. Tax rebate, on the other hand, was tied to specific products and companies exporting them.⁴⁹ With varied rebate rates on different products, the new practice was intended to give incentives to exporters while optimizing the structure of export products. Due to domestic price distortions, companies had found it more lucrative to import than export, and to export raw materials rather than processed goods. The state expected to redress the bias and distortion through the new policy.

The tiao-tiao contracting did have some positive effect on the country's foreign trade position. In 1987, total imports and exports increased by 11.9% over the previous year. Total exports grew by 28.5% whereas imports decreased by 1.5%. Export cost dropped by 2.6%.⁵⁰ Both foreign exchange reserve situations and export profitability improved.

New problem arose, however, as the new system divided the foreign trade sector into different factions of interests and intensified the tension between localities and foreign trade units along the "strips". Normal exchanges and cooperations across "strips" were made difficult as administrative units and companies were wary of possible

⁴⁹ Interviewee 3 (manager at China Resources National Corporation). Also see Ren Rongfu and Chen Xiaojuan (1994):39-40.

⁵⁰ Yin Jiqing, ed. (1998): 53.

infringement of their departmental interests that would compromise their ability to fulfill the contracts. In provinces, battles over sources of export goods continued, but on a different dimension – previously such battles took place between different provinces, now they occurred between provincial FTCs and branches of national FTCs. Procurement activities continued to be based on short-term considerations, as foreign trade units, eager to attain their own targets, still focused more of their efforts on beating their competitors in pricing than on rationalizing their export structure. ⁵¹

“Kuai-kuai” Contracting

Tiao-tiao contracting allowed the central government to see the positive effect of binding contracts upon FTCs and upon the country’s export earnings. But it also complicated the already chaotic situations at the provincial level where parochial interests were in constant conflict with the center’s.

In 1987, following the CPC’s 13th national assembly, the Chinese government made a new initiative on its overall economic development strategy: It decided to promote export-oriented economy along the entire coastal line, focusing on labor-intensive processing industries, with raw materials imported from abroad and final products to be sold on the international market.⁵² Obviously, the Chinese leaders at this point intended China to emulate the model of East Asian NIEs. But given the large size of the country, the Chinese government again adopted a

⁵¹ Interviewee 1. Also see Yin Jinqing, ed. (1998):52-53.

⁵² The then Chinese Premier Zhao Ziyang described the strategy as “Liang Tou Zai Wai, Da Jin Da Chu”. (Literally, “Two ends abroad, huge inflows and equally huge outflows”).

regionally differentiated approach, just as it did with the early rounds of opening up.

This new grand strategy led the Chinese state to quickly adjust its approach to foreign trade reform. In 1988, the tiao-tiao contracting was replaced with kuai-kuai contracting, namely piece by piece contracting. The emphasis of the new contracting system was on central-local contracting. MOFERT entered into contracts with provincial level administrative units, which included governments of provinces, autonomous regions, provincial-level municipalities. Again, the contracts specified three major targets for localities to attain: *the amount of foreign exchange earnings, foreign exchange to be remitted to the central government, and a cap for state subsidies on export losses*. The values of the targets were determined jointly by MOFERT, Ministry of Finance and the State Planning Commission according to an overall evaluation of a particular region's fiscal conditions and its intended position in the country's economic development strategy based on regional particularism. Contracted targets varied across geographical "pieces". And hence the name "piece by piece" contracting.

One important measure for the piece by piece contracting to work was to "unhook" provincial branches of national FTCs with their headoffices and reassign them under the leadership of provincial governments, where authorities directly in charge of these FTCs were local foreign trade departments/bureaus/commissions. Except for a few strategic sectors that continued to be managed by a few national

FTCs and their branches, most branches of national FTCs were now part of the provincial foreign trade network.⁵³

Provincial-level governments, upon concluding contracts with the center, divided tasks among FTCs under their jurisdictions and supervised them to attain their targets. Foreign exchange earnings up to the contracted amount were divided between the center and each locality, depending on the retention rate set by each specific contract. Of the above-target earnings, 80% were to be retained by localities, 20% to be handed in to the center. This latter arrangement was made without regional particularistic considerations and offered all provinces a flat rate of retention and hence a relatively leveled ground for competition.⁵⁴ This new scheme was intended to motivate localities, FTCs and industrial enterprises to increase exports and shoot beyond the contracted targets.

Meanwhile, experiments were made with three industrial sectors, namely, light industry, arts and crafts industry, and clothing industry, where FTCs and enterprises with foreign trade rights were allowed to retain the bulk of their foreign exchange earnings. The state subsidies on export losses, however, were totally withdrawn. The enterprises in these three sectors were supposed to “assume sole responsibility for their profits and losses”. The same policy was applied to the five special economic zones, Shenzhen, Zhuhai, Shantou, Xiamen, Hainan,⁵⁵ except that they continued to get an even more lenient

⁵³ State System Reform Commission Research Institute (1998).

⁵⁴ World Bank (1994). For a summary of the foreign exchange retention scheme under the contracting system, see Liu Xiangdong (2001): chapter 2, Section 3.

⁵⁵ Hainan became a special economic zone in 1988, the biggest SEZ in China then.

retention rate – 100% of their foreign exchange earnings. More swap centers were established in provincial capitals, major coastal cities and provincial-level municipalities, and SEZs where enterprises were allowed to buy and sell their retained foreign exchange at the swap rate.

The state loosened import and export control by limiting the range of commodities subject to “command plan” to a few strategic products and resources. These commodities were to be handled by state-designated national FTCs and their subsidiaries or branches. A few “important” products were covered by the state’s guidance plan. Most products were now open for FTCs of various kinds and strata to handle, although some of these products were subject to export quota or required import or export licenses.

The tax rebate system developed during the tiao-tiao contracting period was continued and reinforced during kuai-kuai contracting. Rebates were made at different links of the value chain, including product taxes, sales taxes, and value added taxes in some cases.⁵⁶

All these measures were intended to make local governments and FTCs more export-oriented, more profit-driven, and less dependent upon state subsidies. Contracting along geographical lines and localized management of FTCs aimed at realigning the interests among local governments, FTCs and production units, thereby reducing “deadweight loss” arising from their frictions and conflicts. The “geographical particularistic” arrangement of foreign exchange retention system was designed to bring export incentives in line with the country’s overall economic development strategy: regions where development of

⁵⁶ Interviewee 2.

export-oriented industries was emphasized were granted generous retention rates and were encouraged to build its foreign trade networks more integrated with the international markets and less dependent upon state planning and subsidies.

Results and Consequences of Foreign Trade Decentralization Phase II

The contracting system gave a strong push on the country's foreign trade activities. Between 1998 and 1990, total value of imports and exports grew by double digits and averaged over US \$100 billion per annum. Exports grew by 20% per year. China's overall trade dependence reached 13.7% and its exports ranked 14th among the world's trading nations'.⁵⁷

The contracting system with administrative units as contracting parties, though effective in revitalizing the foreign trade sector to some degree, produced new problems and tensions between the center and localities.

First of all, whereas the central government intended to make enterprises more independent and profit-oriented through foreign trade contracting, the contracting system in part became a new platform for provincial governments to bargain with the center. Since the central government continued to provide provincial governments with fiscal subsidies on exports based on an estimation of the region's average export costs, provincial governments found it only logical to maximize this part of earnings so as to create a favorable fiscal environment for their own regions. Rather than pressing FTCs and enterprises to reduce

⁵⁷ MOFTEC Import and Export Statistics.

export costs, they tended to encourage them to raise their export costs. In this way, their provinces or regions would be able to obtain maximum amounts of state subsidies in domestic currency on top of the portion of foreign exchange they were allowed to retain. Although foreign trade contracts put a cap on export-related subsidies for each contracting region, total amount of state subsidies remained substantial. In 1988, the aggregate amount of export subsidies reached RMB Y 7 billion, equal to 4% of total export value.⁵⁸ On this issue, provincial governments and MOFERT, which represented the interests of the center, were virtually in a zero-sum game, as former benefited exactly from the latter's losses, although such losses were limited to a certain range by foreign trade contracts.

Secondly, this new round of decentralization in the form of geographical contracting aggrandized some of the problems that had already been in existence during previous stages of foreign trade reform. As more and more local enterprises gained access to foreign trade, competition in the procurement market intensified. As provinces were under the pressure to attain their targets stipulated by their contracts with the center, provincial governments were more active than ever to protect local business interests. Various local protectionist policies were created, blocking procurers from the other provinces to enter local markets. Within each province, prices of exportable goods and raw materials continued to be kept at a high level as numerous trading

⁵⁸ World Bank (1994): 27.

companies and industrial enterprises were now eager to acquire the goods, export them and earn foreign exchange.⁵⁹

A more serious problem was the uncurbed internal “importing” activities. This problem started to emerge in the initial stage of the reform. Although the contracting was intended to make enterprises truly outward-looking, the geographical particularistic nature of the contracting ironically provided incentives for them to continue engaging in “inward-looking” transactions.⁶⁰

During the late 1980s, RMB continued to be overvalued. The actual cost for foreign exchange or the “swap rate” was higher than the official rate. On the other hand, domestic prices continued to be distorted under the planning system. When companies imported goods and materials that required import licenses or were part of the state’s “guidance plan”, the state would cover for the differences between their import costs and official price. The imports were then to be sold in local markets at the domestic prices. When domestic price was still lower than the import price calculated at the official exchange rate, the state would again cover the differences.⁶¹ In this way, the state was providing de facto import subsidies to local governments and enterprises. As coastal regions, especially SEZs and southern provinces enjoyed high foreign exchange retention rate and relative easy access to import licenses, companies in these areas were quick to learn that such privileges constituted a potential source for extra profits.

⁵⁹ Yin Jiqing, ed. (1998): 61.

⁶⁰ Interviewees 2,3. Also see Liu Xiangdong (1994).

⁶¹ Interviewee 3.

Foreign commodities, especially consumer goods regulated by import licenses, did not stop within southern provinces and SEZs after being imported into China. Rather, they were transported and sold to other provinces. The deals were usually concluded in RMB yuan and at higher prices than the original import prices. Businesses in other provinces still found the deals acceptable or even lucrative, since import licenses for the same products would not be issued to their own provinces.⁶²

Officially, transactions of this sort had to be accompanied by both the import license and a special permit. Otherwise, imported goods were not allowed to be transported out of regions they were originally imported to. However, “importing” activities as such went on without much interruption.

The provincial governments, while protective of their local markets for exportable goods, acquiesced to internal import activities and to some extent cooperated with such importers. For both suppliers and buyers, internal imports generated profits for their businesses and therefore increased the revenue income of the provincial authorities.

The Guangdong provincial government, for example, later described its strategy as “moving ahead at the green light and detouring when seeing the red light.” To take advantage of its import license rights and state subsidies, the provincial government virtually allowed its subordinate departments and enterprises to import certain consumer

⁶² Xiao Chen (1996: 76-78); Zhou Weilin (1997: 147-150)

durables items and report them as “materials and technology needed for foreign-invested facilities”.⁶³

The actual transfers of imported commodities were largely channeled through informal inter-provincial networks. The formation of such networks dated back to the pre-reform period. During the 1970s when a province was in shortage of basic supplies such as coal and raw materials, enterprises usually sent procurement agents who had personal ties in other provinces to seek sources of such supply. In the reform era, such networks were turned into another use, which permitted officially banned imports to be transferred to those provinces.⁶⁴

Provincial governments and companies’ gains, however, came at the losses of the state. The central government was actually providing “two-way” subsidies – both import and export subsidies.⁶⁵ Under the contracting system, therefore, local FTCs were still not fully responsible for their profits and losses and were largely after hard currency in their export activities. Meanwhile, importing remained to be attractive business due to lucrative domestic reselling. Overall, the system continued to be somewhat biased towards imports, although at this time developing export-oriented economy was the state’s priority. Between 1987 and 1990, three out of four years total value of imports exceeded that of exports, although exports were growing at a high rate.⁶⁶

⁶³ See Yeung, Y.M and David Chu (1998)

⁶⁴ Lever-Tracy et al (1996): 57.

⁶⁵ Interviewee 2.

⁶⁶ MOFTEC Import and Export statistics.

A more serious concern was import and export structure. With the new coastal development strategy, the central government in the late 1980s intended to encourage export-oriented light and processing industries while developing its import substituting capabilities in technology intensive manufacturing industries.⁶⁷ The special dynamics resulting from regional particularistic contracting, however, tended to erode the central state's effort in this respect. On the one hand, foreign exchange targets motivated local governments and FTCs to grab raw materials and primary products in domestic markets to exchange for hard currency. These products and materials, being low value added, made the value of exports grow at a slower pace than their volume. On the other hand, there was also a mismatch between imported goods and the state's intended industrial policy. Often when the state decided to adopt import substituting strategy on a certain product, there was an opposite import policy initiated on the local side; parts and materials were imported in large volume, assembled and sold to the domestic market.⁶⁸ Theoretically, the state could monitor and manipulate the composition and quantity of imports using import licenses. However, the effectiveness of this mechanism was undermined by the existence of interprovincial channels for "internal imports".

Liberalization of Foreign Trade

Ten years of decentralization revitalized the foreign trade sector in China, just as decentralization did to the other economic areas. But

⁶⁷ State Council "Report on the 7th Five Year Plan", March 1986.

⁶⁸ Yin Jiqing, ed. (1998): 64.

decentralization also came with problems as described above. And rectification of the problems through tightening control always came at the expense of the economy. Just as government officials summarized the cycles of decentralization themselves, centralization leads to a moribund economy, decentralization leads to chaos, and chaos leads to recentralization. It is a vicious cycle.⁶⁹

Moreover, recentralization became more and more difficult as the Chinese economy had experienced all-round decentralizations in many areas leading to the expansions of local governments. Throughout the 1980s, the central government intervened in provincial affairs in an attempt to stop “illegal transactions” and correct “economic irregularities”. It did so by issuing administrative documents which stipulated the limit of local governments’ authority in conducting foreign and interprovincial trade. But administrative orders were not effective, since unlike in the old days, provinces now had a vested interest in increasing local income even at the expense of the interest of the nation as a whole. As argued before, forcing provinces to give up such economic activities through harsh administrative orders meant to revoke the newly gained autonomy of the provinces and reverse the entire decentralization program, which would encounter strong resistance from the provinces and erode the legitimacy of the central government.

On the other hand, pushing the reform along administrative lines seemed to have nearly reached a dead end, as the central state’s policy enforcement capabilities were hampered due to the expansion and

⁶⁹ *ibid*; interviewees 1, 2.

assertion of local authorities and their pursuit of local interests and developmental goals at the expense of the central state's overall developmental strategy and policy goals.

Ironically, one possible way to reassert central authority was to further decontrol the economy. By decoupling administrative authorities from microeconomic activities, the central state intended to disentangle its administrative arms from local and business interests and reduce the means and tools local authorities possessed to pursue parochial interests. In this way, the state apparatus may hopefully regain its bureaucratic autonomy needed for effective management of the economy. The central state did exactly that. From 1991 and on, China has intensified its effort to rejoin GATT (WTO). Reforms since then focused on creating leveled ground for competition, lowering tariffs, reducing licensing controls as well as establishing a new exchange rate system.⁷⁰

Preparations for Liberalization 1991-1993

The central government realized that two major factors had contributed to problems during the contracting period. One was preferential treatment of certain provinces and regions over others, which led to interprovincial trade that reduced economic efficiency and tapped away state interests. The other was non-separation of central state finance with local finances, which stayed in the way of the state's effort to make local FTCs and industrial enterprises truly independent entities responsible for their profits and losses. To correct these

⁷⁰ For a review of foreign trade reform strategy since 1991, see Sheng Bin (2002): 179-184. Sheng calls the period of 1991-1993 "the stage of export promotion and marginal trade liberalization" and the period after 1994 "trade liberalization".

problems, the central government took a sharp turn by reversing some key practices during the previous stage of foreign trade reform. At the end of 1990 the State Council announced its new program of foreign trade reform. Launched formally in 1991, the new program contained the following key measures.

Abolishing Export Subsidies

Beginning from 1991, the state abolished all export subsidies. At the same time, official exchange rate (Yuan to dollar) was adjusted from 4.72:1 to 5.22:1. The new exchange rate was getting closer to reflecting RMB's market value than before, thereby improving FTCs and industrial enterprises' chances to break even in their import and export activities.

Synchronizing Foreign Exchange Retention Rates across Regions

The new program changed regional particularistic nature of the foreign exchange retention scheme by synchronizing the rates along three categories of commodities -- "Special commodities" such as crude and processed oil handled by specialized national FTCs, "general commodities" and "machinery and electronics products". Special commodities were handled by a few designated FTCs, with most of their earnings remitted to the state. For the export of "general commodities", the new program provided that 20% of the foreign exchange earnings were to be remitted to the state, 10% to be retained by the local government, 10% to be retained by domestic producers and the remaining 60% to be retained by FTCs. Those dealing with "machinery and electronics products" got 100% to retain, of which 10% went to

producers and 90% to the FTCs.⁷¹ This generous retention arrangement would allow FTCs and producing enterprises to import the materials and parts needed for the production of exportables in machinery and electronics industries. Overall, regional differentiations of retention rates were therefore eliminated. Companies and enterprises in different provinces were now playing on a leveled ground in their own business areas.

Delinking Local Finances from State Finance

The previous stage of foreign trade contracting subjected local branches and subsidiaries of national FTCs to the leadership of local governments. However, fiscally a local branch was still tied to the department in charge of its headoffice in the central government. The new program “peeled off” FTC branches completely from their headoffices and the central government by subjecting them to the fiscal system of their hosting localities. Starting from 1992, FTCs were required to file their financial plans only with their supervising administrative organs, which, in turn, would review the plans and report the data to higher level authorities for approval. The traditional top-down fiscal planning was in a sense reversed. Organizations and enterprises attached directly to the center and those attached to localities were now “eating in separate kitchens”.

Standardizing Import and Export Control

The new program called for “adapting to international norms on trade”. This involved reforms in import and export management. From

⁷¹ To ensure access to foreign exchange sufficient to meet its own requirements, the central government in this case reserved its right to purchase back 20% of the retained foreign exchange by FTCs and producing enterprises at the prevailing “swap rate”.

January 1992 till the end of 1993, China undertook three rounds of reductions on import tariff rates affecting a total of more than 5,000 tariffs lines.⁷² Overall tariff level dropped by 7.3% as a result.⁷³ Import substitution lists were also abolished in 1993, indicating the state was prepared to use tariffs rather than import protections to manage import activities. Licensing control was also reduced. On the export side, the number of exports subject to licensing was reduced from 235 lines to 114 lines. Except for the export of 16 categories of raw materials which were to be exported by designated FTCs, all other exports became open to all the FTCs.⁷⁴ Import licensing and other forms of quantitative restrictions have also been on the decrease. By 1993 products under import licenses were reduced by over 53%, their value dropping from 66% to 30% of the total value of foreign trade.⁷⁵ In fact, commercial policies such as tariffs and licenses were not widely in use until in the reform era. With the command plan being loosened, these policies and regulations partly replaced administrative orders associated with the plan and laid down the foundation for a standardized trade system. The new program, through reducing tariffs and licenses not only further broke away from the practice of the planning system, but also took great steps towards trade liberalization and the GATT (WTO) standard.

In a sense, the 1991 reform partially undid what the central government had carefully built in the past few years. With a regional particularistic scheme, the central government had hoped to exploit

⁷² Xie Jianzhong et al . eds. (1999): 149

⁷³ *China's White Paper on Foreign Trade and Economic Cooperation* (1999).

⁷⁴ David Wall et al., op.cit.: 106.

⁷⁵ Zou Dongtao (1998): 74.

local initiatives and at the same time maintain its ability to design the course of economic development and control the degree of opening up. Yet the dynamics emerging out of this arrangement turned out to erode the center's planning and supervising capabilities. Caught between further weakening of its power vis-à-vis localities and withdrawal of the reforms it had initiated, the central government found a third way out: it tried to regain control of the situations by further decontrolling the economic actors. With provinces and individual enterprises gaining greater access to imports and exports, and the gap between inland provinces and coastal areas and SEZs in foreign exchange retentions narrowed, incentives for provinces and businesses to engage in "internal importing and exporting" were reduced.

The center's new initiative was not without its risks. With export subsidies completely cut off and local finances totally separated from the center, FTCs and producing enterprises were on their own, without much time to improve the cost structure of their business before hand. MOFERT official observed that the new foreign trade system involved certain risks and would force the country to adjust its export structure and improve economic efficiency, which could mean weakened trading position in the short term.⁷⁶ Loosened control over import licenses, though helping reduce domestic reselling activities, could also result in a rapid increase of imports under the already decentralized trade regime and in turn reduced the foreign reserve that the state had hoped to build.

⁷⁶ *Kaifang*, vol. 1 (1991).

As expected, imports did increase rapidly during between 1991 and 1993. Average growth rate per year was over 20%. Exports, however, also grew at a relatively high rate of 14%,⁷⁷ despite the withdrawal of state subsidies. In 1992, China made it to the 11th place in total exports among the world's trading nations, up from the 15th in 1990.⁷⁸

This positive result was in part due to the growing participation of non-state actors, especially foreign companies, in foreign trade. The early 1990s saw a surge of foreign direct investment in China. Between 1991 and 1993 FDI grew by 7 times, with more than 130,000 new projects approved in 1992 and 1993 alone.⁷⁹ As foreign trade regulations were further loosened, the presence of joint ventures and wholly foreign owned companies in the foreign trade sector expanded rapidly. In 1992 and 1993, foreign invested companies' total value of exports increased by 44 % and 45% respectively. Their total value of exports amounted to 40% of their aggregate industrial output value and made up over 27% of China's total export value.⁸⁰ The increase of foreign invested companies' participation in exports also helped improve China's export structure by expanding China's share of processed goods and industrial manufactures in the international markets. In three years industrial manufactures in total exports increased by more than 7% whereas primary products dropped by about the same percentage.⁸¹ The growth of non-state sector in foreign trade, therefore, aided the Chinese state in its endeavors to rectify problems of the previous stage

⁷⁷ Average export growth rate was around 15% between 1988 and 1990.

⁷⁸ MOFTEC: Import and Export Statistics.

⁷⁹ MOFTEC: Statistics on the Use of Foreign Direct Investment.

⁸⁰ State System Reform Commission Research Institute (1998:77).

⁸¹ Sources: MOFTEC import and export statistics.

of reform. With this new engine of growth, the state was able to free itself from the heavy burden of export subsidies and effectively reduce “economic irregularities” arising from trade privileges without hurting too much the overall growth momentum of the foreign trade sector.

Liberalizing Foreign Trade

The 1991 initiative allowed the state to disentangle itself from micro-level trade activities by replacing several key practices of the planning era with market conforming ones. What were left untouched by the end of 1993, however, were the infrastructure of the foreign exchange retention system and the de facto dual exchange rate system.

Both systems were “innovations” under the decentralization drive and were designed to provide incentives for exports under a decentralized yet still planned trade regime. As mentioned earlier, after China formally abandoned the dual exchange rate system by unifying the internal settlement rate with the official exchange rate in 1985, dual exchange rates continued to exist in the country. Official exchange rate (Yuan to Dollar) was adjusted upwards several times but still overvalued the domestic currency. Meanwhile, authorized enterprises could trade part of their retained foreign exchange in foreign exchange trading rooms or “swap centers” at the swap rate. Although regional differentiations over retention rates were abolished in 1991, enterprises were still subject to different retention schemes pertaining to the industries or businesses they were in. For the same amount of foreign exchange earnings, enterprises could end up exchanging for different amounts of domestic currency: those with higher retention rate were allowed to trade more at the swap rate, and therefore obtain more RMB

for their foreign exchange earnings than enterprise with lower retention rates.⁸²

At the beginning of 1994, the Chinese government took the step to formally unify the exchange rates. Unlike previous rounds of adjustment where an official exchange was artificially determined by the People's Bank of China as part of the state planning, now exchange rate would be determined by demand and supply of the market and would be applied to the payment and settlement of all trade and non-trade transactions. The ultimate aim was to make RMB a convertible currency.⁸³

Related to the exchange rate reform was the abolishment of foreign exchange retention system. Enterprises could now sell their foreign exchange income to banks licensed to conduct foreign exchange transactions and can purchase foreign exchange freely after providing valid documents indicating their need for foreign exchange in legal business activities.⁸⁴

The unification of exchange rate and the abolishment of the foreign exchange retention system naturally put an end to the contracting system between the center and localities. The center no longer issued "targets" for local governments and enterprises to attain. Instead, the central government was trying to conduct "guidance management" over import and export activities. This included a full-fledged export tax

⁸²Because of these complications, some scholars even regarded the exchange rate system before 1994 as a de facto multiple exchange rate system. See discussions in Wu Nianlu and Chen Quangeng (2002).

⁸³ CPC Central Committee: Decisions concerning Building a Socialist Market System (November 14, 1993).

⁸⁴ Wu Nianlu and Chen Quangeng (2002): 136-143.

rebate system, a licensing and quota system for a few important and strategic products and a newly established policy bank that offered “policy credits” to the trading of machinery and electronics products as well as complete plants and equipments.

Despite these “guidance” measures, the focus of the Chinese government was not on building an import and export regime linked with and driven by industrial policy. Instead, with its efforts to join GATT/WTO intensified in 1994, the Chinese government pronounced that its objective of foreign trade reform was to “achieve liberalized trade and eliminate trade barriers”.⁸⁵

To this end, China lowered tariffs on 2989 tariff lines at the beginning of 1994, which accounted for over 45% of the total items under the Chinese customs’ tariff regulations. The overall tariff level dropped by 8.8%. Tariff on major consumer durables such as automobiles was reduced by 36%. In 1995, tariffs on consumer goods such as cigarettes, liquor, audio and video cassettes were further lowered by an average rate of 35.5%. In 1996, another round of massive tariff reductions was enforced on 4997 tariff lines, lowering the overall tariff level to 23%. This level was further lowered to 17% in 1997 and to 15% in 2000.⁸⁶ And in accordance with its WTO commitments, China has been on its way to lower tariffs on all industrial goods to 10% by 2005.⁸⁷

Meanwhile, the government also took measures to limit and reduce non-tariff barriers, although these areas were not covered by the

⁸⁵ *Jingji Ribao*, August 14, 1994.

⁸⁶ Source: PRC General Administration of Customs, China’s Customs Statistics.

⁸⁷ Announcement by the Ministry of Commerce, 2003.

requirements for WTO accession. Beginning in 1995, the Chinese government gradually reduced the number of product categories subject to import quota as well as the number of items on the “specially registered imports catalogue”, leaving most commodities to be traded freely across borders. Between 1995 and 1997, import licenses were removed for 18 product categories and 368 tariff lines, a reduction by 32% and 52% respectively.⁸⁸

On the export side, except for 16 “most important” commodities that were subject to the state’s “unified handling” and about 95 products subject to quota regulations or requiring export permits, all the other products were now allowed to be exported by enterprises with foreign trade rights. In areas where government intervention was inevitable, the state also preferred market conforming mechanism to administrative orders. In 1994, for example, the Chinese government introduced “compensated bidding for export quota” for a few major commodities such as logs, yarn, and certain chemicals. Later, products available for bidding increased to 27 items. These products had caused intense price wars and in turn severe losses among FTCs in previous stage of the reform due to the sheer number of companies engaging in the business and high price elasticity of these products in the international markets. With a bidding system in place for compensated usage of export quota on these products, enterprises were put on a relatively equal footing for competition and were forced to evaluate the profitability of the

⁸⁸Source: MOFTEC and General Administration of Customs: Circular on Adjustments on Import License Catalogues and Licensing Authorities.

businesses they were bidding for as well as the cost efficiency of their operations.⁸⁹

In parallel with the reforms of the exchange rate system and import and export regulations, the Chinese government also accelerated the process of delegating foreign trade rights to enterprises. MOFTEC relaxed the qualification and ratification criteria for granting foreign trade rights, allowing more and more industrial enterprises to obtain the rights to import and export. By 1997, more than 8000 producing enterprises were granted the rights to export their products and import materials and parts for production all by themselves, their total exports making up one fourth of the country's total exports.⁹⁰ By the end of 2000, such rights had been extended to 16,000 foreign invested enterprises (FIEs) and over 3,000 domestic producing enterprises.⁹¹ In the three years that followed China's accession to the WTO, the Chinese government took steps to thoroughly transfer foreign trade rights to the enterprise level. Except for items such as crude oil, tobacco and grain that continued to be managed by designated trading corporations, the trading of other products has become accessible to individual enterprises, be they state-owned, private, or foreign invested.⁹² Instead of filing applications for examination and approval by government

⁸⁹ Interviewee 2.

⁹⁰ At this point these producing enterprises did not have full rights to foreign trade – they could trade their own products or production-related goods and materials, but did not have the rights to procure exportable goods from other producers to sell abroad or to resell their imports domestically.

⁹¹ FIEs comprised of three types of enterprises: joint ventures, wholly foreign owned companies, and cooperative ventures. Source of data: State Economic and Trade Commission and MOFTEC reports.

⁹² Private enterprises were required to have a registered capital of RMB Y 5 million to engage in foreign trade.

department in charge of foreign trade authorization, enterprises now only need to register with local bureaus of industry and commerce before proceeding to engage in the foreign trade business. The range of business enterprises may engage in has also been expanded. They can choose to manage their own products or to become trading agents for other enterprises.

The Logic of Foreign Trade Liberalization

Foreign trade liberalization since 1991 is a crucial component of full-scale marketization efforts undertaken by the Chinese state. An exploration of the logic behind such liberalization measures informs us, to a great extent, of the logic behind the entire marketization conforming liberalization program.

As demonstrated in previous sections, in the past twenty years or so China's foreign trade sector has experienced fundamental changes. Apparently, these changes occurred as if following a coherent design of the "opening up strategy". But a closer examination of the reform process has shown that "the opening up" carried different meanings during different stages of reform, indicating that the fundamental purposes of foreign trade had shifted over time to shape the contour of the reform process.

Underlying the three stages of foreign trade reform were three different strategies of economic development: import substitution strategy, export-oriented strategy based on regional particularism, and a liberal "free trade" approach. Apparently, given the planning capacity of the socialist developmental state as well as China's cultural affinity

with East Asian NIEs, people tend to believe that it would be easier for the Chinese state to adopt a “governed market” approach, emulating the export-oriented strategy of its East Asian neighbors. The reality, however, was that while China switched to export-oriented strategy for its coastal areas a few years into the reform era, export practice was not effectively linked with industrial policy as compared with its East Asian counterparts. And with its bid for GATT/WTO membership, the country soon headed towards market conforming liberalization of the foreign trade sector.

Given its huge domestic market, the bold effort China has taken towards liberalization is especially impressive.⁹³ Obviously, economic arguments on globalization would have difficulty explaining the remarkably high degree of economic openness of China, given that even many economically more advanced nations of similar sizes have lower degrees of trade dependence. As mentioned earlier, one possible political explanation is that foreign trade is a “high politics” issue in China and that China has been forced to choose a liberal approach over a mercantilist one in order to gain WTO membership and end the constant struggles with the US over the annual renewal of China’s MFN/NTR status. But my interviews with MOFTEC officials and foreign policy scholars in China revealed that political pressure was not the major variable in shaping up the Chinese state’s policy decisions on foreign trade and WTO membership. The annual renewal process over

⁹³ It is well argued that small states, exposed to international market forces, may choose to adopt a liberal economic policy. (Peter Katzenstein, 1985). Countries with huge domestic markets, it is conventionally believed, tend to be more conservative in this regard and their level of economic openness is usually lower than that of the small nations.

the MFN status “might be annoying, but never truly dangerous,” given the substantial economic interests at stake in Sino-American trade. In fact, intensifying efforts to join the GATT/WTO was, in part, a means to enforce the state’s grand strategy of economic reforms, including foreign trade reform, and not the other way around.⁹⁴

Through reviewing the process of foreign trade reform in this chapter, I have proposed a different explanation on the logic of foreign trade liberalization in China: the trajectory of China’s foreign trade reform was set by changes in the institutional structure of the state and the central state’s reaction to such changes; it was for the purpose of regaining central state autonomy and macro control that the central state policymakers further decontrolled and liberalized the economy.

This observation was made on the basis of the special characteristics of China’s pre-reform state structure: the omnipresent central state that reached into the society through the party-state system. Under the party state system, the Chinese state was not equivalent to the central state, but composed of the central government and its policy enforcers that were part of the party state network, which included local governments at different levels as well as administrative organizations for various industrial sectors and state owned trading units. The problem with decentralization was that the central government was trying to grant localities some autonomy of economic management and push state-owned trading corporations and industrial enterprises to be responsible for their profits and losses while at the same time still relying on the old state apparatus for enforcement of its

⁹⁴ Interviewee 2.

trading plans. With new economic incentives, however, there was increasingly a “conflict of roles” on the part of the policy enforcers.

In my interviews with managers at the headoffices of major trading corporations in Beijing, ⁹⁵ many managers described the situations under the contracting system as confusing. Although these trading corporations were apparently “economic entities”, during the planning era they functioned more as arms of the state’s planning system. The organizational structure of their headoffices resembled that of government institutions. And state directives were taken and enforced as administrative orders. During decentralization period, however, these companies began to have an independent accounting system, and were increasingly concerned about their own profitability as a result. Conflicts occurred, therefore, between attaining “foreign trade targets” set by the central state and improving the company performance and profitability. As domestic pricing system and foreign exchange rate system during the decentralization period were still not market conforming, state plans and requirements of the foreign trade contracts often had to be fulfilled at the economic losses of the companies. My interviewees admitted that during the contracting period some companies used to utilize economic resources at hand to make money at the expense of the central government, e.g., reselling import licenses or imported goods subject to import licenses. Situations at the provincial level were similar. As the previous sections described, provincial and sub-provincial governments, under a decentralized foreign trade regime,

⁹⁵ Sinochem, China MinMetal, China National Silk Import and Export Corporation, China National Arts & Crafts Import &Export Corporation, as well as China Resources National Corporation (Huarun conglomerate).

were engaged in localist economic activities all at the expense of the central state. The competition between different localities caused further chaos in the foreign trade sector and eroded the central state's ability to effectively link its industrial policy with foreign trade to enforce a truly export-oriented trade strategy.

The institutional consequences of decentralization measures led the central government to reconsider its method of economic intervention. At first, the state sought to rectify the problem through combining decentralization with a binding contract system, only to find its policy enforcement capacity further paralyzed under the new system. It was in pursuit of solutions to problems in this new situation that the central government resorted to market conforming liberalization. In the course of disentangling itself from microeconomic activities and straightening out economic irregularities with a macroeconomic approach, the meaning and functions of the state apparatus were partially transformed. The central state, with MOFTEC, the State Economic and Trade Commission and the State Planning Commission as policy making and enforcement bodies, was becoming a normal state with macro control and management capabilities. The merging of the three organizations into the Department of Commerce further transformed the role of the state - from one of administrative planning to one of supervision and coordination through a modern professional bureaucratic organization.

One final question is that why the liberalization drive did not encounter significant resistance from self-interested local governments and micro players, who might have developed a vested interest in the

decentralized yet non-market conforming trading practice. My interviews revealed two major factors. One was the “bandwagon effect” among localities. As the decentralization program and especially the contracting system were enforced on a regional particularistic basis, localities had been vying for privileges granted to special economic zones, open cities and coastal provinces. And foreign trade was regarded as a lucrative business sector by local micro actors. Liberalization measures were welcomed by the “underprivileged” provinces as they were finally granted equal trading rights and “development opportunities”.⁹⁶

The second reason was the growth of non-state sector in economic activities and the inclusion of non-state actors, especially foreign invested enterprises, into foreign trade. As foreign trade privileges and preferential treatment on foreign direct investment were usually granted hand in hand to certain provinces and regions, provinces, cities, and special economic zones with privileged trading rights were also hosts to most foreign invested companies, many of them export-oriented enterprises in light industries and processing industries. With these enterprises gaining direct access to foreign trade activities, hosting provinces or cities’ economies would benefit as a whole. Moreover, thanks to the regional particularistic strategy of industrial policy during the decentralization period, these provinces and cities had developed an overall economic structure based on labor-intensive processing industries, light industries and electronic manufactures, sectors in which China had a “comparative advantage” and a “competitive

⁹⁶ Interviewees 2, 3. Dali Yang (1997) and David Zweig (2001) also observe that the regional particularistic decentralization created competitive pressures for further opening up.

advantage” in the international market. Liberalization would allow more local enterprises to engage in foreign trade and generate more revenue for local governments. Although full-scale liberalization tended to remove some of the privileges these regions enjoyed in the previous stages of reform, the overall benefits far outweighed the costs. Market conforming liberalization in foreign trade, therefore, became a “joint project” pursued by the central state, provincial and sub-provincial governments as well as foreign trade related business interests.

Foreign trade was one of the pioneering sectors of China’s reform and opening up program. The reform experience of this sector well captures the dynamics of institutional change in China in the past 30 years and offers a self-contained context for studying the relationships and interactions between the central government, provincial authorities and market forces. This chapter demonstrates that administrative decentralization in the foreign trade sector changed the internal structure of the Chinese state and undermined the central state’s policy enforcement capabilities. The central government sought to reassert state authority and control through introducing market-conforming liberalization.

China’s WTO accession efforts constituted an important part of China’s journey towards trade liberalization. Yet the rationale behind China’s commitment to a liberal trade regime goes beyond tactical calculations over the political benefits of joining the WTO. External economic and political pressures may have influenced the country’s trade liberalization process by speeding up or slowing down China’s

WTO negotiations at one point or another and may explain changes of negotiation tactics on the part of the Chinese government.⁹⁷ However, it requires a different explanation to account for the motivation behind the Chinese government's persistent efforts to remove trade barriers and enforce domestic setoral restructuring in the past 15 years. This study has attempted to offer such an explanation through investigating how the institutional effects of one stage of reform impacted the state's choice of strategy in later rounds of reform.

By taking the state as a historically grounded institution, this study has sought to interpret market-conforming liberalization of the foreign trade sector as an intentional move on the part of the central state. This contrasts with the rational-choice institutionalist treatment of the state as a collection of interest-maximizing individual politicians and solves the puzzle as to why China was able to move away from the political equilibrium of partial reform while delineating a political rather than economic logic of the Chinese state's liberalization initiatives.

⁹⁷ For example, the bombing of Chinese embassy in Belgrade in 1999 resulted in a suspension of WTO talks between China and the US.

CHATER THREE

BANKING REFORM

Financial reform is crucial to nearly all modernizing and liberalizing economies. In the case of China, scholars and policy researchers generally identify financial sector restructuring as a critical and central theme of the Chinese economic reform.¹ This observation has a twofold meaning. On the one hand, it is widely acknowledged that the establishment of a sound financial system is indispensable to the country's healthy economic development and growth as well as macroeconomic stability in the long run. On the other, the transformation of the financial system itself is linked with and affected by other important issues that China is faced with, such as the reform of the state-owned enterprises (SOEs), systems of foreign trade and investment, and even the country's social security system.² These two aspects make financial sector reform an issue of particular high stake and complexity on Chinese policymakers' reform agenda.

Whereas financial sector reform includes both banking system reform³ and the creation and development of the capital market, the former deserves primary attention in the specific socioeconomic context of China. Financial sector restructuring in China started with the

¹ See, for example, Barry Naughton (1995), On Kit Tam ed. (1995), Raymond Blanchard, Jr (1997), Nicholas Lardy (1998); Donald D. Tong (2002); Wu Jinglian (2002); Dai Xianglong (2002).

² For discussions about the relationship between finance/banking, SOEs and social security, see Donald D. Tong. *op.cit.*

³ Here the banking system comprises of banks and non-bank financial institutions such as credit cooperatives and trust & investment companies, as will be discussed later in the main text.

creation of a two-tier banking system that replaced the monobank structure in the pre-reform era. In the first decade of the reform, the number of financial institutions multiplied and credits and loans grew dramatically to support the country's economic growth. State-owned banks played a particularly dominant role in this process, accounting for 85% of the total financial assets, 80% of total loans and 75% of total deposits.⁴ Capital markets, on the other hand, were underdeveloped during the same period. Apart from informal fund raising activities, stock markets did not start to develop until the early 1990s. And bond markets remained small as well. By the mid 1990s, funds provided through capital markets made up only around 20% of the total value of finance.⁵ Financial institutions provided the other 80%, and state-owned banks alone provided 60%. Banks and non-bank institutions, therefore, assumed an important developmental role during the period of reform while they themselves were also undergoing major changes. How the banking system evolved and reasons behind its evolution constituted the main part of the story of financial reform.

Moreover, what path the Chinese state chose in reforming the country's banking reform had a direct impact on the development of the capital market and the "paradigm of financial reform" in entirety.

White and Bowles proposed three paradigms of financial reforms for socialist and industrializing economies: "market socialism", "finance and development" and "the NIC model of late development".⁶ The

⁴ People's Bank of China (1997).

⁵ People's Bank of China (1997); Donald Tong (2002)

⁶ Gordon White and Paul Bowles., in McCormick, Barrett and Jonathan Unger eds. (1996)

paradigm of “market socialism” refers to the model of reform of some East European countries in the 1980s, which involves a substantial amount of financial marketization but retains certain socialist political and institutional features such as planning and public ownership. *“Finance and Development” paradigm* refers to the neo-classical model of financial liberalization, which maintains that “the thrust of financial reform in developing countries should be to restrict the role of the government as an active promoter of development and promote its role as the regulator of a market-led development process supported by a market-based financial system.” This model of reform emphasizes “competition between banks and other financial institutions, the privatization of financial institutions and the encouragement of money and capital markets, especially equity markets.” The *“NIC late development” paradigm* refers to the reform experience of East Asian NIEs characterized by “an active interventionist state with control over the financial system to promote late development.” The state intervenes to “generate savings and allocate credit in developmentally crucial directions” and “create and advance key industrial sectors.” The state influences the allocation of bank credit not only through interest rates but also through policy loans to enforce its strategy of industrial development.

As far as a country’s overall developmental strategy is concerned, banking and capital market are not two separate issues to be addressed, as the adoption of a particular strategic approach would determine the patterns and directions of development for both sub-sectors of the financial system. My study of financial sector reform, therefore, focuses

mainly on the reform of China's banking system. By exploring the evolution of the banking system and the logic behind it, the study may hopefully unravel the complexity of the multi-dimensional reforms of the entire financial system.

According to White and Bowles, financial reforms in China have been influenced by all the three paradigms. Making their observation in 1996, they concluded that the future trajectory of financial policy and institutional change in China would involve "a moving tension and/or fusion" between the late-development and finance and development models, which had different underlying views regarding evaluations of the efficacy of market and state-led strategies. White and Bowles predicted that overall the result of the competition of the three models would be closer to the credit-based late development model of East Asian NICs or Germany as described by John Zysman⁷ rather than to the capital-market-based system along Anglo-American lines. This means that banks would play a dominant and developmental role in the country's modernization process whereas the role of the capital market would remain limited.

A review of banking reform in the past two decades suggests that whereas White and Bowles correctly identified the tension between different models of financial reforms in China, the actual developments in the financial area in recent years seem to point to a different direction than White and Bowles predicted. As banking reform is an ongoing process, existing studies describe and divide stages of the reform in various ways, depending on the timing of the investigation and the

⁷ See Zysman (1983): 286-287.

author's perspective.⁸ Yet just as in the case of Foreign Trade, there were two distinctive stages in banking reform: decentralization and liberalization. The 1980s and early 1990s saw the central state's effort to establish a decentralized banking system while maintaining the state's credit plan. From 1994 and on, however, the central government became more firmly committed to building a full-fledged commercial banking system and an independent central bank in charge of macroeconomic policies. If in 1996 it was still hard to determine, as White and Bowles argue, whether these measures would lead to financial liberalization or whether they were part of the revisionist efforts to build a banking system after the late development model by combining plan with market, by 2003 it seemed to be clearer that the initiatives that had started from 1993 and subsequent measures were

⁸ See, for example, Ou Jiawa in On Kit Tam ed. (1995) Zhang Chenghui in Masuyama et al eds. (1999), Feng Wei (2000), Donald Tong (2002). Generally speaking, banking reform in China can be divided into five stages. The first phase was from 1979-1984, during which the Chinese government tried to transform budget grants into bank credits and created a two-tier banking system to replace the monobank system. The second phase was from 1984 to 1988. This period saw a rapid development and diversification of financial institutions such as new national and regional banks, and non-bank financial institutions including trust and investment companies, finance companies, and insurance companies. The third phase was from 1988-1993, during which a stabilization program was introduced to curb the over-heatedness of the economy. New administrative policies regarding loans and credits were introduced to maintain macroeconomic stability. The fourth phase was from 1994-1997, during which several key issues were put on the agenda and implemented, such as the commercialization of the state-owned banks, the legislation of the central banking function of the People's Bank of China (PBC), and the strengthening of supervision over financial institutions. Reforms after 1997 were characterized by intensified efforts to build an independent central bank, and to transform state commercial banks into true commercial banks. Asset management companies were set up to purchase non-performing loans of state-owned commercial banks so that the latter were given a chance to become truly profit-oriented and independent enterprises freed from social obligations under the planning system. In 2003, the Bank Supervising Committee was set up, which was intended to take over the supervising function of the central bank, allowing the latter to focus on monetary policy and macro control. In 2004, the central government "injected" US \$45 billion to state-owned banks as reserve fund to prepare for their stockization (i.e., share-issue privatization).

leading the country's financial system more towards the "finance and development paradigm" than the "late development" model . On the key issues over which White and Bowles foresaw a competition between the two models such as central bank independence, the extension of capital markets, the extent of policy loans, the determination of interest rates and the role of foreign banks in the economy, solutions more in line with the liberalization approach than with the interventionist approach are being pursued.⁹

What's the logic behind the evolution of China's banking system towards liberalization? A few external factors may have exerted certain degrees of influence over policy choices regarding the Chinese banking reform. For example, from the mid 1980s and on advocates of neoclassical doctrines such as the World Bank and later the IMF began to participate in Chinese domestic policy debate over banking and financial reforms.¹⁰ Moreover, China's accelerated efforts to join GATT/WTO in the mid 1990s gave China's reform programs including financial reform another push towards the direction of liberalization. Finally, the Chinese government may have drawn lessons from the Asian Financial Crisis, and in turn became more dedicated to market-oriented restructuring in the banking sector in order to reduce and eliminate non-performing loans and strengthen financial security.¹¹

⁹ See Robert Parry "Central Bank Credibility, Inflation, and Financial Reform" in Chen et al (2000); Feng Wei (1999:30-34).

¹⁰ White and Bowles op.cit.

¹¹ See for example, Dai Xianglong (Governor of PBC) and Gao Shangquan (Standing Vice-President of China's Institutional Reform Study Society) in Kang Shaobang ed. (1999). Also see Xin Wen (1998); Li Chengsen (1998) for scholarly reflections on the necessity of adopting market-oriented reform of the banking system in the aftermath of the Asian Financial Crisis.

These factors may have impacted the Chinese banking reform at different points of time. However, they appear inadequate to explain the entire trajectory of the banking reform, especially regarding the timing of key decisions that shaped the contour of the reform process.

In this chapter, I seek to explain the logic of banking sector reform through examining changes in China's state structure and their impact on central state strategy. Existing studies of the Chinese reform have interpreted the Chinese reform either as a political game of deals and compromises or as shaped by the law of market.¹² By treating the state as a historically grounded institution, this chapter will demonstrate how the central state developed a motivation to pursue market-conforming reforms in the banking sector. Similar to foreign trade liberalization, liberalization initiatives in the banking sector show that the central state was able to make strategic a move beyond the political equilibrium of partial reform. Meanwhile, although the move itself was market-conforming, the rationale behind it was political institutional rather than economic.

Like foreign trade decentralization, the decentralization in banking and finance was initially intended to redistribute the power over credit planning and allocation between the center and localities. What was more complicated with the process of decentralization in banking was the fact that the central government had to build a banking system in its conventional sense from scratch, as during the pre-reform era, the

¹² As mentioned in chapter one, Susan Shirk's rational-choice model treats the state as a collection of rent-seeking and interest-maximizing politicians. Wedeman and Naughton, arguing from different perspectives, offer economic explanations about the logic of the Chinese reform.

People's Bank of China (PBC), the sole cash, credit and settlement center of the country, was merely an administrative agent of the state's planning system. In the decentralization era the Chinese government tried to separate bank regulation and commercial activities by making the PBC the central bank and restoring or creating four specialized banks to undertake commercial activities. As reform went on, financial institutions were diversified to accommodate the decentralized credit allocation system. However, banks were not fully commercialized and the system as a whole was still expected to act as an arm of the economic planning system. In particular, local branches of both the PBC and commercial banks at the provincial level and below were subject to the double leadership of both the center and local governments. As local authorities were more incentivized than ever to pursue local economic interests under fiscal decentralization,¹³ local branches of both banking regulatory body and commercial banking institutions were oriented by local governments to serve local developmental or entrepreneurial goals. This in turn created an unintended effect upon the central state's credit planning and the country's macroeconomic environment. When administrative measures were exhausted without effectively rectifying the problems, the central government resorted to market-conforming and liberalization-oriented reforms to decouple the state from microeconomic activities.

In the following sections, I will review the process of China's banking reform, examine changes in China's domestic structure and evaluate their impacts on the trajectory of banking reform. Whereas banking

¹³ See Christine Wong (1991).

sector reform basically can be explained in the same logic as foreign trade reform, distinctive features of the decentralization process, such as high concentration of market power, absence of foreign actors in the banking system and relatively “egalitarian” rather than regional particularistic approach in decentralizing financial power, resulted in different institutional and market dynamics, which may explain why the path of banking reform has been particularly thorny and the process slow as compared with the impressive and forceful transformation of the foreign trade sector.

Banking Decentralization

Financial System under Centralized Planning

In a market economy the primary role of banks and other financial institutions is to serve as an intermediary between savers and investors and to facilitate payments between economic units.¹⁴ But in pre-reform China, the banks were hardly “financial intermediaries”, but were administrative agencies of the state. Beginning in 1953, China began to build a monobank system after the Soviet model. Under this system, the People’s Bank of China (PBC) was actually the country’s sole financial institution. Its branches were set up all over the country in consistency with administrative divisions of regions. The PBC performing multiple functions and activities, ranging from formulating country’s credit and loan policies and conducting financial control and management to undertaking specific financial businesses such deposits, loans,

¹⁴ Nicolas Lardy (1998): 59.

settlement, cash registering, etc. All the other financial institutions only existed in name. ¹⁵

This monobank system was part of the state apparatus to enforce the state's fiscal plan so as to facilitate capital construction and industrial production. The production and sales of state-owned enterprises as well as the scale of capital construction were planned directly by the State Planning Commission and the Ministry of Finance. The responsibility of the banking system was to provide the needed funds. In the banking circles, this process was widely described as "the State Planning Commission entertaining the guests, the Ministry of Finance ordering the dishes, and the banks paying the bill." ¹⁶ Deng Xiaoping also commented that the pre-reform banks were not banks, but accounting offices, cashiers, and money issuing companies.¹⁷

This system was largely a closed one. Funds were allocated top-down, whereas profits from state-owned enterprises were channeled

¹⁵ For example, the Bank of China was the foreign exchange section of the PBC, specializing in the country's "external businesses". The Agricultural Bank of China was set up in 1955 to manage funds for agricultural development. Its functions and roles overlapped with the PBC's in many aspects. At the grassroots level branches of the two institutions sometimes clashed and conflicted with each other. As a result, the Agricultural bank was abolished, then restored, and abolished again and finally incorporated into the PBC in 1965. Similarly, the People's Construction bank was set up in 1954 to undertake the responsibility for budget appropriation and fundraising for capital construction. Four years later it was converted into the Department of Capital Construction Finance of the Ministry of Finance but officially kept the name "People's Construction Bank". In the 1960s and 1970s the bank was reestablished, and then incorporated into the PBC and finally re-subjected to the Ministry of Finance. But even during its days of "independence", the bank was more a fiscal agency of the state in charge of fund allocation, supervision and settlement for capital construction rather than a bank in its real sense. Apart from these state-owned "banks", there were also Rural Credit Cooperatives -- institutions that were set up to meet the credit need in production activities and daily lives in rural areas. These institutions were virtually basic-level units of the PBC and in many places the credit cooperative and the PBC shared one office.

¹⁶ Bank interviewee 1 (PBC)

¹⁷ Deng Xiaoping (1993): 193.

The Creation of the Two-Tier System

As economic decentralization was carried out in China, the need for financial sector reform was pressing. Decentralization initiatives allowed enterprises to retain part of their profits. Reform of the wage system and adjustment in the procurement prices of agricultural products channeled more funds from the central government into the pockets of individuals in rural and urban areas. As a result, the proportion of fiscal income to total national income was decreasing. Between 1978 and 1983, government revenue as of GDP percentage decreased by more than 8 points.¹⁸ Accordingly the central government's disposable fiscal resources were shrinking. Meanwhile, the burgeoning economy was creating a huger than ever demand for funds and credits. And profits retained by enterprises and boosted income of individuals constituted potentially new sources of funds for the banks to absorb. Back in 1979, the State Council already issued orders to restore the Agricultural Bank of China (ABC), to separate the Bank of China (BOC) from the PBC, and to make the People's Construction Bank of China (PCBC)¹⁹, which by then had been part of the state fiscal system under the leadership of the Ministry of Finance, "a "unit under the direct control of the State Council." These measures were to support the reform and opening up programs that were being rolled out in the country. Yet the three banks remained to be specialized agencies of the state and their commercial banking activities too limited to satisfy the economy's need for credit and capital.

¹⁸Calculated based on China Statistical Yearbook (1998).

¹⁹ In 1996 PCBC was renamed as China Construction Bank (CCB).

On the other hand, the revitalized economy also called for competent macroeconomic management. As elements of “commodity economy” had already been introduced into the country’s economic life, macro control and management by monetary authority was needed to curb economic overheatedness and disorder. ²⁰

Against this backdrop, financial sector reform was initiated with a focus on building a two-tier banking system. In September 1983, the Chinese State Council passed a resolution to separate central banking from commercial banking functions. The PBC no longer engaged in industrial and commercial credit activities or urban and rural savings businesses, and instead concentrated its resources on performing central banking functions.²¹ Its commercial banking business was taken over by the Industrial and Commercial Bank of China (ICBC) created in 1984. The ICBC thus became the largest of the four state-owned banks with more than 405,000 staff members and over 21,500 branches, sub-branches, business offices and savings bank offices, providing day-to-day financing for industrial and commercial enterprises and handling urban saving deposits. ²²

The separation of central banking from commercial banking and the establishment of the ICBC completed the transition of the banking system from a monobank one to a two-tier one. The PBC began to perform standard central bank responsibilities such as issuing currency, setting interest rates, supervising foreign exchange business

²⁰ Bank interviewee 1 (PBC).

²¹ State Council: Resolution on the Issue of the People’s Bank of China Performing Central Bank functions. September 17th, 1983.

²² *Almanac of China’s Finance and Banking* 1986: II-46.

and setting credit reserve requirements for the commercial banks. Meanwhile it was also assuming central planning responsibilities such as promulgating credit targets, coordinating activities within the state credit plan and adjusting the flow of funds across banks. Finally, the PBC also assumed the role of supervising and regulating financial institutions.

The four state-owned banks, namely, the ABC, BOC, PCBC and the newly created ICBC, formed the mainstay of China's commercial banking network. These banks, called state-owned specialized banks, initially had their specific scopes and types of business in their respective sectors. Since the mid 1980s, their businesses became gradually overlapping, hence introducing competition into the commercial banking sector. The ICBC, for example, was set up to handle commercial banking business in urban areas within China. Gradually, its businesses extended to rural and international areas. The BOC, in turn, lost its monopoly in foreign exchange business as ICBC and the other specialized banks were allowed to enter international business. And the ABC was allowed to set up branches in urban areas, taking deposits from individual residents and making loans to industrial enterprises.²³

In addition to the four specialized banks, the latter half of the 1980s also saw creations of various new financial institutions, both banks and nonbank institutions. These include two national commercial banks, the Bank of Communications and CITIC Industrial Bank, a wholly owned subsidiary of China International Trust and Investment

²³ Zhao Haikuan and Guo Tianyong (1998: 15-20)

Corporation (CITIC).²⁴ These national “comprehensive” banks were allowed to conduct all commercial banking businesses without geographical or sectoral restrictions. In the early 1990s three other national banks of smaller scale were established, namely, the Everbright Bank, the Huaxia Bank, and the Minsheng Bank. New commercial banks also include several regional banks, established by local governments in Special Economic Zones and coastal areas to support regional developments.²⁵

Nonbank financial institutions also began to flourish in the mid 1980s. More than 1600 urban credit cooperatives were set up to serve urban individuals and collectively owned enterprises by the end of 1987. Various investment companies, such as trust and investment companies, finance companies, finance leasing companies, and securities companies, were established to engage in the business of investment banking. Many of these companies also entered commercial banking area, taking household deposits and making working capital loans to local industrial enterprises.

Whereas these banking and nonbank institutions continued to grow in number in the 1990s, by the late 1980s a two-tier banking system with diversified financial institutions had already taken shape. Apparently, this transformation was a big step towards building a

²⁴ CITIC was established in 1980, chartered by the State Council, to raise fund in the international capital markets.

²⁵ Major regional banks include: Shenzhen Development Bank, China Merchants Bank, Guangdong Development Bank, Fujian Industrial Bank, and Xiamen International Bank, Shanghai Pudong Development Bank, etc.

banking system similar to that in market economies. But the banking system indeed was far from being commercialized and marketized.

Banking Reform as Administrative Decentralization

The two-tier banking system that was established in the 1980s carried some characteristics of both the market socialism paradigm and the late development paradigm. On the one hand, two key elements of the market socialist model, i.e., planning and public ownership, remained intact. On the other hand, following the late development model, the Chinese state went beyond socialist planning and employed monetary policy to advance its developmental goals. Under the administrative decentralization scheme that the Chinese government carried out in the financial sector as it did in the other economic areas, these characteristics combined to produce a series of social and economic outcomes that were unexpected of either model.

Decentralization and the PBC

After PBC became the central bank, finance authority and state fiscal authority were formally separated as the PBC was no longer affiliated with the Ministry of Finance (MOF). Instead, the PBC was now a functional ministry directly under the State Council. In principle it was accountable only to the State Council, which appoints its Governor. But in reality the PBC's autonomy as the central bank was rather limited. The PBC's policy making body, called the Board of Counselors, was comprised of the PBC governor and deputy governors, one deputy minister each from the State Planning Commission (SPC), the MOF, and the State Commission of System Restructuring, as well as presidents of all the four SOBs, and the People's Insurance Company.

The PBC's policy making autonomy, therefore, was significantly limited and compromised at the national level by the participation of the other state ministries and especially of the specialized banks (which were supposed to be targets of regulation by the central bank) in the policy making process.²⁶

This characteristic measured the degree to which the central bank functioned as an independent legal entity or as a subordinate state bureaucracy. What affected the effective functioning of the central bank the most, however, was its structure and organization at the local level. PBC's branches were set up in accordance with the administrative jurisdiction of provincial, municipal, and county governments. Before 1988, its provincial branches, sub-branches and county offices were subject to the "dual leadership" of the PBC headoffice and the local government. Whereas nominally PBC branches were accountable to the headoffice, it was the provincial governments that were responsible for appointing branch managers in consultation with the headoffice. PBC branches also had to coordinate key banking functions with local Finance and Planning Bureaus and to be responsive to the guidelines issued by local political authorities.²⁷

This "divided administration", combined with new economic incentives in the decentralized economy, undermined the PBC's capability to pursue national policy goals, be they macroeconomic or developmental.

²⁶ See Jinglian Wu (1994): 4-5.

²⁷ World Bank (1991):4.

Under fiscal decentralization scheme of the economic reform program, provinces were granted greater fiscal authority. The central government signed contracts with provinces on an individual basis, stipulating the amount of revenue to be remitted to the center each year. These contracts required local authorities to remit either a lump-sum amount or a fixed percentage of their local income annually.²⁸ The provinces, therefore, acquired an incentive to boost local incomes since they may retain a substantial part of the income after remitting a certain amount of revenue to the center. The profit-sharing arrangement was replicated between different tiers of local governments. Various tiers of administrative authorities, from provincial governments to village and township ones, were eager to set up factories and shops, introduce production lines, and build their own distribution channels, all in an effort to increase local revenue income.²⁹

The behavior of local governments at the provincial and sub-provincial levels went into conflicts with the central government and the PBC's policy goals in two aspects. On the one hand, local governments' investment frenzy often contradicted with the PBC's macroeconomic objectives. Under the reformed banking system, credit plan remained in place and was a major monetary instrument of the PBC. The PBC set credit and monetary targets for commercial banks and used instruments such as additional lending, credit ceilings and quantity rationing to control money supply.³⁰ Under the principle of

²⁸ These contracts phased out in 1994, when China established a dual-level tax system, see Christine Wong (1997).

²⁹ Zhou Weilin (1997: 121-122, 133-137).

³⁰ Tam (1995): 60.

“unified plan and hierarchical management”, local PBC branches had autonomous decision-making power over lending while having to adhere to the target control on the difference between lending and deposits.³¹ Under this decentralized structure for controlling money supply, local PBC branches in principle had the responsibility of ensuring that local banks and enterprises complied with credit and monetary targets. But due to interference by local administrative authorities, PBC branches tended to over-lend and, therefore, often compromised macroeconomic objectives for local developmental goals. This in turn resulted in loss of control over money supply and credit over-expansion. On the other hand, local entrepreneurial behavior also compromised the central government’s developmental objectives. As the central bank, the PBC in the 1980s had developmental functions and the responsibility to promote state strategy concerning regional and industrial development. The Bank lent directly to promote the country’s coastal development strategy and to key SOEs and special projects. Local PBC branches were expected to optimize credit structure to promote state developmental goals through their lending decisions and monitoring functions. But under the pressure and influence from local governments, they often diverted funds earmarked for special purposes to projects or enterprises sanctioned by local governments.³²

Under decentralized financial authority and dispersed credit management regime, therefore, the central government’s ability to conduct macroeconomic control and promote economic development

³¹ Ibid.

³² On Kit Tam ed. (1995: 125).

through monetary policy was substantially compromised. The key factor here was the changed role of local governments and its impact on local PBC offices. In the pre-reform era the PBC branches had already been under the “dual administration” by both the center and local authorities. Pending fiscal and financial decentralization, however, local governments acted more as a link on the state apparatus, assisting and supervising bank operations and enforcing state policies. After the central state launched its initiative of “devolving authority and sharing profits”, local governments were increasingly acquiring a dual role: state policy enforcer and patron of local development. The central bank, with its branch structure and its dual leadership, was also experiencing this “conflict of interests”. As one interviewee from the PBC ³³ commented:

Prior to reform, the PBC had about 15,000 offices nationwide. Between 1979 and 1988, this number was reduced to about 2,400, as the PBC transferred its micro banking business to the ICBC, and its staff reduced by two thirds. But this does not mean the new system was easier for the headoffice to monitor and manage. Branch offices were empowered to have independent operations and have their own discretions over issues such as regional money supply in accordance with the actual situations of their hosting regions. This was supposed to improve the operational efficiency of the PBC. But the reality was that the headquarters tended to lose control over local affairs. Before 1988, PBC branch managers were appointed by the provincial governments. Provincial authorities had a strong say in the bank’s operations and policies. Of course, both branch managers and

³³ Interviewee 2 (PBC)

provincial government leaders are state cadres. But in many areas local and central interests diverge. This is inevitable in the reform years.

As decentralization progressed, the apparent strong multi-tier state apparatus tended to lose its policy enforcement capabilities as its local ends were increasingly entangled with local and societal interests. In the area of banking, this effect compromised the central state's ability to promote its macroeconomic and developmental goals through its central banking operations.

Decentralization and Commercial Banks

The separation of the PBC from commercial banking and the creation of the ICBC signaled the establishment of a relatively complete commercial banking network³⁴. In the second half of the 1980s, financial institutions were substantially diversified. The degree of market concentration, however, was still high. By the end of 1988 the four specialized banks' combined shares of deposits and lending were estimated to be 93% and 94%³⁵.

These state-owned banks (SOBs)³⁶ were organized hierarchically with their headoffices in Beijing and branches corresponding to provincial boundaries. Since financial reform began state banks went through "enterprization". During the pre-reform years state banks were state agencies working within the budget system, subordinate to state fiscal authorities. In the decentralization years specialized banks

³⁴ This network also encompasses nonbank financial institutions that engage in banking business.

³⁵ Tam (1995): 58.

³⁶ In this study, SOBs are equivalent to state-owned specialized banks. These two terms are used interchangeably.

became relatively “independent” commercial entities. The profit retention system was applied to state-owned specialized banks as to many other state-owned enterprises. A specific retention rate was determined for each specialized bank. The banks were allowed to retain the agreed proportion of after-tax profits. Banks branches were granted greater autonomy with regard to business operations and personnel and financial affairs. Provincial and municipal branches adopted independent accounting and had the right to set up sub-branches and subsidiaries³⁷. Contract responsibility system was also introduced into specialized banks to specify the responsibilities and risks of bank branches.

Despite the progress made towards commercialization, the specialized banks were not fully profit-oriented commercial entities. They continued to provide part of the policy loans to enterprises according to state credit plans. It was estimated that total outstanding policy loans amounted to one-third of total outstanding loans extended through the banking system at the beginning of the 1990s³⁸. These loans were to be made at the interest rates determined by the state. Loan rates varied across sectors, regions, and enterprises reflecting the state’s policy preferences with regard to development priorities. These rates were set at the level of lending rates from the PBC to commercial banks. The latter were allowed a floating margin in rediscounting the loans. However, the flexibility was limited as the base rates were

³⁷ Subsidiaries include entities such as UCCs (urban credit cooperatives), RCCs (rural credit cooperatives), and local trust and investment companies.

³⁸ Mehran et al (1996). A case study of an unidentified state-owned commercial bank by Song Zhexu(1996) shows that at the beginning of the 1990s about 70% of loans the bank extended were policy loans.

administratively decided. The specialized banks, therefore, had to supply these loans without proper assessment of risks and enterprises' loan repayment capabilities. The result was an accumulation of non-performing loans and deterioration of SOBs' asset liability ratios. In fact, SOBs had little incentive to improve its loan portfolios and risk management, as their losses would finally be covered by the state. An interviewee from the BOC³⁹ observed that this problem should be ultimately attributed to state ownership of the banks:

State-owned banks are more or less like state institutions (guojia jiguan). From the headoffice down to branches and sub-branches, many characteristics of state administrative offices (xingzheng keshi) are retained. As commercial banks, we are supposed to serve as financial intermediaries to the society. But from time to time, we would act like government institutions. For example, SOBs sometimes provide free services to SOEs and other working units such as distributing salaries and wages on their behalves. But in fact every service has its costs and would have implications on the banks' income and profitability. When banks extend loans to SOEs, this is often considered as a duty because we are both owned by the state and are virtually "one family".

The fact that state-owned specialized banks were not profit-oriented commercial banks like their foreign counterparts does not mean that they were not profit-seeking. Whereas banks did not pay due attention to the issue "bank solvency", they focused on short-term profits, i.e., profits derived from differences between loan interests and deposit

³⁹ Interviewee 3 (BOC).

interests. These profits were directly linked to the level of bonus and welfare of bank employees. The top priority of SOBs, therefore, was attracting profits and expanding credits. SOBs and their branches were eager to set up subsidiaries in urban and rural areas in order to compete for deposits. Between 1985 and 1988, bank branches, subsidiaries and offices across the country increased by almost 70%, total staff increased by 60%.⁴⁰ Total deposits in the banking system increased by 80% in the three years.⁴¹

Accordingly, lending activities were expanding rapidly. The waves of credit expansion were propelled bottom-up by localities (regions). In principle, commercial banks should limit their lending volume within the “credit quota” set by the central bank, thereby maintaining the overall scale of credit and loan the central bank hoped to achieve. This re-lending quota was determined through negotiations with the center, where local governments already exerted their influence.⁴² Yet local branches of state banks often went further to make loans or issue credit before they petitioned for extra credit quota. Thus, such bottom-up pressure forced the state to change its annual credit plan.

Again, as in the case of the PBC branches, local branches of the specialized banks were strongly influenced by local administrative authorities and were usually willing to cooperate with the latter to support regional developmental goals, which could be distinctively different from the objectives of the state’s overall developmental strategy.

⁴⁰ World Bank (1991): 8.

⁴¹ *ibid.*

⁴² Wu Jinglian in Tam (1995): 95.

My interviews with managers and employees at major commercial banks in Beijing⁴³ suggest that two main reasons contributed to the collaboration between local governments and SOB branches.

Firstly, the branch offices were tied to local governments through personnel relations. Unlike the case of the PBC where branch managers were appointed by local governments, branch managers of specialized banks were designated vertically by their headoffices. But speaking of organizational/personnel relations (*zuzhi guanxi*), leading cadres of the bank branches still belonged to the provincial or municipal system under the leadership of the local governments and Party Committees. In Beijing, for example, headoffice of the ICBC was a central level unit, whereas ICBC Beijing branch and sub-branches were all city level units. Staff of the branch and sub-branches relied on the city government to provide welfare, housing, and schooling for their children, etc. Bank managers' future prospects were also tied to the city government to a great extent, as when the latter set up new city-level banks, trust and investment companies, or key projects, these managers could be transferred and assigned to important posts in the new organizations. Leading cadres of the banks also had a political career prospect tied to the local administrations. For instance, they could be promoted to join the leading team of the local government or and the Party Committee. All these factors led branch offices to willingly and actively cooperate with local governments when called upon.

⁴³ Interviewee 3 (BOC-headoffice), Interviewee 4 (ICBC Beijing Branch), Interviewee 5 (Beijing Bank of Commerce/ICBC Beijing/ PBC Beijing)

Secondly, although it was the banks that extended loans to enterprises, how much of the loans the enterprises would repay annually was virtually determined by the local governments. In China, interests on loans were usually repaid before tax. The size of enterprises' profit base before tax decided how much revenue the locality could retain after submitting the due amount to the center. Local governments, therefore, would use administrative means to determine the annual loan or interest repayment so as to maximize local fiscal income. Although SOEs and SOBs were supposed to act as corporate entities with independent accounting, in practice the "soft budget constraint" syndrome still existed.⁴⁴ Under state ownership, creditors' rights and debtors' responsibilities were not clearly stipulated. The local government, which represented the state at the local level, could still use administrative power to allocate resources among SOEs and SOBs, albeit indirectly rather than through the budget system. Bank branches, therefore, would naturally bow to the request of local authorities in making loans as eventually the economic well-being of their specific branches would depend on the discretion of the local governments whereas the risks and losses for the bank as a whole would be shouldered by the state.

The source of this problem was the same as in the PBC case – local administrative authorities at different levels acquired a dual role under the decentralization program, which prompted them to pursue entrepreneurial goals that could diverge from those of the central state.

⁴⁴ See Janos Kornai (1986): 3-30. Also see Kornai (2003), Justin Yifu Lin and Guofu Tan (1999).

But the relationship between the state-owned commercial banks, local governments, and the central state was a bit more complicated. On the one hand, the central state was trying to build a commercial banking network to serve as financial intermediaries between investors and borrowers. On the other hand, it tried to maintain the developmental role of financial institutions with an attempt to incorporate their commercial activities into the planning system. This prevented these state-owned banks from fully assuming a societal role as they were tied back to the state by ownership and by the missions imposed upon them. Ironically, these ties in turn prevented the banks from fulfilling their due part in the central state's overall development strategy as what they served were indeed the developmental or entrepreneurial needs of the local states.

Consequences of Financial Decentralization

The dynamics under decentralized financial regime had important consequences for China's macro and micro economic situations, which eventually caused the central state to reconsider its reform approach.

Conflict of macroeconomic and developmental goals: As mentioned above, the entrepreneurial behavior of local governments and state banking institutions' collaboration with them led to over-expansions of credit. As local governments competed with each other to set up and duplicate projects, production lines, factories and shops, and as banks supplied funds to support this investment rush, the economy soon became overheated nationwide. In the second half of 1984, for example, money supply in terms of M1⁴⁵ increased by about 40% in the second

⁴⁵ In China M1 refers to money in circulation and demand deposit by enterprises.

half of 1984. Inflationary pressure was mounting. The central bank, however, was not effective and timely in taking adjustment measures to curb overheated microeconomic activities and stabilize macroeconomic environment. One important cause for this was the PBC local branches' tendency to meet local governments' needs rather than follow the order of the bank headquarters. While the decision to tighten money supply was already made at the Governor's meeting in early 1985, enforcement measures were not taken until the latter half of the year.⁴⁶

When the center's will was finally enforced, administrative means rather than monetary instruments such as adjustment of interest rate were used. The PBC issued directives to its branches, imposing credit ceilings on local banks and enterprises to tame down aggregate demand. This, however, caused another problem, which was credit shortage. Since supply of capital was cut back through administrative retrenchment, enterprises in different market situations were indiscriminately affected. Factories whose products were in high demand were forced to stop production due to shortage of working capital.⁴⁷ Under administrative directives, many local banks could not lend to enterprises in need of working capital even if they had excess reserves with the central bank, as they had reached the limit of their re-lending quota.⁴⁸

The retrenchment efforts, however, did not solve the problem of local governments' intervention in the economy. Directives from the center only stipulated ceilings on credit quota. But local governments could

⁴⁶ OU Jiawa in Tam (1995):63.

⁴⁷ *ibid.*

⁴⁸ Interviewee 5 (ICBC Beijing/PBC/BBoC)

still influence how credit within the quota was allocated. As one interviewee observed ⁴⁹:

The problem of credit over-expansion and economic over-heatedness was caused mainly by the investment fervor of different localities, with many duplicated projects (chongfu shangma xiangmu). For example, when one village set up a furniture (production) shop, all the other villages within the region followed suit. Or when one province introduced an assembly line, many other provinces would do the same thing and soon their products would be competing in a crowded market. There was a lack of economy of scale and economic efficiency. Macroeconomic control should aim at solving these problems and optimizing investment structure. But in reality, local governments often had different calculations as they always wanted to endorse their local (regional) key projects. During periods of tight money supply, they would influence local PBC and commercial banks to cut off credit on projects other than their key projects, although the former projects could be of higher priority from the perspective of the central government.

At the level of the central government, widespread credit shortage phenomena caused decision makers to worry, as macroeconomic measures were slowing down economic growth, which was considered a top priority by the Chinese state during the reform era. To ease the credit shortage and maintain the momentum for high growth, the central government and the PBC eased credit control only a few months into the retrenchment program in 1985. Additional credit was added on

⁴⁹ Interviewee 5.

top of the original credit plan to supply enterprises in need of working capital. By the mid 1986, an easing of monetary policy was formally enforced. Whereas output growth accelerated as expected, inflationary pressures also came back as the economy began to overheat. Between 1986 and 1987, GNP growth picked up by 3 %, whereas the rate of change in the general retail price index increased by 5%. This led to another round of short-lived retrenchment cycle in late 1987⁵⁰. However, for the same reason as before, the central government soon reversed the policy to ease money supply. By mid 1988, economy became severely overheated and inflation rose to more than 20%, which led to widespread withdrawal of deposits from banks and buying spree at shops in anticipation of further increases in prices.

Under administrative decentralization, this conflict of macroeconomic and developmental goals was inevitable given the structural problems in finance and investment activities caused by the special dynamics and interactions between the center, the localities and state banks. By resorting to administrative means to control money supply, the Chinese central state was constantly caught in the dilemma of attaining one goal at the expense of the other. In this regard, the experience of the Chinese financial sector echoed the country's general experience during the decentralization era that Chinese officials and economists have summarized in one sentence: "loosening of economic control would invariably lead to chaos whereas tightening of control would invariably kill economic vigor."

⁵⁰ National Bureau of Statistics of China: *Annual National Statistical Reports 1986 & 1987*.

Financial regionalization and debt problems: Local credit expansion drives under limited supply of credit led to regionalization of financial and economic activities. Under the influence of local governments, local branches of SOBs tended to lend mainly to enterprises in the same region. The situation could worsen during time of tight money supply, when loans were made solely to local enterprises and were prevented from flowing out. The lack of mobility of capital not only regionalized financial activities, but also added fuel to credit expansion. As demand for capital could not be satisfied through mobility of funds like in a market system, each local government would only press local banks to extend additional loans, which in turn gave pressure back to the central government and the PBC to expand overall credit plan.⁵¹ Moreover, during periods of tightened control, local governments would advise local banks to stop payment on goods and services purchased from enterprises outside the region, the latter mostly being large state-owned enterprises offering goods and services beyond regional boundaries. This practice led to indebtedness between enterprises, or between banks and enterprises, and contributed to the mounting “triangle debts” among SOEs.⁵²

As for the banks themselves, one important means of credit management developed during the reform era was interbank lending and borrowing. During pre-reform years, the boundary between state budgetary system and financial system was blurred. Credit and cash

⁵¹ Interviewee 1 (PBC). Also see Xu Shipiao (1994) for an analysis of the credit overexpansion problem from the Central Bank perspective, and Hong Shen et al (1994) for a study of major reasons behind the distortion of state credit plans.

⁵² Interviewee 5; Also see Zhou Weilin (1997: 151-157) for analyses about the triangle debt problem.

plans were constantly adjusted by the state to meet the changing need of the banking system. When financial reform began and the central bank and commercial banks were separated, the PBC formulated new rules for commercial banks' credit and cash management, which required the commercial banks to link the amount of lending to the level of deposit taking and disallowed overdrafts from the central bank.⁵³ Against this background, interbank money market was developed to allow lending between banks and across regions to provide banks with the needed liquidity to replenish their reserves.

Although interbank market was hailed as a major development of financial marketization by the Chinese official sources, its functions and purposes were somewhat different from those of interbank activities in market economies. Normally, interbank borrowing is an instrument to ease banks' fluctuations in liquidity and is conducted in relatively small amounts to cover a bank's overnight open position. But in China banks often borrowed from each other not to replenish liquidity, but to extend the funds as loans to enterprises.⁵⁴ The maturity of interbank lending could be as long as one year as opposed to a few days in the case of standard interbank market transactions. And the amount of lending could be truly substantial, sometimes several times the level of bank reserves.⁵⁵

As interbank lending and borrowing became means to obtain loanable funds, the regional factor again kicked in. Local banks tended to limit lending and borrowing within their own region. A 1986 ICBC

⁵³ PBC: Rules for credit funds management, 1984.

⁵⁴ Xia Bin "Analysis of China's Interbank Money Market" in On Kit Tam (1995).

⁵⁵ Interviewee 3.

study of financial reforms in ten cities suggests that 68% of interbank transactions by specialized banks and 87% of transactions by local trust and investment companies and other financial institutions were conducted within their own regions.⁵⁶

Another characteristic of interbank money market was the establishment of multiple interbank “lending centers”. For one city, there were usually various tiers of interbank markets, such as the center for interbank lending between the local PBC branch and branches of the specialized banks, the network for local UCCs and other financial institutions, as well as the center for national level transaction, mainly conducted by the specialized banks.⁵⁷ Financial centers were set up and duplicated across the country, mimicking the situation in the real sector, where factories and shops for the production of the same physical goods were repeatedly built by various localities. As interbank markets in different regions were largely segregated and information often delayed or blocked, borrowers and lenders could not take advantage of an efficient market to optimize transactions and opportunities.

Since “insolvency” was never a problem on SOB bank managers’ minds, they did not worry so much about defaults in interbank transactions, and instead were keen on expanding credit by means of interbank borrowing. Very often funds were not returned at maturation. Thus debts also accumulated between banks. In so doing, banks

⁵⁶ Zhang Xiaojie and Zhao Yujiang (1988).

⁵⁷ Interviewee 3 (BOC headoffice). For more about problems and defects of China’s interbank market, see Luo Zhifang and Guo Jian (1994): 31-34; Zhao Dayun (1994): 90-91.

actually channeled banking institutions' excess funds into local development and construction, getting themselves indebted and letting the state take the losses eventually.⁵⁸

Recentralization Attempts and Consequences

By early 1988, waves of investment expansion had rendered the Chinese economy seriously overheated. Coastal provinces were accelerating their “outward looking” economies whereas provinces of the inner land were eager to catch up. Total demand for credit surged as a result. In the meantime, as radical price reforms began in early 1988, provinces competed with each other to adjust commodity prices upward to start the process of “full liberalization” of prices. Although presidents of PBC branches held a meeting in early 1988, seeking to reverse the unstable and abnormal macroeconomic situations by recalling short-term loans, “controlling total amount of credit and making structural adjustment”,⁵⁹ the credit expansion fervor could hardly be suppressed with these limited measures. As money and credit grew rapidly in the economy, inflationary pressure was also mounting. As a result, waves of panic buying swept across the country and beginning in May, run on banks happened in major cities such as Nanjing and Hangzhou. Bank savings deposit, which had been growing at an annual rate of 30% most of the time during the 1980s, fell to negative growth in August, 1988 whereas average retail price nationwide rose by 18.5%.⁶⁰

⁵⁸ Interviewee 3 (BOC).

⁵⁹ Interviewee 1 (PBC)

⁶⁰ Zhao Haikuan and Guo Tianyong (1998)

As credit expansion and the ensuing inflation spiraled out of control, the central government enforced a stabilization program in 1988 and 1989 to “improve economic environment and straighten out economic orders”. The program entailed stabilization measures in the areas of monetary, fiscal, investment, price, wages, and trade policies. To the central government, the primary task was to tighten money supply and curb overheated investment. Adjustments in the financial sector were at the core of the stabilization program.

Monetary policy adjustments consisted of interest rate adjustment and credit policy revision.⁶¹ But given price distortions in the domestic economy, the effect of interest rate changes was not immediate or strong enough on taming the wave of investment expansion. Normally, interest rate would be used as a macroeconomic instrument to adjust the level of investment and reallocate resources. But distortion of prices continued to draw funds into high-profit industries such as processing industry, electrical appliances manufacturing, etc., whereas basic industries that were less profitable were further depleted of funds under tighter money supply.⁶²

The primary tool for macroeconomic control, therefore, remained to be administrative directives over credit policy. The center set rigid credit targets on working capital and fixed assets for various economic sectors and imposed credit ceilings accordingly. Firm and compulsory credit quotas were established for provinces and provincial branches of the

⁶¹ With regard to interest rates, the center raised the long term lending and deposit rates by 1% in September 1988 and then increased all lending rates by 2% and all deposit by rates 3% in early 1989. Retail price-indexed interest rates were introduced from late 1988 to attract savings and stem panic buying. (World Bank, 1990: 12-13)

⁶² Interviewee 5; also see Zhao Haikun and Guo Tianyong. *op. cit.*

PBC were made responsible for controlling the total allocation of credit by local branches of the specialized banks so that they lent within their total local lending limits. PBC branches also took the responsibility to supervise and control non-bank institutions such as trust and investment companies (TICs) over their lending activities. Many of these companies were reorganized, merged or closed as a result, reducing the total number of TICs significantly.⁶³

As monetary and credit policies were being enforced to cool down the overheated economy, the center was reexamining the decentralization measures that had so far been taken in the financial sector. By this time, it was clear to the central state leaders that the self-interested financial behavior of the local governments under decentralized regulations constituted a major hindrance to the central government's achieving its own macroeconomic and developmental objectives. To the central government, the crux of the problem was how the tension between the center and the localities can be resolved in favor of the overall policy objectives of the state.

The dominant view held that the chaos and irregularities in the financial sector were due to competition nurtured under decentralization. State banks were now doing business and competing with each other in all economic sectors, their pursuit of economic interest in constant conflict with the need of the state plan. To ensure effective functioning of the state planning system, this view argued, the central bank should exercise tighter control over the specialized banks, not only through monetary instruments, but also through reinforced

⁶³ *ibid.*

administrative means such as credit ceilings and targets. The specialized banks should limit their activities within their specialized sector and not diversify its business into other economic areas. As state banks, they should go beyond their commercial activities to assume the responsibility of macroeconomic adjustment, along with the central bank.⁶⁴

An opposite view also existed among economists and pro-reform policy makers who saw the root of the problem as lying in the incompleteness of bank commercialization. This view argued for further enterprization of the state-owned banks so that they establish an equal and cooperative relationship with industrial enterprises whereby banks make lending decisions solely on commercial ground rather than serving as state-owned enterprises' welfare provider or extending policy loans on behalf of the state. And as commercial banks, SOBs cannot at the same time take the primary responsibility for macroeconomic control. Instead, the independent authority of the central bank should be strengthened, and indirect macro control measures such as deposit reserve ratio and rediscount rate should be promoted in lieu of administrative directives and guidance.⁶⁵ With commercial banks turned into modern and independent corporations fully responsible for their profits and losses, they would respond appropriately to the central bank's macroeconomic control signals rather than coalescing with local governments to over-expand credits.

⁶⁴ Summarized from discussions with interviewees 1, 2, 5.

⁶⁵ See Wu Jinglian in Tam (1995).

Under the conservative political atmosphere in the aftermath of the failed price reform of 1988 and the social instability it caused⁶⁶, the second approach did not appear to be a viable option for reformers. Even the fundamental strategy of the reform and opening to the outside world was questioned and challenged. Administrative recentralization, therefore, prevailed during the retrenchment period.

The stabilization efforts did curb credit expansion and brought the overheated economy down to earth. The growth rates of industry and agriculture dropped to 6.8% and 3.3% respectively and GNP growth down to 3.9%.⁶⁷ Many problems of overheating, such as shortages of energy and raw materials, inflation and rising prices, trade deficits, were lessened or cured.

The negative effects of the stabilization program were also evident, especially in the financial area. One major symptom of administratively enforced macroeconomic control was the so called “hard landing” of the economy. Although the central bank had raised savings deposit rates and lending rates, enterprise paid little attention to these signals of economic contraction and monetary deflation. They continued to build their stocks of raw materials and kept on expanding production. When banks were finally tied by administrative directives over lending quota and ceilings, enterprises suddenly found themselves lacking working capital and demand in the market shrinking dramatically. As a result, their excess stocks of raw materials and finished goods accumulated,

⁶⁶ It was widely believed among Chinese scholars that the social turmoil triggered by the students’ “democratic movement” in 1989 had its deeper roots in people’s discontent with the price reform and its consequences.

⁶⁷ World Bank (1990):23.

causing cash-flow problems for these enterprises. This in turn led to high levels of arrears between enterprises, between banks and enterprises, and between different banks. Under the circumstances of tight money supply, many local governments ordered banks within their administrative jurisdiction not to lend to parties outside their own regions and asked local enterprises to stop payments on purchases made in other regions. Inter-regional arrears and triangle debts mounted up. In 1989, arrears in interest and principal payments to banks amounted to 6% of the GNP.⁶⁸ Another consequence of economic hard landing was excess labor force. As factories reduced production or closed down temporarily, workers were sent home while maintaining their basic wages. SOBs, in turn, had to take over the burden of welfare provision for the socialist state, which further worsened the banks' own financial situations. Ultimately, these financial losses and burdens would be passed on to the state.

Moreover, banks also suffered from the conflicts between different aspects of the administratively enforced stabilization program. To curb inflation, price-indexed deposit rates were enforced to "recall money" from the real sector. In the meantime, lending rates were also raised but not as much as the deposit rates. Even during the period of economic contraction, the state had to keep growth incentives to a certain level to and had to support the operations of economically inefficient and debt-laden SOEs by extending loans to them at an accessible rate. However, as both prices and interest rates were administratively determined, the costs of balancing the state's macroeconomic and

⁶⁸ Ibid: 25.

developmental objectives had to be borne by the state banks.⁶⁹ Profitability of the banking system was further reduced.

The stabilization program also depressed the formerly prosperous interbank money market. Due to economic contraction and tightened money supply, interbank loan transactions decreased sharply. In the first half of 1989, the level of transactions dropped to 70% of the 1988 level.⁷⁰ In late 1989, interbank market activities almost ceased across the country. Under stringent credit quotas and ceilings, banks withheld from lending to other financial institutions even if they had excess funds for fear that the latter would not be able to repay the loan.⁷¹

In the wider economic sphere, the major drawback of the administratively enforced stabilization measures was felt in the conflict between the sectoral preferences of the credit policies and the regional economic dynamics. Unlike the regional differentiated arrangements in fiscal and foreign trade areas, credit policies were relatively consistent across geographical areas. Lending limits were set to favor certain sectors and ownership forms over others. The result was that economically inefficient state-owned enterprises and the basic industrial sectors they dominated got the bulk of the total credit allocated whereas high growth industries were collectively and

⁶⁹ Interviewee 5.

⁷⁰ *Almanac of China's Finance and Banking* (1988; 1989)

⁷¹ According to interviewee at the Treasury Department of the BOC headoffice (interviewee 3), in standard commercial banking operations, excess funds would not be left idling as when they are turned into loans, they can generate income and will increase a bank's earnings. The Chinese specialized banks, however, are state banks that are not entirely profit-oriented when making business decisions. Besides, even from an economic point of view, when monetary conditions are tight, keeping the excess funds would at least be no harm whereas lending them out would possibly end up only increasing the bank's bad loans.

privately owned enterprises populated were substantially cut back on credit supply. And this in turn indirectly and unevenly affected the growth momentum of different geographical regions. As state owned enterprises and the relevant industrial sectors were concentrated in traditional industrial bases such as Shanghai and the Northeast provinces, whereas enterprises of new ownership forms such as township and village enterprises engaging in the manufacturing of processed goods flourished in coastal provinces such as Jiangsu and Zhejiang, regions of the latter type were more negatively influenced by the tightened credit policy. A world bank study shows that in 1989 there was a significant correlation between growth of credit and economic growth performance of the preceding six years.⁷²

In this sense, while the macroeconomic stabilization program cooled the overheated economy effectively, it did so almost by killing the engine of growth. Meanwhile, although the central government had intended to use credit policies as instruments to enforce certain industrial and sectoral policies, such an approach ended up further reducing economic efficiency, increasing SOE's dependence upon the state, contributing to the problem of non-performing loans that would loom large in the 1990s.

The June 4th Incident of 1989 further distressed the economy as tourism incomes and foreign investment declined substantially. Faced with the hostile international environment, Chinese political leaders adopted a conservative stance in the country's economic and political lives. Possibilities of any bold reforms were not on the immediate

⁷² World bank (1990):29.

horizon. However, the flip side of the incident was that with the legitimacy of the Communist regime more threatened than ever before and with the path towards political reforms blocked, the Chinese leaders reached the consensus that the “socialist cause” could only be sustained through economic growth. As Deng Xiaoping observed in 1990, “the fundamental factor in maintaining political stability lies in sustained economic growth and improvement of people’s living standard.” “If the economy grows only at the relatively low speed of 4% or 5% per year, after four or five years, there is no guarantee that the people will continue to support us.”⁷³

This reasserted emphasis on growth prepared psychologically and politically for ending the austere program and starting a new round of development and growth drive. The concern about decentralized financial system and its tendency to induce credit-over-expansion paled in front of the utmost necessity to maintain a strong growth momentum. The stabilization program was formally put to an end after Deng Xiaoping made his Southern Tour Speech in 1992, during which he called for developing market economy and “socialism with Chinese characteristics”.

Towards Banking Liberalization

The Chinese economy entered another booming period in 1992. Soon, all the symptoms of monetary expansion and investment

⁷³ Deng Xiaoping “International Situations and Economic Issues.” 1990.

overheating reappeared. As a major consequence and indicator of over-expansion, inflationary pressure was mounting again.⁷⁴

In China's economic circles, the debate about growth as a priority and macroeconomic stability was revived. One view, led by renowned economist Li Yining, argued that inflation was socially tolerable in a high-growth economy whereas a slowdown of the economy would cause unemployment, which would in turn result in social instability.⁷⁵ The other view, led by equally renowned economist Wu Jinglian, argued that using monetary expansion to solve the difficulties SOEs face will only prove to be like "drinking poison to quench thirst" and that maintaining low unemployment rate by allowing high inflation rate has already been criticized as an erroneous application of the "Philip Curve" in Western economist circles⁷⁶.

Surrounding this debate were too more straightforward arguments about the necessity of actions on overheating. One view held that there was no such a thing as "an overheated economy"; the so called macroeconomic adjustment would only take the road back to centralized control of the pre-reform era. The other view argued against it, asserting that a sound macroeconomic control system is indispensable to the healthy functioning of a market economy. This view also objected to the proposal of a two level macroeconomic control

⁷⁴ The price of investment items rose by 12.1% in 1992 and by 26.6% in 1993. Purchase prices of energy and raw materials rose by 11% and 35.1% in 1992 and 1993 respectively. Correspondingly, average price of industrial output grew by 24% in 1993. Retail prices were rising again, of which increase in production costs accounted for 70% of the total increase. (Economics Daily, October 24, 1994).

⁷⁵ Li Yining, "Jiuye Youxian, Jiangu Wujia Wending (Employment First, Price Stability Second)" in *Gaige (Reform)* (1994): 10-13.

⁷⁶ Wu Jinglian "Lun Tonghuopengzhang Zhengce Zhi Bu Kexing. (The inviability of inflation policy and the way out)" in *ibid*: 7-9.

system jointly managed by the center and localities and instead emphasized that monetary authority and the power of macro control have to be concentrated at the center.⁷⁷

Obviously, the pro-expansion view had the backing of economic interests at the level of localities whereas the pro-macro control view concurred with the central government's stance on these issues. The then premier Zhu Rongji expressed on several occasions that macro control was essential to social stability and the success and progress of the reform program and that unemployment as an economic and social problem can only be tackled by improving the social security net rather than by blind-mindedly expanding investment and production.⁷⁸ However, although macro control by tightening credit and money may quell the current wave of over-expansion, the root of the problem remained: as long as the banking system cannot work independently from local governments, soon the central government will again find itself forced to expand credit and loosing macro control capabilities, unless it resorts to permanent recentralization of credit and monetary authority. This latter approach was facing increasingly strong opposition as the overall reform and opening up program headed onwards. As economist Wu Jinglian observes, as a result of ten years of economic development and economic reform, the changes that had taken place in the degree of complexity of China's economy and the degree of its diversity were tremendous. It was extremely difficult to place one's hopes in forced administrative methods of control to improve

⁷⁷ See Tong Dalin (1994); Yu Guangyuan (1994); Xiao Zhuoji (1994); Fan Gang (1994); Hu Daiguang *Economics Daily* (Jingji Ribao) September 2, 1994.

⁷⁸ *Market (Xiaoshou Shichang)*, no. 4, 1994.

the situation in the financial sectors, especially if the aim was to fully mobilize funds, to have effective resource allocation and thus maintain long-term financial stability.⁷⁹

The central government realized that to regain effective macro control capabilities without compromising long-term developmental goals, the key issue to be addressed was the entanglement of the banking system with local administrative authorities. As described before, such entanglement was seen in two aspects.

On the one hand, the authority of the central bank was divided by its branches set up in accordance with geographical divisions of provincial administrative authorities. At the level of locality, the provincial government was the formal representative of public ownership and in a sense was the reified state to local economic organizations. Obviously, local governments' agenda were increasingly different from the central state as decentralization progressed, their role shifting from one of policy enforcer to one of local interest sponsor. Local branch of the central bank, supervised by the local government, shared this characteristic of a dual-role player. The central state's effective control over credit and money was significantly compromised as a result. Every time the center resorted to harsh administrative measures to discipline PBC branches, it did so to redress problems already in place due to inappropriate expansion of credit forced by the collaborating local governments and PBC branches. The country's macro control and economic development activities, therefore, were always caught in a vicious cycle and conflicting with each other.

⁷⁹ Wu Jinglian in Tam (1995).

On the other hand, the role of specialized banks was ambiguous and confusing. As commercial banks they were supposed to operate as commercial organizations rather than as government agents. However, as there was no clear distinction between policy loans and commercial loans, the specialized banks were extending loans to cater to local development priorities. Loan decisions were made neither to reflect commercial assessment nor the policy goals of the central state. As funds earmarked for agricultural and sideline product procurements and for key SOEs or national projects were loaned to enterprises and projects that enjoyed local backings, the central state and the PBC therefore were forced to expand total credit to cover this funding gap. Meanwhile, loans extended to serve local entrepreneurial interests included many bad loans and non-performing loans, dragging the whole banking system towards insolvency.

To disentangle the state monetary authority from local economic interests and the banking system from local administrative authorities, therefore, the central government chose two measures to begin with: the separation of policy banking from commercial banking and the building of a truly independent central bank.

The Creation of Policy Banks

The central government, led by Premier Zhu Rongji, embarked on a new round of financial reform in 1993. One major step was the establishment of three policy banks in 1994. The policy banks are “policy-oriented non-profit financial institutions to enforce the country’s industrial policy and regional development strategy.”⁸⁰ These banks do

⁸⁰ Interviewee 1, PBC.

not absorb deposits from the general public. Instead, funds were supplied to these banks mainly through fiscal appropriation, issuance of financial bonds, and loans by the central bank. The banks are expected to make lending decision based on overall assessments of “national interests” rather than out of consideration of corporate interests of the banks. ⁸¹

While the state set up these policy banks to enforce its policy objectives in different economic areas, it was far from using policy lending as an instrument of credit-based active industrial policy. Indeed, the proportion of policy lending makes up a small percent of China’s total loans. ⁸² On the contrary, the main purpose for the establishment of the policy banks was to clear the way for further deregulation of the Chinese banking system and for fully commercializing the state-owned specialized banks.

⁸¹ In March 1994, the first policy bank, the State Development Bank, was established. Based in Beijing, the bank targeted at policy lending for key national projects. The bank was responsible for satisfying the funding needs of key construction projects nationwide while at the same time optimizing the total amount and overall structure of fixed asset investment. On the other hand, by concentrating the power of lending decision over key construction projects in the hands of the State Development Bank, the central government intended to avert the situations of duplicated projects and repeated investment that frequently happened under a geographically decentralized financial system. The second policy bank, China Import and Export Bank, was set up in Beijing in July 1994. The bank specializes in providing credits, loans and credit guarantees for foreign trade corporations. Its funds mainly came from issuing “policy bonds” and through raising funds in international financial markets. The bank was set up, in part, to coordinate with the reforms in the foreign trade area by replacing export subsidies and import protections with standard international practice such as buyer’s credit and seller’s credit. The third policy bank, China Agricultural Development Bank, was set up in Beijing in November 1994. The bank established branches all over the country to provide funds for the production, procurement, storage and marketing of agricultural and sideline products. Its main funding sources included deposits from enterprises, PBC loans, fiscal “agricultural supports”, and policy bonds.

⁸² By 1998, total policy lending took up about 13% of total loans (*Almanac of China’s Finance and Banking 1998*).

In fact, policy banks were set up largely as responses to existing problems caused by the mixture of commercial and policy lending rather than as interventionist arms of the state to “pick winners” and lead industrial trends. By centralizing the authority of lending decisions for national construction projects and agricultural activities, for example, the central government sought to rectify the problem of forced credit expansion due to the specialized banks’ unrestrained and undisciplined lending. Now that commercial banks were no longer assigned the tasks of policy lending, they could no longer divert policy funds for other purposes and push the center to expand credit beyond its original plan. Accordingly, as the credit expansion problem was ameliorated, the possibility was also less for the state to use harsh administrative measures to cut back the banks’ credit quotas at a later stage.⁸³ The separation of policy banking from commercial banking, therefore, was a preparatory and necessary step for standardizing the Chinese banking system.

The Building of Central Bank Independence

The core measures of the new round of financial reform centered around the establishment of a truly independent central bank. Since the second half of 1997, the PBC took rapid actions to cut off its ties with commercial financial institutions and other for-profit economic

⁸³ Of the three policy banks, the China Import and Export Bank appeared to have the strongest industrial policy outlook. The bank was set up to “promote the export of mechanical and electrical products, especially complete plants and equipment, as well as high-tech, high value added products.” However, this measure was taken in the larger context of foreign trade liberalization – the state was trying to remove fiscal subsidies and adopt internationally accepted practice of providing credit and loan services to importers and exporters. And such services were more to facilitate trading activities rather than to actively provide extra incentives for exports. The more incentive-based measure was export tax rebates, discussed in Chapter 2.

entities. At the branch level, many local financial institutions such as regional banks and trust and investment companies were often endorsed by both the local government and the PBC branch. The PBC headquarters ordered its branches to sever their ties with such institutions and companies so that the bank could focus its efforts on financial regulations, monetary control, and the provision of financial services to commercial financial institutions.

The Central Bank Law

A major step in building an independent central bank was the formulation and enforcement of the Central Bank Law, or the Law on the People's Bank of China, effective May 1995. The law has clear provisions that separate the central bank from the influence of administrative authorities at various levels. Article 7 of the Law on PBC provides that

“PBC shall, under the leadership of the State Council, independently implement monetary policies, perform its functions and carry out its operations according to law free from any intervention by local governments or government departments at all levels, public organizations or individuals.”

Accordingly, the law stipulates that the People's Bank shall not give any overdraft in exceeding financial budget of the government, and shall not directly subscribe to or act as sole sales agent for state bonds and other government bonds.⁸⁴ Meanwhile, the PBC must not provide loans to local governments, governmental departments of various levels, non-bank financial institutions and other

⁸⁴ The Law on People's Bank of China, Article 28.

organizations or individuals except to non-bank financial institutions specially permitted by the State Council; it must not act as financial guarantor for any organization or individual.⁸⁵ In this way, the PBC is expected to acquire the role of an independent and detached regulator.

The emphasis on central bank independence does not mean that the central government stayed passively out of banking issues. According to the Central Bank Law, the PBC is under the direct leadership of the State Council. And in 1995, Zhu Rongji, then Premier of the State Council, was also President of the People's Bank of China. In fact, the central government took an active role in ensuring that the PBC is freed from the influence of administrative authorities. Since 1994, Zhu Rongji laid down the rule for the central government that the government may no longer borrow or overdraft from the central bank to cover the differences in its fiscal income and expenditures or offset its budget deficits.

The central government also sought to increase PBC independence through the reform of its policy-making body. As mentioned before, the PBC's policy making body until the mid 1990s had been the Board of Counselors, consisting of the governor and vice governors of the PBC, one deputy minister each from the State Planning Commission, the Ministry of Finance, and the State Commission of Economic System Reform, and presidents of the SOBs and the People's Insurance Company. The Central Bank Law of 1995 provides that a Monetary Policy Commission (MPC) should be established to replace the Board of

⁸⁵ The Law on People's Bank of China, Article 29.

Counselors. To help enforce it, the State Council issued the “Regulations on the Monetary Policy Commission of the People’s Bank, of China” in 1997. The MPC was composed of governor and vice-governors of the PBC, as well as representatives from departments and organizations in various economic areas, and one independent expert. The SOB chairs were cut from four to two and the People’s Insurance Company is no longer represented in the MPC, thereby reducing the influence of state-owned financial institutions over central bank policy making. And by adding an independent consultant to the Commission, the central government strengthened the role of professional opinion in PBC’s policy making. The structure and function of the MPC were modeled after the Open Market Operation Committee of the US Federal Reserves, and the Commission was expected to “advise the PBC and the State Council with professional, scientific and objective opinions and proposals over monetary policies based upon comprehensive analysis of macroeconomic situations.”⁸⁶

In terms of the approach to macro control, the central government encouraged the PBC to use indirect control and adjustment mechanism. The law provides that the ultimate aim of monetary policies is to maintain the stability of the value of the currency and thereby promote economic growth.⁸⁷ In the past, the focus of PBC monetary policy had been on direct control over credit volume. Under the new law, the PBC should instead focus on the control of total money supply in terms of M1. Accordingly, the PBC began to mainly rely on monetary instruments

⁸⁶ Interviewee 1 (PBC)

⁸⁷ Law on the People’s Bank of China, Article 3.

rather than administrative directives over credit quotas for macro financial control. Instruments such as open market operations, discount and rediscount policy were adopted since mid 1990s and their business scope expanded over time. Interest rate formation system was also improved. The nationally unified interbank market was established in 1996, and interest rates were liberalized for the interbank market in June of the same year.

By relying on these indirect control instruments rather than resorting to administrative recentralization, the PBC successfully assisted the central government in achieving “soft landing” of the Chinese economy following the economic overheating of 1992 and 1993. In 1998, in the aftermath of the Asian Financial Crisis, the PBC used various monetary instruments such as interest rate, reserves fund, open market operations and rediscount to stimulate domestic demand so as to keep the momentum of economic growth without devalue its currency. The result was quite successful, indicating that the PBC is equipped with the basic ability to regulate the economy and make necessary macro adjustment base on indirect control mechanism.⁸⁸

Reform of the PBC Institutional Structure

Although the Central Bank Law and subsequent measures strengthened the functional and financial independence of the PBC, the problem local governments’ interference in PBC businesses was not totally cured. The root of the problem lay in the structure of the PBC branches. PBC branches were set up in accordance with the administrative jurisdiction of local governments at provincial and

⁸⁸ Zhao Haikuan and Guo Tianyong (1998: 207)

municipal levels. Inevitably the operations of the PBC branches were subject to the influence of local governments, even though legally all the ties between the two were severed. At the national conference on financial work held in November 1997, a plan was laid out for the establishment of PBC branches “across administrative district divisions”. The reform was enforced in late 1998 and at the beginning of 1999, the PBC formally abolished its branches at provincial and municipal levels and instead set up nine regional branches.⁸⁹ In provinces where a PBC branch was not present, an office of financial supervision and regulation was established to serve as the arm of the “cross-district” PBC branch. The main responsibility of such an office was to supervise the operations of all PBC sub-branches as well as monitor and regulate the activities of all the other financial institutions within the jurisdiction of the PBC branch the office is affiliated with.⁹⁰

It was desired that with this new organizational structure, the PBC would be largely protected from the interference by local governments. The reform was also designed to promote regional economic

⁸⁹ The new branches include Tianjin, covering the city of Tianjin, Hebei and Shanxi Provinces and Inner Mongolia; Shenyang, covering Liaoning, Jilin, and Heilongjiang Provinces; Shanghai, covering the city of Shanghai and Zhejiang and Fujian Provinces; Nanjing, covering Jiangsu and Anhui Provinces; Jinan, covering Shandong and Henan Provinces; Wuhan, covering Jiangxi, Hubei, and Hunan Provinces; Ghangzhou, covering Guangdong and Hainan Provinces and the Guangxi Zhuang Autonomous Region; Chengdu, covering Sichuan, Guizhou and Yunan Provinces and Tibet; and Xi'an, covering Shaanxi, Gansu, and Qinghai Provinces and Ningxia and Xinjiang. The Beijing and Chongqing branches were abolished and their business put under the direct control of the PBC headoffice's Business Department.

⁹⁰ Under the new system, there are altogether 20 such offices led by the 9 PBC branches, managing 326 “central subbranches” (i.e., subbranches established in provincial capitals) and 1827 county level subbranches. When the new branch structure was being established, all presidents of PBC branches were reassigned to different regions from their original ones and two thirds of cadres in charge of various departments of each PBC branch were shuffled across regions.

development and bank efficiency, redressing the problems of “financial regionalization” and local protectionism under financial decentralization. The decoupling of PBC branches’ jurisdictions from the spheres of administrative divisions also strengthened the PBC’s ability to supervise and regulate the banking industry and to penalize violators of financial laws and regulations when necessary, thereby reducing moral hazards in the financial sector.⁹¹

Liberalizing Commercial Banking

The most critical yet thorny problem in the central government’s effort to free the banking system from local government influences was the reform of the commercial banking system. The separation of policy banking from commercial banking and the strengthening of central bank independence removed some key underlying causes for the local government interference into banking affairs. Yet to fully disentangle the banking system from local administrative authorities and the economic interest they endorsed, it was necessary to make the commercial banks truly “commercial”.

The commercial banks, namely the state-owned specialized banks and other newly established national and regional banks, as well as non-bank financial institutions such as investment and trust companies, were at the nexus between the government and market and between macroeconomic and microeconomic spheres. Although “enterprization” of banks was initiated back in the 1980s, there continued to be much confusion over the role and responsibility of

⁹¹ Interviewee 5. Also see Zhihao Liu (1998) for an explanation about the state’s plan to establish cross-regional PBC divisions.

commercial banks in the 1990s. In fact, prior to 1992, the term “commercial banks” were cautiously avoided by Chinese policy makers and bankers on official occasions.⁹² The four major SOBs were called “specialized banks”, which emphasized their original role as fund providers for particular industrial or economic sectors, although their businesses were significantly expanded and diversified during the decentralization era. The newly established national banks were called “comprehensive banks” rather than “commercial banks”. The choice of words reflected central policy makers’ hesitancy to free banks from their macroeconomic and developmental functions and let them be fully oriented by commercial incentives.

As interviewees revealed, even after policy banks were established, the specialized banks still had to carry out certain government entrusted tasks, e.g., making “command plan” loans such as fixed asset investment loans, and even “stability and unity” loans to large SOEs. On the other hand, the banks were restrained by state plans over total loan quotas. These quotas were fixed for each season in line with the state’s overall macroeconomic objectives and banks had little freedom to modify these artificially determined plans according to actual microeconomic and financial situations relevant to the banks themselves.⁹³

These legacies of the planning system imposed upon the SOBs many non-commercial responsibilities. And as described before, when local administrative authorities called upon the SOBs within their

⁹² Interviewee 3.

⁹³ Interviewee 3; interviewee 4. Also see Shen Rui (1996) and Yuan Zhenxing (1996) on state-owned commercial banks and their policy loan obligations.

jurisdictions to perform these functions, the result was often contradictory to what the central government hoped to achieve: Instead of stabilizing the macroeconomic environment, banks were sometimes disturbing economic order through improper expansion of credit. And rather than helping the state advance its developmental goals, locally oriented activities tended to perpetuate the reliance of economically inefficient SOEs upon the state banks for welfare and assistance, resulting in cumulating non-performing loans for the banks, especially the four specialized banks, where more than 90% of the total non-performing loans were concentrated.⁹⁴

To redress these problems, the central government decided that its own expectations of the SOBs needed to be adjusted, i.e., SOBs should be profit-maximizers, rather than macroeconomic stabilizers, welfare providers or industrial policy promoters. Ironically, only by liberalizing the commercial banking sector and disentangling the banking system from the government can the central state have more effective macro control of the financial and the real sectors. To this end, the central government has taken a series of measures of banking deregulation and liberalization since the mid 1990s.

Law on Commercial Banks

The first step in formally deregulating banks was the new legislation. In 1995, the Law on Commercial Banks was passed by the National People's Congress. The law acknowledges that the specialized banks as well as the newly established banks engaging in commercial banking business are "commercial banks". The specialized banks, for example,

⁹⁴ State System Reform Institute (1998): 186.

were now called “commercial banks solely owned by the state”. Commercial banks were granted the legal person status as enterprises vis-à-vis as state institutions in the cases of policy banks and the central bank. And as enterprises, commercial banks were expected to “independently manage their businesses, shoulder their own risks, be responsible for their own profits and losses and follow the principle of self-restraint in conducting commercial activities.” Although these provisions only spelled out the basics of a standard commercial banking system, the law was nonetheless regarded as a cornerstone in China’s bank deregulation process. Before the Law on Commercial Banks were made and enforced, state banks had many “fathers and mothers in law” – government interference in banking business was constant. With the new law, at least legally the banks’ independent status is guaranteed.⁹⁵

Reform of the Credit and Loan System

To free the commercial banks from the planning system, the central government also decided to change the practice of credit and loan management. Previously, the PBC would impose credit and loan quotas upon commercial banks according to the “comprehensive credit and loan plan” of the PBC. Commercial banks were not allowed to make loans beyond the planned volume, unless the PBC reexamined and modified the original plan. Such artificial restraint placed upon commercial banks not only made it difficult for the banks to mobilize funds efficiently, but also had little effect in actually disciplining the banks’ credit and loan activities. With bank activities integrated into the

⁹⁵ Interviewee 4. Also see the PBC’s studies on the Law on Commercial Banks and its implications for the commercial banking system. Lijuan Wang (1995), Zheyi Hu (1995a, 1995b).

state plan, the demarcation between banks and state finance remained blurred, which tended to perpetuate banks' reliance upon the state and give rise to irresponsible lending behavior.

Again, the central government found that to make the banks exercise self-restraint over their lending activities, it was necessary to relieve them from the artificial restraint currently in place. Starting from 1998, the PBC removed the control over bank loan quotas. Commercial banks were now allowed to determine their loan volumes according to their companies' financial situations, as long as they maintained the required level of bank reserves and repaid the loans made from the PBC. This does not mean, however, that the banks could lend without constraint. As the asset-liability ratio system by then had been introduced into bank management,⁹⁶ banks were now expected to optimize their asset to liability ratios and plan their credit and loan activities accordingly.

Making SOBs "Competitive"

Whereas new rules and practices were adopted to make commercial banks independent legal entities, the SOBs still carried many burdens of the past. The most serious problem was the one of non-performing loans. According to Chinese official sources by 1994 bad debts of Chinese banks totaled RMB 1 billion yuan.⁹⁷ By the end of 1995, classified loans, namely, past due loans, doubtful loans and bad debt

⁹⁶ Asset to Liability Ratio Management was experimented among newly established national banks such as the Bank of Communications as well as urban credit cooperatives in the late 1980s and 1990s. However, the practice was not introduced to the four state-owned specialized banks until 1994.

⁹⁷ *China Daily*, January 9, 1995: 4..

mounted up to nearly one fourth of the four major SOBs' total loans.⁹⁸ The banks' total liabilities exceeded their total assets, rendering the banking system virtually insolvent. Since 1998, the Chinese government has attempted a series of measures of bank recapitalization, such as setting up asset management companies (AMCs) to take over and manage the non-performing loans of the SOBs, directly injecting capital into bank assets as well as debt write-offs. All these efforts were intended to get the SOBs back on their feet and improve their competitiveness under the reformed and liberalizing financial system. Even with these measures, however, the bad loan problem remains daunting. In 2002, banks' total "lost loans" amounted to 1.267 trillion yuan, whereas total net assets of the four major banks were only 592 billion yuan.⁹⁹

Scholars have pointed out the crux of the problem lies in public ownership, which entails ownership issues for both state-owned financial institutions and state-owned enterprises – major customers of the state banks. This view argues that most of the existing problems in the financial sphere today such as the commercial banks' bending the rules and playing games with the central bank, and the lingering SOE debt problem could all be ultimately attributed to the simplistic division of state-ownership in the reform era. Decentralization and reform only increased the number of parties representing public ownership, with each party, be it a local government, a state-owned enterprise, or a bank, attempting to claim the whole pie. In order for all the efforts taken so far

⁹⁸ *Jinrong Shibao*: April 21, 1996: 5.

⁹⁹ Li Hua, *China Economics Times*, December 19, 2003.

to demarcate the boundaries between the government and banking institutions to be truly effective, the ownership structure of both the SOBs and SOEs should be reformed.¹⁰⁰ Although there has been an ongoing scholarly debate as to how the “stockization” (i.e., share-issue privatization) of SOBs should be operationalized, the central government has recently announced the timetable for the four SOBs to “go public”: between 2004 and 2007, the four SOBs should complete their initial public offerings in a sequence, starting with the China Construction Bank, and ending with the Agricultural Bank of China.¹⁰¹ Again, with a “letting go” strategy, the central government actually expects to achieve more effective macro control over the financial system.

The Logic of Banking Reform

Similar to the case of Foreign Trade, banking reform in China experienced two major stages: administrative decentralization and market-oriented liberalization. This chapter has attempted to look into domestic structure changes resulting from decentralized decentralization for a possible explanation for the logic of banking reform, especially the rationale behind the shift from decentralization to liberalization. Specifically, under the decentralized financial system, the central state’s policy enforcement capabilities were eroded as local governments at the provincial and sub-provincial levels, having administrative power over both the local branches of the state’s credit

¹⁰⁰ See Zhang Jie (1995), Zheng Jiangang (1997) on ownership structure reform of SOBs and adjustment of SOB-SOE relations.

¹⁰¹ *Caijing Shibao*, January 12, 2004.

planning body (PBC) and credit issuing organizations (commercial banks), oriented them towards serving local economic goals. Such institutional dynamics in turn had an unwanted effect upon the country's macroeconomic situations, pushing decentralization strategy to a dead end. To get out of the quagmire and regain macro control capabilities, the central government found it necessary to deregulate and liberalize the banking system so as to separate the banking system from the government. With this shift of strategy, the expected role of banking has also changed in the eyes and conceptions of Chinese policy makers, i.e., from one of development promoter to one means among others to raise and mobilize funds in a marketized economy.

Compared with foreign trade reform, the Chinese government has been very cautious with the reform and liberalization of the banking system. Resistance to change has also been stronger in the banking sector than in the foreign trade sector. Accordingly, reform progress in the banking and finance has been relatively slow. This in the first place has to do with the complexity of the task and the special position of banking and finance in the Chinese economy during the reform era: While the "real economic sector" has largely benefited from the reform initiatives and enjoyed exponential growth as a result, the banking sector has been the one to bear the "cost of reform". When the major engine of growth changed from traditional heavy industries to export-oriented light and processing industries, for example, many state-owned enterprises were on the verge of bankruptcy and layoffs became inevitable. The banks, for a long time, had to shoulder some of the social burdens resulting from such industry reformation and

restructuring. When the government finally decided that benefits of making the banks truly commercial outweighed those of keeping them as social welfare providers, the steps of change were also designed cautiously and implemented gradually to minimize social repercussions.

Another reason for the gradual and particularly painstaking nature of the banking reform as compared with foreign trade reform has to do with the pattern of initial decentralization and its ensuing dynamics. In foreign trade reform, decentralization was undertaken on a regional particularistic basis and accompanied by an increasing number of “windows of opening to the outside world”. State monopoly on foreign trade was broken as numerous FTCs and export-oriented enterprises of a variety of ownerships engaged in foreign trade. The regional dynamics played out during the decentralization process created a bandwagon effect among the numerous foreign trade enterprises as well as their local governmental sponsors to push for greater foreign trade privileges and for enlarged windows of “opening up” opportunities, which coincided with the state’s determined efforts to marketize and liberalize the foreign trade sector.

In the banking reform, however, initial decentralization was carried out without much regional differentiation and in a largely closed environment. Although SEZs enjoyed certain privileges with regard to interest rate, and the forms of financial institutions they were allowed to set up, in the banking sector there was no systematic arrangement based on regions like the foreign exchange retention system in the foreign trade area. Moreover, although financial authority was

decentralized to the provincial and sub-provincial levels, state monopoly over commercial banking remained intact, with the four state-owned specialized banks mustering the dominant market power. The result of such institutional characteristics was that the bandwagon effect for change was largely absent, as banking institutions and local governments at various levels were mostly content with taking advantage of the existing system. The banking system as a whole, therefore, displayed substantial inertia and resistance to change.

Overall, the reform experience of the banking sector again demonstrates that the institutional effects of administrative decentralization on the Chinese state's internal structure provided the motivation for the central state to adopt market-conforming reforms. The chapter has sought to delineate a political logic of economic liberalization from the interactions between the central state, provincial governments and the market. The central government's decisive move to liberalize the banking system suggests that the Chinese state was capable of moving beyond the political equilibrium of partial reform. What guided this move, however, was not the economic law that was driving the economy towards its market equilibrium as some author suggests. Rather, it was the urge to regain autonomy and control that drove the central government to liberalize the sector.

CHAPTER FOUR

THE REPACKAGED IDEOLOGY

The previous two chapters attempt to explain the logic of China's economic reform by looking at the changes of the country's domestic structure under administrative decentralization and their impact on state strategy. In many economic areas, the Chinese reform experienced a shift from decentralized planning to market-oriented liberalization.

Apparently, the Chinese state, by allowing economic liberalization to happen, has been loosening its grip of the country's economic activities – a sign that usually indicates a state's retreat in the face of international market forces as neoliberal economists would argue. But as the cases of foreign trade reform and banking reform suggest, the liberalization drive was indeed initiated by the Chinese state and was intended to help the state reassert its policy autonomy and thereby acquire the ability to effectively regulate the economy and control the course of economic development.

The question remains: How did the Chinese state manage to enforce its liberalization strategy in the first place, given its weakened authority due to administrative decentralization?

As the previous chapters have mentioned, the regional particularistic decentralization in certain sectors such as the foreign trade sector created inter-regional competition and a bandwagon effect for further opening up, which could partially explain why the central government could rally support for its liberalization measures in such

sectors.¹ However, in other sectors such as finance and telecommunications, where decentralization was carried out with less regional differentiation, vested interest tended to stick to the status quo.²

It is true that China's decision to pursue GATT/WTO membership was made in a relatively centralized fashion and GATT/WTO issues were defined as foreign policy issues, thereby bypassing most of the industrial ministries as well as provincial governments.³ However, related to China's GATT/WTO accession talks were eight years of domestic restructuring in both real and financial sectors. While the trade negotiations were off-again on-again, largely depending on the international situations China was caught in,⁴ domestic reforms were pushed forward without interruption throughout those years in order to "meet WTO standard".⁵

What mattered, in fact, was not whether a move on the part of the government was sanctioned by particular interest groups, given the centralized decision making process in China. Rather, the question was how the central government was able to gather enough consensus as to

¹ See also David Zweig (2002) and Dali Yang (1997).

² See, for example, Mueller and Lovelock (2000), Chen Xiaohong (2000) on telecom reform; Mehran and Quntyn (1996), Lardy(1998), On Kit Tam (1995) on financial reform.

³ See Susan Shirk (1994): 73. Susan Shirk was describing the situations related to China's GATT negotiations in early years. My interviews with MOFTEC ministries confirmed her observation: When China finally bid for WTO membership, the talks continued to be dominated by a few key government agencies. In later years more industrial ministerial leaders were included into the discussion. But the whole negotiation process was still dominated and coordinated by MOFTEC under the direct leadership of the State Council.

⁴ For example, the bombing of Chinese embassy in former Yugoslavia led to a suspension of the WTO bilateral talks between China and the US.

⁵ See Magarinos et al ed. (2002), Jiang Zhuyan (1999), Qian Xiaoan (2000) for the costs of entry and domestic adjustments China had to make.

keep its liberalization efforts legitimate and welcomed in the wider society despite resistance or opposition from certain groups or factions. As Wei-wei Zhang points out, the Chinese economic reform process was characterized by ideological controversy. Differences in opinions, derived from different ideological orientations, could affect the pace, scope, content and nature of economic reforms.⁶ Seeking policy legitimation and building ideological consensus, therefore, was vital to effective policy enforcement.

An interesting phenomenon to note is that generally speaking, the Chinese society demonstrated great enthusiasm over the issue of China's WTO accession during the 1990s. The media painted a rosy prospect of the post-WTO life: ordinary citizens would benefit from lowered prices of consumer goods and services ranging from automobiles and designer clothing to telecommunication services. Mainstream economists championed the merits of globalization and trade liberalization, propagating concepts such as "efficient allocation of resources", "comparative advantage", "trickle down effect" whereas government officials openly proclaimed that globalization was an irreversible trend and that China should embrace this trend to benefit from international competition.⁷

There were indeed discussions about the challenges looming ahead for national industries and agricultural sectors upon China's WTO accession. "The wolf finally comes" was the eye catching title the media

⁶ Wei-wei Zhang (1996): 1-4.

⁷ See for example, Ren Quan (2000); Fan Gang (1999, 2002), Lin Yifu (2000, 2001), Yang Fan (2000), Liu Haofeng and Liuyu (2000).

used to describe the oncoming international competition.⁸ However, it appeared that the agreed-upon solution was to “dance with the wolf” rather than “fend it off”.⁹

Then was the Chinese society, as it appeared to be, so much influenced by neoliberal/neoclassical doctrines that it was ready to embrace the neoliberal world of free trade, free capital flow and free competition? Apparently, this looks inexplicably true as mainstream public opinion was eulogizing the “market mechanism” and “participation in international division of labor” and stressing the importance of building domestic competitiveness as if China was not a developing country and a transition economy with vulnerable domestic sectors and an ailing social security net, but a loyal supporter and enthusiastic advocate of the “Washington consensus.”

However, a closer look at the reasons given by the media and economists for supporting economic liberalization and China’s WTO entry shows that they subtly differ from the neoliberal rationale. Underlying liberal doctrines is a fundamental belief in the freedom of choice and wealth maximization for individuals.¹⁰ Advocates of economic liberalization in China, however, frequently resorted to concepts such as national interests and overall national strength to justify China’s pursuit of WTO membership.

⁸ This notion about “the wolf” derives from the ancient fable on false alarms. As there were so many ups and downs in China’s GATT/WTO talks, the Chinese people were prepared time and again for the challenges they would need to deal with in post-WTO world and many times they found it was only false alarm as the agreement didn’t come through. Hence the analogy to the wolf’s finally coming as the talks entered into final stages with substantive results coming out.

⁹ See, for example, Wang Bingcai (1998), Liu Debiao (2000), Chen Yuming et al (2000).

¹⁰ On neoliberalism, see David Harvey (2005), Saad-Filho and Deborah Johnston (2005), Noam Chomsky and Robert McChesney (1998).

According to one official analysis of the political and economic consequences of China's joining the WTO, for example, joining the WTO will create a benevolent environment for China's economic development by reducing uncertainty in international trade and by allowing China to participate in formulating the rules and regulations governing international trade. In so doing, the analysis argues, China will be able to push for provisions and proposals that are conducive to the country's economic development rather than passively accepting the rules set and partly manipulated by big powers. Moreover, by joining international competition, China will enhance its "economic standard" and thereby improve its economic performance. Finally, further opening the economy and joining the WTO will help ameliorate the China threat and therefore create a favorable external condition for China's economic development in the next two decades or so.¹¹

The rationale for economic liberalization, therefore, appeared to be more grounded in nationalist considerations than in a commitment to neoliberalism. An exploration of the shift in ideological trends in China during the reform era and the process of liberalization suggests that the Chinese government, in its drive to enforce market-conforming and liberalization-oriented reforms, combined neoliberal rhetorics with economic nationalist objectives to legitimize its liberalization program and facilitate its enforcement.

¹¹ Zou Dongtao, Hua Xiaohong eds. (1999).

Economic Nationalism, Policy Choices, and the Chinese Liberalization Drive

The concept of economic nationalism has often been associated with interventionist policies such as protectionist trade and industrial policies and an autarkic economic system.¹² Recent studies, however, suggest that economic liberalization can be pursued for nationalist reasons. For example, Derek Hall's study of liberalization in Japan shows that liberalization and deregulation in Japan were often motivated by nationalist goals and have to be understood in the context of the reform advocates' perceptions of Japanese national identities. Klaus Müller observes that Germany's adherence to liberal economic policies in the postwar period was rooted in the national pride that endorsed the establishment of a superior economic model for other nations to follow. Eric Helleiner shows that nationalists in Quebec support North America monetary union in an attempt to advance nationalist agenda for Quebec independence.¹³

All these examples show that economic nationalism is not inimical to liberalization policies. The question, however, is how economic nationalism is related to the policy outcome of economic liberalization. Among studies of economic nationalism, one view holds that economic nationalism as a national identity has an autonomous explanatory power in accounting for economic policy choices.¹⁴ Another view treats

¹² See, for example, Robert Gilpin (1987); Mancur Olson "Economic Nationalism and Economic Progress," *World Economy* 10,3(1987); Otto Hieronymi ed. (1980); Peter G Peterson (1984)

¹³ See Derek Hall, Klaus Müller, Eric Helleiner in Eric Helleiner and Andreas Pickel (2005).

¹⁴ See, for example, Rawi Abdelal (2001); Woo-Cumings in Helleiner and Pickel (2005).

economic nationalism as a legitimating tool serving materialist purposes, which should be examined as “a form of domestic political struggle” and defined as “the attempt to link a particular understanding of national identity to certain economic prescriptions, and thus take advantage of the legitimating effects that the concept ‘nation’ brings with it”.¹⁵

Whereas the former approach argues convincingly when a state’s economic behavior diverges from the rationalist expectations, it has less explanatory power in cases where state behavior is in line with the rationalist logic. As for the latter view, the problem, as I see it, is that by treating economic nationalism/national identity as a political tool whose content is determined by the materialist interests of state or social actors that promote such an identity, this view leaves national identity so much contested and so instantly constructible that the concept of the nation itself becomes hollow and ahistorical. What is the point, after all, for state actors or social groups to appeal to the notion of “nation” for legitimation of their policy preferences if there is no relatively stable and historically constructed national identity to talk about in the first place?

This chapter does not intend to explore any direct causal effect between economic nationalism and the policy choice of economic liberalization in China. Rather, it explores how economic nationalism assisted the central state in enforcing this policy option.

Economic nationalism as discussed in this study has two analytical attributes. First, I define economic nationalism in terms of purpose or

¹⁵ Maya Eichler in Hellener and Pickel (2005).

objective. Arguments that associate economic nationalism with protectionism and mercantilism tend to understand economic nationalism as the ideological advocate of specific policy orientations and prescriptions. Yet evidence about nationalism-guided liberalization as mentioned above suggests that nationalist pursuit can be served by adopting liberal economic policies. Secondly, economic nationalism denotes societal objectives rather than state policy goals. As Abdelal observes, nationalism differs from statism in that it is an expression of a societal identity rather than one of an autonomous state.¹⁶ In this sense, economic nationalism can be understood as an expression of a common objective or purpose of the nation shaped and informed by historical memory and experience. It is therefore not the ideological representation of any specific economic approaches, but the social consensus of orienting economic activities towards enhancing national strength.

In the case of China, the central state decided to liberalize the economy in an attempt to reassert state authority and control. To legitimize and facilitate this move, the central government tweaked neoliberal economic principles to be in line with a nationalist economic goal. At the state level, the story is largely rationalist. The central government invoked economic nationalism to serve its practical end. However, my argument is not entirely one about ideology serving materialist purposes, as the content of such an ideology was not supplied by the specific context of political struggles over competing

¹⁶ Rawi Abdelal (2001): 20.

policy preferences¹⁷, but was grounded in the historically constructed national identity. Economic nationalism as an expression of a societal objective is not single-handedly created and manipulated by participants of domestic political struggles driven by materialist motives. Rather, it is historically informed and collectively shared by members of the society.

As I will describe in this chapter, during the reform era the Chinese government has constantly appealed to economic nationalism to rally support for reformist policies. As party conservatives resisted reform initiative on the ground of ideological orthodoxies of socialism, the reformist government positioned market as a neutral and effective tool to promote economic growth, thereby appealing to the nationalist aspiration for national glory. Such an ideological repositioning gave the concept of “market” a positive connotation. Subsequently, the Chinese government presented the liberalization program as an extension of the planning vs. market debate and combined the rhetorical power of neoliberal economic doctrines and a nationalist end goal to justify its liberalization move. In pushing for both the plan-to-market transition and economic liberalization, the Chinese government, in an attempt to rally popular support for its policy initiatives, chose to adjust the official socialist ideology and the neoliberal discourses against the value system of economic nationalism. In this sense, economic nationalism, therefore, was not the ideological discourse that the Chinese state employed to manipulate public opinion, but the social criteria against which expedient ideological discourses were to be repackaged.

¹⁷ See Maya Eichler in Helleiner and Pickel (2005): 72-74.

In the following sections, I will first examine the historical origins of modern Chinese nationalism and explore how economic nationalism became the societal basis for policy legitimacy in the reform era. Then I will describe how the Chinese government backed the neoliberal discourses with a nationalist end goal so as to build the popular basis for its liberalization strategy. This process entails two stages. During the first stage the Chinese government repositioned the official socialist ideology along the economic nationalist line to legitimize the plan to market transition. In the second stage the Chinese government positioned its liberalization program as a natural extension of the plan-to-market transition by exploiting the rhetorical compatibility between economic nationalism and neoliberal discourses.

My investigation of the origins and attributes of modern Chinese nationalism is based on a review and analysis of existing literature in this regard. And I make the proposition about the economic nationalist foundation of China's liberalization drive on the basis of a review and assessment of scholarly comments and media information. A more rigorous research strategy would require textual analyses of primary material on both the official and societal aspects of ideological orientations during the reform era in order to provide adequate and solid evidence for the argument, which is lacking in this preliminary study. Further study should seek to provide evidence for the proposed argument.

Nationalism, Modernization and China's Economic Reform

Chinese Nationalism Revisited

There are various interpretations of Chinese nationalism, its origins and its content.¹⁸ But as several China scholars have noted, Chinese nationalism was initially a cultural or civilizational identity.¹⁹ Chang observes that in imperial China, foreigners invaded China only to be absorbed and assimilated by the Chinese culture.²⁰ The distinction between the Chinese and the foreign was not so much racial-ethnic as it was cultural-civilizational. Conquerors like the Manchus had to adopt the Confucian state ideology and a whole set of Chinese bureaucratic and cultural practices to be able to govern the empire's vast territories. This sense of cultural supremacy and superiority, however, was shattered when the Europeans arrived in the 19th century as the Chinese found that these Westerners could "be neither pacified, deflected nor assimilated". "They were not only equipped with powerful armaments produced by modern industry, but were also convinced of their superiority in culture, morality and civilization."²¹ To the Chinese,

¹⁸ On cultural or civilizational origins of Chinese nationalism, see James Townsend in Unger ed. (1996), Maria Hsia Chang (2001: 33-50), Arthur Waldron in Harumi Befu(1993: 36-60); on state nationalism or developmental nationalism, see John Fitzgerald in Unger, ed. (1996), Maria Hsia Chang (2001: 107-140); on various formulations about Chinese nationalism in post-Mao era such as patriotic nationalism, assertive nationalism or confidence nationalism, see Maria Hsia Chang (2001: 175-204), Yongnian Zheng (1999:87-109) Allen Whiting(1983: 913-933), Michel Oksenberg (1986-87: 501-523), on new nationalism of the 1990s, see Peter Hays Gries (2004:); on ethnic nationalism, see Dru C. Gladney in Dru C.Gladney ed. (1998:106-131), Emily Honig (1992); on the relations between economic openness and nationalism, see Wang Gungwu in Unger ed.(1996), Lucian Pye in Unger ed.(1996), George T. Crane in Unger ed. (1996); Also see Yongnian Zheng (1999), Dittmer and Kim (1993), Lung-Ke Sun (2002) on the formation of Chinese national identity. For Chinese scholars studies on Chinese nationalism, see, for example, Yu Zuhua (2001), Wang Xiaoming (2002), Zhao Jun (1996).

¹⁹ See Maria Hsia Chang (2001) and Lucian Pye, James Townsend in Unger ed (1996).

²⁰ Maria Hsia Chang, op.cit : 57

²¹ *ibid*: 58.

therefore, the period of Western domination and conquest between the 1840s and the 1990s was “a century of humiliation” not only because the Chinese territories were lost to and divided among Western imperial powers but also because the Sinic culture was marginalized and the sinocentric world order was toppled. Meanwhile, as many scholars observe, the building of the modern Chinese nation was closely related to the process of the old Chinese empire being assimilated into the system of modern nation-states.²² Partly due to this simultaneity of state-building and nation-building processes, Chinese nationalism generally carried the following distinct characteristics.

First of all, modern Chinese nationalism tends to regard state-building as its major objective. As Vivienne Shue observes, state legitimacy in China’s imperial era mainly hinged upon three key factors, i.e., “Truth”, “Benevolence” and “Glory”, each representing a set of norms and doctrines to maintain social harmony and stability as well as the Sinic world order.²³ Although the Qing government arduously pursued policies in accordance with the principles of Truth and Benevolence, the sheer military and technological backwardness vis-à-vis the Westerners rendered the world order centered on Chinese cultural superiority impossible to sustain.²⁴ Shue further observes that as a consequence the legitimating ideal of national “glory” traditionally understood in terms of civilized behavior and cultural florescence was redefined in the more vulgarly material terms of “wealth

²² See, for example, Yongnian Zheng (1999):22-29.

²³ Vivienne Shue in Gries and Rosen (2004: 30-32)

²⁴ *ibid*: 32-33.

and power”.²⁵ The loss of civilizational glory and cultural superiority itself, however, was a major blow to the Chinese sharing a common cultural identity. And an immediate source to blame was the incompetence of the imperial state. From reformers like Kang Youwei and Liang Qichao to revolutionaries such as Sun Yat-Sen all sought to strengthen or rebuild the Chinese state in one way or another. Even though Sun Yat-Sen’s nationalist proposal of “driving away the barbarians and restoring China”²⁶ appeared to be a strong expression of ethnic nationalism, his main concern, as observed by John Fitzgerald, however, was his fear of the “death of the state”. By launching a revolution against the incompetent Manchurian rulers and replacing the imperial system with a republic polity, Sun saw a path leading the Chinese out of the crisis to avoid becoming “slaves who had lost their states” and avert the fate of “the destruction of the race”. Sun even equated his own principle of nationalism to the doctrine of the state.²⁷ Following Sun Yat-Sen, almost all the revolutionary groups saw it their mission to build a strong and competent state and to do so, they employed various doctrines and tools, some even resorting to Leninism which was antipathetic to nationalism.²⁸ It can be argued, therefore, that although modern Chinese nationalism rose in the course of the Chinese empire’s clashes with the European states that more than ever sharpened the sense of “we-ness” versus “they-ness”, the focus of

²⁵ Ibid: 32-33.

²⁶ The barbarians here refer to Manchurian rulers of the Qing Dynasty.

²⁷ John Fitzgerald in Unger (1996: 68-69).

²⁸ It is in this sense that Mao and the communists were often regarded as nationalists in their hearts as although the ideology they upheld championed fraternalism between different nations, they never abandoned the idea of a distinctively Chinese nation when they set out to create their own state. (Fitzgerald, op.cit: 72).

Chinese nationalism after the fall of the Manchus appeared to be on building “internal competence”. To this end, Chinese nationalists like Sun Yat-Sen naturally and willingly regarded the advancement of state interests as a priority on the nationalist agenda as to them state interests were hardly separable from national interests.²⁹

Related to this, the aspiration to restore past glory is another characteristic of modern Chinese nationalism. Wang Gungwu calls this restoration nationalism. According to Wang, whereas there are generally two terms for types of post-independence nationalisms, “preservation and “renewal”, one distinct feature of Chinese nationalism is that it combines elements of both preservation and renewal but ties in the faith in a glorious past more directly with a vision of a great future. ³⁰ This “urge to link future with a more admired past” not only motivated the Chinese nationalists to pursue recovery of sovereignty, unification of divided territory and national self-respect³¹, but also led them to seek cultural rejuvenation and restoration of Sinic world order.³²

The implications of such nationalist priorities were twofold. One was that the Chinese nationalists tend to be utilitarian in pursuing “wealth and power” for the nation. In their efforts to modernize and strengthen China, nationalists were searching for every possible means – ranging from the May 4th Movement’s advocacy of Mr. Science and Mr. Democracy to the call for restoring Confucianist ideals in the New Life Movement, from proposing total Westernization to introducing the

²⁹ Maria Hsia Chang (2001): 110-112.

³⁰ Wang Gungwu(1996):7.

³¹ See Maria Hsia Chang (2001: 9)

³² See Tu Wei-ming (1991), Wang Gungwu (1996), Chang Pao-min in Suryadinata (2000) for discussions about nationalism and a Sinic world order.

Soviet model.³³ In other words, these efforts were “nationalist” by nature not because they stressed a distinct identity based on “the realities of the living Chinese mass culture”³⁴, but because their ultimate purpose was to revive past glory by making China stronger and wealthier through modernization. Just as Sun Yat-sen stated, “To drive out the bandit remnants and reconstruct China in order to restore the order of the Ancients and follow the ways of the West, and thus cause myriads of people to be revived and all things to flourish, this is a task that fulfils Heaven’s way and meets the wishes of Man.”³⁵ In Sun’s account, the revival of the people and restoration of the ancient order were to be pursued by following the ways of the West. Again, the nationalist goal was stressed here but the means could be un-Chinese.

The second implication of an obsession with restoring past glory was the existence of a globalist element in Chinese nationalism. According to Chang Pao-min, the traditional Chinese perception of the world was based upon the all-encompassing concept of *tian xia*.³⁶ The Chinese empire as the center of civilization was inclusive of all nations and races that were willing to be associated with and socialized into Chinese culture and way of life. Modern Chinese nationalism with its emphasis on a clearly defined and delineated territorial state distinct from all other states emerged only in the second half of the nineteenth century. However, the idea of globalism was inherent in the Chinese brand of

³³ See Wang Gungwu (1996) and Chang (2001) for descriptions of nationalists efforts in the first half of the 20th century.

³⁴ Lucian W. Pye, op. cit.: 93.

³⁵ Sun Yat-sen’s letter to Herbert A. Giles in 1896, quoted by Wang Gungwu (1996).

³⁶ Meaning, under heaven, the world.

nationalism, which led modern China to aspire for a global role for itself and strive to regain its cherished status at the center of civilization.³⁷

Economic Nationalism and the Policy of Reform and Opening to the Outside World

As China struggled out of the Cultural Revolution in the 1970s, there was widespread disillusionment with the communist ideals in the Chinese society. Although the communist revolution led by Mao was sometimes described as a nationalist movement,³⁸ an undeniable fact was that the communist party managed to achieve its leadership position in the Chinese revolution and consolidated its rule after the founding of the People's Republic by appealing to a foreign ideology. In defeating other versions of Chinese nationalism to establish its authority and orthodoxy in China, the Chinese communist party adopted a selective but essentially hostile approach in treating Chinese traditional culture. According to Lucian Pye, the communist party turned the traditional Chinese formula of Ti (Essence) – Yong (Instruments) inside out. The traditional formula regarded Chinese value as Ti and Western technology as Yong. The communist party, however, regarded the Marxism-Leninism-Mao Zedong Thought as the essence and some useful elements of the traditional culture (other than those bashed and attacked as “feudal legacies”) as the instruments.³⁹ The result was that a rigid orthodoxy became the core and this core was

³⁷ Chang Pao-min in Leo Suryadinata (2000): 276-293. According to Chang Pao-min, China's aspiration for a global role is based on cultural and moral pursuit rather than expansionist ambitions. The term “globalism” (rather than “imperialism”) is used here, which denotes integration rather than domination and cultural and moral influence rather than territorial expansion.

³⁸ See Wang Gungwu in Jonathan Unger (1996).

³⁹ Lucian W. Pye in Jonathan Unger (1996):103-107.

“only the partisan position of a party and hence there was not even a pretence that it could be the basis of a nationalism that was more than just the slogans of a partisan movement.”⁴⁰ Therefore, the communist party was, on the one hand, claiming that it was the only competent force to “save China” and to defend the nation against foreign aggression and bullying. On the other hand, its core ideology downplayed or even excluded traditional Chinese values rather than preserving them.

By the end of the 1970s, however, the communist ideal was largely shattered as the country emerged from the turmoil and calamities of the Cultural Revolution.⁴¹ Externally, China had departed from the communist camp to seek strategic relationship with the US. The communist movement itself was in decline and the socialist system worldwide was entering into crisis. As Wang Gungwu observes, the world itself had radically changed during the years when Mao had kept the PRC in isolation. By 1979, there was no world revolution to join or to return to.⁴²

In a world of relative capitalist success, the communist party led by Deng Xiaoping found a way to reestablish the party’s credibility and its popular basis for support by shifting away from the obsession with political orthodoxies and class struggles to focus on achieving the Four Modernizations.⁴³ As Deng Xiaoping pointed out in 1978 and 1984, the

⁴⁰ Ibid: 105.

⁴¹ See Alan R. Kluver (1996) for a detailed analysis of the legitimacy crisis the communist party state faced in the late 1970s. Also see “Communique of the Third Plenum of the Eleventh Central Committee of the CPC” *Peking Review* vol 21, no 52 (December 1978) for an official assessment of the economic and social problems the country was facing in the aftermath of the Cultural Revolution.

⁴² Wang Gungwu, op.cit: 114-121.

⁴³ The concept of Four Modernizations (modernizations of industry, agriculture, defense, and science and technology) was first put forth by Zhou Enlai in 1965.

major contradiction in contemporary China lay in the gap between low productivity and people's increased demands for consumer goods rather than in class struggle; in the end, if socialism could not achieve higher productivity than capitalism, the party would not be able to convince people of socialism's superiority over capitalism. Political primacy, therefore, should be given to modernization and economic development.⁴⁴

This new emphasis on economic development not only aligned with the Chinese society's general sentiment for striving for a more normal and wealthy life after a decade of political turmoil and sheer economic scarcity, but also appealed to the long-cherished goal of pursuing national revival among the Chinese people. As Wang Gungwu argues, contrary to the conventional interpretation of history, the 1911 Revolution and the 1949 Revolution should be treated as two parts of the same revolution that had originated in the 1890s when Sun Yat-sen and his supporters began their quest for restoring China to greatness through radical changes. The communist party, with an "alien" Soviet ideology, was able to establish itself as the revolutionary leader by playing down its revolutionary ideals to be inside the Chinese revolution and by including the majority of the Chinese people into its revolutionary drive. However, after the founding of the People's Republic and especially after 1956-1957 when Mao launched the anti-rightist movement against intellectuals, the revolution that had started to be inclusive was becoming more and more exclusive as the majority of the Chinese people became objects of ideological education and

⁴⁴ Deng Xiaoping (1993a):182; (1993b):141.

indoctrination rather than active participants of the nationalist pursuit.⁴⁵

By shifting the focus from “political movements” to “economic construction”, Deng Xiaoping and the reformist government were able to bring government policy orientation in line with the traditional nationalist aspirations. The new modernization drive re-included previously alienated social groups, especially the “intellectuals” and harnessed social energy for a new round of nation and state building through pursuing development. As Fang Ning et al observe, the official denouncement of the “Cultural Revolution” and the pronouncement of the “four modernizations” as a national goal helped replace the “sentiment of disillusionment” with a new sense of mission and responsibility for “revitalizing China”.⁴⁶ The implications of the government’s overriding policy focus on economic development, therefore, went beyond the provision of economic welfare. And the drive for economic growth was much more than a simple craving for material benefits. Economic performance was not merely employed to fill an “ideological vacuum”.⁴⁷ Rather, the new policy orientation enjoyed solid social support as it provided a new and promising path towards restoring national glory that the revolutions of the early half of the 20th century set out to pursue.

This new emphasis on “economic construction” resonated well with the general sentiment in post-Cultural Revolution Chinese society. The

⁴⁵ Wang Gungwu in Unger (1996): 112-119.

⁴⁶ Fang Ning et al (2002): 22-27.

⁴⁷ Feng Chen (1996), for example, treats the Chinese government’s emphasis on economic performance as purely instrumental and as “a means to redeem what ideology failed to achieve”.

policy of reform and opening to the outside world, articulated at the Third Plenum of the Eleventh Party's Congress in 1978, won widespread popular support.⁴⁸ Since then, giving economic construction the "central priority" became the "basic national policy" in the post-Mao era.

Neoliberal Developmentalism: The Nationalist Pursuit of Economic Liberalization

As argued above, the government's new policy line won popular support by appealing to the shared aspiration of the Chinese nation. This does not mean, however, that the path was cleared for enforcing the government's reform and opening up strategy. Deng's approach to reform was characterized by pragmatism and a learning-by-doing attitude. By stressing "practice as the sole criterion for testing truth", Deng encouraged reforms experiments on the one hand, and avoided open theoretical confrontations with ideological orthodoxies on the other. "Marxism and Mao Zedong Thought" remained the officially sanctioned ideology and the communist party vowed to adhere to the socialist road.

However, as the gap between economic realities and ideological orthodoxies widened, disputes between reformers and party conservatives were inevitable. More often than not, resistance to reform initiatives surfaced in the form of struggles on the ideological front rather than as open objections to specific economic policies and measures.⁴⁹ Although the economic landscapes have been completely

⁴⁸ See Alan R Kluver (1996:48-49) Wang Gungwu in Unger ed. (1996: 120-121)

⁴⁹ Feng Chen, op.cit: 4-5.

transformed in the past 25 years, almost every major step in the change process involved painstaking political justification and ideological rationalization. On the one hand, the Marxist orthodoxies that the communist party had always upheld were increasingly challenged by the changing economic realities. Reformers found themselves in constant need to reinterpret the Marxist doctrines to quell voices of suspicion and dissent from “political hardliners” within the communist party. On the other hand, as reforms were rolled out, those whose interests were touched often resorted to Marxist orthodoxies to question and resist changes. Disputes and confrontations on the ideological front, therefore, were more than theoretical debates as they involved tensions, conflicts and negotiations of political interests in the reform era.⁵⁰ Ironically, when it comes to the enforcement of the liberalization program, it was the early round of ideological realignment that provided the basis and momentum for policy justification.

As described in the previous chapters, the transition from planned economy to market economy entailed two major stages, i.e., administrative decentralization and market conforming liberalization. Indeed, the latter stage involved two different but interrelated processes – marketization and liberalization. China did not open its market as a fully developed capitalist economy. Rather, the country was experiencing the process of post socialist transition and the one of economic liberalization almost simultaneously. “Marketization” entailed the establishment of a market system as the country converted its planned economic system into a market-oriented one. “Liberalization”,

⁵⁰ Wei-wei Zhang (1996): 134-152.

on the other hand, primarily concerned the choice of economic models under a market system. In theory, these two processes required different policy justifications. As economist Wu Jinglian notes, the most critical task of marketization was the establishment of the price mechanism whereby price was to be determined by supply and demand rather than by plans and targets.⁵¹ The major obstacle to such a shift, however, stemmed from the Marxist-Leninism orthodoxies that regarded economic planning as a defining characteristic of socialism and “market mechanism” as an attribute of capitalism. Liberalization, on the other hand, was a policy issue faced by market economies worldwide and the choice here was largely between economic efficiency and social equity.

To induce and legitimize the marketization move, Deng Xiaoping positioned “market mechanism” as a neutral economic method that could be applied to both the socialist and the capitalist systems. By invoking the “criterion of productive forces” to judge whether a reform measure or approach is conducive to the development of socialism or not, Deng appealed to the economic nationalist logic of seeking economic growth by whatever means available and effective. In this way, “market”, although portrayed as “a neutral economic tool”, acquired positive connotations as the nation favored development and progress over orthodoxies and dogmas.

The popular preference of “market” over “plan” aided the policy justification process of the liberalization drive, although in this latter case, the crux of the problem was not between plan and market but

⁵¹ Wu Jinglian (1992): 6-10.

between a free market approach and a more protectionist and welfare-based approach. In enforcing the liberalization measures and pushing for the country's WTO accession, the Chinese government extended the logic of the previous round of policy justification to the current round, positioning economic liberalization as an effective means to achieve economic growth. Given the nationwide enthusiasm towards building a market economic system, the audience were receptive to the neoliberal economic argument that carried an overriding emphasis on market and treated economic liberalization as a necessary step in the transition from the planned economy to the market economy. The rhetorical power of the neoliberal discourses, however, was grounded in the nationalist aspiration for a powerful comeback onto the "world stage" rather than in a commitment to liberal principles such as freedom of choice and wealth maximization for individuals.

Socialism, Capitalism and the Market Economy

Before the mid 1990s, the most disputed theme was the one of socialism vs. capitalism. As to what constitutes socialism, the traditional and "orthodox" view in China focused on three "fundamental characteristics", namely, public ownership, distribution according to work, and proletarian dictatorship.⁵² In the pre-reform era, these three characteristics were embodied in state control over the national economy, egalitarian income distribution system and preeminent status of workers and peasants in the society.

The reform initiatives challenged the status quo on these fronts. As the reforms were carried out on an experimental and particularistic

⁵² Xing Fensi in *Xin Shiye (New Horizon)* (1994).

basis, the new tagline was “let part of the population get rich first”. The egalitarian distribution system was disturbed not only at the individual’s income level where “more work, more remuneration” was replacing “distributional equality”, but also at the regional level as profit-sharing scheme between the center and localities favored certain regions over others.

In the meantime, as the central state loosened its grip on regional economies and introduced certain market elements into the decentralized economy, the old rigid planning system was partially transformed and state monopoly in many economic sectors broken. The effects of such changes were mixed. On the one hand, the new measures, by providing incentives to individuals, enterprises and local governments through profit-sharing, instilled vigor into the economy and geared it towards high growth. On the other hand, the loosening of state control over economic planning, the new and growing market elements, as well as the entry of non-state actors in economic activities were obvious deviations from the orthodox socialist model as perceived by traditional views. Although these phenomena and practices were deliberately introduced by the government under the principle of “feeling for the stones when crossing the river”, they lacked theoretical endorsement. When problems and difficulties arose in the course of decentralization, as described in previous chapters, such “deviations from Marxist principles” often became targets of blame and those opposing the reform measures tended to argue for the reversal of the practices in order to maintain loyalty to the socialist cause.

Such ideological confrontations grew particularly salient when the reform efforts encountered bottlenecks towards the end of the 1980s. As domestic price reforms failed and caused inflation, run on banks and social instability and international environment turned hostile due to the June 4th incident, the policy of reform and opening up was facing mounting pressure. The conservative view attributed the turmoil in the country's economic and political scenes to the revisions that reform initiatives had done to Marxist-Leninist classics: On the political front, this view accused, the opening up policy resulted in the invasion and infiltration of bourgeois thoughts, which in turn undermined the foundation of socialism – the proletarian rule; in the economic sphere, the conservatives pointed fingers at the loosening of the planning authority during decentralization for the chaos and disorder in economic life, although the reforms during this period was hardly market-driven. In fact, as “planned economy” was considered one of the key features of socialism, the Chinese government carefully avoided the word and “market” and instead crafted the phrase “the planned commodity economy” to introduce elements of “prices and markets” in its effort to enforce its economic strategy of “revitalizing the domestic economy and opening to the outside world”.⁵³ Yet maintaining the planning mechanism was generally believed to be essential to adhering to the socialist road. Market, on the other hand, was regarded as a feature of the capitalist system. Accordingly, price and market mechanism that had been introduced by the reform, albeit in a primitive

⁵³ Resolution of the 3rd Plenary Session of the 12th National Congress of the CPC.

form and distorted manner, was suspiciously capitalist in the eyes of communist conservatives.

In late 1989, the country entered a period of “rectifying (economic environment) and straightening out (economic order)”. The bold measures of price reforms that had been tried out since 1988 were suspended and price caps were enforced by administrative orders on consumer necessities and major production materials.⁵⁴ Although these measures helped the central government curb the surging inflation and thereby restore social stability, they also signaled a retreat from the experiment with the “market mechanism”. The entire reform program was on the verge of being rolled back in the name of adhering to the socialist road.⁵⁵

The situation was only reversed when Deng Xiaoping made his Southern Tour Speech in 1992. In this speech, the term “socialist market economy” was formally adopted.⁵⁶ According to Deng, plan and market are both methods of resource allocation and are not defining features of a country’s social system. “Planned economy is not necessarily socialist whereas market economy is not necessarily capitalist. They are both economic method...Whether there is more ‘plan’ or ‘market’ in our economy should be not be our concern. And plan need not dominate the economic scene.”⁵⁷

⁵⁴ State Council “Decision on strengthening management and control over price rises.” October 1989

⁵⁵ Ma Licheng and Ling Zhijun (1998): Chapter 5.

⁵⁶ It was in 1979 that Xiaoping first used the term “socialism market economy” when he met with American and Canadian visitors. Then he was using the term to emphasize the necessity of learning from capitalist countries without changing the socialist nature of the country’s political system.

⁵⁷ Deng Xiaoping, Southern Tour Speech, 1992.

Deng's comments on plan and market de-linked the choice of plan or market with the country's social system and established a new rule for the reform era, i.e., no more questioning on whether a reform measure is socialist or capitalist by nature. His theorizing about plan and market as politically neutral economic methods provided new discourses for pushing the Chinese reform forward in the 1990s.

Before the Southern Tour Speech, the official discourse for economic reform was partially defined and confined by the so called "bird cage theory" advanced by communist veteran Chen Yun. According to Chen, revitalization of the economy should be guided by planning. And "this is analogous to the bird and the cage. One cannot always hold the bird in one's hand and will have to let it fly someday. However, it should only be allowed to fly inside the cage. Without the cage, the bird will fly away and never come back."⁵⁸ This means that "while the market mechanism is employed to revitalize the economy, it should only play its due role as allowed by the plan".⁵⁹ By 1992, reform measures had been carried out largely in consistence with this philosophy. The dual track economic system that was introduced during this period was in a sense a natural but unintended result of this kind of thinking. On the one hand, market was only allowed to play its part in the above-plan portion of the economy. Not only were the sectors and industries where market mechanism was introduced determined by plan, for the same product there was also artificial dichotomy of the "normal price" and "bargained price", with the former set by plan and

⁵⁸ Chen Yun(1995): 320.

⁵⁹ Ibid.

the latter determined by actual supply and demand in the limited market sphere.⁶⁰ On the other hand, the dual track system, by introducing market incentives into a planned system, diverted resources significantly from projects and sectors under state plan. As reforms went on, negative effects of the dual-track system increasingly manifested themselves in the country's economic life, such as the deterioration of the central government's fiscal situation due to heavy subsidy to keep down the "normal price", shortage and inflation due to oversupply of money and surging demand under the distorted price system, as well as corruption arising from the opportunities to make profits by selling across the two price tracks.⁶¹

As efforts to "unify commodity prices" failed and caused consumer panics and run on banks in the late 1980s, pressure was up for abolishing the dual-track system. Without a proper theory to justify a market-conforming approach to economic reforms, however, the conservative forces were quick to blame the market portion of the dual-track system for causing chaos in the country's economic life. As a result, attempts to merge tracks in the late 1980s and the early 1990s resorted to the old planning mechanism. For example, in 1989 and 1991, the central government decided to merge the two price tracks for important production materials such as rubber and cement. The initiative, however, stipulated a fixed price for all factories producing such materials.⁶² The rights to set and adjust prices that enterprises

⁶⁰ Yu Xingfa (1999):36.

⁶¹ Ibid.

⁶² Zhang Gu (1994):23-26. Also see Wu Jinglian (1999).

had just gained recently were revoked. The old practice under the planning system was reinforced.

In retrospect, Chinese economists regard such “merging track” efforts as a setback for the policy of reform and opening up.⁶³ Under the mixed price system of the 1980s, the general tendency was towards loosening control over price regulations and empowering enterprises in setting prices. The merging track measures refocused the government’s efforts on regulation and control by administrative means. The economic reality after a decade of reform, however, was getting too complex for the planned track to handle. Usually, it took around half a year for a decision regarding a price change to be evaluated and made at the central planning level and then passed on through different departments to be finally enforced in the “market”, which was too slow to react to price changes in the international market and increasingly unfeasible as the Chinese economy became more and more internationalized.⁶⁴

At the beginning of the 1990s, therefore, there was the practical need for marketizing the price system. However, as the process of marketization would inevitably involve a whole series of reforms that would challenge the established notion of socialism, such a practical need could not be addressed properly due to political pressure and a more conservative approach was adopted to re-control price and market with central planning in the name of “deepening reform and straightening out economic order”.

⁶³ Zhang Gu. *Op.cit.*

⁶⁴ Lu Nan (1994): 43-46.

Deng's southern tour speech cleared the way for the needed reform by positioning "market" and "plan" purely as economic methods rather than as the defining features of socialism. This new argument became official discourse at the Communist Party's Fourth National Conference in 1992. The Conference formally announced that the objective of economic reform was to set up a socialist market system. For the first time "market" took the place of "planned commodity economy" or "a system where planning is aligned with market" to become the desired foundation for economic activities. Being treated as an economic approach, "market" was no longer a fundamental part of the social system and therefore was able to avoid being the target of attack in future disputes regarding socialism vs. capitalism.

Apparently, there was still a strong association between socialism and market in official discourses as embodied in the term "socialist market system". However, Deng's speech had also, to a great extent, redefined "socialism" itself. According to Deng, the three fundamental objectives of socialism were: 1) liberate and develop productive forces; 2) eliminate exploitation and narrow the difference between the rich and the poor 3) achieve common prosperity. Of these three tasks, however, the first one was the basis for realizing the other two. "Only when the productive forces are liberated through reform can the latter two be realized."⁶⁵ This argument was soon propagated as "the New View on Socialism". In this view, the traditional definition of socialism that regards public ownership, remuneration according to work and proletarian rule as the three pillars of socialism has one critical

⁶⁵ Deng Xiaoping (1993b):373.

drawback, i.e., it overlooked the elements of productive forces and common prosperity.⁶⁶ These two elements should indeed be the fundamental characteristics of socialism whereas the three pillars should be means with which to attain the two fundamental characteristics.⁶⁷ In this way, enhancing productive forces became the first and foremost task of socialism as it was the prerequisite to achieving common prosperity. And when the “means” do not fit the ends, it would be legitimate for policy makers to undertake proper reforms in these areas or even seek alternative means.⁶⁸

When it comes to “market”, therefore, the emphasis was more on market as a competent approach to enhance productive forces rather than on the socialist nature of the market system. Accordingly, although “market” was positioned as a neutral economic tool, it began to have a positive connotation and almost became a symbol for the policy of reform and opening up.

Despite accusations from communist leftists that the overriding focus on economic growth was turning the communist party into “a party of productive forces”, Deng’s new definition of socialism and his endorsement of the market system were well-received by the wider society. It was suddenly a fashion for workers, professionals and even civil servants to engage in moonlighting, usually various sorts of trading activities in commodity markets.⁶⁹ Some bureaucrats even resigned from their posts to “jump into the sea (of business)”. In other cases,

⁶⁶ Xing Fensi in *Xin Shiye* (1994):6.

⁶⁷ Deng Xiaoping. op.cit.

⁶⁸ Xing Fensi. op.cit.

⁶⁹ Pan Gang, “Di San Ci Shang Chao” *Dangyuan Wenzhai* (December, 1992)

government agencies at various levels set up their own “subordinate companies”; many of them spun off to become profit-seeking economic entities.⁷⁰ By June 1992, the total number of companies nationwide increased by more than 20% over the previous year.⁷¹ It appeared that the whole nation demonstrated great enthusiasm and motivation towards the cause of “building the socialist market system” that Deng and the central government decided to pursue. According to Wei-wei Zhang, the business fervor unleashed by the new campaign for building a market economy was less driven by profit-seeking impulses than by renewed support for the policy of reform that the government had initiated more than a decade ago. In the aftermath of the June 4th Incident, the delinkage of market from capitalism and the emphasis on developing productive forces signaled to the Chinese people that the government under the strategic leadership of Deng Xiaoping by no means wanted to roll back the reform program and to restore the political and economic order of the Maoist era.⁷² As Wei-wei Zhang argues, Deng’s talks contributed to a reconciliation between the regime and the society after the Tiananmen Crisis.⁷³ If the social turmoil in the late 1980s in part reflected a surging desire among the Chinese people to pursue the May 4th spirit of political freedom,⁷⁴ the post-1989 Chinese society gained a more realistic assessment of the need for the country’s stability and refocused energy on the other goal of the May 4th Movement, i.e., economic modernization. Previous dissatisfaction with

⁷⁰ See Yin Jiqing (1998) and Margaret Pearson (1997).

⁷¹ Pan Gang, op.cit.

⁷² *Xin Jing Bao* August 20, 2004.

⁷³ Wei-wei Zhang (1996): 192.

⁷⁴ Wang Gungwu (1996): 122-123.

problems and evils that had manifested themselves in the reform process was now redirected towards the conservative attempt to revert the course of reform in the name of keeping the socialist road. The support for the government's position on the question of reform was therefore translated into enthusiasm towards the market. "Market" almost became a synonym for reform, progress and development.⁷⁵

Development through Liberalization: An Economic Nationalist Agenda

The politicization of the market prepared socially for the new round of economic liberalization. As the Chinese economy entered into a new round of high growth, problems intrinsic to the decentralized planning system resurfaced. The economy was overheated due to overly high and repeated investments in capital construction and industrial projects across the nation. Raw materials were in shortage and inflationary pressure was mounting. Instead of ordering factories to stop or reduce production through administrative directives, the central government determined to achieve "soft landing" by conducting macro adjustment of the market. As mentioned in the previous chapters, the central government sought to straighten out economic order and attain macro control through market-confirming economic liberalization.

Surrounding China's accelerated efforts on its GATT/WTO accession, a series of domestic reforms were underway in the 1990s. Although these reforms were being carried out under the overarching theme of building socialist market system, the problem went beyond a

⁷⁵ See Zhang Chuanping (2002); He Wei in Zhang Zhixiong (1996) for discussions on building market economy under socialism.

choice between market and planning. Rather, it was a matter of choosing between different market models. As the country's economy was further opening up under the liberalization program, issues and problems that had been carefully avoided in previous rounds of reform were now waiting to be addressed. The reform of SOEs was facing a bottleneck as measures that were based on the existing ownership structure such as the contract responsibility system proved inadequate to help SOEs improve their efficiency and achieve financial turnarounds. As competitive pressure from the international market, reform of the SOEs was inevitably moving towards the sensitive area of changing ownership structure.⁷⁶ Consequentially social issues such as worker layoffs and inadequate social welfare provisions became increasingly acute. The tension between economic efficiency and social justice that had been once regarded as the “fundamental problem” of capitalism was now manifesting itself in the Chinese society.

Given the central government's policy priorities in the 1990s, maintaining high-speed economic growth and enforcing market-conforming reforms were pursued in preference to equality and social fairness.⁷⁷ Up until the early 1990s, the Chinese government had adopted a partial approach towards economic reform. Changes were carried out on an experimental or “above target” basis and overall such changes created positive spillover effects in the society and generated popular support for the reform program.⁷⁸ The liberalization program of the 1990s, however, would inevitably create losers as major economic

⁷⁶ See Li Jun(1995:17-19) for a review on the question of SOE ownership reform.

⁷⁷ See He Qinglian in *Kaifang Chao(Fujian Reform)* (1998b).

⁷⁸ See Lawrence J. Lau et al (2001): 120-143.

sectors experienced painful restructuring and adjustment. The challenge for the central government was how to rally support for this new drive in order to attain the policy goal of regaining macro control.

The Chinese government found rhetorical justification for the new program in neoliberal economic doctrines. The previous planning vs. market debate had successfully positioned “market” as a pro-reform and pro-development concept. The country’s quick reaction to Deng’s Southern Tour Speech and the new business wave and growth spiral nationwide signified the Chinese people’s great enthusiasm towards building a market system. The central government wasted no time in harnessing such energy to help carry its liberalization strategy forward, although “market” in the new context was in fact not only distinguished from the old planning system, but also associated specifically with the open and laissez faire form of market economy. As “new leftist” scholar Han Deqiang observes, the mainstream economic discourse of the 1990s was one of market romanticism; state policy championed free competition and the media were selling hard the concepts of the “invisible hand” and “comparative advantage”.⁷⁹ Such neoclassical rhetoric, however, was woven into a more familiar argument about building the country’s glorious future through maintaining high-speed economic growth. Although the Chinese government’s remedies for structural problems in the Chinese economy were neoliberal by nature, the rhetorical emphasis was less on economic freedom and individual choice than on how such solutions could improve economic efficiency, thereby enhancing economic growth for the nation. Liberal

⁷⁹ See Han Deqiang (2000), part III.

prescriptions were aligned with nationalist goals to provide backings and justifications for the liberalization drive.

Neoliberal Discourses and Chinese Government's Policy Goals

As an economic doctrine and the foundation of economic policies, and sometimes equated with neoclassical economics, neoliberalism has become widespread in the past 30 years or so. Consistent with classical libertarian thinking, neoliberalism champions the rule of the market and free trade. And as a modern *laissez faire* economic theory, it rejects the statist liberalism's argument for extensive state regulation and selective intervention in a capitalist economy.⁸⁰ Reflected in economic policies, these theoretical tenets endorse free competition through deregulation, privatization and reducing social safety net for the poor as well as free capital flow across national borders.

Apparently, as a late developing country in catch-up mode, China appears to be a least likely advocate of the neoliberal doctrines. A closer look at the main tenets of neoliberalism and the Chinese government's reform agenda in the 1990s, however may help explain the apparent anomaly as to why China willingly adopted the discourses of "the rich". The following table compares the major elements of the neoliberal argument and the priorities of the Chinese government in the 1990s, when administrative decentralization weakened the authority of the central state and the central government needed to play the market against economic irregularities created by decentralized planning.

⁸⁰ See Elizabeth Martinez and Arnolando García (2000); J. Bradford DeLong (1999).

Table 4.1: Neoliberal Discourses and State Policy Goals

Neoliberal views	Chinese state's policy priorities
Economic growth as measured by changes in real GDP is given priority over other socioeconomic issues	Promoting and maintaining economic growth as the primary task.
Free market approach is imperative to improving economic efficiency – deregulation is needed; government intervention in the economy should be minimal.	Building a market system to eliminate “economic irregularities” resulting from decentralized planning.
An open trade system is essential to healthy economic growth.	Promoting export-oriented “outward looking” economy.
Competitiveness-building should be stressed over social welfare provision; social justice will ultimately be achieved through the trickle-down effect of economic growth.	Reforming state-owned enterprise; breaking the “iron bowl”; making enterprises economic entities responsible for their own profits and losses.
Free capital flow improves economic efficiency and is conducive to economic growth.	Reforming the banking system and building capital markets.
Privatization of state assets is necessary for the healthy functioning of a <i>laissez faire</i> market economy	Ownership reform as an alternative to the “contracting system” under decentralization.

To the Chinese central policy makers, the decision to liberalize the economy not only involved lowering tariffs and opening domestic sectors, but also entailed a series of domestic reforms such as ownership reform and social security reform. As mentioned before, the previous stage of reform under decentralization was considered as a period of “reform without losers”. Market experiments were made in limited geographical

areas and in the above-plan portion of the economy. The Chinese people were able to taste “the sweetness of the market” while continuing to enjoy the benefits and welfare provided by the planning system. The move to liberalize the economy, however, created a dilemma for the Chinese government. On the one hand, further opening up of the economy would inevitably expose Chinese domestic sectors to foreign competition, which, in turn, called upon the government to ameliorate the shock by building a competent social safety net. On the other hand, liberalization of a transition economy required a fundamental restructuring of the state sector and the abolishment of many socioeconomic practices under the planning system. To many Chinese enterprises and individuals, this meant the removal of the shelter and protection that the socialist planning system had provided.

Independent scholar He Qinglian observes, reforms after 1992 followed the path of “efficiency first”. As part of the market-conforming reforms in major economic sectors, the Chinese government pushed for “stockization” (share-issue privatization) of state-owned enterprises and privatization of state assets to solve the efficiency problem that was fundamental to the planned economic system. These moves, however, caused more and more “members of the society” to bear the ever increasing costs of the reform.⁸¹

As the table shows, the central government’s reform priorities, in many aspects, matched neoliberal economic doctrines at the rhetorical level. As Deng Xiaoping noted in 1992 that without market economy, competition, comparison and exchange (among countries), science,

⁸¹ He Qinglian (2002)

technology and products would remain underdeveloped, which will in turn adversely affect consumption and trade.⁸² He called for market reforms “at a bolder and faster pace”. Accordingly, neoclassical/neoliberal economic arguments to a large extent became the mainstream discourses in the Chinese political and economic circles in the 1990s. Han Deqiang observes that during the course of reform and opening up, classical and neo-classical economics were increasingly gaining voice in officially endorsed policy debates.⁸³ Into the 1990s, “competition and capital became the key words of economic reform. State policy was increasingly justified and guided by the logic of free competition, and the WTO became the media’s favorite.”⁸⁴ As a self-proclaimed “new-leftist”, Han sees the root cause for such an orientation in policy and public opinion as lying in government officials and mainstream economists’ worship of Western economic theories that started with Adam Smith’s free trade to neoliberal economic globalization. According to Han, “the majority of the Chinese economists were enthusiastic followers of Adam Smith and Milton Friedman’s economic theories. Government officials of all levels were trained with the ‘Smith dogma’ and therefore unconditionally believed in free trade and market economy. Neoliberalism advocated by multinational corporations dominated the academic circle and shaped public opinion, whereas reformers in the central government were eager to copy the American example in every aspect, from setting up “second board”

⁸² See Zhang Gaoling (2004): 209.

⁸³ Han Deqiang (2001).

⁸⁴ *ibid.*

financial market to deregulating and disintegrating the telecommunication industry.”⁸⁵

Whereas Han and other new-leftists portray market-conforming liberalization of the 1990s as a result of ideological transformation, the actual process only partially complied with their observation.

A closer look at the liberalization process suggests that the free-market fervor as described by the new-leftists was largely a managed effort on the part of the Chinese government to facilitate the enforcement of its reform measures. Rather than being swept over by the neoliberal doctrines, policymakers in the central government only selectively employed neoliberal rhetorics to support and justify their policy choices in the 1990s. First of all, the Chinese leaders tended to stress the elements of “efficiency” and “growth” that were associated with the neoliberal proposal while downplaying “freedom of choice” borne with the liberal arguments. At the operational level, neoliberal economic principles were cited to rationalize the government’s strategic moves in liberalizing the economy. But the end goal of following neoliberal prescriptions was carefully formulated as enhancing national strength and glory.

For example, as China accelerated its trade and investment liberalization in the wake of its failed attempt to access the WTO in 1995, oppositions in the academic circle warned against the “uncurbed inflow of foreign investment and uncontrolled trade opening up”, which, according to them, would lead to the dominance of the Chinese market

⁸⁵ *ibid*; Han sees Smith and Friedman’s theories as the foundations of the neoliberal thinking.

by Western corporations and impose the “American rules of the game” upon the Chinese market and national industries.⁸⁶ As an official response, the People’s Daily carried a series of articles to defend the government’s reform measures and emphasize the necessity of further opening up the economy. The arguments, for the most parts, were reminiscent of the IMF or World Bank view on free flow of trade and investment. Investment by multinational corporations on a large and systematic scale, it was argued, would promote market competition and push Chinese companies towards building truly competitive brands, and in turn would strengthen domestic enterprises in the long run.⁸⁷ Foreign investment’s participation in the Chinese economy through joint venture not only brought in capital but also technological and managerial know-how, which would be conducive to endogenous innovation of Chinese companies and the competitiveness of SOEs.⁸⁸ It remained an important strategic task, therefore, to further improve the environment and conditions for foreign investment, standardize market rules and foster fair competition.⁸⁹

The ultimate justification of these arguments, however, rested upon the claim that the liberalization measures were indispensable to attaining the goal of modernizing China. In supporting lowered barriers for foreign consumer products, for example, a People’s Daily article cited the examples of successful joint ventures between China and Western companies and argued that such cooperations helped create powerful

⁸⁶ See, for example, Yu Quanyu(1996), Zhou Chunguan (1996), Wang Luolin (1996).

⁸⁷ Gong Wen, People’s Daily (09/05/1996)

⁸⁸ Jiang Xiaojuan, People’s Daily (09/21/1996)

⁸⁹ People’s Daily (07/14/1997)

brands for their respective industries and therefore would enhance China's overall national strength in the long run.⁹⁰ "In the world today there are no strictly domestic or foreign markets. Entry of foreign companies in the domestic markets may cause some domestic enterprises to lose market share or even exit the market. However, this will strengthen the competitiveness of Chinese industries as a whole, which, in the long run, will allow products "made in China" to thrive in the international markets."⁹¹ Echoing such an argument, Long Yongtu, Deputy Minister of MOFTEC, chief-negotiator of China's WTO accession talks, commented on several occasions, positioning China's entry to the WTO as a necessary step for the country's comeback to the "world stage" with enhanced economic capacity.⁹² The neoliberal justification for economic openness, therefore, was carefully combined with a common aspiration for national glory to persuade the audience.

More illustrative of this utilitarian and selective employment of neoliberal discourses was the Chinese government's changed policy tone in the early 2000s under the new leadership of Hu Jintao and Wen Jiabao. In the post-WTO era, the Chinese government, on the one hand, continued to pursue all-round market-conforming reforms in accordance with the WTO arrangement, on the other hand, the new government began to give more emphasis to the social issues and problems that came along with the liberalization process. At the 3rd Plenary Session of the 16th CPC Central Committee, Hu Jintao declared

⁹⁰ People's Daily (09/05/1996)

⁹¹ Ibid.

⁹² Economics Daily (10/12/1997); Xinhua News Agency 2001; also see Chen Jiyong (1999).

that the government was committed to pursuing a development strategy that was “human-oriented”. With this commitment, the government pledged to go beyond a mere concern for GDP growth to “foster social harmony and development” in order to strike a balance between “economic efficiency and social justice” and between “participation in the global economy and domestic social harmony”. The central government has invited more economists and social scientists outside the circle of “mainstream economists” to participate in policy debate and consultation.⁹³ However, rather than breaking away from past practice, as some of the new-leftist scholars argue, at the policy level there has been more continuity than difference between the two “administrations”. Liberalization programs in key economic sectors have continued to be enforced. Domestic ownership reforms, stockization and privatization of state-owned enterprises have continued to progress. The major difference from the previous period is that the Chinese government is now more candid about the social repercussions of marketization and liberalization. On the one hand, social problems associated with the liberalization process such as unemployment, widening income gap, inadequate health care protection and peasant worker rights problems, have created increased tension within the society, pressing the government to confront these issues and seek solutions for them. On the other hand, with the WTO accession a fait accompli and market-conforming reforms an irreversible trend, the government is now in a position to spare some energy from defending and justifying the liberalization moves and refocus it on tackling the problems and

⁹³ Han Deqiang, *opt. cit.*

evils that inevitably came along. As Long Yongtu admitted in an interview with the Finance and Economics Magazine, “the most important role of the WTO agreement has been to impose a timetable upon China’s liberalization process. With those commitments, industry and institutional reforms followed suit. The WTO accession was only a beginning of further opening up and it ensures that the opening up process is irreversible.” The government’s refreshed concern over distributional justice and social harmony, therefore, was directed towards supporting the liberalization program with complementary measures rather than rectifying the overall orientation of reform. The observable consistency in policy orientation underlying the two periods suggests that the Chinese government’s propagation of neoliberal principles in the 1990s was largely at the rhetorical level and arose from the practical need of justifying the reform measures.

Neoliberal Developmentalism: the Nationalist Foundation of Economic Liberalization

If neoliberal economic principles were tweaked to be in line with a nationalist economic goal to facilitate the enforcement of liberalization strategy, the question is why the Chinese audience were particular receptive to such discourses. As argued before, associated with Chinese nationalism is an aspiration to restore past glory and to this end the Chinese modernization effort has been characterized by a utilitarianism attitude in pursuing wealth and power and a globalist ambition. The neoliberal prescriptions, while fitting into the Chinese government’s reform priorities in the 1990s, were also rhetorically compatible with the nationalist sentiment. In other words, by weaving neoliberal discourses

into an economic nationalist argument, the Chinese government sought to justify liberalization measures with a nationalist end goal. But the liberal and nationalist components of such an argument were not strange bedfellows artificially put together to justify state policies.

First of all, the overarching goal of achieving modernization made the neoliberal prescriptions a possible and desirable choice for policymakers and the general public alike. As mentioned before, the political legitimacy of the communist regime in the reform era to a large extent hinged upon the government's ability to create growth and development. This does not mean, however, that economic well-being was the only thing that the Chinese cared about in the post Cultural Revolution era. Rather, such an overriding concern on economic growth was in line with the nationalist tradition of pursuing "wealth and power" in order to restore past glory. The communist party's failure to attain this nationalist goal through Marxist-Leninist model left the reform-minded politicians a mixed legacy in the post Cultural Revolution era. On the one hand, the political crisis and economic bankruptcy caused by the Cultural Revolution eroded the credibility of the Marxist-Leninist ideology, driving central policymakers to search for new ideological basis for maintaining regime legitimacy. On the other hand, the failure of socialist orthodoxies and the memory associated with them provided the reformers a particular advantage in their struggle against communist conservatives. As argued before, although Deng Xiaoping positioned plan and market as neutral economic methods, market carried a positive connotation as it provided an alternative and effective means to revitalize the economy, whereas plan,

given its association with the largely discredited socialist orthodoxies, was generally regarded as something that held back China from pursuing the wealth and power that were essential to regaining the country's past glory. Yu Guangyuan, renowned Chinese economist observes that after Deng Xiaping's Southern Tour, there was growing consensus in the Chinese society that the criteria for judging an economic system is not whether it is socialist or capitalist but whether it is advanced or backward. And whether a system is advanced or not depends on whether and how much it can promote the development of productive forces. The old rigid planning system was increasingly regarded as an impediment to promoting the development of productive forces.⁹⁴

Voices of dissent and complaint did exist. But such complaints in a sense confirmed Yu's observation. For example, the internally circulated edition of the party's magazine *Qiushi* carried an article in 1994 warning about "a general trend of thought and sentiment among party members, government officials and the wider society that championed the development of productive forces" as the sole criterion for evaluating reform measures". "Should this trend continue, the communist party will degenerate into the party of productive forces and the socialist cause will be in jeopardy"⁹⁵ Likewise, economists favoring planning also deplored the situation of "market worshipping", as according to their observations, the general public and the media tended to equate "market" with reforms and treat "market mechanism" as the panacea for

⁹⁴ Yu Guangyuan (1995)

⁹⁵ Li Mingsan in *Qiushi* issue 23, edition for internal circulation (1994)

all economic problems. If one was against the market approach, he was easily labeled as against reform and with a “rigid mindset”.⁹⁶

In fact, the term “market” had very different meanings in different periods of time. In the beginning of the reform it meant the limited reforms “above the plan” to “revitalize the economy”. In the context of building a socialist market system it meant getting the price determined by supply and demand rather than completely or partially determined by plan. When it came to China’s WTO accession and corresponding liberalization moves, however, market was used to refer to an open and laissez faire economic model. In this final case, the crux of the problem was actually not about market vs. planning, but about which market model to adopt. However, the Chinese government positioned the new initiative as a continuation and extension of the previous stages of reform. In this way, liberalization was pitted against planning, which allowed the government to capitalize on the positive connotation of market in previous rounds of the reform and to convince the general public that economic liberalization essential to promoting development and growth and therefore was the “good cat that can catch the mouse”. The power of liberal rhetorics, therefore, was grounded in the nationalist commitment to a strategy of high growth.

Secondly, neoliberal discourses also resonated well with the underlying globalist aspiration of Chinese nationalism. As mentioned before, Chinese nationalism was hardly shaped by the “we vs. they” awareness. Rather, inherent in it was the idea of globalism that drove modern China to aspire for a global role after “a hundred years’

⁹⁶ See Tang Changli (1996), also see Hu Jun (1995).

humiliation.” From the beginning of the reform, reform minded policymakers tried to position the policy of reform and opening to the outside world as a strategic effort to redress a glaring historical mistake, i.e., the closed-door policy of the Manchurian government, which was believe to be the major cause for China’s economic backwardness and its being bullied and humiliated by Western powers in modern history. It was argued that the international political environment after the founding of the PRC prevented the country from adopting an open-door policy earlier. But time was ripe for the country to “opening to the outside world”, which was a necessary and indispensable move in order for China to achieve a powerful comeback to the world stage. Consequentially, concepts such as globalization and economic openness were very differently received in China than in its third world counterparts. Han Deqiang notes that against the backdrop of China’s WTO accession initiative, the political environment for those opposing it became rather hostile. “Trade protection is equated with favoring the heavily bashed ‘closed door policy’. People who oppose China’s WTO endeavor are criticized as being short-sighted and narrow-minded. The media propagated the WTO accession as a win-win for both China and the world.”⁹⁷ Han might not be accurate and unbiased in describing the situation as there were indeed heated debate about the pros and cons of China’s entry to the WTO.⁹⁸ But he was right in his observation about the political dynamics surrounding the WTO accession issue. As economist Hai Wen observes, the issue of WTO accession was more than

⁹⁷ Han Deqiang (2001)

⁹⁸ See for example, Zuo Dapei (1996), Zhang Shuguang (1996), Renlie (1996).

an economic issue; it was about international acceptance and about the Chinese nation's aspiration to return to the center stage of world affairs.⁹⁹ Ordinary Chinese citizens may know little beyond the fact that WTO accession will eventually lower the prices of imported cars and other consumer goods. But they saw the WTO accession as an event concerning national pride and a positive step to lift the country's image in the international arena. ¹⁰⁰

The aspiration to achieve “national renaissance”, therefore, provided rationale and motive for the country's commitment to the WTO framework and related liberalization measures. The rhetorical power of the neoliberal discourses in justifying the Chinese government's liberalization moves was grounded in the Chinese nationalism's distinctive characteristics that were derived historically. A neoliberal approach with an end goal of achieving development and national rejuvenation supplied the content of Chinese economic nationalism and rationalized the market-conforming moves taken by the Chinese government in the 1990s.

⁹⁹ Hai Wen (1999): 33-34.

¹⁰⁰ According to an opinion poll on China's WTO accession by Outlook Weekly and CCTV, 94% of the population believed that China's WTO accession would lift China's image and promote its status in the international society and 86% believed that it would enhance the country's overall national strength. And these two items were voted as the top two benefits of China's joining the WTO on the benefits list.

CHAPTER FIVE

CONCLUSION

The reform experience of China entails three distinctive yet interrelated themes, namely, development, marketization and liberalization. As a late developer making the transition from a planned economic system to a market-oriented one in an age of increasingly globalized trade and finance, China offers a fresh opportunity for studying the interplay between state and market as well as the rationale behind the state's approach to the market.

State, Development and the Over-asserted Growth Hypothesis

The statist approach in studying economic development generally argues for a causal relationship between state intervention and economic growth. It is often assumed that a state committed to economic development will adopt an economic approach that is differentiated from a market-conforming one.¹ Empirically the development experiences of a number of newly industrializing

¹ See, for example, Chalmers Johnson (1982; in Deyo 1987), Robert Wade (1990; 1992; 1993), Alice Amsden (1989; 2001), Frederic C. Deyo, ed., (1987), Ziya Onis (1991). The literature on East Asian developmental states generally treats an interventionist approach to the economy as a necessary condition for economic growth. So does Kohli (2004) in his more general comparative studies. Evans's (1995) study has a different focus: instead of tracing causality between state intervention and growth outcomes, one part of his study seeks to explain variations in the specific forms of state intervention. Yet state intervention is still taken as given and the possibility of the state's taking a non-interventionist approach is left unexplored. On the role of bureaucratic state and industrial policy, also see Helen Shapiro and Lance Taylor (1990), Meredith Woo-Cumings (1999), W. G. Huff (1995), Linda Low (2001), Kris Olds and Henry Wai-Chung Yeung (2004).

economies, especially East Asian NIEs, appeared to offer positive evidence for this argument.

The statist enterprise in search of the cause for economic growth suffers from a few methodological weaknesses other than the most cited one about case selection on the dependent variable. Firstly, the time span of these projects was mostly limited to the period between the 1960s and late 1980s when the political needs of the Cold War created a rather tolerant environment for the NIEs to grow with an export-led strategy while maintaining a certain degree of domestic protection. The rise of the neoliberal consensus and the trend towards globalized finance and trade in the post-Cold War era have posed empirical challenges to the statist claim. On the one hand, the interventionist approach was at least partially blamed for causing the vulnerability of some of those NIEs in the face of major market turbulences such as the Asian Financial Crisis.² The very merit of state intervention was put under question. On the other hand, as more and more NIEs swim with the tide to liberalize their economies, statist scholars are left with a smaller pool of empirical examples to study with. Kohli, for example, explicitly states in his study of developmental states that the study focuses primarily on the period before the neoliberal trend set in.³ Then is the causal claim made by statist a generalizable one? Or do statist omit important variables for growth even for the period of their intensive

² See, for example, Chris Rowley and Johnseok Bae "Introduction: The Icarus Paradox in Korean Business and Management" in Rowley and J. Bae ed. (1998), Paul Krugman (1997).

³ See Kohli (2004: 23)

studies? And are states no longer concerned about growth once they adopt a hands-free approach to the economy?

Secondly, the statist studies have primarily focused on capitalist developmental states. In such cases the state usually faces a well-developed market and a clearly demarcated private sector. It is on the basis of such a domestic structure that the examination of the state's approach to the market is made. Such studies, however, largely exclude the situation where market is in its embryo and where state may actively "intervene" to create a market and enforce rules that are market conforming.

The Chinese experience of reform and development in the past three decades has provided an opportunity whereby a state's development drive, market transition initiative and the globalization trend were juxtaposed to form the new context for observing state-market interactions. As a matter of fact, the Chinese case alone does not invalidate the statist hypothesis on the interventionist model of state-led growth. Nor was this study intended to do so. Rather, by providing an empirical alternative of a state's approach to the market in seeking developmental goals, the sectoral examples of the Chinese reform illustrate that a state's strategic actions to promote economic development can be compatible with a market-conforming economic model and that the introduction of such a model is not necessarily an indicator of the "withering of the state" in the face of market forces. In other words, there can be different growth models for developmental states to pursue. The actual choice of model is largely determined by the specific historical and socioeconomic conditions that a LDC is in.

State Structure, State autonomy and Development strategy

In this study I have examined the reform processes in two critical economic sectors: foreign trade and banking. Reforms in both sectors went through the stages of administrative decentralization and market-conforming liberalization. The course of development in the latter stage constitutes a puzzle to both students of Chinese politics and those of developmental states in general. Signaled by its determined bid for the WTO membership, the Chinese state shifted away from a partial and dual-track approach to pursue full-scale market-conforming liberalization in major economic sectors. As the two cases in my study illustrate, the logic of the state's policy choice can be found in the change of the state's institutional structure and the effect of such a change upon state autonomy and in turn, its policy enforcement capabilities.⁴ It was in pursuit of the lost autonomy and control that central state policymakers resorted to market-conforming liberalizations.

The explanations I give for the logic of economic reform in China are differentiated from and complementary to those of existing studies in Chinese politics. The study draws insights from existing studies on the logic of China's economic reform, especially Shirk's observations about the political basis of economic decisions as well as Wedeman's analysis of how reform measures impacted central-local relations and interactions. However, unlike the rational-choice institutional

⁴ State autonomy here follows Leftwich (1995)'s definition that it is "the ability of the state to achieve relative independence from the demanding clamor of special interests (whether class, regional or sectoral)"

explanation that sees the government's policy outcomes as deals and compromises struck between self-interest maximizing politicians⁵, I treat the state as a historically grounded institution and seek to explain its policy choice by exploring the characteristics and changes of state structure and the ensuing socioeconomic dynamics. And unlike the "growing-out-of-plan" argument and the "equilibrium-seeking" theory⁶, which offer fundamentally economic explanations for the logic of Chinese reform, my study has tried to identify the political incentive behind the paradigm shift of development strategy on the part of the Chinese state.

Empirically I have studied the sectors of foreign trade and banking intensively to test my hypothesis on the logic of economic liberalization in China. I selected these two sectors for three major reasons. First of all, the two sectors are self-contained and relatively homogenous units for observing and comparing the complete processes of economic reforms at the sectoral level. Secondly, the two cases provided the setting for observing key variables and processes while controlling for the factor of external influence. The presence of foreign players in the foreign trade sector and the lack of foreign participation in the banking sector allowed me to evaluate the explanatory power of a domestic institutional analysis of China's economic liberalization. Thirdly, while institutional change as a major explanatory variable is present in both sectors, the actual mode of administrative decentralization in the two sectors

⁵ Susan Shirk (1993) is an example in point. Wedeman (2003) is basically a rational-choice institutionalist analysis, too. But the latter part of his analysis leaves the political games in the background and invokes the economic law as the ultimate explanation.

⁶ See Barry Naughton (1995) and Andrew Wedeman (2003) respectively.

displayed a degree of variation. This allowed me to observe and assess the causal mechanism between institutional change, state autonomy and policy outcomes.

Decentralization in both the foreign trade and banking sectors empowered the provincial and sub-provincial governments, providing them with unprecedented means and resources to pursue developmental or entrepreneurial goals within their own geographical areas. On the national scale, however, such provincial/local initiatives were often expressed as local protectionism and rent-seeking behavior at the expense of the central authority. The autonomy of the central state was eroded as the state apparatus was horizontally intersected and its ability to pursue the overall national developmental goal compromised. Reflected in the economic sphere, parochially driven strategies gave rise to interregional trade barrier and financial arbitrage, aggravating the indebtedness of state-owned enterprises and draining the central government of its incomes and resources. By introducing WTO conforming trade standard and financial rules, the central government sought to remove the rent havens created during the decentralization period and restore the bureaucratic coherence and cohesiveness required for effective policy enforcement.

Central to this account was the description of a shift of strategy on the part of the central state in an attempt to advance its political objectives, which sets the argument apart from the more economic arguments that see the liberalization drive either as part of a well-designed transition that was implemented incrementally and step

by step or as a political follow-up to match the equilibrium seeking economic reality.

As the study shows, the reforms of the foreign trade and banking sectors largely followed the same logic. But liberalization of the foreign trade sector was carried out more smoothly and at a faster pace than that of the banking sector. Such differences can be explained by looking at the differences in institutional arrangement for these two sectors and the ensuing dynamics under the decentralization program. The regional particularistic arrangement of foreign trade decentralization and the regionally differentiated privileges associated with such an arrangement created a bandwagon effect when the liberalization program was finally introduced. In the banking sector where no regional particularistic benefits were directly involved, the industry demonstrated weaker propensity to change as vested interests were more inward-looking and sought to preserve the benefits gained from the administratively decentralized banking regime. This finding is partially consistent with the observations about “spatial internationalization” and “competitive liberalization”, both of which highlight the effect of regionally differentiated reform strategy upon the dynamics of economic internationalization and liberalization.⁷ But the contrast between the two cases gives an example of varied dynamics across sectors with regard to the opening up process, suggesting that it would be partial and simplistic to explain the liberalization process in China as a self-induced one that worked itself out amid inter-regional competition. In my account the initiative on the part of the central state was crucial

⁷ David Zweig (2002, Dali Yang (1997).

to the country's turn towards full-scale liberalization. In fact, it was by eliminating much of the regional differences under the decentralization scheme that the central government created conditions for all-round market-conforming reforms.

Economic Liberalization and Ideological Justification

The reform process in China was filled with political struggles. But oppositions to reform policies were often expressed not as direct objections to the reform programs the government initiated but as disputes and confrontations in the ideological sphere. As Kohli observes, very often developmental states have to resort to ideological mobilization to win acceptance in the society.⁸ This also applies to the Chinese state. The central state policymakers introduced the liberalization program in order to eliminate economic irregularities and regain macro control and policy autonomy. But the ultimate success of this initiative hinged upon whether the government could rally enough social support in enforcing the program. My study shows that during this process the Chinese government repositioned and reinterpreted the neoliberal economic ideology to legitimate and justify the liberalization measures. Underneath the neoliberal/neoclassical rhetorics was a nationalist core and an attempt to link liberalization measures with national developmental goals. Although institutionally the Chinese government took big steps towards a liberal regime, ideologically the reform program in the 1990s was still driven by economic nationalism. In my study I mainly focus on how the Chinese government tweaked

⁸ Kohli (2004): 10.

neoliberal discourses to be compatible with economic nationalism and to justify reform measures and mobilize public opinion. This argument is mostly rationalist as it does not take ideology as a central explanatory variable to account for state behavior and policy choice. But the explanation is still different from the ones that treat ideology solely as a practical legitimating tool, as my study suggests that the content of economic nationalism was historically grounded and constructed rather than supplied by the specific contest of political struggles. Economic nationalism, as an expression of the social consensus on aligning economic activities with the end goal of enhancing national strength, was shaped and informed by the historical memory and experience of the Chinese nation. The attributes of modern Chinese nationalism determined that the neoliberal discourses were rhetorically appealing and powerful to the Chinese audience. Although not further explored, potentially there exists some normative compatibility between the Chinese strand of economic nationalism and the neoliberal economic ideology.

Limitations and Directions for Future Research

Possible Fusions between State and Society

In exploring the effect of institutional change upon state autonomy and policy enforcement capacity, my study has focused primarily on changes to the internal structure of the state. My research gathered data mainly on the changed role of provincial and municipal governments under the decentralization scheme and how this affected the coherence and cohesiveness of the central state apparatus and in

turn state autonomy. But a closer look at the state society dynamics at the sub-provincial level -- especially at the village and township level -- reveals that in many instances it was not a matter of local states pursuing developmental or entrepreneurial goals that conflicted with the national development strategy but a matter of the state getting entangled with the society. What was unique about the state-society relations in China was that, unlike in a mature capitalist economy where public and private spheres are clearly defined and where there are existing and established private interests for the state to regulate upon, the decentralization era in China saw new markets and sectors in the making and therefore new interests in the making.⁹ As Dorothy Solinger observes, under the reform program there emerged new borderline institutions that were at once both public and private in nature; the officials and merchants were shaped alike and have become dependent, mutually interpenetrated semi-classes.¹⁰ The local end of the central state apparatus was therefore 'entangled' with the society through local state and society's collaboration, cooptation or state-society hybridism.¹¹

A study of possible fusion between state and society at the local level could strengthen my argument about the erosion of state autonomy under the decentralization regime. According to Kohli and Evans state

⁹ Barry Naughton, "China's Transition in Economic Perspective" in Goldman and MacFarquhar (1999); Margaret M. Pearson (1997).

¹⁰ Dorothy Solinger in Arthur Lewis Rosenbaum, ed. (1992).

¹¹ See Baum and Shevchenko's discussion on corporatism and civil society in "The state of the state" in Goldman and MacFarquhar, in which they describe the new hybrid pattern of state-society interactions. Margaret Pearson (1997) also describes the rise of new business elite and the emergence of hybrid state-society relations in Post-Mao China.

autonomy does not preclude linkages to the society. An autonomous state is not necessarily insulated from the society but may have institutionalized channels effectively linking itself and the society.¹² The pre-reform Chinese state had been equipped with such institutionalized channels that reached deep into the society. However, when the state and the society became entangled or even fused with each other at the local level, central state autonomy and authority could be significantly weakened as the local branches of the state apparatus got partially captured by societal interests¹³. An empirical examination of such dynamics at the local or enterprise level, which is not pursued in this study, could potentially strengthen my argument concerning the effect of institutional changes on state autonomy.

The Effect of Case Selection on Findings

In this study I have selected the sectors of foreign trade and banking to explore the logic of economic liberalization. One major reason for selecting these two cases, as stated earlier, is that these two cases are self-contained and comparable units for studying the interaction between institutional changes, state-society dynamics and reform outcomes. In each sector there was an old plan-based regime at the onset of the reform. And when the industries were commercialized, state players continued to dominate the sectors. Administrative decentralization empowered provincial and local governments, subjecting state-owned industry players to multi-level leaderships, causing central state interests to be tapped away and its developmental

¹² Evans (1995: 12); Kohli (2004:10).

¹³ This is different from the phenomena of intra-state entanglement as demonstrated in this study.

goals compromised. It was in response to such problems that the central state launched the liberalization program. Both cases focus on analyzing state actors and state-owned enterprises and trace a change process that was state-dominated. In other economic sectors where there was no such an intact mechanism to reform upon, however, the change process could demonstrate different dynamics. For example, Zweig's study of China's internationalization approaches the issue of economic liberalization by looking at central government's institutional innovations such as SEZs in the reform era and the influence of FDI in these areas. The SEZs and the new FDI regime adopted in these areas were components of the reform program in the 1980s. They were products of system change rather than targets of institutional reform. Observations and analysis based on the developments in these innovative and "above-plan" areas with less state presence and involvement at the very outset, therefore, tend to produce more societal-based explanations that highlight the interaction and collaboration between domestic societal actors and international market forces. In fact, an observation about state-initiated and state-dominated change and a more societal-based analysis may capture different dimensions of socioeconomic changes in China. Further comparing and contrasting these cases could potentially yield new and more comprehensive insights into the liberalization process in China.

Market Conforming Reforms and Normative Change

In this study I treat the Chinese government's liberalization initiative as part of the central state's effort to reassert central authority.

The market-conforming measures were compatible with the national developmental goal that the central state was trying to pursue. And the neoliberal/neoclassical economic discourses were propagated to the public in the 1990s to justify and legitimate the liberalization program that the Chinese government initiated.

What is not fully identifiable in the current period, however, is what long-term effect the liberalization program will have on the organization of the Chinese state and its normative commitment. The question here is whether the Chinese state, in adopting neoliberal measures to advance its developmental goals, will be eventually transformed by the neoliberal rules and principles that come along with the liberalization program. An interesting development in this regard is that MOTEC, the preeminent government agency that played a pivotal role in China's WTO accession process was merged with the trade sections of the State Economics and Trade Commission and the State Planning Commission in 2003 to become the Ministry of Commerce. Not only has the new bureaucratic organization shrunk significantly in size, its also possesses much less power than its predecessor. As trading rights have been granted to individual enterprises, the major function of the Ministry of Commerce is to "monitor market orders" and "provide assistance for enterprises engaged in foreign trade."¹⁴ The changed role and status of MOFTEC is just one example of how the organization and function of the state can be transformed as liberalization goes on. Whether the state will maintain its developmental objectives or whether it will ultimately evolve towards the neoliberal minimal state in this

¹⁴ *China Industrial and Commercial Times* (March, 7, 2003).

self-initiated liberalization drive remains a question to be answered by future research.

The reform experience of China has been the focal point of three interrelated and ongoing processes—development, marketization and liberalization. This study has used China's sectoral examples to demonstrate how changes in the country's state structure under the decentralization scheme affected the central state's autonomy and effective control over the economy and in turn, shaped its choice of development path. The Chinese examples show that market-conforming reforms may be advanced by the state intentionally to reassert its autonomy and control. This constitutes an empirical anomaly to the conventional view on state-market relations, which tends to pit the state against the market, especially against the backdrop of economic globalization. The Chinese experience can serve as a starting point for more systematic and cross-country comparative investigation of state-market relations and interactions along any one of the three dimensions of late development, post-socialist transition, and economic liberalization.

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