

ization and deregulation, the government gradually lost its capacity to monitor and supervise the business operations of Korean firms and banks, especially with respect to short-term foreign borrowing and risky financial investment in the foreign markets. In addition, democratization aggravated the legitimacy crisis of the high-debt model. All democratically elected governments were compelled to introduce economic reforms. Every new government vowed to promote reformist labor policies and to take the measures necessary to moderate the market power of the *chaeböl* and enhance their competitiveness, but, in almost every area of reform, the government oscillated between reform and the status quo. New governments began with ambitious reform projects, but finished by backsliding at the end of their administrations (Mo and Moon 1998, 15–17). The inconsistency in government policy toward labor and the *chaeböl* eventually undermined the confidence of the international financial community, which had always assumed that the Korean government would stand behind the *chaeböl* and the banks in a time of trouble. Specifically, the government's indecisiveness in handling the Hanbo bankruptcy in January 1997 and the Kia crisis between July and October 1997 sent a shock wave not only through Korea but also through the international financial community, which began to call in loans and deny roll overs. After failing to secure a bilateral rescue package from the U.S. government, the South Korean government had no choice but to apply for IMF standby loans. Thus, in the South Korean case, there is a clear link between democratization and the economic crisis; the fluctuations of reform efforts have clearly followed electoral cycles. Under a democratic regime, and with an underdeveloped party system, the state could no longer act effectively as the risk partner of the *chaeböl*. In a nutshell, democratization and globalization have eroded the institutional foundation for the South Korean high debt model.

In comparative terms, Taiwan's economic resiliency is, in the final analysis, founded on the resiliency of its "one-party dominant regime" (Pempel 1990). The KMT's ability to achieve its historical projects—security, development, and international legitimacy—remains unhampered under democracy. The incumbent elite continued to deliver a streak of electoral successes while the principles of popular accountability and open political contestation were being legitimized and institutionalized. The KMT has built its winning coalition around a development strategy that brings about growth with equity and around a set of macroeconomic priorities that underscore monetary autonomy, financial stability, and fiscal conservatism. Undisrupted hegemonic presence in society, in turn, has enabled the ruling party to shape the terms of policy discourse over the issue of financial liberalization. A government confronted with the famous "trilemma" of macro policy—free capital movement, a stable exchange rate, and an effective monetary policy—can have only two of the three (Wade 1999, 7). The incumbent elite has always been able to resolve the conflict in favor of a stable exchange rate and an effective monetary policy. These proved politically critical in Taiwan's survival of the Asian economic crisis.

China: Domestic Restructuring and a New Role in Asia

Barry Naughton

Given China's new openness to the world market, the Asian financial crisis has inevitably had an important impact on the domestic economy and politics. Yet, despite important economic effects, the Asian crisis is not the main force changing the Chinese political economy. Instead, China is in the midst of an important *domestic* economic and political transition that is recasting its political economy. The Asian crisis is important for China because it changes the terms on which this domestic transition will take place.

The latest changes make up the latest phase of the country's long march from socialism. Yet the current phase has important characteristics that distinguish it from the country's other key stages of transition since 1978. Since the death of Deng Xiaoping in February 1997, the leadership team of Party Secretary Jiang Zemin and Premier Zhu Rongji has cobbled together a distinctive and generally coherent strategy whose purpose is to accelerate domestic transformation, consolidate power, and give their regime longevity. A more aggressive role for domestic policy was developing just as the Asian crisis broke out. Indeed, the financial crisis in Thailand emerged literally within days of the reversion of Hong Kong to Chinese sovereignty, which—because it was seen as successful—was a key milestone in the consolidation of the post-Deng regime. On balance, the Asian crisis has made the risky domestic transformation even more difficult.

This chapter begins with economics and moves into political economy; it concludes with some speculations about the future of Chinese politics. (The first sections describe the effects of the Asian crisis on China and the interaction between the Asian crisis, Chinese macroeconomic policy, and economic reform strategy.) Later sections discuss political economic aspects of the domestic transformation and the interaction between Chinese domestic politics and the Asian crisis. A key point is that the recent evolution of Chinese politics is in many respects counterintuitive: despite

the passing of the old guard, Chinese politics may be moving toward a more decisive form of authoritarianism with few purely political checks on decision making.

Impact of the Asian Crisis

There are many reasons to expect that China would be vulnerable to the economic turmoil that began in Thailand. China became a relatively open economy in the 1990s. Exports as a share of GDP increased rapidly, from 12 percent in 1988 to 22 percent in 1994, and then stabilized. Openness to foreign investment is even more striking. Since 1993, China has been the second largest recipient of fdi in the world, after the United States; even when scaled to China's large economy, inflows have been large, surpassing 5 percent of GDP annually. Of the total inflow of fdi, slightly more than one-half came from Hong Kong alone and approximately two-thirds from the predominantly Chinese industrializing economies together: Hong Kong, Macau, Taiwan, and Singapore. Nearly 80 percent of total inflows have come from East Asia. Clearly, China's economic fate is increasingly intertwined with that of its East Asian neighbors.

The pattern of investments in China is similar to the patterns of investment in the Southeast Asian countries most seriously affected by the crisis. Beginning in the early 1990s, China and the ASEAN-4 (Indonesia, Malaysia, Philippines and Thailand) all benefited from the restructuring of East Asian export networks, made possible by the inflow of investment from the predominantly Chinese industrializing economies and Japan; all five economies quickly moved into new export sectors and experienced rapid growth. China is thus in the same structural position in the world economy as the economies of the ASEAN-4. China produces similar—though not identical—labor-intensive export goods, and China and the ASEAN-4 are competitive for new export markets and for new inward fdi flows. During 1992–93, China began to exploit the additional advantage of its huge domestic market, granting significant market access to foreign-invested firms, and it was rewarded with a flood of incoming investment. For a period, China seemed to be overshadowing ASEAN as an attractor for investment, but further liberalization in ASEAN and some disillusionment with China worked to reestablish balance after the mid-1990s (Tan 1997).

Krause (1998) argues that, “for several years and through different mechanisms, China and Japan had been putting tremendous pressure on the entire Asian region. This trend may account for the virulence of the Asian flu.” Krause locates the Chinese pressure in export competition. But, although in a few relatively small commodity classifications there is a direct trade-off between Chinese and Southeast Asian exports, in numerous examples of commodities there is a clear division of labor between the regions. For example, China produces virtually all the toys and telephone handsets imported by the United States, whereas ASEAN countries produce virtually all the hard disc drives. Although a generalized export competition of course exists, it is important to stress that, until 1996, whatever

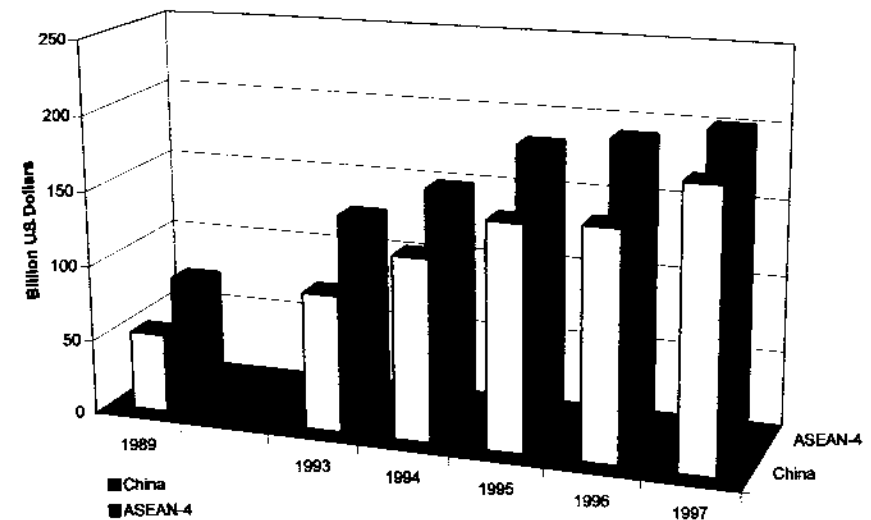


Figure 10.1 Comparative exports: China and ASEAN-4

competition existed was experienced within the context of very rapid growth of both regions. As Figure 10.1 shows, the ASEAN-4 export more than China does, and the exports of each have been growing with nearly equal rapidity (IMF 1998). Between 1989 and 1995, Chinese exports grew 19 percent annually, and those of the ASEAN-4 grew 17 percent. Export growth slowed dramatically in 1996, but Chinese exports actually slowed more abruptly (to less than 2 percent, versus nearly 5 percent for the ASEAN-4), due to problems with the Chinese export tax rebate program. It was not until the second quarter of 1997—with crisis in ASEAN already looming—that Chinese exports began to rebound significantly, ending the year with a sharp recovery to 21 percent growth, significantly outperforming the 5.4 percent growth registered by the ASEAN-4. Thus, although competition exists, the really striking fact is the commonality of experience: extremely rapid export growth through 1995 and increased difficulties since 1996. China and ASEAN have, arguably, both faced similar challenges of saturated markets and excess capacity in some export sectors.

Like the ASEAN nations before crisis, China has effectively pegged its currency to the U.S. dollar, and it has experienced real currency appreciation as domestic inflation exceeded U.S. and world inflation levels. China devalued the renminbi by approximately 40 percent at the beginning of 1994, when it unified its exchange rate and set a new dollar rate that has changed little since (the HK dollar was already linked to the U.S. dollar). By 1997, though, China's real exchange rate against the dollar had returned to its 1993 level and, indeed, was slightly higher. In addition, as the Japanese yen depreciated against the dollar, China and other dollar-

linked currencies experienced additional appreciation against the yen. The post-1996 export slowdown could plausibly be linked to these changing currency rates as well.

Finally, China resembles the crisis economies in being a rapidly industrializing economy that has in important respects outgrown its financial system. Like other East Asian economies, China has a bank-dominated financial system, in which total bank lending is large in relation to GDP, and capital markets are relatively less developed. Banks—in China's case, state-owned—regularly accept direction from the government. Government interference in lending decisions is entangled with cronyism and favoritism at both local and central government levels. As a result, the Chinese banking system is no better off, and probably worse off, than banking systems in the rest of East Asia. Estimates of nonperforming loans are not precise but tend to hover in the range of 20 percent of total loans, equivalent to 18 percent of GDP, a huge number (*New York Times* 16 July 1996; Naughton 1997c; Lardy 1998b). A fundamental cause of these problems is the utter lack of transparency surrounding lending decisions and government-business relations at the local level. In China, as in many of the other East Asian economies, the banks are big but weak. When these fragile giants stumble, they threaten to disrupt the forward march of economic development.

Despite the fundamental structural similarities, there are nonetheless even more profound differences between China and the Southeast Asian developing economies. First, the Chinese system is more closed, politically and economically. Despite China's emergence as an export power, important limits to its economic openness exist; these limits reflect the ways in which China adapted its economic policy to the opportunities provided by the East Asian restructuring described earlier. China liberalized policy toward fdi to a much greater extent than it did other aspects of its external economic relations. As a result, the flood of investment into China in the 1990s has been overwhelmingly in the form of fdi. From 1993 to 1997, China tapped a total of \$250 billion in foreign investment capital, of which 78 percent, or \$194 billion, was fdi and only 22 percent, just over \$55 billion, was in the form of loans. That means that China was spared the destabilizing impact of "hot money" flows into and out of domestic markets. By contrast, the ASEAN crisis nations got into really serious trouble only after the inflow of fdi was augmented by other, more liquid forms of finance. The Chinese renminbi is convertible only on the current account (meaning that documentation of a legitimate trade or other approved transaction is required to change money). The capital account is still closed. This does not mean that businesses and individuals cannot find ways to move money in and out of China, but it does mean that it is difficult to place large, leveraged bets for or against the currency. As a result, the currency is much less vulnerable to speculative pressures.

China's opening to foreign trade has been similarly circumscribed (Naughton 1996). The most liberal part of the trade regime is "processing trade," under which imported inputs intended for export production enter the country duty free and without significant administrative obstacles. Liberal policies toward export

processing facilitated the movement into China of Asian export production and complemented the liberal policies toward fdi. As a result, processing trade was the main force driving China's export expansion; it accounted for 55 percent of China's exports in 1997. By contrast, imports directly to the Chinese market continue to be hobbled by various kinds of non-tariff barriers, including, most importantly, the restriction of import trading rights to small numbers of foreign trade companies, nearly all of which are state owned. The government thus retains more tools to influence trade flows than would be the case in a fully open economy. In essence, these systemic features, which provide some insulation to China, reflect the particular nature of its integration with its East Asian neighbors: by serving as the "factory in the back room" for merchants in neighboring economies, China gives up some share of the profits, but it is also buffered from some of the financial instability.

Second, the Chinese government has followed relatively conservative policies that have limited its vulnerability to crisis. China had accumulated \$140 billion in foreign exchange reserves at the end of 1997, which was the third largest reserve in the world and equal to a full year's imports. More important is that most of that reserve was built up after 1994, due to large, persistent surpluses in the balance of payments. In 1997, China had a trade surplus of \$46 billion and, even after accounting for deficits in services of almost \$6 billion and a net outflow of profits of foreign-invested firms of \$16 billion, ran an overall current account surplus of almost \$30 billion. At the same time, given the massive inflow of \$45 billion of fdi, the capital account also showed a large surplus—\$23 billion by year-end 1997. As a result, even after deducting \$17 billion of "errors and omissions," reflecting primarily smuggling and capital flight, China accumulated foreign exchange reserves of \$35 billion in 1997 alone (SSB 1998, 92–93). Thus, despite the trend toward currency appreciation, China has avoided the deterioration of its current account position that we would normally expect, while continuing to enjoy capital inflows. It is not simply that China's stock of reserves is abundant, but also that current flows are highly favorable. Although China also has a significant foreign debt—\$131 billion at year-end 1997—only 14 percent is short-term, and of the remainder, a large part is loans from governments and international organizations, often at concessionary rates (*China Daily* 6 April 1998).

China thus differs from the most seriously affected crisis countries both because its economic system provides more insulation and because its current economic condition (a large surplus) provides it with more room to maneuver. Yet, both these differences reflect policy choices. They spring from the preference of China's current leadership to maintain a modicum of control, particularly over aspects of the economy that relate to the world economy. The systemic features remain because China's leaders have consistently moved slowly, resisting advice that they open their economy more rapidly to the outside. The current accumulation of foreign reserves is equally the outcome of a cautious policy. Standard economic advice was that China's reserves were more than ample, and that it would be sound—and contribute to growth—to use some of those reserves to finance larger imports of

investment goods. China resisted that advice out of a desire to maintain a more conservative and secure position.

These basic features help to clarify both the nature of Chinese vulnerability to the Asian crisis and the trade-offs facing Chinese policy makers. Susceptibility to financial *contagion* is limited, because the financial markets that spread contagion have limited influence on China. But, on the other hand, China is potentially vulnerable to transmission of crisis through economic *competition*. China produces goods similar to those produced by the crisis economies and must compete with those countries for foreign investment. Foreign investment has been an important driving force behind China's export growth in the 1990s, and the most important source countries for investment are themselves liable to suffer from a protracted crisis and invest less in China. As the Asian crisis spread, all of China's neighbors devalued their currencies, with the exception of Hong Kong (now a Special Administrative Region of China). China's currency was already overvalued—arguably so against the dollar, and certainly against the yen—and appeared increasingly out of line as all other Asian currencies dropped lower against the dollar. Beginning in 1998, China faced the danger of a very substantial slowdown, and perhaps even a shrinkage, of export growth. Inevitably, this meant that the growth impetus from rapidly growing exports in previous years would be lost.

These pressures help to explain Chinese policy choices during 1997 and 1998. Because China was not susceptible to large capital flows and thus financial contagion, it could not be *forced* to devalue. However, because its long-term competitive position was seriously undermined, it had important reasons to devalue. Thus, the question of a possible Chinese devaluation emerged as one of the most watched and speculated-about issues of 1998. A devaluation was feared because it might lead to a further spiral of competitive devaluation among affected countries, but also because it would indicate a willingness on China's part to take advantage of crisis to improve its own position at the expense of its East Asian neighbors. In fact, China was able to resist devaluation through 1998, in a decision that proved to be surprisingly easy. While the devaluation of all the other Asian currencies in theory made China less competitive, in practice the economic disruption of the crisis was so severe—particularly the disruption in trade financing—that competitor economies really did not provide an attractive alternative to China throughout most of 1998.

Indeed, during the first seven months of 1998, Chinese exports grew only 7 percent—a significant slowdown—but the distribution of growth was somewhat reassuring. Exports to Asia dropped, but exports to developed-country markets grew almost 20 percent (CSICSC 1998). This was only a temporary reprieve, though, and from October 1998, Chinese exports began to decline. Ironically, China's position will become most difficult when crisis countries begin to recover: when export financing resumes and normal economic relations are restored, crisis countries will pose formidable competition as they desperately try to expand exports to retire huge debt loads. In this sense, some of the most serious economic repercussions of the Asian crisis on China will only begin to unfold in 1999.

Silver Linings

During the first eighteen months of the Asian crisis, China was unusual not only because it suffered relatively few harmful effects, but also because it was one of the very few countries that actually benefited, however slightly, from the crisis. The crisis was both a warning to China and an opportunity: a warning, because China's financial system has all the characteristics and all the flaws of the financial systems in the rest of East Asia, which had proven so vulnerable; an opportunity, because the sharp setbacks experienced by the other economies in the region and the relatively limited impact of the crisis on China provided the country with an unprecedented opportunity to exert leadership in Asia.

In the face of crisis, China has been able to demonstrate responsibility and leadership through its policy choices. Most important has been the Chinese willingness and ability to maintain the value of the Chinese currency against the U.S. dollar, whereas the currencies of every other Asian nation have been devalued. This choice has won wide praise and contributed to a perception of China as a responsible power. Of course the policy is not selfless, because it is based on a calculation that devaluation, by contributing to a deepening of the crisis, would end up providing little or no benefit for China. But it is nonetheless responsible, because China bears all the economic costs of keeping its currency high, whereas the costs of devaluation would be shared with its neighbors. Further responsible actions have been evident in the Chinese willingness to provide financial aid to crisis countries, culminating in a \$4.5 billion commitment to the IMF in November 1998 (*Wall Street Journal* 2 September 1998; CND 1998a).

Both the United States and Japan, in their own very different ways, contribute to a perception of China's enhanced international stature. Clinton's June 1998 visit to China, his apparent lack of prior consultation with Japan over some key political issues, and his failure to stop in Japan on the way contributed to a perception in some parts of Asia that the United States was "tilting" toward China and away from Japan. As for Japan, although it has attempted to play a responsible role in the Asian crisis—offering to sponsor regional credit facilities—good intentions have been swamped by Japan's remarkable and persistent failure to get its own economic house in order. Japan has thus marginalized itself. China lacks the power and weight to launch itself into the group of leading powers on its own, but China is moving into a responsibility vacuum in Asia, created by the abdication of Japan and the absence of any other credible middle-ranked powers. Ezra Vogel (1998, 8) has recently declared a "new 'Era of Three Kingdoms,' . . . the first time in history that China, Japan, and the United States have all been strong Asian powers at the same time."

The short-term effect of these aspects of the crisis has been to strengthen the Chinese leadership. The heightened respect China seems to be commanding plays into the neonationalist appeals that are the basis of recent Communist Party claims of legitimacy. The role of the Chinese currency has become entangled with national pride and self-perception. A particularly curious occurrence has been the

latest addition to the East Asian "No" literature; a recent book entitled *The Renminbi Can Say No* (Tong 1998) is a novel expression of national pride.¹ The current premier, Zhu Rongji, has a reputation within China as an effective economic policy maker. The Asian crisis strengthens his hand by showing the dangers of economic policy mistakes and increasing the esteem in which his talents are held. At the same time, the Asian crisis is a warning to the Chinese leadership about economics and the transitory nature of power. Chinese policy makers have been following fast-breaking events closely (see Xiong 1998). It has confirmed their belief in the basic correctness of their own approach to economic transformation. But it has also given increased urgency to the tasks and challenges that confront the Chinese leadership today: dealing with the financial system, dealing with discontent caused by unemployment and corruption, and navigating through the economic demands of foreign countries. Increased urgency, however, does not automatically reveal the appropriate direction or speed of the response. Does the increased danger of financial crisis, for example, mean there is less time to fix things (and thus indicate a faster pace) or greater danger from mishandling reforms (and thus a slower pace)? The crisis has confirmed Chinese leaders in their belief that they need to be tough, maintain control, and proceed cautiously, but also that they have to keep moving ahead, because those who fail to develop will not survive.

The Economics of Domestic Transformation: The Zhu Rongji Policy Regime

The impact of the Asian crisis on China must be seen in the context of changes in China's domestic political economy. The first year of the crisis was also the first year in which the post-Deng Xiaoping Chinese leadership was established and making policy on its own. The current heads of the Communist Party (Jiang Zemin) and of the government (Zhu Rongji) were named to their positions by Deng Xiaoping and served for several years while Deng was still around to watch over them. But it is only since the February 1997 death of Deng—and the deaths of a handful of other revolutionary elders—that they have shaped a fully independent policy package. In the post-Deng era, Jiang and Zhu have taken policies they had already established and pushed them further, in more fundamental and more radical directions. From their past actions, we have substantial information about their preferences and policy choices. In the economic realm, the most important policies are closely associated with the premier, Zhu Rongji.

Zhu began to put his personal stamp on economic policy making during 1993. A wave of Deng Xiaoping-supported reform was in process, packaged in a typical (for China) combination of decentralization, marketization, and slackening of rules and oversight. Although important breakthroughs were made in the transition to a market economy, the burst of reforms in 1992 and 1993 was accompanied by enormous financial laxity, rampant speculation and corruption, wide-scale diversion of public resources, and significant inflationary pressures. In this sense,

it was a clear continuation of past patterns of macroeconomic policy cycles, in which major periods of reform and decentralization were also major periods of macroeconomic disorder and inflationary growth. In 1993, China undeniably was experiencing a "bubble economy," and its vulnerability to financial contagion would have been at a maximum at that time.

Zhu immediately set out to burst the financial bubble that had formed and quickly ended some of the most speculative financial activities. Moreover, he set in motion a consistent set of policy initiatives that have persisted. Zhu's policy regime consisted of two main pillars: macroeconomic restraint and regulatory reforms. Macroeconomic restraint was initiated in 1993, and it was held steadily for the next four years. After a lag, the rate of inflation fell: from a peak annual rate of 24 percent in 1994, growth of the consumer price index slowed annually, and it began to fall in early 1998. Most remarkably, inflation was controlled with only moderate costs in terms of economic growth. Real GDP growth for 1997 was 8.8 percent, according to Chinese official figures, below the unsustainable 14 percent growth in 1992, but still quite rapid. During 1997, Chinese economists and policy makers spoke with understandable pride of their success in achieving a "soft landing."

The fundamental factor leading to the control of inflation was a shift in the relative bargaining position of enterprises and banks. Zhu Rongji—serving for part of this time as the head of the central bank—was able to create a banking system that had a certain amount of independence from the state enterprise system. At the least, the banks gained bargaining power that enabled them to resist some of the many demands placed upon them. Zhu was able to give the banking system the power to say "no," at least some of the time. How was he able to do this?

Clearly, the foundation of macroeconomic restraint was a conservative monetary policy. The real growth rate of credit was restrained, and much irregular credit generated off the books by the banking system during 1992–93 was recalled. Standard administrative tools were used to increase monitoring and keep credit growth down. As in the past, tools such as credit quotas were crude but effective in breaking inflationary momentum, slowing the economy, and beginning to restore macroeconomic discipline. Moreover, as inflation came down, real interest rates rose. Although nominal interest rates were reduced repeatedly, they did not decline as rapidly as the inflation rate, so real interest rates for bank loans increased from –10 percent in 1994 to between 7 and 8 percent in 1997. As enterprises found themselves paying substantial interest rates, they began to rethink their dependence on easy access to bank credit. The endless supply of cheap credit having disappeared, and bankers having become increasingly assertive about the need to pay on time, many firms found themselves unwilling to increase already high levels of bank debt.

Along with these changes in basic economic conditions, important changes were made in the way the banking system functioned. First, the 1995 banking laws recentralized the banking system, making local bank branches more dependent on their Beijing headquarters and correspondingly less attentive to local government officials. Second, Zhu Rongji personally laid down the law to the (Beijing) bank

heads: he is reputed to have said that any bank head who didn't turn a profit would be fired, period. Third, it was made clear that the banks had decision-making authority—at least veto power—over the use of their own money. At the same time, new restrictions were put in place that substantially limited some of the flexibility bank officials had enjoyed during the 1992–93 episode, which brought widespread diversion of funds and questionable speculative activity. Bank officials were subject to greater monitoring but clearly gained more authority within their authorized scope of business. It should be emphasized that these changes did not amount to central bank independence. Rather, they implied central bank subordination to a policy line clearly established by the top leadership. The central leadership lent its own authority temporarily to the banking system and then put in place a modest package of regulations and incentives that tended to keep at least some of that authority with the banking system.

At the same time, the financial pressures resulting from a large trade surplus and capital inflow were used to place the banking system itself under greater externally imposed discipline. With intense pressure from the top to carry out a domestic policy of macroeconomic austerity, the banking system had to contain overall credit growth within strict limits. Internal balance required slow credit growth. At the same time, the central bank had obligations to achieve external balance, meeting government policy objectives in foreign exchange markets. Specifically, the central bank was instructed to prevent (nominal) currency appreciation after large trade surpluses emerged in 1994. This meant that the central bank had to buy up the foreign exchange revenues China's exporters were generating, building up foreign exchange reserves and releasing renminbi into the domestic marketplace. Because most of the growth of the money supply was coming from the buildup of foreign currency reserves, the central bank had almost no leeway to create money through central bank lending. The share of total central bank base money creation that was attributable to the increase in foreign exchange reserves was 61 percent in 1996 and a whopping 79 percent in 1997 (G. Chen 1998). The central bank was sterilizing capital inflows, so it was unable to make significant new loans to commercial banks; as a result, it could credibly refuse to bail out local commercial banks if they overspent their reserves.

In short, the budget constraint for banks was being gradually hardened; as bankers found themselves with harder budget constraints and more decision-making authority, they in turn imposed tougher requirements on their customers, and especially on SOEs and their local government patrons. Bargaining power had swung away from the enterprises and to the bankers.

Along with macroeconomic austerity, Zhu Rongji presided over a new, more regulatory approach to economic reform. The new reforms were regulatory in the sense that they introduced new rules (and new prices) that, at least in principle, applied equally to all economic actors. There was more focus on creating and regulating competition as a force for economic change, and less on direct government action in restructuring organizations and providing new incentives.² Although this represented a real change of emphasis, it also reflected a natural movement from

one stage of reform to another. Reform during the 1980s had introduced markets and incentives. By the 1990s, the economy having "grown out of the plan," the most important tasks were to improve the legal and regulatory environment, create a "level playing field," and reduce some of the most obvious distortions in the economy (Naughton 1995). As regulatory reforms proceeded, they led to a greatly enhanced emphasis on restructuring state enterprises. State enterprise restructuring has meant converting vaguely defined public ownership into more explicit, legally defined ownership categories, sometimes involving privatization. Restructuring is related to regulatory reforms in that both envisage the creation of a legal framework that allows market forces to work. As I argue later, restructuring is driven primarily by market forces and is itself an adaptation to increased market competition. Such reforms were in harmony with the tough macroeconomic policies that were adopted. Regulatory reforms and the new macroeconomic policies both stressed the need to adhere to tough and objective rules; moreover, macroeconomic austerity made market conditions more difficult and thus tended to strengthen market discipline.

Regulatory reforms have been promulgated in nearly every area of the economy. The most important were the foreign trade reforms and the fiscal and tax reform of 1994, and a number of important financial regulations covering banks (1995) and equity markets (1996–97). The foreign trade reforms—particularly the devaluation and unification of the exchange rate on 1 January 1994—quickly brought about impressive results. China's exports surged, and the country began to run the sustained trade surplus discussed earlier. The fiscal reform was an especially important turning point. Over the course of more than fifteen years of reform, China's fiscal position had eroded significantly. Reform strategy through 1993 stressed decentralization and distribution of benefits and tolerated slackening of oversight and some corruption. Not surprisingly, government tax revenues slid, dropping from 35.8 percent of GDP in 1978 to only 11.2 percent at their low point in 1995 (Figure 10.2). No doubt marketization and dismantling of government monopolies were responsible for most of the fiscal decline. Still, the chosen reform strategy also contributed to it, and by the early 1990s, it was widely perceived that China had a serious fiscal crisis.

Fiscal reforms in 1994 were designed to arrest this slide by introducing new taxes, such as the value-added tax, with relatively low, uniform rates that applied to all economic actors. Reforms were not immediately effective, but by 1997 the corner had apparently been turned. The low point in budgetary revenues as a share of GDP was in 1995. The revenue share of GDP increased two years in a row and reached 12 percent of GDP in 1997 (see Figure 10.2). In a related manner, the central government share of revenues and expenditures, which continued to erode in the immediate aftermath of fiscal reform, stabilized (Figure 10.3). These trends indicate an increasing degree of compliance with the legal provisions of the fiscal system. Although the changes are neither enormous nor unambiguous, they are significant, because they represent changes in the direction of powerful, long-standing tendencies. It is a difficult task to shift 1 percent of GDP into the gov-

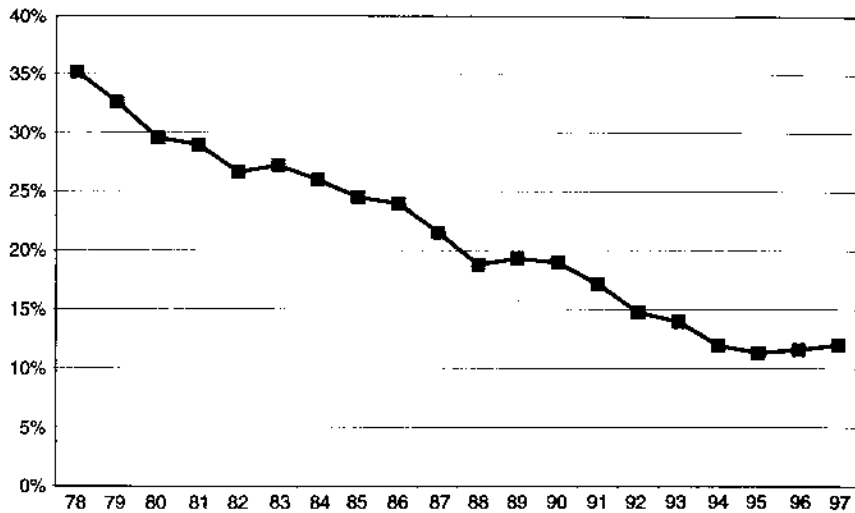


Figure 10.2 Fiscal revenues as a share of GDP: China, 1978-97

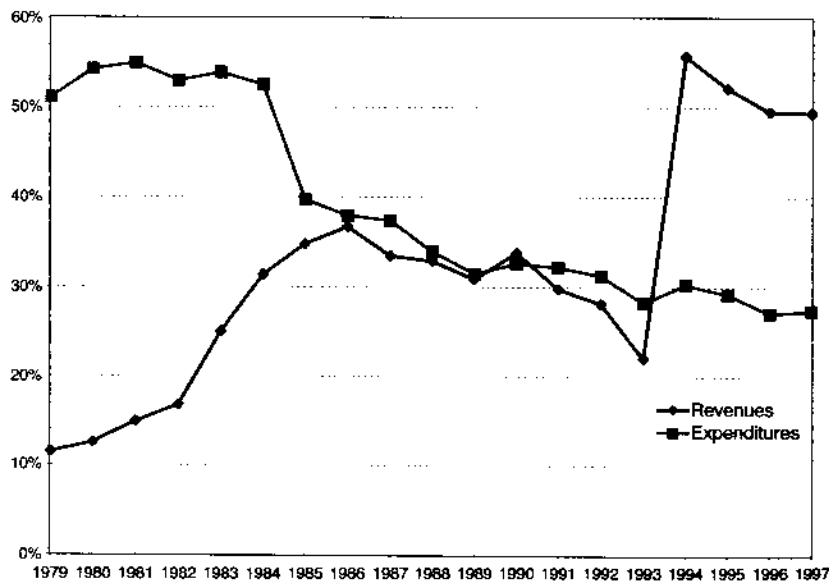


Figure 10.3 Central share of revenues and expenditures (excluding borrowing): China, 1979-97

ernment revenue column. In both banking and fiscal areas, the Zhu Rongji policies are associated with a stronger, more authoritative set of institutions.

During 1997, the economic conditions described earlier were allowed to drive a restructuring, and shrinkage, of the state enterprise sector. After the Fifteenth Communist Party Congress in September, local government officials were given an almost free hand to proceed with state-sector reforms that included bankruptcy, sales and auctions, mergers, and "corporatization." The result was a new wave of enterprise reform, diverse and multiformed, generally labeled *enterprise restructuring*. This wave of reform is still unfolding, and it is too early to draw up a comprehensive summary of the reform's bottom line. It is beyond question, however, that the current wave is an important change that is in the process of fundamentally recasting the economic landscape. Throughout almost twenty years of economic reform between 1978 and 1995, although the state sector shrunk in relative importance, it continued to grow in absolute terms, both in output and in employment. Only since 1995 has policy shifted to permit state-sector employment to decline absolutely.

Given the decentralized nature of the Chinese economy, the progress of SOE restructuring depended predominantly on the incentives facing local governments, which "owned" the majority of SOEs. The policies that followed in the late 1990s shifted that incentive environment in crucial ways: reducing access to easy credit, decreasing profitability, and increasing competition. Given the shift in bargaining power to the financial system, enterprises were unable to turn to government patrons to secure bank-funded bailouts. In Kornai's terms (1980), the enterprise "soft budget constraint," under which SOEs could always incur short-term losses, ceased to be a guaranteed option for firms.

SOEs have ceased to be cash cows on which local government officials can always draw for financial and material resources and for employment. Due to changes both in real competitive ability and in the taxation and accounting system, SOE industrial profits, which once were huge, are now quite modest. Industrial SOE profits were 15 percent of GDP in 1978, but fell below 2 percent of GDP in 1996-97. Because loss-making enterprises lost approximately 1 percent of GDP through most of the period, net profits of industrial SOEs sank to only 0.6 percent of GDP in 1997. The financial relationship between SOEs and local governments had already begun to change with the initiation of the new tax system: instead of drawing an ill-defined "surplus" from local SOEs, local governments now rely primarily on taxes, which are, in principle, levied on SOEs at the same rate as on any other ownership. Moreover, as SOEs found themselves under enormous pressure from the marketplace, due to intensified competition, and from the financial system, due to the enhanced bargaining position of bankers, local governments began to rethink the value of possessing their own SOEs. Increasingly, local governments began to conclude that they derived few advantages from local state ownership that could not equally be derived from a generally prosperous local economy, even if that economy were based on private ownership. If, moreover, the emerging private entrepreneurs were linked to government officials through ties of kinship, patronage, or friendship, that would further tilt the calculus in favor of privatization.

Local governments rushed to use "corporatization" to rationalize local industrial systems and reduce burdens. At its least significant, such restructuring involved the merger of various enterprises and the creation of various forms of joint ventures. Some of these were "shotgun marriages" in which financially healthy enterprises were compelled to take over less solvent firms, sometimes to gain access to land or other assets the insolvent firms possessed, sometimes simply because they were ordered to do so by superior organs. The steel industry is notorious for a number of economically irrational and clearly coerced takeovers of this sort.

Far more significant, however, has been a wave of sales, privatizations, and bankruptcies of local enterprises. The Fifteenth Party Congress essentially removed any remaining ideological barriers to local restructuring. As long as restructuring can plausibly be presented as in the public interest, local governments are free to carry out almost any program, including one that involves significant *de facto* privatization. Although the word *privatization* is still avoided, the reality is that an enormous wave of privatization is in fact occurring in China. The number of employees of manufacturing SOEs has declined from a peak of 35.3 million in 1992 to 30.1 million at the end of 1997, and the process is accelerating (SSB 1998, 138).

Because of the variety of local experiences, it is not yet possible to get a comprehensive sense of the scope of enterprise restructuring. It is not clear how much of the 5 million-worker reduction in state manufacturing employment corresponds to privatization, how much to bankruptcy, and how much to formation of joint stock companies that may be effectively state-controlled in all but name. It is clear that the number of joint stock companies is increasing rapidly, and, although most have a government agency as the controlling shareholder, some do not. The number of companies listed on the Shanghai and Shenzhen stock exchanges—a small but important subset of all joint stock companies—increased from 530 to 745 during 1997, and total capitalization of all listed companies jumped from 14 to 23 percent of GDP during the same period (Zhong and Zhuang 1998). There is little doubt that an important process is under way that will dramatically reshape China's economic landscape.

Through 1997, an extremely coherent economic policy configuration prevailed. Macroeconomic austerity, combined with regulatory reforms, was being used to drive a substantial downsizing of the state sector. The most important impact of the Asian crisis on China was that it made this policy package unsustainable in its original form. During 1997, the Chinese economy was already slowing, due to the delayed effects of the macroeconomic austerity program. Growth in 1997 had come to a significant extent from an expansion of net exports, and the Asian crisis made it inconceivable that growth of that magnitude would continue through 1998. Further slowing of the economy would be difficult to accept, because it would increase unemployment, already increasing rapidly in the wake of enterprise restructuring. As a result, beginning in December 1997 and throughout 1998, a series of policies was rolled out with the intention of maintaining GDP growth at 8 percent for the year. Those policies included increasing the growth rate of state fixed investment, lowering interest rates, stepping up mortgage financing to con-

vert housing privatization into a growth opportunity, liberalizing conditions for fdi, and increasing the value-added tax rebate for exporters. A common theme of most of these measures is that they relax, to varying degrees, the intense macroeconomic austerity and financial discipline that were biting into enterprise operations, particularly in the state sector.

It makes perfect sense to use domestic stimulus to replace external demand lost as a result of the Asian crisis. This is straightforward Keynesian aggregate demand management. Many of the Asian crisis countries have been deprived of this option because of their open capital accounts. They are unable to set an autonomous domestic policy of lowering interest rates and stimulating credit and investment, because capital would simply continue flowing out. China, however, having already foregone full access to world capital, now has the extra flexibility of being able to wage an independent domestic macro policy. But the new policies have substantial costs and risks. Relaxing macroeconomic discipline and propping up the economy through rapid growth of bank credit would upset recent achievements by reversing the tremendously important shift of bargaining power away from enterprises and toward the banking system. There is much more at stake than the ordinary economic arguments about macroeconomic management. This is specifically evident in the fear of increasing unemployment, which led to an obvious reduction in the urgency with which the central government has been promoting enterprise restructuring. To see what is at stake, we must look at broader political economy issues.

Redefining the Urban Social Compact

State-sector restructuring reflects a historic turn in the political economy of China. For four decades—and throughout most of the reform era—urban workers were a privileged social and political class in China. Within urban areas, incomes and social benefits were evenly distributed. Membership in the privileged group of urbanites in and of itself produced higher incomes and benefits, with workers in SOEs having slightly more generous benefits than workers in other types of organizations. Returns to education were nil, and remaining differentiation among urbanites was due largely to political status (Griffin and Zhao 1994). Moreover, workers were almost never fired. Even through the first fifteen years of the reform process, this basic arrangement did not change. Reforms introduced some flexibility into the system, but layoffs, and quits and fires from the state sector, remained extremely small through 1992. China has now dismantled the system of central planning and adopted a market economy. Thus, the privileged position of urban workers has been the single remaining feature of the socialist regime that most sharply distinguishes China from her East Asian neighbors.

Since 1993, the guarantees given China's urban workers have largely evaporated. The clearest indication of this change is the rapid growth of unemployment. Unemployment in China's cities is composed of two classes of worker: registered

Table 10.1 Urban Unemployment and Layoffs (Year-End, in Million Workers)

	Registered Unemployed	Laid-Off Workers
1993	4.2	3.0
1994	4.8	3.6
1995	5.2	5.6
1996	5.5	8.9
1997	5.7	11.5

Sources: Yang Yiyong 1998; SSB 1998.

unemployed and laid-off workers. Registered unemployed workers have no links to existing enterprises and have filled out forms at local labor offices indicating they are looking for work. Their numbers have increased moderately, from 4.2 million in 1993 to 5.7 million at the end of 1997 (Table 10.1). Far more striking is the rapid increase in the number of laid-off workers (*xiagang rennyuan*), which jumped from 3 million in 1993 to 11.5 million at the end of 1997. Laid-off workers retain ties to their former workplaces but have no current jobs with those firms. Their ties to the workplace are kept to ensure some access to various benefits, to possible early retirement pensions, and to enterprise-supplied housing. Some laid-off workers in fact have found new employment, particularly in the informal sector, and retain ties of convenience to their former enterprise because it is in their interest to do so. Moreover, there may be some double-counting of individuals in the registered unemployed and laid-off categories. Total unemployment, therefore, cannot be calculated simply as the sum of these two numbers. I estimate that urban unemployment has increased from less than 4 percent in 1993 to between 7 and 8 percent at the end of 1997.

State enterprises are under enormous economic pressure, and they are simply unable to shield their own workers from it. Chinese workers are now fully at risk from layoffs and unemployment. Even those workers who retain ties with their former work units frequently find that payments are sporadic and well below the minimum benefit level established by most municipalities. Many workers fall through holes in the social safety net.

Not all urbanites will suffer from the current changes: there will continue to be an urban elite, more privileged in relation to the rest of society than ever before. But that elite is defined by wealth and skills, not simply by residence in an urban area. Urban workers without special skills or education, wealth, or connections to the wealthy and powerful increasingly find themselves in competition with China's vast reservoir of rural workers. That competition stems from the increased mobility of China's workers, which has brought rural residents into urban job markets in unprecedented numbers, but also from the deepening progress of state enterprise reform, which pushes workers into the same job markets that are attracting rural workers (Beijing University 1998).

These changes are far more important to the Chinese leaders than is the Asian crisis as such. Chinese leaders believe that a restructuring and shrinkage of the state sector is necessary if the Chinese economy is to develop and grow into a world-class economy. Economic competition between China and other East Asian economies—and also between different regions within China—dictates leaner enterprises that have the flexibility to trim surplus workers. At the same time, Chinese leaders have always displayed enormous sensitivity to the political activity of the urban working class. They understand that an urban working class in active opposition to Communist Party rule will spell the end of their system. Fear of working-class opposition was a major reason that no leader dared dismantle this system during the reforms of the 1980s.

This is the context within which the impact of the Asian crisis needs to be understood. The previous section described the shift in macroeconomic policy during 1998 designed to prevent the economy from slowing too abruptly. Similarly driven by the gravity of the Asian crisis, concern with rapidly increasing unemployment led central government leaders to shift emphasis during 1998 away from the urgency of enterprise restructuring and toward the importance of creating re-employment opportunities for laid-off workers. The emphasis moved from efficiency to welfare considerations. With the shift in central government rhetoric and the reduced pressure of macroeconomic austerity, the impetus to enterprise restructuring clearly diminished during the course of 1998.

These events show that Chinese leaders will be managing the Asian crisis with an eye toward the main game: the transition in the role of urban workers. China's leaders would prefer to unwind the privileged position of urban workers gradually and "safely." The Asian crisis presents the frightening possibility that the compact would disintegrate rapidly, causing massive social dissatisfaction and unrest. As a result of these concerns, the central government has done some back-pedaling on enterprise restructuring.

But, whereas China's dramatic transformation of the role of urban citizens faces formidable challenges, it is also driven by a powerful economic and social logic. Most important, the restructuring process is driven primarily at the local level. Each restructuring initiative brings powerful local interests into play and creates new opportunities for personal gain. Moreover, the dominant interest is that of local government. Rapid SOE restructuring occurs in those localities where local government leaders have concluded that restructuring is in their interests; restructuring limps along slowly when local government leaders decide it is against their interests. Moreover, as Solinger (1998) shows, local governments interpret central government re-employment policies stressed during 1998 according to their own interests as well. Some local governments give re-employment a predominantly free market spin, stressing more rapid absorption by the private sector, while others give it a predominantly welfarist spin, emphasizing ongoing obligations by state firms to laid-off workers.

The fundamental logic driving enterprise restructuring is powerful enough that it is unlikely to be substantially altered by short-term fluctuations in central gov-

ernment policy. The emergence of an increasingly fluid and competitive society, on the one hand, combined with the government's hunger for revenues and a disciplined macroeconomic policy, on the other, implies that the pressures reshaping the state enterprise sector will continue to be intense. Regions that restructure promptly and thoroughly will enjoy a competitive advantage over regions that delay and carry larger subsidy burdens into the future. Over time, the incentives pushing local governments to restructure their public enterprise sectors are likely to intensify, rather than moderate, regardless of central government proclamations.

Conclusion: The Changing Political Process

We can further clarify the political changes in China by placing them in the context of the dichotomy between policy credibility and policy decisiveness used by MacIntyre in chapter 7. In this framework, policy credibility is provided by an institutional setup with sufficient checks and balances built into the system to provide a real assurance that established policies and political rights or property rights will be fully respected. By contrast, policy decisiveness is most easily achieved on the basis of an opposite institutional setup—one without significant checks and balances, allowing an authoritative policy maker to promptly and fully respond to changing conditions. It is important to recognize that China is moving toward a much more decisive type of policy making. This shift appears to be deeply rooted, reflecting economic, political, and institutional factors.

Economically, one of the main lessons Chinese policy makers have drawn from the Asian crisis is the need to maintain economic positions that permit a high degree of policy decisiveness. For example, the Chinese leaders see that the financial setup in Taiwan, described by Chu in chapter 9, gives policy makers a high degree of autonomy in setting financial and macroeconomic policy, and this has arguably contributed to their ability to weather the Asian crisis more effectively than other economies. Conversely, Chinese leaders see that the decline in policy decisiveness associated with political transitions in the region has contributed to the severity of the crisis. Zhu Rongji himself clearly believes that greater government decisiveness is needed to clean up financial irregularities and prevent the emergence of speculative bubbles.

Perhaps surprisingly, an image of decisiveness and toughness also contributes to Zhu Rongji's political standing. Zhu Rongji is an unusual politician by Chinese standards. He is much less closely associated with Communist Party insiders than are other top Chinese leaders (such as Li Peng). Indeed, Zhu was designated a "rightist" in 1957, and was only "rehabilitated" at the end of the 1970s (Gao and He 1995). He spent his entire career as an economist, until he was suddenly appointed mayor of Shanghai in 1987. In the Chinese context, he is a technocrat. He has no foreign degrees but possesses considerable economic and administrative expertise. An image of tough impartiality and competence makes him quite popular. Although no opinion poll published in the PRC would be credible, it is inter-

esting that a poll in Hong Kong—which retains freedom of speech and of the press—reports approval ratings of 77 percent for Zhu Rongji and 73 percent for Jiang Zemin, but only 46 percent for the Beijing-appointed chief executive of Hong Kong, Tung Chee-hwa (CND 1998b). Of course, Zhu Rongji carefully tends his image, and he has shown a knack for displaying—for example, at press conferences—an image that is simultaneously authoritative and informal.

During 1998, even as Zhu Rongji and Jiang Zemin were in some respects retreating from their agenda with respect to SOE restructuring, they took care to maintain the impression of authoritative, decisive action. Most striking was the launching of simultaneous campaigns against smuggling and military involvement in business. These campaigns have significant economic benefits, reducing imports that threaten to surge because of the overvalued currency, facilitating increased monitoring and nontariff barriers to legal imports, and increasing government revenues; but they also alienate potentially powerful interest groups. Similarly, Zhu has vowed to push ahead with government downsizing, designed to reduce the number of government employees by one-half within three years (Mo 1998, 28–29). To China's urban workers, government downsizing sends a strong message that government employees are not exempt from the pain of unemployment. Thus, rather than retreating, Zhu has chosen to capitalize on his political assets, and the resulting "strong man" approach to economic policy is evident across the board: toward the renminbi (no devaluation); toward state enterprises and government (slimmed down to face market forces); and toward smuggling and military involvement in business (crackdown).

More surprising is the fact that the institutional underpinnings of the Chinese system are shifting in a way that favors greater policy decisiveness. One would normally assume that a nondemocratic authoritarian system, run by a hierarchically organized Communist Party and dominated by charismatic individuals like Mao Zedong and Deng Xiaoping, would always display a high degree of decisiveness. However, the lack of decisiveness in Chinese policy making during the 1980s is well attested. During this period, Communist Party elders, most crucially Deng Xiaoping but also, importantly, Chen Yun and several other, more conservative elders, had significant veto power and an important influence over policy. Next-generation leaders, such as the premier Zhao Ziyang and the party secretary Hu Yaobang, faced important constraints on their decision-making authority. Various central leaders, in competition over specific policy choices, sought to mobilize winning political coalitions by "playing to the provinces," in Shirk's evocative term. The result was an indecisive policy process that nonetheless in many respects "muddled through" to some important successful outcomes (Shirk 1993). There were many checks and veto points in decision making, but they were dependent on personalities rather than formal institutions. This political process allowed local political elites and privileged urban workers to maintain their privileges, because the political coalition building required made it virtually inconceivable that such important groups would be seriously excluded.

Jiang Zemin and Zhu Rongji have already begun to change some of the economic phenomena consistent with this institutional setup, including declining gov-

ernment revenues and a declining central government share of revenues. Not surprisingly, they would also like to change the institutional underpinnings to consolidate their personal political positions. In this they have the advantage that the formal institutions at hand are highly authoritarian, reflecting the organizational principles of the Communist Party and its dominance of the government. Now that the elders are gone, there are many fewer informal veto gates that must be crossed, and formal positions correspond better with real authority.

Substantial dangers are associated with this process. First, increased decisiveness brings with it, almost inevitably, decreased credibility. The policies are more highly associated with a single individual, and although individual policy outcomes may be desirable, they retain a degree of fragility. Precisely because policies have not passed through multiple veto gates, they do not have the broad-based support they would have acquired had more decision makers signed off on them. In this respect, it is striking that Zhu Rongji and Jiang Zemin have invested far more in building up *personal* credibility than in building up the credibility of the policy process as a whole. Outside core economic strategy, Chinese government policies fluctuate significantly, but Zhu and Jiang display an ability to make their personal views stick.

Second, the current leadership is forsaking some of its traditional pillars of support. The desire to develop more policy-making autonomy inevitably means that some social groups that (at least passively) supported the regime in the past will now have less motivation to do so. It is not clear whether the regime can forfeit the support of urban workers or the military and still survive. The pressures are great, and the potential for open political opposition from the urban working class is significant. In this context, the events that took place in Mianyang, a medium-sized city in the Sichuan province, cannot have escaped the notice of Chinese politicians. Mianyang, a city in interior China with intense economic problems, was selected in 1996 as a keypoint test city for industrial restructuring. In the subsequent two years, sixty-two SOEs were declared bankrupt, with more than twenty-one thousand workers (7 percent of the municipal total) laid off (Mo 1998, 18). But there were major demonstrations in Mianyang, caused not only by the layoffs, but also by failures to pay wages and pensions at these and other firms. Demonstrations apparently met with a brutal police response that, according to one report, led to scores of deaths and hundreds of injuries (CND 1997). Despite the remoteness of Mianyang, reports of these demonstrations made their way through China's dissident network to the West, where they were given significant play in human rights publications and newspapers. Although the link with government economic policies was not noted in the Western press, it certainly would not have escaped Chinese leaders, particularly those with doubts about the policies. If the Zhu policies provoke excessive resentment and unrest, and if they are perceived to be unsuccessful, it would be easy enough for other leaders—including Jiang Zemin—to distance themselves from Zhu and let him fall.

It is hard for China's leaders to believe that they can get through this transition without authoritarian political controls. The Asian crisis brings greater costs and

greater vulnerability to China than would otherwise be the case. This intensifies the Chinese leadership's fear of economic disruption and political challenge, because they perceive this as perhaps the most delicate and contested step in the entire economic transition. Now, of all times, they would like to maintain control. The Asian crisis strengthens their desire for control, while also throwing up another set of unpredictable and potentially threatening economic developments. Thus, although the underlying economic processes driving change in China are deeply rooted and likely to persist for the foreseeable future, the political institutions are being reshaped in new and sometimes surprising ways. Whether these institutions are adequate to cope with the broad social changes occurring in China must remain an open question.