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# The Evolution of "Political Business Cycle" in Post-Mao China

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*In the heyday of China's socialist economy during the Mao era, economic fluctuations were highly correlated with central government policy cycles. In post-Mao China, economic fluctuations are again found to be closely related to political rhythms. A "political business cycle," with a logic different from that observed in Western democracies, seems an increasingly significant phenomenon. By scrutinizing the evolution of the political business cycle in post-Mao China, this article concludes that profound institutional changes have taken place from the Deng regime to the Jiang/Hu regime in three respects. First, China's economic cycle has become more responsive to the political rhythms of formal political institutions, rather than changes in informal politics. Second, when Chinese leaders have needed to manipulate macroeconomic policies to bolster their political popularity, they have increasingly relied on market instruments rather than plan measures to achieve their goals. And third, as China's economy has been rapidly integrated with the global capitalist system, international factors have played an increasingly important role in determining China's domestic monetary environment. In other words, the Chinese government's monetary autonomy has been largely undermined by the growing effects of globalization.*

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In post-Mao China, what have been the essential changes in the nature of Chinese elite politics? How have changes in leadership politics affected economic policymaking? Have economic reforms provided Chinese policymakers with better instruments to achieve their political and economic policy goals? Students of Chinese politics have probed these questions from different vantage points and found answers in a variety of policy aspects. In general, the findings from research focusing on diverse policy areas and covering different time periods seem to converge at the following conclusions. First, although informal politics has been the dominant form of elite politics in post-Mao Zedong (毛澤東) China, formal political institutions have played an increasingly important role in the political system, especially in the 1990s when the old revolutionaries faded from the scene.[1] Second, the economic transition from plan to market has fundamentally changed the state's role in the economy.[2] Top policymakers, no longer commanding the economy, have had to rely on quite different policy instruments to "govern the market."[3] Finally, the economic transition has involved not only "reform" but also "opening." China's rapid integration into the global capitalist system has also had a

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[1]Kenneth Lieberthal and Michel Oksenberg, *Policy Making in China: Leaders, Structures, and Processes* (Princeton, N.J.: Princeton University Press, 1988); Susan Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993); Joseph Fewsmith, *China Since Tiananmen: The Politics of Transition* (Cambridge: Cambridge University Press, 2001); Frederick C. Teiwes, "Politics at the 'Core': The Political Circumstances of Mao Zedong, Deng Xiaoping, and Jiang Zemin," *China Information* 15, no. 1 (2001):1-66; and Jonathan Unger, ed., *The Nature of Chinese Politics: From Mao to Jiang* (Armonk, N.Y.: M.E. Sharpe, 2002).

[2]Barry Naughton, *Growing Out of the Plan: Chinese Economic Reform, 1978-1993* (Cambridge: Cambridge University Press, 1995); Andrew G. Walder, ed., *China's Transitional Economy* (Oxford: Oxford University Press, 1995); and Susan H. Whiting, *Power and Wealth in Rural China: The Political Economy of Institutional Change* (Cambridge: Cambridge University Press, 2000).

[3]The term "govern the market" is borrowed from Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton, N.J.: Princeton University Press, 1990).

deep impact on economic policymaking.[4] By observing how the correlation between economic fluctuations and political cycles has evolved in post-Mao China, this article intends to contribute to our understanding of these trends in the particular policy aspect of macroeconomic stability management.

Economists find a correlation during the Mao years between economic fluctuations and central government policy cycles.[5] Throughout the reform era, observers have consistently noted a relationship between economic cycles and certain political rhythms. For example, in the mid-1990s, Dittmer and Wu asserted that there was a synchronization of factional politics, economic reforms, and business cycles throughout the Deng Xiaoping (鄧小平) era.[6] At almost the same time, Chinese economist Hu Angang (胡鞍鋼) found a correlation between economic expansion and the dates of Chinese Communist Party (CCP) congresses and meetings of the National People's Congress (NPC).[7] By tracing the evolution of the political business cycle to date, this article finds there were three profound institutional changes in the 1990s. First, China's economic cycle has become more responsive to the rhythms of formal political institutions than to changes in informal politics; second, when Chinese leaders need to employ expansionary policies to create economic prosperity, they have increasingly relied on market instruments rather than plan measures to achieve their goals; and third, as China's economy has been rapidly integrated with the global capitalist system, international factors have begun to play an important role in determining China's domestic monetary environ-

[4]Thomas G. Moore, *China in the World Market* (Cambridge: Cambridge University Press, 2002); and Yongnian Zheng, *Globalization and State Transformation in China* (Cambridge: Cambridge University Press, 2004).

[5]Alexander Eckstein, "Economic Fluctuations in Communist China's Domestic Development," in *China in Crisis: China's Heritage and the Communist Political System*, ed. Ping-ti Ho and Tang Tsou (Chicago: University of Chicago Press, 1968), 691-752; and Chu-yuan Cheng, *China's Economic Development: Growth and Structural Change* (Boulder, Colo.: Westview, 1982).

[6]Lowell Dittmer and Yu-Shan Wu, "The Modernization of Factionalism in Chinese Politics," *World Politics* 47, no. 4 (July 1995): 467-94.

[7]Hu Angang, *Zhongguo jingji bodong baogao* (Report on China's economic cycle) (Shenyang: Liaoning renmin chubanshe, 1994), 191.

ment—that is to say, the Chinese government's monetary autonomy has been largely undermined by the growing effects of globalization. In sum, institutional changes in elite politics and the management of monetary policies over the past decade have made the Chinese government more able to handle stable growth in a market economy, but the effects of globalization have also increasingly constrained this capacity.

First, this paper suggests that while most observers of the Chinese economy focus on the surge in foreign reserves as the primary driver of the latest run of monetary expansion, the convening of the Sixteenth Party Congress is another factor that has been ignored. This is followed by a discussion of how political factors have affected economic cycles of boom and bust in general, as well as in the post-Mao period in particular. It is suggested that there is a political business cycle in China. Although the underlying causal mechanism of this synchronization of economic and political cycles is totally different from the one observed in Western democracies, it has gradually evolved in a rational manner since the early reform period. The third section provides an in-depth analysis of three institutional changes that the evolution of China's political business cycle has reflected. Finally, the paper concludes that the observations of the changes in correlations between leadership succession and macroeconomic policies in this article confirm the consensus that institutionalization of the Chinese political economy has accelerated from the Deng to the Jiang Zemin (江澤民)/Hu Jintao (胡錦濤) regimes.

## A Hidden Factor in China's Recent Monetary Expansion

As international pressure for the appreciation of the *renminbi* (RMB, 人民幣) has intensified in the past few years, the surge in China's foreign reserves is often seen as the major factor behind the expansion of the domestic money supply.[8] China's foreign reserves increased sharply from

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[8]Eswar Prasad and Shang-Jin Wei, "The Chinese Approach to Capital Inflows: Patterns

2001 alongside rapid growth of the trade surplus, capital inflows, and the domestic money supply (see chart 1). Measured by the growth rate of broad money (M2), China's money supply grew by 13 percent in 2001, 16.5 percent in 2002, 19.6 percent in 2003, and 15.5 percent in 2004.

In theory, the surge in foreign reserves, by increasing the Chinese central bank's monetary base (so-called *high-powered money*), did help build excessive liquidity in China's financial system.[9] Nonetheless, the money supply has also been determined by how much credit the Chinese banking system created through loans to economic actors in the real economy.[10] In other words, the Chinese state-owned banks' lending decisions were also an important factor driving expansion of the money supply.

Although the Chinese government has since 1998 encouraged state-owned banks to make more loans to accommodate its "proactive fiscal policy," the banks have only become enthusiastic about extending credits since the second quarter of 2002. Before then, quarterly increases in bank loans never exceeded 400 billion *yuan*. After that, quarterly loan increases did not fall below 500 billion *yuan* until the first quarter of 2004, when the central leadership launched its "macro adjustment and control" (宏觀調控, *hongguan tiaokong*) policy (see chart 2).

Most of the bank loans were used to fuel China's investment in fixed assets. The annual growth rate of China's total investment in fixed assets accelerated in 2002 with a growth rate of 16.1 percent. It continued to grow

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and Possible Explanations," *IMF Working Paper* (2005), WP 0579; Nouriel Roubini and Brad Setser, "China Trip Report" (Working paper), April 2005 (www.rgemonitor.com); and Morris Goldstein and Nicholas R. Lardy, "A Faulty Strategy Weakens China's Prospects," *Financial Times*, March 4, 2005.

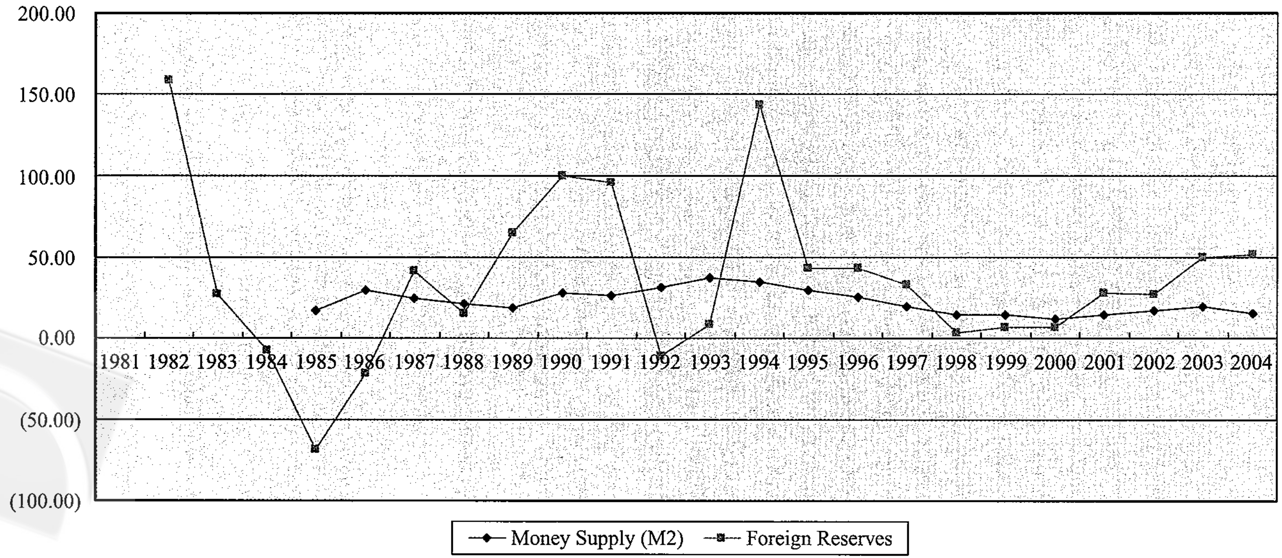
[9]For the definition and measurement of China's monetary base, see People's Bank of China, "China Monetary Policy Report, Quarter One, 2004."

[10]The relationship between monetary base and money supply can be expressed as following equation:

$$M = m * MB$$

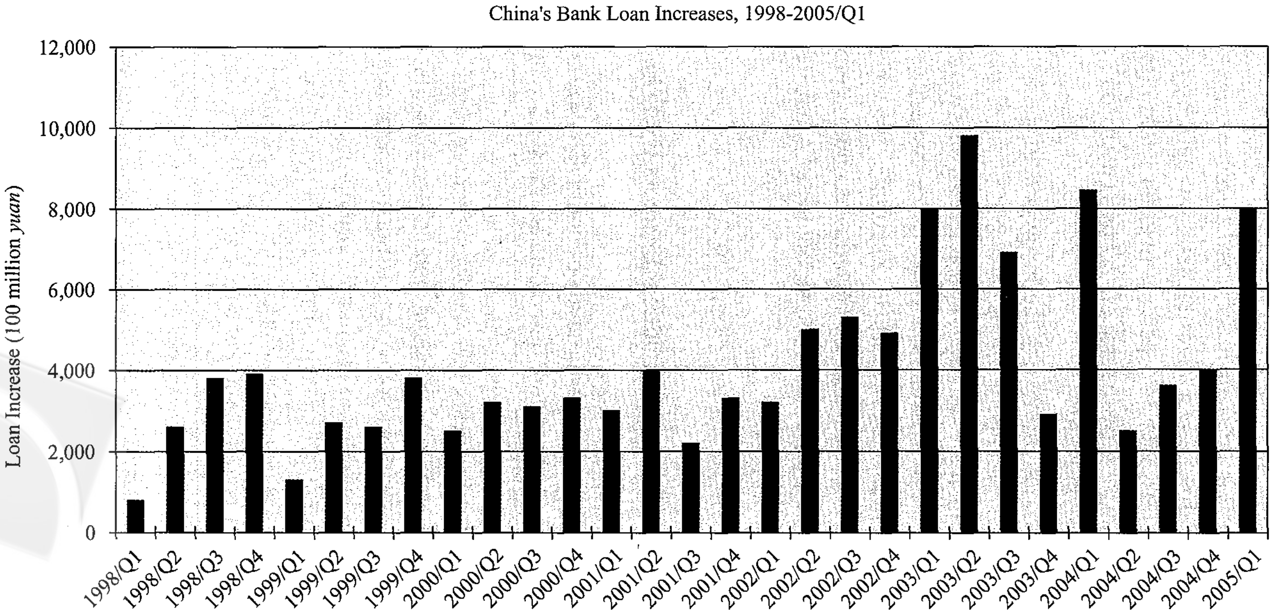
Where $m$ is the money multiplier, MB is monetary base, and M is money supply. The money multiplier reflects the effect on the money supply of other factors besides the monetary base. The money multiplier can be seen as a parameter that reflects the willingness of creditors to create credits. See Frederic S. Mishkin, *The Economics of Money, Banking, and Financial Markets*, fifth edition (New York: Addison Wesley, 1998), chap. 17.

**Chart 1**
**Growth of China's Foreign Reserves and Money Supply (M2), 1982-2004**




**Sources:** People's Bank of China (PBC), *Almanac of China's Finance and Banking*, various issues; and PBC website (http://www.pbc.gov.cn).

**Chart 2**
**The Quarterly Growth of Bank Loans, 1998Q1-2005/Q1**




**Sources:** People's Bank of China, "China Monetary Policy Report, Quarter Three, 2003"; and PBC website (http://www.pbc.gov.cn).

at rates of 28.4 percent in 2003 and 25.8 percent in 2004 (see chart 3). Moreover, the surge in investment was attributable *exclusively* to local governments. Local fixed-asset investments grew by 23.4 percent in 2002, 36.2 percent in 2003, and 34.5 percent in 2004 while central investment declined sharply, with growth rates of -2.7 percent in 2002, -4.7 percent in 2003, and 3.1 percent in 2004.

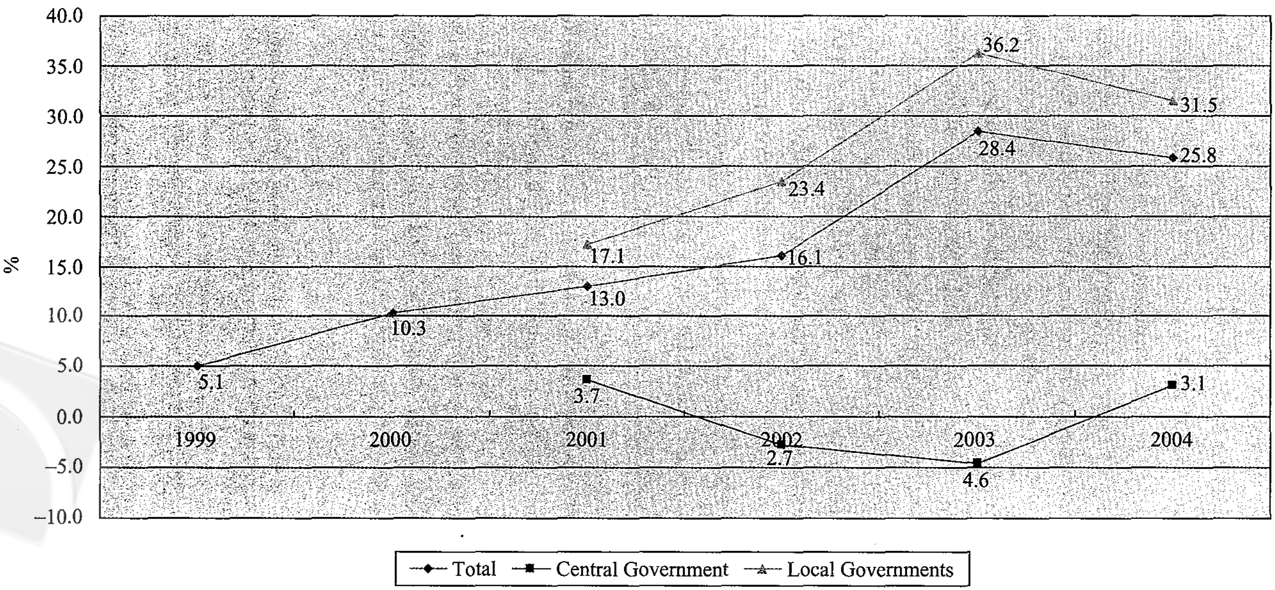
Judging from the timing and the instigators of the investment boom, i.e., the local governments, it seems plausible to argue that the sharp increases in both bank loans and fixed-asset investments were related to both the convening of the Sixteenth Party Congress in late 2002 and the government power transition in early 2003. Therefore, the central leaders' attempts to win political support by fostering economic prosperity during the transition can be seen as a hidden factor in China's recent monetary expansion.

## The Evolution of the Political Business Cycle in China

In Western democracies, the study of political business cycles (PBCs) is a well-developed field, where fierce debates can lead to important breakthroughs in theories and methods for studying political economy. In brief, the theory of PBCs suggests that, in democratic regimes where political transitions are determined by regular popular elections, incumbents interested in maximizing their votes should pursue expansionary policies to produce favorable pre-election economic conditions.[11] The theory is compelling, but empirical evidence is difficult to obtain for two main reasons. First, political cycles in democracies are difficult to define because election cycles of different government branches and levels overlap. Second, rapid

[11]The theory was first developed by several renowned scholars of American politics in the 1970s. See William D. Nordhaus, "The Political Business Cycle," *Review of Economic Studies* 42 (1975): 169-89; Ray Fair, "The Effect of Economic Events on Votes for President," *Review of Economics and Statistics* 60 (May 1978): 159-73; and Edward Tufte, *Political Control of the Economy* (Princeton, N.J.: Princeton University Press, 1978).

**Chart 3**
**Growth of China's Fixed-Asset Investment, 1999-2004**




**Source:** National Bureau of Statistics website (http://www.stats.gov.cn).

global integration of financial markets has largely reduced government monetary autonomy in each country. This has, in turn, created too many "intervening" factors from purely economic sources for us to trace the synchronization of political and economic cycles in real life.[12]

The difficulty of empirical examination in Western democracies has not prevented PBC theory from inspiring students from the developing world. In fact, PBCs are probably a more significant phenomenon in developing countries because the lack of independence of government branches, such as central banks and finance ministries, may allow more room for governments to manipulate monetary and fiscal policies for political ends. Stephan Haggard and Steven Webb find, for example, that in newly democratizing countries "the probability that a government will undertake a stabilization program declines significantly in election years and the preceding years."[13] A more recent study of eighteen Latin American democracies also finds that exchange rate-based stabilization policies are more likely to be introduced during elections because of their potential to generate short-term economic booms, though such policies tend to destabilize the economy in the long run.[14] Political uncertainty during elections usually shortens incumbents' time horizons and provides strong incentives for them to adopt policies that may benefit their own short-term political survival even though long-term economic disaster is foreseeable.

Correlations between economic and political cycles have also been found in non-democratic countries where political transitions are not determined by contests for consent from the majority of voters. For ex-

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[12]For the debates and examples of empirical studies examining the validity of PBC theory, see David G. Golden and James M. Poterba, "The Price of Popularity: The Political Business Cycle Reexamined," *American Journal of Political Science* 24, no. 4 (November 1980): 696-714; James Alt and K. Alec Chrystal, *Political Economy* (Berkeley: University of California Press, 1983); D. Roderick Kiewiet, *Macroeconomics and Micropolitics: The Electoral Effects of Economic Issues* (Chicago: University of Chicago Press, 1983); and Nathaniel Beck, "Elections and the Fed: Is There a Political Monetary Cycle?" *American Journal of Political Science* 31, no. 1 (February 1987): 194-216.

[13]Stephan Haggard and Steven B. Webb, "What Do We Know About the Political Economy of Economic Policy Reform?" *World Bank Research Observer* 8, no. 2 (1993): 149.

[14]Hector E. Schamis and Christopher R. Way, "Political Cycles and Exchange Rate-Based Stabilization," *World Politics* 56, no. 1 (October 2003): 43-78.

ample, Valerie Bunce has tested PBC theory in socialist states and found that an economic cycle stimulated by changes in investment and budgetary priorities *did* follow a political cycle of leadership succession in the Soviet bloc. Bunce argues that investment-led economic booms were created *after rather than before* leadership successions because, in the Soviet political system, there was a "succession crisis" in which members of the top collective leadership, seeing the structural predominance of the leadership over the bureaucratic system as the pressing problem, would have had the incentive to work together to earn popular support *right after* the formal power transition was complete. She thus asserts that there was a "succession connection" between investment priority changes and succession politics in the Soviet political system.[15] The finding suggests that, even in non-democratic systems, politicians in the face of power transition uncertainty would also care about their political popularity.[16]

As early as 1968, during the Mao era, Alexander Eckstein pointed out that there was a correlation between China's policy cycle and economic fluctuations. Eckstein explained the policy-led fluctuations as "a confrontation between Mao's vision of development possibilities in the Chinese economy and society and the country's economic backwardness."[17] Chu-yuan Cheng (鄭竹園), in his analysis of the changes in China's economic development strategies, also finds that "a fundamental factor causing eco-

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[15]The phenomenon was observed not only in the former Soviet Union, but also in other East European communist countries. Moreover, leadership succession at both the national and republic levels led to investment priority changes. See Valerie Bunce, "Leadership Succession and Policy Innovation in the Soviet Republics," *Comparative Politics* 11, no. 4 (July 1979): 379-401; and Valerie Bunce, "The Succession Connection: Policy Cycles and Political Change in the Soviet Union and Eastern Europe," *American Political Science Review* 74, no. 4 (December 1980): 966-77.

[16]Actually, there is no consensus in studies of the Soviet political system on whether politically vulnerable national leaders cared about their political popularity, either among bureaucratic political elites or the broader public. For example, Philip Roeder argues that during succession crises national leaders would care more about their popularity among elites than among the general public. See Myron Rush, *Political Succession in the USSR* (New York: Columbia University Press, 1965); and Philip Roeder, "Do New Soviet Leaders Really Make a Difference? Rethinking the 'Succession Connection'," *American Political Science Review* 79, no. 4 (December 1985): 958-76.

[17]Eckstein, "Economic Fluctuations," 693.

nomic fluctuations has been the incessant shifts of development policies and the changing attitudes toward economic planning and management."[18] In a command economy where policymakers monopolize most means of production and use political mobilization to promote economic development, it is natural for economists to find that government policy is paramount in affecting economic fluctuations. As Lawrence Brainard argued in modeling the business cycles of Soviet-type economies, "there is a basic incompatibility between the directive principle of administration ... and the market principle.... The interplay of these conflicting patterns of behavior leads to shifts in the relative importance of the directive and market principles in a way which generates cycles in policy."[19]

Nonetheless, it would be going too far to see the policy-economic cycle as a pervasive phenomenon and to characterize politics in Mao's China as a pattern of policy oscillations. In a critique of the tendency to characterize policymaking in Mao's China as following a pattern of left-right oscillations, Andrew Nathan has, through a nuanced review of history, forcefully pointed out that overusing the notion will not only tilt our perspective toward the Chinese official line, but also blind us to important secular changes that took place all over the country during the Mao era.[20] And despite attempting to develop a general model of cyclical economic fluctuations under socialism, Brainard also asserts that, in contrast to the capitalist business cycle, the fluctuations his model is intended to explain need not be pervasive. Indeed, he says that it "is unlikely that a general theory will be found which could bring into focus in a systematic way the diverse and complex interrelationships of politics and economics in socialist countries."[21]

Only when we enter the post-Mao era can we identify a pattern in the correlation between the political and economic cycles. For example, in an

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[18]Cheng, *China's Economic Development*, 323.

[19]Lawrence J. Brainard, "A Model of Cyclical Fluctuations under Socialism," *Journal of Economic Issues* 8, no. 1 (1974): 68.

[20]Andrew J. Nathan, "Policy Oscillations in the People's Republic of China: A Critique," *The China Quarterly*, no. 68 (1976): 720-33.

[21]See note 19 above.

attempt to find the effects of factional politics on economic policymaking, Lowell Dittmer and Yu-Shan Wu argue that a correlation between the economic cycle of boom and bust and the political cycle of factional politics can be observed in post-Mao China. Dittmer and Wu first modified the original model of Chinese factionalism to one which saw a faction as "concerning itself not only with particularistic group and member interests, but also with economic and other public policy issues."[22] Then, they analyzed the relationship between macroeconomic policies and factional conflicts within the top leadership and found a synchronization of three cycles in reform China—factional politics, economic reforms, and business cycles.[23]

Based upon economists' observations of the policy-economic cycle in Mao's China, Chinese economist Hu Angang has attempted to develop a general model of China's political business cycle.[24] He argues that the origins of China's economic cycles are exogenous shocks. First, the central government's "political mobilization shocks" generate economic expansion. Later, the central government's "political order shocks" result in economic recession. They are exogenous because they are not an economic factor, but a political factor.[25] Hu has found that while economic cycles during the Mao era were highly correlated with political power struggles, economic cycles in the reform era are correlated with Party congresses and meetings of the NPC every five years since 1977.

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[22]Dittmer and Wu, "The Modenization of Factionalism in Chinese Politics," 467. For the original model and subsequent theoretical debates on Chinese factionalism, see Andrew J. Nathan, "A Factionalism Model for CCP Politics," *The China Quarterly*, no. 53 (1973): 33-66; Tang Tsou, "Prolegomenon to the Study of Informal Politics in CCP Politics," ibid., no. 65 (1976): 98-114; "Andrew Nathan Replies," ibid., 114-17; and Unger, *The Nature of Chinese Politics*.

[23]In line with Dittmer and Wu's argument, Victor Shih contends that the relationships between macroeconomic policies and factional conflicts even last through the post-Deng era. See Victor Shih, *Not Quite a Miracle: Factional Conflict, Inflationary Cycles, and Non-Performing Loans in China* (book manuscript, 2004); and Victor Shih, "Factional Matters: Personal Networks and the Distribution of Bank Loans in China," *Journal of Contemporary China* 13, no. 38 (2004): 3-19.

[24]In addition to Alexander Eckstein and Chu-yuan Cheng, according to Hu Angang, there are at least two Chinese economists, Lu Jian (盧建) and Chen Dongqi (陳東琪), who have also found a policy-economic cycle in China. See Hu, *Zhongguo jingji bodong baogao*, 184.

[25]Ibid., 190.

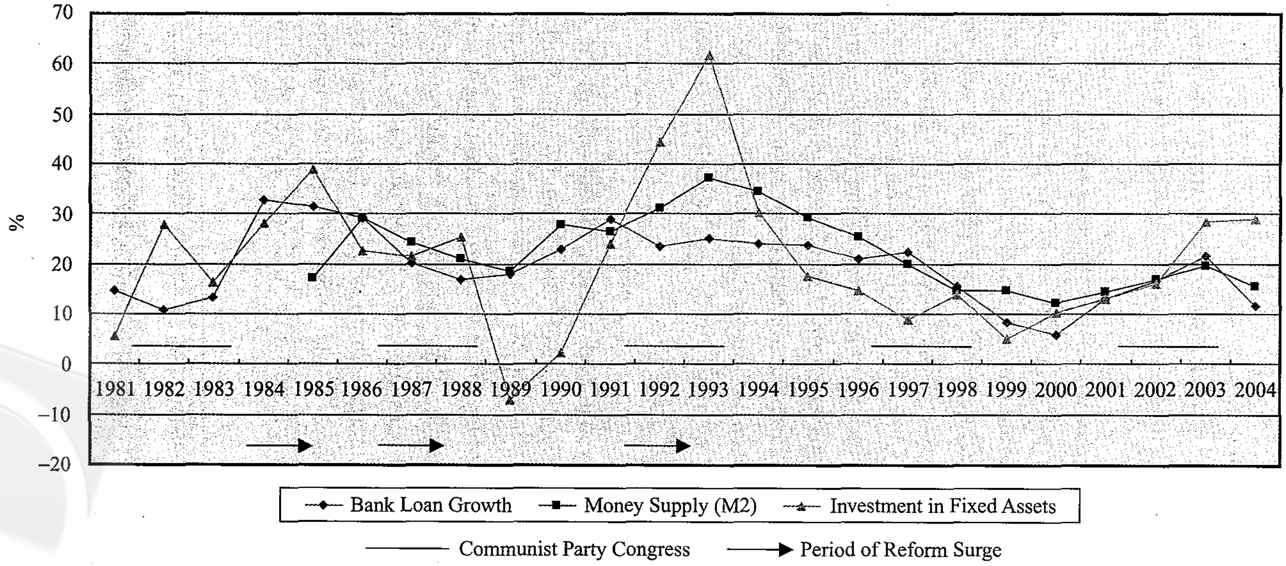
The political business cycle in reform China seems to reflect first the logic proposed by Dittmer and Wu and later that suggested by Hu (see chart 4). In the 1980s and early 1990s, periods of reform always led to economic expansions; expansions led to retrenchments when the economy overheated, retrenchments resulted in stagnations, and stagnations gave way to the resurgence of reform. Over this period, the political business cycle correlated closely with power and policy shifts between two factions of the Chinese political leadership—a pro-growth faction led by Deng Xiaoping and a pro-stability faction led by Chen Yun (陳雲)—rather than with an institutionalized interaction between the political elite and their constituents, as in Western democracies. Since 1987 the business cycle has also fluctuated in time with the schedule of Party congresses and NPC meetings. Measured by the growth rate of the total investment in fixed assets, the economic cycle seems to repeat every five years, with peaks in 1988, 1993, 1998, and 2003—the years right after the 13th, 14th, 15th, and 16th Party congresses. This new development seems to suggest that the periodic power transitions in formal political institutions, including the Party and government, have become increasingly important in determining China's macroeconomic policies.

Chart 4 also shows that the economic cycle, albeit correlated with a certain political cycle, has become less dramatic since 1993. That is, economic expansion does not have to overheat before contractive policies are introduced, and contractive policies do not necessarily lead to serious recessions that require radical measures to stimulate growth. The "normalization" of the economic cycle seems to suggest increasing sophistication in the policy instruments that Chinese leaders can employ to manage the macroeconomic environment.

## Evolution of the PBC and Domestic Institutional Changes

The evolution of the political business cycle in China from the early reform period to date reflects rapid institutional changes in both Chinese elite politics and the transition toward a market economy. At least three

**Chart 4**
**Political Business Cycle in China, 1981-2004**




**Sources:** Lowell Dittmer and Yu-Shan Wu, "The Modernization of Factionalism in Chinese Politics," *World Politics* 47, no. 4 (July 1995): 486; People's Bank of China (PBC), *Almanac of China's Finance and Banking*, various issues; PBC website (http://www.pbc.gov.cn); and National Bureau of Statistics, *China Statistical Yearbook*, various issues, and its website (http://www.stats.gov.cn).

ongoing institutional changes are worthy of tracing. They are the increasing importance of formal politics over informal politics, the transition of economic governance from plan instruments to market instruments, and the growing effects of globalization on China's macroeconomic stability.

*The Increasing Importance of Formal Political Institutions*

There has been a gradual evolution of the political business cycle in China, in which the correlation between the economic cycle and the cycle of factional politics declines, and the correlation between the economic cycle and the cycle of government power transitions emerges (see chart 4). Although the exact mechanism for the synchronization of economic and political cycles during the last four terms of the Chinese national government is still unclear, the assertion that Chinese formal political institutions have induced certain behavior patterns in economic policymaking is consistent with the consensus among students of Chinese politics. That is, "institutionalization of the affairs of the political elite has been a key trend of the post-Mao period."[26]

The institutionalization of elite politics has been observed both at the apex of the political system and in the rank and file of the bureaucratic system. For example, both Lowell Dittmer and Susan Shirk have noted that the rules of term limits and pre-mortem retirement for national leaders were well enforced and played a pivotal role in avoiding potential political conflicts in the 1990s, especially when the old revolutionaries died or disappeared from the political stage.[27] For the bureaucratic system as a whole, Cheng Li also finds an increase in importance of administrative experience and objective criteria, such as education and age, for recruitment and promotion.[28] As the rules of the game in formal political institutions have

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[26]Frederick Teiwes, "Normal Politics with Chinese Characteristics," in Unger, *The Nature of Chinese Politics*, 246.

[27]Lowell Dittmer, "The Changing Form and Dynamics of Power Politics," in Unger, *The Nature of Chinese Politics*, 224; and Susan Shirk, "The Delayed Institutionalization of Leadership Politics," ibid., 297-311.

[28]Cheng Li, *China's Leaders: The New Generation* (Lanham, Md.: Rowman & Littlefield, 2001).

become clearer and more predictable, it is increasingly plausible to argue that formal political institutions matter more in Chinese economic policy-making.

The Chinese political business cycle in the early reform period is by nature different from the central bank system in Western democracies as well as the situation Bunce describes in the former Soviet Union and Eastern Europe. In both Western democracies and in the Soviet bloc during the period Bunce studies (1929 to 1977), politicians in the face of political power transition would earn popular support through the manipulation of monetary or fiscal instruments to create economic booms. In transitional China, the economic cycles of boom and bust are not a result of policy shifts aimed at pleasing the public, but rather the result of opinion contests between two factions within the ruling elite. It seems that in the early reform era Chinese policymakers cared more about the political support of Party revolutionaries than of the masses.

In the last fifteen years or so, the synchronization of the economic cycle and the five Party congresses indicates that what Bunce has observed in other formal socialist states may have also occurred in China. That is, as the gerontocracy has faded, Chinese leaders have given the same, if not more, weight to their political popularity as they have to the support of faction leaders. The trend has become even more evident since the demise of the old revolutionary leaders in the 1990s.[29] In other words, although under authoritarian rule Chinese central leaders are not held accountable by citizens in an institutionalized manner, the leaders' popularity has played an increasingly important role during political succession.

However, it is still unclear whether there is a "succession connection," or what the exact "succession connection" might be in the apparent synchronization of China's political and business cycle. According to Bunce, the "succession connection" between political transitions and shifting government budgetary priorities in the former Soviet bloc was in-

[29]Deng Yingchao (鄧穎超) and Hu Qiaomu (胡喬木) died in 1992, Wang Zhen (王震) and Li Xiannian (李先念) in 1993, Chen Yun in 1995, and Deng Xiaoping in 1997. See Dittmer, "The Changing Form and Dynamics of Power Politics," 224.

vigorated by top leaders' attempts to prevent social unrest from embarrassing or even challenging the inaugurated leadership, and later by the need to satisfy expectations of prosperity.[30] Philip Roeder challenges Bunce's view by arguing that succession competition may constrain the general secretary from taking policy initiatives immediately after succes-sion. The political succession would result in policy stagnation, rather than policy innovation, amid fierce competition until the general secretary's power had been consolidated. Roeder employs more advanced statistical methods to test his hypothesis against Bunce's and concludes that there was a "consolidation connection," rather than a "succession connection," between economic and political cycles during the Khrushchev and Brezhnev era.[31]

Actually, here Bunce and Roeder emphasize the dynamics of political succession at different levels. For Bunce, the "succession connection" to economic policymaking is at the *institutional* level. She argues that the need for consolidation of a *new regime* over the bureaucratic system as well as the whole society would provide *incentives* for members of the new regime to temporarily unify and introduce policy innovations. On the contrary, Roeder's "consolidation connection" occurs at a *personal* level. He asserts that only when the political power of the *new general secretary* has been consolidated does he or she have the *capacity* to take policy initiatives. In other words, in the Bunce-Roeder debate over the relations between political succession and economic policymaking in the former Soviet Union, Bunce looks at the effects of *institutional succession* on economic policymaking while Roeder traces how the dynamics of *power succession* within the collective leadership constrains economic policymaking.

The political business cycle that we have observed at an aggregate level over the last four government terms seems to suggest a resilient pattern of the effects of *institutional succession* on economic policymaking in post-Mao China. On the contrary, as shown in table 1, the dynamics of

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[30]Bunce, "The Succession Connection," 968.

[31]Roeder, "Do New Soviet Leaders Really Make a Difference?" 969-71.

**Table 1**
**The Dynamics of *Power Succession* in the Latest Four *Institutional Successions* of the Chinese Communist Leadership**

| | | **Intra-generation Competition** | |
|---|---|---|---|
| | | Yes | No |
| **Inter-generation Conflict** | Yes | 13th Party Congress in 1987 | 16th Party Congress in 2002 |
| | No | 15th Party Congress in 1997 | 14th Party Congress in 1992 |

*power succession* within the collective leadership varies from one Party Congress to another. At the Thirteenth Party Congress, old revolutionary leaders led by Deng Xiaoping and Chen Yun had just replaced Hu Yaobang (胡耀邦) with Zhao Ziyang (趙紫陽) as the general secretary. In the face of potential inter-generational conflict with old revolutionary leaders, Zhao Ziyang also had to deal with potential competition between outgoing Party general secretary Hu and the newly-inaugurated Premier Li Peng (李鵬). At the Fourteenth Party Congress, Jiang Zemin was designated as the "core" of the third-generation collective leadership. The old revolutionary leaders were fading, and Deng Xiaoping removed the largest obstacle to the consolidation of the new "core"—the Yang Baibing (楊白冰) family in the military. New challengers from Jiang's cohort had not yet emerged. In comparison to the other three Party congresses, the general secretary of the Fourteenth Congress was temporarily faced with neither inter-generation conflict nor intra-generation competition. At the Fifteenth Party Congress, most of the first- and second-generation leaders stepped down from the political stage. Jiang Zemin as general secretary was delicately dealing with intra-generational competition with Qiao Shi (喬石), and implicitly Li Peng and Zhu Rongji (朱鎔基). Finally, at the Sixteenth Party Congress, Hu Jintao, the heir assigned by Deng Xiaoping, succeeded Jiang Zemin as Party general secretary. Given that no leader in Hu's generation has the same degree of administrative experience or support from Party elders as

Hu, the power succession at this moment is more about conflict between generations. That is, between Hu on one side and Jiang with his large constituency on the other.[32]

The synchronization of economic cycles with *institutional succession* rather than *power succession* seems to provide further evidence for the consensus among students of Chinese politics, that "institutionalization of the affairs of the political elite has been a key trend of the post-Mao period."[33] Although further research is needed on the underlying causal mechanism, the evolution of the Chinese political business cycle at the aggregate level seems to show that, since the late 1980s, consolidation of institutional power of the top leadership over the bureaucratic system and society has provided consistent *institutional incentives* to create economic booms during institutional succession.

*Transition from Plan to Market in Central Banking Instruments*

The "normalization" of the political business cycle suggests a transition of the Chinese central leaders' macroeconomic policy instruments from plan measures to market ones. If we compare the latest political business cycle in 2002-03 with the cycle around the Fourteenth Party Congress in 1992-93, where economic expansion was first stimulated and later cooled down, we will discover how profoundly the Chinese central banking institutions have changed.

During the political business cycle around the Fourteenth Party Congress, the money supply in 1992 and 1993 grew by 31.33 percent and 37.32 percent, respectively. The money supply in 2002 and 2003 grew much more modestly—only by 16.8 percent and 19.6 percent. Economic expansion in the early 1990s was largely achieved by plan measures (see table 2). Deng Xiaoping's 1992 southern tour played a key role in launching the

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[32]For a nuanced analysis of the evolution of succession politics in post-Mao era, see Zhiyue Bo, "Political Succession and Elite Politics in Twenty-First Century China: Toward a Perspective of 'Power Balancing'," *Issues & Studies* 41, no. 1 (March 2005): 162-89.

[33]Teiwes, "Normal Politics with Chinese Characateristics," 246. Also see Li, *China's Leaders*; and Xiaowei Zang, "Institutionalization and Elite Behavior in Reform China," *Issues & Studies* 41, no. 1 (March 2005): 204-17.

**Table 2**
**The Transition of Macroeconomic Policy Instruments in China**

| | Before Zhu's Administration Reform | After Zhu's Administration Reform |
|---|---|---|
| **Expansionary instruments** | **Fiscal:**<br>• Increasing government budget through borrowing from the central bank<br>• Encouraging investment through political campaigns | **Fiscal:**<br>• Increasing government budget by issuing government bonds through financial markets |
| | **Monetary:**<br>• Expanding bank credit quotas in the credit plan<br>• Expanding central bank lending directly to government and state-owned enterprises<br>• Expanding central bank re-lending for growth<br>• Cutting interest rates | **Monetary:**<br>• The credit plan abolished in 1998<br>• The central bank no longer allowed to directly lend to the government and enterprises since 1995<br>• Expanding central bank re-lending for restructuring<br>• Cutting interest rates<br>• Reducing deposit reserve requirements<br>• Pumping up liquidity through open market activities |
| **Contractive instruments** | **Fiscal:**<br>• Cutting investment in capital construction<br>• Dispatching inspection teams to regions to examine investment projects and financial probity | **Fiscal:**<br>• Reducing government budget expenditures |
| | **Monetary:**<br>• Cutting credit quotas<br>• Reducing central bank's lending to government, enterprises, and financial isntitutions<br>• Raising interest rates<br>• Shutting down illegal/informal financial institutions | **Monetary:**<br>• Raising interest rates<br>• Increasing deposit reserve requirements<br>• Reducing liquidity through open market activities |

investment-led economic expansion at that time. In contrast, in early 2002, the Chinese central leaders mainly relied upon market measures to achieve their expansionary goals. Based upon the "proactive fiscal policy" initiated in 1998, the leaders further stimulated the economy by both increasing government budgets and cutting interest rates. In addition to issuing 150 billion *yuan* in long-term government construction bonds in 2002 to continue the momentum of this "proactive fiscal policy," the Chinese central government also cut the official interest rate for bank deposits by 0.25 percent and for bank loans by 0.5 percent on February 21, 2002. The government also widened the floating band of official interest rates from 50 to 100 percentage points for the first time since 1999.[34] The loosening of monetary policies was a clear "green light" for local governments and local enterprises to obtain more loans from state banks. Bank loans therefore have risen sharply since the second quarter of 2002.

When the central leaders wanted to cool down the economy in late 1993, Zhu Rongji sacked the governor of the People's Bank Li Guixian (李貴鮮) and took the position himself. Zhu used the Party's ad hoc mandatory order to call for all local governments and state-owned enterprises to stop ongoing investment projects. Nonetheless, it took three years to cool down the economy. In 2003 and 2004, in addition to cutting the issuance of long-term government construction bonds from 150 billion *yuan* in each of the previous three years to 140 billion in 2003 and 110 billion in 2004, Chinese leaders mostly relied on the People's Bank of China, the Chinese central bank, to do the job. The People's Bank used market instruments, such as open market operations, bank reserve requirements, and interest rate increases, to cool the economy.

The sharp differences are a result of institutional changes that took place during the Zhu administration. As summarized in table 3, they include (1) increased central bank independence; (2) state banking system reforms; and (3) the development of financial markets.

[34]People's Bank of China, "China Monetary Policy Report, 2002," 3, http://www.pbc.gov.cn/detail_frame.asp? col=1734&id=7498&keyword=&isFromDetail=1.

**Table 3**
**Institutional Changes Related to the Transition of Macroeconomic Policy Instruments in China**

| | |
|---|---|
| **Central Bank independence** | • The "People's Bank Law" in 1995<br>– Stipulated that the central bank's main task is to maintain monetary stability<br>– Stipulated that the central bank is directly subject to the supervision of the State Council, implying its independence from the Ministry of Finance<br>– Forbade the central bank from directly lending to the government<br>• The abolition of the credit plan in 1998 made the central bank<br>– independent from government economic planning agencies<br>– independent from the intervention of local governments in the expansion of credit quotas<br>The establishment of the nine trans-regional branches in 1998 ensured its independence from local government intervention. |
| **Reforms of the state banking system** | • Passage of the Commercial Bank Law in 1995<br>• Abolition of the credit plan in 1998<br>• Increase of capital adequacy since 1998<br>• Reduction of nonperforming loans since 1999 |
| **Development of the financial markets** | • Establishment of the national inter-bank money market in 1996<br>• Establishment of a T-bond repurchasing market in 1997<br>• Establishment of the national inter-bank bond market in 1997<br>• Marketization of government bond issuing in 1998 |

The enhancement of central bank independence relieved the central bank of the fiscal function it had helped the Ministry of Finance to bear for a long time.[35] With passage of the "People's Bank of China Law" in 1995, abolition of the credit plan in 1998, and the creation of nine trans-regional

[35]For the fiscal role of the Chinese banking system during the early reform era, see Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington, D.C.: Brookings Institution, 1998), chaps. 1 and 3.

branches in 1998, the central bank has been made independent from the Ministry of Finance, central economic planning agencies, and provincial governments. The central bank law also clearly stipulates that the bank's main task is to maintain monetary stability; it is not allowed to finance government units directly.

During the socialist era, the Chinese central bank relied on the annual cash and credit plans to control the money supply. However, these two monetary instruments became increasingly unreliable as financial institutions and instruments proliferated during the reform era.[36] Adjusting government-controlled interest rates thus gradually became another important monetary policy lever. Abolition of the credit plan in 1998 opened the door for the Chinese central bank to rely solely upon market instruments to maintain monetary stability.

Reform of the state banking system has its own purpose in reducing systemic financial risk and enhancing Chinese state banks' competitiveness.[37] Nonetheless, the reforms also have affected the transition of Chinese central banking from plan to market. In brief, by relieving the state banking system from the financial burden of loss-making state-owned enterprises, the reforms allowed it to become profit-oriented and therefore sensitive to the market instruments the central bank uses to maintain monetary stability.

Development of the financial markets, especially the bond market, has provided the People's Bank with an environment for open market activities. As the Ministry of Finance, the state policy banks, and the central bank issued more government bonds through financial markets, government bonds have become a major component of the assets held by Chinese financial institutions, and the bond market thus has become the primary market for financial institutions to adjust their liquidity. The Chinese

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[36]World Bank, *China: Macroeconomic Stability in a Decentralized Economy* (Washington, D.C.: World Bank, 1993).

[37]For the contents and purposes of the financial reforms in the mid-1990s, see World Bank, *The Chinese Economy: Fighting Inflation, Deepening Reforms* (Washington, D.C.: World Bank, 1996).

**Table 4**
**Channels for the Provision of Base Money by the People's Bank of China, 1996-1999 (billion *yuan*)**

| | 1996 | | 1997 | | 1998 | | 1999 | |
|---|---|---|---|---|---|---|---|---|
| **Loans to financial institutions** | 301 | 49% | –11 | –3% | 166 | 50% | 122 | 33% |
| **Foreign reserves** | 277 | 45% | 307 | 81% | 44 | 13% | 101 | 28% |
| **Purchase of securities** | 0 | 0 | 113 | 30% | 88 | 26% | –0.5 | 0 |
| **Open market operation** | –1 | 0 | 0 | 0 | 70 | 21% | 192 | 52% |
| **Others** | 39 | 6% | –29 | –7.5% | –36 | –10.7% | –47 | –12.7% |
| **Total** | 615 | 100% | 380 | 100% | 332 | 100% | 368 | 100% |

**Source:** Xie Duo, "Zhongguo gongkai shichang yewu shijian" (The practice of China's open market operation), *Dongnan xueshu* (Southeast Academy), 2000, no. 4:28.

central bank now can use the bond market as the major channel to provide base money. In 1999, 52 percent of the central bank's base money was provided through open market operations (see table 4).

### *The Growing Effects of Globalization on Domestic Economic Stability*

Finally, the third trend underlying the evolution of the political business cycle in China is the growing effect of globalization on domestic economic stability. The growth of China's foreign reserves in the 1980s was volatile. And it was only after the 1994 foreign exchange reforms, which strictly limited domestic holdings of foreign reserves and fixed the foreign exchange rate at 8.28 RMB to the U.S. dollar, that growth of foreign reserves stabilized. Since then, foreign reserves have become one of the major sources of the central bank's monetary base. Growth of the money supply thus became highly correlated with the growth of foreign reserves. Therefore, international factors such as the terms of trade and international capital flow trends have played an increasingly important role in determining China's domestic macroeconomic environment. In other words, the growing effects of globalization have largely undermined China's monetary autonomy.

According to the theory of the "unholy trinity," a country cannot have capital mobility, a fixed exchange rate, and an autonomous monetary policy at the same time. It can have at most two of these three conditions.[38] Despite China's strict capital controls, the rapid growth of foreign trade and investment has resulted in serious leakage in the officially closed capital account.[39] As *de facto* capital mobility has increased, the fixed exchange rate policy has led to the decline of monetary autonomy.

For example, the growth of China's total investment in fixed assets reached another peak in 1998 (see chart 4), the year after the Fifteenth Party Congress. According to PBC theory, this is an indicator of the correlation between the economic and political cycles However, the growth of money supply actually slowed down in 1998. This was mainly caused by the sharp decline of foreign reserve growth in that year, when the Asian financial crisis seriously hindered both exports and foreign investment inflows. The events of 2003 provide another example. After the government power transition in early March, the People's Bank of China saw signs that the economy was overheating in several coastal cities and prepared to implement contractive policies. However, the outbreak of severe acute respiratory syndrome (SARS) forced a postponement of the new policies. In the summer, when the Chinese central bank thought conditions more

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[38]Robert A. Mundell, "The International Disequilibrium System," *Kyklos* 14 (1991): 153-72; Robert A. Mundell, "The Appropriate Use of Monetary and Fiscal Policy for Internal and External Stability," *IMF Staff Papers* 9 (1962); Paul Krugman, "A Model of Balance of Payments Crisis," *Journal of Money, Credit, and Banking* 11, no. 3 (1979): 311-25; Jeffry Frieden, "Invested Interest: The Politics of National Economic Policies in a World of Global Finance," *International Organization* 45, no. 4 (1991): 425-51; and Benjamin J. Cohen, "The Triad and the Unholy Trinity: Problems of International Monetary Cooperation," in *International Political Economy: Perspectives on Global Power and Wealth*, ed. Jeffry Frieden and David Lake, fourth edition (New York: St. Martin's, 2000), 245-56.

[39]From 1994 to 2002, the error and omissions item in China's balance of payments averaged US$14 billion a year, totaling US$122 billion of capital flight during that time. In 2002, the error and omissions account dramatically reversed, mostly due to the rapid inflows of speculative hot money, posting a surplus of US$7.8 billion. See International Monetary Fund (IMF), *Balance of Payments Statistical Yearbook 2002* (Washington, D.C.: IMF, 2002).

favorable for cooling the economy down, the task was complicated by inflows of speculative hot money in response to expected appreciation of the RMB. Because of mounting pressure for RMB appreciation, China's foreign reserves grew from US$286.4 billion at the end of 2002 to US$609.9 billion at the end of 2004, an increase of US$323 billion, or 113 percent, in two years.[40] In other words, the People's Bank of China was forced to purchase an average of more than US$10 billion of foreign exchange every month in these two years. The resultant rapid increase in the monetary base made the Chinese central bank's task in cooling down the economy much more difficult.

These examples demonstrate that as China's economy has become more internationalized, the Chinese government's monetary autonomy has been undermined by the huge amount of cross-border capital flows. The international economic environment also constrains Chinese leaders' efforts to use expansionary policies to create economic prosperity at critical political moments.

## Conclusion

This article has investigated how much progress China has made in the management of its monetary policy. It finds that as in Western democracies, there is a political business cycle in China, where the economic booms and busts are correlated with political rhythms. By scrutinizing the evolution of the political business cycle in China, this article finds that profound institutional changes in three aspects have taken place in the 1990s. First, China's economic cycle has become more responsive to the political rhythm in formal political institutions, rather than changes in informal politics; second, when the Chinese leaders need to employ expansionary policies to create economic prosperity, they have increasingly

[40]It already excludes the injection of US$45 billion into the two state-owned banks—the Bank of China and the Construction Bank of China. The foreign reserve figure is from China's State Administration of Foreign Exchange, http://www.safe.gov.cn.

relied upon market instruments rather than plan measures to achieve their goals; and third, international factors have played an increasingly important role in determining China's domestic monetary environment. That is to say, globalization's growing effects have largely undermined the Chinese government's monetary autonomy.

These findings confirm the emerging consensus in the study of elite Chinese politics that "institutionalization of the affairs of the political elite has been a key trend of the post-Mao period"[41] and the trend has become even more obvious from the Deng to the Jiang/Hu regimes. Informal politics seems to have gradually faded from the political stage with the decline of the old revolutionary leaders.

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[41]Teiwes, "Normal Politics with Chinese Characteristics," 246.

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