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in Shanghai's Financial Industry (abstract)***

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Sebastian Heilmann

Professor of Government / Political Economy of China

Sebastian Heilmann
Department of Political Science
Trier University, 54286 Trier, Germany

E-mail: heilmann@uni-trier.de

Sebastian Heilmann

Policy-Making and Political Supervision in Shanghai's Financial Industry

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Abstract

This study deals with the political economy of local financial industries in China. It focuses on the changing patterns of political interference and the key role of Communist Party bodies in shaping business incentives. The centralization measures in the financial sector that were implemented under the Zhu Rongji government in 1998 and 1999 turned out to be not very effective in supervising local financial institutions. From 2000 to 2003, a trend towards a reaffirmation of local control in financial business emerged. Local governments began to set up new financial work bodies with comprehensive functions and extensively used local banks as their 'moneybag' again. Reducing the risks involved in the current politicized management of local financial business will be inseparable from political, legal and regulatory changes: curbing the Communist Party's role in cadre appointments, strengthening legal corporate governance structures and clarifying the division of labor among national and local supervisory bodies.

Introduction

In 1998 and 1999, the Zhu Rongji government pushed through a centralization of financial regulation and supervision that was aimed at 'doing away with local and departmental interference' in China's banking, securities and insurance business. Local politicians' influence on banks was said to be one of the main causes of an irresponsible expansion of credit issuance and a rapid accumulation of non-performing loans. Central government control over financial regulatory bodies, national financial companies and the stock exchanges in Shanghai and Shenzhen was strengthened by applying classical Leninist methods. New Communist Party supervisory organs and a hierarchy of Party Committees in national financial institutions were established to achieve 'vertical leadership' in China's financial industry.

Yet it is often overlooked that these measures were confined to *national* financial companies. Zhu Rongji's centralization efforts left companies whose assets were controlled by local governments under the purview of these governments. Most importantly, the 'personnel link' between these financial firms and local governments remained unbroken. Local Communist Party bodies continued to appoint the senior executives of local financial firms. And starting from about 2002, a trend towards an open reaffirmation of local government influence in financial business emerged. Local governments began to set up new financial work bodies with varying names and functions in their jurisdiction. These new bodies were seen by central regulators with suspicion. But since banking, securities and insurance supervision by central regulatory bodies suffered from many obvious inefficiencies, the central government tolerated the emerging new local financial work institutions.

China's local urban banking system, at the end of 2003, consisted of 11 joint-stock commercial banks, originally set up by provincial-level governments, with subsidiaries in several provinces and major cities, and 112 municipal commercial banks without subsidiaries in other places. Moreover, there exist thousands of usually small-scale urban or rural credit cooperatives that are supposed to be merged into larger commercial banking units in the next few years. Whereas the big four national state-owned commercial banks held 61% of total loans and 67% of total deposits in China's banking system at the end of 2002, local joint-stock banks and urban credit cooperatives together held 14% and 16%, respectively. Although local banks thus can be seen as 'lightweights' in China's national financial system, it became manifest in 2003 that the financial risks in most local banks were growing rapidly. While investment in central government controlled projects decreased during the first half of 2003, investment projects initiated or supported by local governments (urban redevelopment, real estate construction, public display projects) and predominantly financed by bank loans increased by 42%.

This marked discrepancy between central financial tightening and local financial expansion can only be explained by taking a closer look at the political economy of China's local financial industries. The changing patterns of political interference in local financial companies and, in particular, the role of Communist Party bodies in shaping business incentives, are under-researched topics. Only a few Chinese authors present information on the interplay between central and local government regulators in the making of Shanghai's financial market and, probably so as to avoid sensitive political issues, they do not even mention the role of CCP organs in policy-making and business supervision. Chinese research on the political economy of finance, including methodologically ambitious works such as Luo Jinsheng's book on the role of local government-controlled banks as interest groups in institutional transition, avoid the delicate key issue of CCP control over financial executives and instead present a highly formalized analysis that seems rather remote from the rules of the game in China's financial business. In recent Western research on China's financial system, some authors describe Communist Party control as retreating. Stephen Green criticizes as a 'myth' assessments of China's capital market that stress the continuing importance of Communist Party control over regulatory bodies and over state controlled financial firms as the main impediment to regulatory improvement. In contrast to Green's position, I argue that Communist Party supervision that is exercised mainly through control over senior executives (appraisal, appointment, removal and discipline inspection of 'leadership cadres') is still a key factor shaping the behavior of decision-makers in China's financial business.

In this study, the structures of policy-making and political supervision in local financial industries will be subject to closer scrutiny. Shanghai serves as an instructive case study because of its strong and trend-setting position in China's financial business. Through a study of political supervision in Shanghai's financial sector, I want to show how far-reaching the influence of Party bodies can still be and how the structures of political control are subject to adaptive pressures in a changing economic context. In the following section I deal with peculiarities of local financial supervision and the emergence of diverse financial work bodies that are only loosely connected to national financial regulation. Then, drawing on Shanghai case studies, I successively turn to the context and main participants of local financial sector policy-making, to the functions and powers of Shanghai's financial work bodies, to the procedures, effects and inherent frictions of the executive appointment system and to the institutions set up to fight misconduct among financial executives. I come to the conclusion that, under the current framework of political and administrative supervision, the mounting risks in local banks cannot be contained by central government regulators who have authority over national financial institutions but lack effective levers to influence management decisions in local financial firms.

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Conclusion

This study presented strong evidence for the limitations of national financial regulation in China. The centralization efforts undertaken by the Zhu Rongji government have not done away with local government interference in the financial system. Except for scandal-driven discipline enforcement in individual cases, the central government has only weak incentives and constraints at its disposal to prevent local banks from serving as the moneybag [*qianbao*] for local governments. Therefore, in the current institutional framework, ‘the mounting problems in local banks cannot be solved by central government regulators’. The expansion of local financial supervision bodies was not only driven by the ineffectiveness of central regulators and by a desire of local governments to reaffirm their control over investment channels. Jurisdictional competition emerged as a major factor. Provincial and municipal financial work bodies became instruments in the struggle of local governments to improve the competitiveness of financial centers by providing better infrastructure and administrative services.

China’s financial industry continues to be heavily politicized, and Communist Party bodies play a key role in this. As long as local governments, through investment and asset management units controlled by them, function as the main indirect shareholders in local financial institutions, and as long as local Party Committees control executive appointments, local financial institutions will serve as a policy tool for politicians that are eager to support economic growth in their jurisdiction, or their personal prestige projects, by pumping money into the economy while ignoring the inherent risks to the financial system. In Shanghai, CCP control in the financial industry appeared to be even more elaborate than at the Party Center. Whereas the CCP’s Central Financial Work Commission was dissolved in March 2003 and most of its functions transferred to state bodies, such a redefinition of Party control in economic regulation has been averted by the Shanghai Municipal Party leadership. In Shanghai, the practice of ‘the Party taking the place of the government’ (*yi dang dai zheng*) was maintained despite a major reorganization of the municipal Party apparatus in summer 2003. Thus, Party bodies still played a key role in the day-to-day administration of Shanghai’s financial industry and were not clearly focused on cadre management as in central government regulatory bodies. Shanghai’s leaders were less willing than central government politicians to give up controlling the economy through secretive Party bodies that operate on the basis of internal, unpublished documents.

Is there evidence for political business cycles as a main cause of financial expansion? Naughton suggested that new local political leaders installed in 2002 and 2003 may have tried to consolidate their positions by boosting urban redevelopment, the real estate industry and embarking on political show projects. In Shanghai, which is characterized by an investment euphoria that was pushed along by central politicians already since 1992, new municipal leaders indeed proved to be very expansive in their investment plans. Significantly, they delayed and toned down measures to curb investment in the wildly growing real estate sector when the Central Bank tried to rein in this overheating market in summer 2003. Weakening central political pressure on local governments’ financial behavior and on banks’ lending discipline in the final years of the Zhu Rongji government appears to be a powerful factor in explaining the massive expansion of local investment in late 2002 and in 2003. The centralization measures initiated under Zhu Rongji from 1998 to 2000 were only incompletely realized, could not be sustained and were already undermined when the Wen Jiabao government was established in March 2003. A cycle of tightening and loosening of central control, typical of economic regulation in China’s reform period, thus unfolded between 1998 and 2003 in the financial industry.

Importantly, this will not simply lead to a reassertion of local government control. There are new forces at work that may constrain political influence over the management of financial firms in the near future. Communist Party bodies, faced with new types of shareholder structures and growing pressures to make business performance the supreme criteria for choosing senior managers, are compelled to reorganize their methods of 'cadre' selection for financial companies. And in the context of multiplying activities of transnational financial firms, politicians are not anymore as free as before in their business interferences if they want to avoid deterring the foreign investment they rely on for the wealth of their jurisdictions and for their careers. But clearly China's politicians are not yet prepared to leave executive appointments to legal corporate governance procedures. Communist Party bodies continue to claim ultimate control over 'leadership cadres' even if the majority of shareholders in financial firms comes from the private sector. Appointments of bank managers by Party bodies have produced a situation in which managers are not primarily responsible to their bank's corporate bodies but to the outside political patrons they were promoted by. The authority of Party-appointed managers meets with no effective constraints within firms since they are seen as externally empowered. And government interferences in management decisions are irrefutable under the current appointment practice. In such a structure of career incentives and constraints, political opportunism and political connections are still a more solid basis for advancement than business performance. Therefore, reducing the risks involved in the current politicized management of local financial business will be inseparable from political, legal and regulatory changes: curbing the Communist Party's role in cadre appointment, strengthening legal corporate governance structures and clarifying the division of labor among national and local supervisory bodies.