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**Chinese economic reform: approach, vision
and constraints**

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The paper discusses the major aspects of economic change in China in relation to the government's 1981-1985 development strategy. It examines the various reform experiments introduced in 1978-79 and leading to the adoption of 1984-85 as a landmark, together with the major elements of the 1981-85 strategy for development. It also discusses the role of the government in the reform process and the impact of the reform on the economy.

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Abstract

This paper examines the major aspects of economic changes in China in relation to the government's long range goals for economic reform. Various reform experiments introduced in 1978-79 and leading to the reforms of 1984-85 are examined, together with the major elements of the Chinese blueprint for the economic system. A survey is made of the constraints on policy realization in agriculture, industry and the foreign sector.

China, similar to that experienced in the Soviet Union and some other Eastern European countries because of their success at the end of the 1970s in demonstrating the viability of centrally planned and administered, centralised development. Some of the factors in China have emerged as an more reformist movement. The need to control inflation prompted the Chinese government to adopt administrative measures to limit price rises and to expand enterprise autonomy. This seems to be in contrast with the Eastern European and Soviet reforms, in that the decentralisation, as it happened in East Germany in the late 1970s and in the Soviet Union in the early 1980s, was not so much a matter of reducing central control of the economy, to achieve the primary objective of increasing macroeconomic efficiency within the conventional Leninist context of 'democratic' state led to increased centralised control of enterprise and joint enterprise in the Soviet Union.

In addition, there was certainly a belief in the need to decentralise policy objectives of decentralisation in terms of delegating decision-making power to individual enterprises. Decentralisation in the Chinese economy has not only been a result of the reform but also the Chinese government has to the plan directly, probably because a state controlled by the state of decentralisation adopted in the Eastern European countries. This raises two points. The first is that the government's decentralisation vision of 'control through the market' has probably yielded in a way to pressure for increased government liquidity within the decentralisation drive. The second, and perhaps most important is the fact that increased decentralisation has improved the flexibility of price responses, especially with respect to output pricing.

¹ This is a preliminary version of the author's work. The author is grateful to the staff of the Institute of Economics, Chinese Academy of Social Sciences, Beijing, for their helpful comments on an earlier draft.

² This study is based on the author's field research in China in 1984-85, the period of implementation of the reform. It is possible that some of the data may be subject to change as a result of the implementation of the reform in 1985-86.

Chinese economic reform: approach, vision and constraints

Y.Y. Kueh

Introduction

Economic reform in China is entering its second decade. The possibility of a backlash, similar to that experienced in the Soviet Union and some other Eastern European countries because of their attempts in the mid 1960s to decentralize the Stalinist system of centralized planning and bureaucratic control, has developed. Signs of the backlash in China have emerged amidst severe inflationary pressures. The need to control inflation prompted the Chinese government to use physical-bureaucratic measures to limit once again the expanded enterprise autonomy. This seems to be at variance with the Eastern European and Soviet reforms, in that the recentralization, as it occurred in East Germany in the late 1960s and in the Soviet Union in the early 1970s, was not so much a matter of inflation control: it was the failure to achieve the reform objective of improving microeconomic efficiency within the conventional Leninist context of *Khozraschyot*¹ that led to increased centralized control of enterprise input and output targets in the Soviet Union.

In either case, there was certainly a backlash against the proclaimed policy objective of decentralization (in terms of relegating decision-making power to individual enterprises). Nevertheless, in the Chinese case, the fact that inflation was regarded as the culprit implies that the Chinese reforms have in the past decade probably assumed a scale unmatched by any standard of decentralization adopted in the Eastern European countries. This raises two points. The first is that the conventional Soviet-style wisdom of 'control through the Ruble'² has probably yielded in some way to pressures for increased investment liquidity amidst the decentralization drive. The second, and perhaps more important is the fact that increased deregulation has improved the flexibility of state enterprises, especially with respect to price setting.

¹Basically this is the principle of 'economic accountability' which Lenin formulated after the failure of 'war communism', as a means to control performance of state enterprises (Nove 1977:28).

²Taken simply this means tightening fiscal-monetary control by minimizing the provision of working capital to state industries to prevent any build-up of liquidity which may be used to finance economic activities prejudicing the fulfilment of the state plan targets (cf. Grossman 1968:5-6).

At any rate, runaway inflation in China since mid-1988³ illustrated what the East Europeans were fearful of in the 1960s: they thought only of deregulating the highly monopolized and dominant state economic sector in order to create a more or less competitive market environment for improving enterprise performance. In China, the most interesting question is whether the observed backlash is only a minor setback in an irreversible program of pushing reforms to their ultimate goal - that is, the dismantling of Soviet-style central planning in favour of fully-fledged marketization of the economy.

From an international perspective the important question is whether the current difficulties encountered on the domestic front could eventually lead to some substantial modification, or an abandonment altogether, of China's open-door policy. If so, this could lead to a reversal of the trend towards the increased integration of the Chinese economy observed in the past decade with the free trade system of the west, which has been associated with the search for foreign capital and technology.

This paper examines the major aspects of the ongoing economic changes in China in relation to the long-range goals of reform as perceived by the Chinese leadership. The discussion will hopefully help to shed some light on the possible outcome of the current anti-inflation and readjustment campaigns, and at the same time point to the long-term implications of the reform experiments conducted in China in the past few years. The discussion will begin with an illustration of the various reform experiments which were first introduced in 1978-79 leading to the formulation in 1984-85 of the long-range Chinese vision of 'socialism with Chinese characters'. An examination of the major elements of the Chinese blueprint for their future economic system and a survey of the possible constraints for its realization in agriculture, industry and the external sector will follow. The paper will conclude with a brief evaluation of the possibilities of the Chinese leadership breaking through the perceived constraints and more closely assimilating the Chinese economy into the western system.⁴

The trial-and-error approach, 1979-84

The post-Mao economic reforms in China started with the Resolution of the Third Plenum of the Eleventh Party Congress convened in November 1978.

³The official rate of inflation, taken as the rate of increase of retail prices, was 18.5 per cent for 1988, a record high since the liberation. Price increases in the later half of the year accounted for most of the inflation (Naughton 1989).

⁴For a comparative review of the major problems encountered in Chinese economic reforms see Perkins (1988). Perkins adopts a topical approach, while this paper is essentially a chronological survey with a view to revealing the important economic policy considerations which prompted the reform experiments in various spheres to change from one phase to another. Cf. also Hua *et al.* (1988) for a comprehensive topical review (in Chinese) of the Chinese reform experience.

The initial policy measures amounted, however, essentially to a restoration of the institutional arrangements of the pre-Cultural Revolution period. Thus, in agriculture, the workpoint system was reintroduced to replace the highly egalitarian Maoist practice of farm income distribution. Parallel measures designed to improve incentives were adopted in industry. Enterprise funds were re-established with provisions for their disposal as workers' bonuses and as minor renovative self-financing investment to improve production efficiency (Reynolds 1982; Kueh 1983).

No matter how minor the new-found initiatives might have appeared, they were a precursor of bold experiments; the inherent logic for refinement soon unfolded, with the blessing of the official doctrine of 'seeking truth from facts', as formulated by Deng Xiao-ping. In agriculture, industry and in the national economy as a whole, the initial reform measures led to further experiments, resulting in a series of changes in China over the following ten years.

Changes in agriculture

The changes in rural China were indeed most spectacular. They began, following the death of Mao in 1976, with the modest restoration of the workpoint system in agricultural collectives. From an incentive perspective the workpoint system leaves much to be desired. Regardless of how hard a peasant may work, his final income, as derived from his relative workpoint contribution to the common collective pool, depends substantially on what each workpoint is worth (in terms of grain in kilogram or money value). This in turn is a function of the work effort of all the other collective members, and perhaps more importantly, the level of farm accumulations imposed by the government upon the collective. Thus, the peasants' feeling of working for 'a common pot of unknown size' persisted.

This was not compatible with the pragmatic new policy reorientation and within two to three years the long-established commune system began to crumble. By 1984, collective farmlands were firmly re-parcelled and a year later, compulsory farm deliveries, in force since 1953, were replaced by contractual purchases (Kueh 1984; Oi 1986; Watson 1988). This effectively brought rural China back to the pre-collectivization situation of 1949-52, when landed properties had been confiscated from the rich and redistributed to the poor, with state-peasant market relations dominating the rural scene (Kueh 1985; Perkins 1966:28-42).

From 1984, peasants' leasehold right was limited to 15 years, but given the present political milieu, there seems to be little doubt that this could be extended substantially, if not in perpetuity. Also, a rental market, no matter how rudimentary in form, seems to be emerging. Peasants are

encouraged to tender any redundant holdings for 'fair' compensation. Likewise, land-scarce families may now offer their redundant labour for employment elsewhere. The Marxian theory of labour value and exploitation has obviously yielded to the simple but forceful allocative rule of equalizing marginal returns across different land plots. It remains to be seen whether the Henselian 'Systemzwang zum Experiment'⁵ will eventually lead to the emergence of a market for landed properties, with prices being freely determined to capitalize the potential rental yields (Wiens 1987).

Mention should be made of a strategic economic factor which helped to trigger and accelerate the process of rural decollectivization. This involved the huge price and income benefits offered to the Chinese peasants in 1979-80 by way of the decreed increases in state farm procurement prices. The increases amounted to an average of 25 per cent in 1979 alone, with very substantial premiums for above-quota sales (Kueh 1984). According to some prominent Chinese economists, the increases were meant to relieve the Chinese peasants from the burden of the compulsory farm quota system which had applied for the last three decades or so, and which had taken all output in excess of what was necessary to maintain bare subsistence (Xue 1980:180-9).

However, the new farm pricing policy was also tied in with the overriding objective of improving peasants' output incentives. Given the then prevalent collective-egalitarian distributive structure, the decreed price increases could amount to a once-and-for-all living subvention for the peasants, without any positive output effect. This is by no means trivial, considering the fact that the combined total of the extra state outlay for farm purchases plus tax concessions made in 1979-82 amounted roughly to two-thirds of the state budget expenditure for 1982 (Kueh 1984:361). Certainly no pragmatic Chinese leaders wanted to see this as a deadweight loss.

The logical outcome was to make sure that the offered price and income benefits were directly linked to output performance within the most easily accountable context - hence the rush to family farming.

Adjustments in the industrial and foreign trade sectors

The huge increases in farm procurement prices as decreed in 1979-80 had wide-ranging repercussions not only within rural China, but also in the urban-industrial sector. For one thing, the extra income generated needs

⁵In light of the Eastern European reforms in the 1960s, the late Professor K. Paul Hensel (1977) advanced the thesis that there was a forceful dynamic built into all socialist economies requiring an initial reform measure to call for a successive chain of experiments in the perennial search for optimum decentralization.

which had to be absorbed, predominantly by an increased supply of consumer goods, given that income elasticities of consumption of a Chinese subsistence peasants are bound to be high. The best way for the Chinese government to meet the demand with minimum opportunity costs was clearly to promote rural self-sufficiency, so that the bulk of available investment resources could continue to be retained for the preferential urban, especially heavy-industrial, sector. It was against this strategic background that there developed, after 1979, a strong rural economic diversification campaign - an event which just a few years earlier would have been subject to severe repudiation as having advanced the capitalist cause.

Nevertheless, the new peasant liquidity was too excessive to be absorbed by rural non-farm industries and services alone. The bulk of peasant cash income is normally spent on industrial consumables and was bound to spill over to the urban sector. Reinforced by consecutive wage increases for urban workers in the late 1970s, this was clearly one of the major factors which led to the formulation of the entire *Economic Readjustment* policy (Howe and Walker 1984). This decreed that production and investment in heavy industries were, commencing from mid 1979, to be scaled down in favour of light industries and agriculture, presumably as a measure to correct 'the basic disproportionality in the national economy'.

This readjustment resembled in a way the initial post-Stalin Krushevian reorientation toward a less harsh consumption policy in the USSR in the 1950s. But the scale of the Chinese readjustment and its institutional impact were even greater. Two or three important points may be made in this regard.

First, the readjustment rendered idle a series of heavy-industrial enterprises, leaving substantial excess capacity. Many were encouraged to turn to the 'markets' for purchase orders to keep their factories running. As a result, the producer goods sector was marketized to a considerable extent. Further, in the early 1980s, for the first time in Chinese history heavy industries became the single largest source of exports. This stands in sharp contrast to the experience of the Soviet Union where, even during the heyday of the Kosygin reform in the mid 1960s, rising consumer preferences could only call for the partial marketization of the consumer goods sector. Spillovers into the heavy-industrial sphere were not permitted.

Second, the partial marketization of the producer goods sector reinforced the initial reform measure of allowing profit retention in enterprises making innovative investments. This is because improved investment liquidity must obviously be matched with concomitant

At any rate, no sooner had the first round of readjustment been implemented in 1979-80, than it became imperative for the central planners in China to limit industrial reforms in favour of macroeconomic stability. Under the rapidly formulated policy slogan 'reforms must give precedence to economic readjustment', obligatory treasury bills were issued to soak up local liquidity, and the much celebrated 'right to profit retention' was turned to industrial responsibility *vis-à-vis* the planning and financial authorities' in 1981-82. Nevertheless, by early 1983, the central authority was coerced by the emerging crisis to scale down the planned state capital construction expenditure for 1983 by 45 per cent, a substantive reduction from the original target of RMB 55 billion yuan which had been announced as late as September 1982.⁷

Readjustments on such a scale involved scrapping many ongoing investment projects or postponing the implementation of many approved blueprints. In a hasty attempt to balance the trade deficit and cool down the 'overheated' domestic economy important import plans were shelved and approved orders suspended. Despite the degree of real resource waste implied in these measures, the massive second-round readjustment did work, though not without the application of powerful administrative fiat which, according to some prominent Chinese economists, should nevertheless prove the major 'merit of socialism'.

The dust of the 1983 readjustment thus settled quite quickly, and partly with the blessing of the bumper harvests of 1984, the situation stabilized appreciably. This enabled the Chinese leadership to embark on a second round of reform initiatives - hence the historical Resolution of the Third Plenum of October 1984 - charting the future course for the reformation of the entire Chinese economic system. It should be noted that during the heyday of the readjustments when many western observers tended to view the fate of the initial industrial reform as sealed, assertions were repeatedly made by the Chinese leadership that the reform was still a long-term objective once the readjustments were completed. This has proved to be the case.

Formulation of long-range visions of reforms, 1984/85

Overall objectives. The October 1984 reform blueprint was essentially directed towards the large and medium-scale state industries, about 8000 enterprises, accounting for over half of the country's industrial output - the core of central planning in China. Under the *Leitsatz* to 'enliven' these industries, the majority of the enterprises were to be gradually detached

⁷The original planned figure for 1983 was roughly equal to the realized amount for 1982. Despite the planned reduction, however, the realized total of capital construction investment for 1983 was still 7 per cent higher than that for 1982. See State Statistical Bureau (1987:43).

from centralized control through a master scheme of deliberate transition. Specifically, the scope of 'mandatory planning' was to be reduced in favour of so-called 'guidance planning'. This in turn was to be regarded as a transition to the ultimate phase of 'market regulation', to establish a 'planned socialist commodity economy'. To replace centralized physical input and output control, indirect fiscal-monetary levers, namely taxes, prices, bank loans and interest rates, as well as foreign exchange incentives, were to be increasingly applied. This would ensure compliance of enterprise behaviour with the aggregate policy objectives of regulating demand and supply, accumulation and consumption, and intersectoral reallocation of investment funds, labour and material resources (Renmin Ribao 1984).

The new reform program therefore, incorporating a most confusing double-track system, gradually changed the market into a single-track system, a step in the direction of 'full-fledged market in the industrial sector. In the immediate aftermath of the October 1984 Plenum, the number of manufactured products subject to mandatory balancing by the State Planning Commission was reduced from 123 broad categories to 60. Likewise, the nomenclature of materials subject to unified distribution by the State Materials Bureau was scaled down from 256 categories to 65 in 1985, and 25 in 1986 (Kueh 1989c). The reductions were all made in favour of the emerging sectors under 'guidance planning' or 'market regulations'.

State industries. Between 1985 and 1988, a number of important complementary policy measures were adopted to reinforce the creation of a market-type 'socialist economy with Chinese characters'. This included first of all, the conversion for state industries of obligatory profit remittances into the familiar western-type tax-linked system. For many enterprises though after-tax profits are still subject to so-called regulatory taxes which are necessary for balancing major inter-branch inequalities in profitability due to price distortions.

Second, state enterprises of different ministerial or territorial origins were encouraged by the central authority to break through the respective administrative barriers to set up joint ventures of mutual benefit. Such 'lateral economic ties' purported to redress excessive vertical industrial integration and promote specialization and compatible resource usage across provinces. It is difficult to verify to what extent this has been effectively carried out because very often the superior authorities attempted to block, with various 'invisible tariff barriers', any intersectoral and inter-regional flows of resources associated with emerging joint ventures (Kueh 1989c:388).

Third, an attempt was made to provide a theoretical justification for, and formulate an operational distinction between, socialist ownership and the disposal/management rights of state enterprises. This ushered in a series of daring experiments to tackle the touchy property rights issue. Since 1986, an increasing number of medium and large-scale enterprises had been 'leased' or 'contracted' to presumably independent management teams. This followed the successful application of the same methods to small-scale state enterprises in previous years. Moreover, the experiments with 'joint-stock corporations' also received renewed official sanction in 1987.⁸ More interestingly perhaps, where foreign capital participation is involved, especially in the Special Economic Zones, landed properties may now be put up for auction for leasehold of up to fifty years or more.

However, so far as the purely domestic sector is concerned, it is still not clear how a 'contract of profit fulfilment', for example, can possibly be well defined in both economic and accounting terms. Because input or output decisions of a particular enterprise are fully or partly subject to centralized dispositions, they are also subject to uncertainties of a nature not found in the familiar investment and marketing risks encountered by western corporations. The situation with small enterprises may be different. They were in the first place not as strictly integrated with the centralized planning system as large and medium-scale industries. Under the decentralization drive, they have indeed been largely operating in a market environment.⁹

Fourth, facilities for the development of capital markets were established. This complied with the experiment related to 'joint-stock corporations'. However, markets are still highly rudimentary, with small industrial undertakings issuing stock shares, transferable or otherwise, to absorb scattered idle capital owned by private individuals. It remains to be seen to what extent centrally controlled large-scale industries may be 'privatized' by way of stock issues, and how in the absence of floating relative prices the shares concerned can be subjected to mass evaluations for purchases and sales, familiar phenomena at western stock markets.

Price system. Virtually all the issues raised presuppose the solution to China's pricing problems. This is understandable, because any system of decentralized decision making will have to rely on a rational price system as a coordinating mechanism to bring about optimum resource allocation. However, the Chinese price system had become highly

⁸See Premier Zhao Ziyang's report 'Forward along the road to socialism with Chinese characters' to the 13th National Party Congress held in October 1987. In this report, Zhao for the first time also made use of the official term 'the primary stage of socialism' to describe the present state of the Chinese economy.

⁹It is also against this background that it has taken so long for the Chinese authorities to draft the bankruptcy law, and why the final version as promulgated in 1987 is hardly of any operational value as a means of checking the performance of the loss-making large and medium-scale industries.

distorted, with prices bearing, for many industrial sectors, hardly any relationship to changes in demand and input costs.

On the whole, prices for primary industries were biased downwards. For example, the lack of depletion allowances for coal mining kept the price of coal very low. Processing industries continued to receive high output prices relative to input costs despite years of productivity improvements. Similar sectors, for example in the metals and machine industry, experienced unexplainable differences in price trends. Decades of scissor-price control resulted in very unfavourable terms of trade for agriculture against industry. The post-Mao increases in farm procurement prices mitigated, but did not eliminate the discrepancy. State subsidies became necessary for urban wage earners to cope with the rising cost of living.

Price reform is clearly essential to make state enterprises financially independent of the state budget, enmeshed as they are at present in a web of taxes and evasions unrelated to any consistent profitability indices. Without it the new developed authority system will not work.

Thus, the October 1984 Resolution envisaged a comprehensive program of price reform to be carried out starting in 1985. The existing two-track pricing system was to be converted into a single-track system by gradually adjusting prices for important producer goods to prevailing market prices. Prices for less important commodities were to be freed straight away. This differed from the approach, adopted in most Eastern European countries, of periodic and piece-meal administrative corrections to irrational prices.

However, this ambitious program of price reforms had to be hastily shelved in 1985 due to inflationary pressures induced by the economic reforms which followed the October 1984 Resolution.

Control through Renminbi. The abrupt expansion of bank credit in December 1984 directly helped to fuel the flames of inflation. Bank loans extended in that particular month amounted to nearly half the size of that extended for the whole of 1984 which in turn represented an increase of nearly 30 per cent over 1983.¹⁰ Obviously there was a strange rush on the part of the banks to cash in on something. The cause was simple; earlier in October 1984 it was announced by the central banking authority that the sum total of bank loans extended for the whole of 1984 would be taken as a

¹⁰See Zhao Ziyang's government report 'Current economic situation and reform of the economic structure' delivered at the 3rd session of the 6th National People's Congress on 27 March 1985, in *Renmin Ribao*, 12 April 1985. The drastic increases in bank loans were also compounded by an equally impressive increase in wage expenditure in 1984 by 19 per cent over 1983. And for reasons similar to the run for bank loans in December 1984 as explained in the text, wage expenditure recorded an increase of 38 per cent for the fourth quarter of 1984. See Zhao, *ibid.* Total capital construction expenditure also increased by 45 per cent in 1985 over 1984 (State Statistical Bureau 1987:43).

basis for determining the new quota of loans for each of the state banks which, commencing the first of January, 1985, were all to be placed on a commercial footing largely independent of the People's Bank (i.e. the Chinese equivalent of the Soviet Gosbank).

The question of how the crisis was finally solved will not be discussed here. More important is whether the incident is to be taken as a unique operational mistake, and whether from now on the new central banking arrangements will help to harden the 'budget constraints' of the various bank branches inducing them to adopt prudential lending policies (Naughton 1985; Chow 1987).

The fundamental constraint and its amplifications, 1985-88

The Stalinist rationale. The crux of China's problems is that at present it seems difficult for any decentralization attempt, let alone an outright marketization of the industrial sector, to co-exist with the overriding Stalinist economic strategy of maximizing savings and growth - in the sense of the preferential growth of heavy industries. Note that the Chinese national savings ratio stood at around 35 per cent of the Chinese version of national income in 1987, only marginally down from the high of 37 per cent for 1978 (State Statistical Bureau 1988:60). This is exceedingly high by the standards of developing economies with a per capita income comparable to that of China.

Setting aside the possible institutional implications of such a high savings ratio on wage and consumption control, it should be clear that the corollary of the imposed austerity is pervasive supply shortages in producer goods, especially in relation to the virtually insatiable demand for investment - a phenomenon commonly referred to as 'investment hunger' in socialist countries. This in turn necessitates centralized control and allocation. As a consequence prices for both investment and consumer goods must be controlled as well, to prevent market forces from undermining the planner's intentions by bidding up the prices for major producer goods. Any relaxation of the relative price system is thus potentially disastrous, as is shown by the latest inflation crisis.

The implications for industrial reform have been dealt with in considerable detail in a separate paper (Kueh 1989a). The discussion here is relatively brief, focusing on the agricultural and trade sectors and on the economy as a whole.

Supply shortages and industrial reforms. As long as the bulk of producer goods are subject to some sort of centrally planned distribution, it is difficult to abandon the institutional arrangements developed to manage the planned allocation. Thus, vertical ministerial lines of control, as well as

the territorial authorities whom act as allocative agents, still persist to ensure compliance, despite claims of increased political reforms matching economic reforms designed to free industrial enterprises.

While the categories of industrial commodities subject to centralized allocations have been reduced successively since 1985, it is difficult to verify the size of such decentralization in terms of the proportion of industrial output effectively deregulated. Nevertheless, under the pressures of chronic supply shortages, there have frequently been complaints levelled on the part of user enterprises to the effect that deregulated producer goods have often turned out to be even more strictly controlled by the superior administrative authorities which monopolized purchases.

As long as major input requirements or output are placed under some form of centralized control it is premature to discuss the rights of managers or institutions to retain or dispose of surpluses (Dong 1988).

Breakthrough in agriculture? Agriculture suffered from the forced institutionalization of the Chinese economy. For well over thirty years Chinese peasants were denied expression of demand elasticities under forced collectivization. Their terms of trade against industrial supplies were deliberately depressed under the effort made by the regime to maximize agricultural surplus to finance industrialization. Against this background, any relaxation in agricultural control would have resulted in increased uncertainties in farm supplies and hence in the pace of industrial growth. The problem was exacerbated by the potentially high income elasticities of demand of subsistent peasants.

This issue was addressed in the reforms at two levels. First the Economic Readjustment policy adopted in 1979 to correct the excessive heavy-industrial biases moderated investment in urban industry, thus lessening demand pressures for agricultural surpluses. Second, the agricultural reforms made possible by the readjustment policy of increasing state farm procurement prices promoted agricultural productivity growth. Increased farm output supplies since 1979 were largely absorbed by the peasants themselves, resulting in a real improvement in their living standard, at the relative expense of the state in terms of industrial investment and growth (Kueh 1988).

Nevertheless, no sooner had the dust of the Economic Readjustments settled and the 'structural imbalances of the national economy' corrected, industrial constraints on further agricultural reform rapidly re-emerged. This was reflected in a number of ways.

First, in many localities, 'farm purchase contracts' were 'imposed' upon the peasants, with the terms and conditions being one-sided, fixed by state agencies, then solved subject to very tight procurement targets.¹¹

Second, officially fixed procurement prices were still considerably lower than 'negotiated' or free market prices for similar farm products.

Third, the purchase contracts were normally tied in with promises by the state agencies to supply such essential farm inputs as chemical fertilizers, diesel oil, pesticides etc. at preferential non-market prices, to encourage the peasants to sell as much as possible to the state. This is characteristic of a monopsonistic market.

As many Chinese scholars themselves see it, the new procurement method is little different from the conventional system of compulsory deliveries.

A qualification should be made in connection with the third point about state control of input supplies. This does indicate an important change, to the extent that the state has now to accommodate the profit-maximizing behaviour of the peasants. This should be interpreted within the entire post-Mao rural context which has been increasingly diversified, marketized and monetized. The economic diversification drive has rendered inoperative the conventional bureaucratic control of rural locational and occupational mobility, providing the peasants with increased employment and earning potential, thus making them more conscious of the concept of opportunity costs.

The more important point to be made, however, is that under such circumstances, state farm procurements tend to become less stable compared with forced siphoning (Kueh 1984:366-70). This creates a need for tighter control, or manipulation, of the farm purchase contracts to ensure stability of supplies to the urban-industrial sector. Given the need to maximize industrial growth, it seems unrealistic to expect full relaxation of control in Chinese agriculture in the relatively near future. Agricultural surpluses in China will be comparatively meagre in the coming years, and are likely to remain so.

Foreign exchange control and the open-door policy. The industrial constraints influencing reforms in China's external economic relations are similar, although the obvious changes associated with China's 'open-door' policy have very often tended to conceal critical inter-industrial linkages. It is interesting to ask how China's trade volume could increase so dramatically after 1979. Was there a total relaxation of control of China's

¹¹This has been frequently brought forward during my conversations with Chinese scholars at both the Rural Development Institute of the Chinese Academy of Social Science and the Research Centre for Rural Development of the State Council.

export and import from the national trading monopolies? Obviously this was not so.

For the most part, trade liberalization occurred in the export rather than the import sector. It is clear that China's comparative advantage lies in farm and related products, handicrafts and arts, and light industrial consumables. Apart from some bulky standardized commodities, such as grain, minerals, and petroleum (a new and important source of exports in recent years), these goods are obviously too heterogeneous to be conducive to centralized control in production and export marketing. This is exactly where the decentralization occurred (Kueh and Howe 1984). Parallel to domestic industrial reforms, producer industries may now engage in direct export, and as an incentive, exporters are given the right to retain part of their foreign exchange earnings. From 1988, for some selected new export industries, notably in electronics, all foreign exchange earned may be retained by the enterprises concerned (New China News Agency 1987).

This new provision should, nevertheless, not be taken to signal a trend towards the total relaxation of control in foreign exchange, and hence the entire import sector. Rather, it is meant to encourage new producers to familiarize themselves with the world markets. On the whole foreign exchange has remained strictly centralized despite the most intensive export drive in recent years, apart perhaps from special privileges given to Guangdong and Fujian provinces. Even the disposal of foreign exchange earnings retained by individual enterprises, including those in Guangdong and Fujian, are subject to varying degrees of import licensing and quota control.

The foreign exchange retained by exporters is small compared to the amount available to the central authorities for centralized allocation. The bulk is still earmarked for imports of iron and steel, and machinery and transport equipment. The combined share of these two major import categories has never fallen below 40 per cent of total imports since 1979, except for the two serious Readjustment years 1981 (33 per cent) and 1982 (31 per cent). It actually increased to a record high of 55 per cent in 1985 (State Statistical Bureau 1986:565). These imports constitute of course an integral part of the highly centralized industrialization program. One can therefore hardly speak of any relaxation in major import controls at all, in the sense that user industries may freely obtain foreign exchange from the state or the market at 'market-clearing rates'.

Taken together, the export sector assumes a role similar to that of the agricultural sector, in that both sectors are coerced into generating income to finance the country's concerted industrialization drive. The same fundamental economic constraint has frequently led to renewed export controls in the past few years, whenever price competition among the

decentralized export industries threatens to reduce the proceeds in foreign currencies.

Something should finally be said about the Chinese search for foreign capital and technology. Most of the difficulties encountered by foreign investors in China can be traced to the same fundamental industrial constraint facing the decentralization of the regular trade and agricultural sectors. Several major points may be made.

First, Sino-foreign joint ventures are normally expected to balance any demand for foreign exchange by exclusively directing their products for export. The Chinese rationale for this is clearly to minimize any drain on foreign reserves, while attempting to maximize benefits from any technological contacts with the west. This could of course be very disappointing for foreign investors who come with an eye on the huge Chinese market.

Second, the same urge for maximizing hard foreign currency earnings also makes it obligatory for Sino-foreign joint ventures to resort, where possible, to domestic Chinese sources for input supplies. This often includes important construction materials, such as iron and steel, cement, timber, etc. which are subject to centralized allocation. Prospective foreign investors familiar with the chronic phenomenon of supply shortages in China are, however, acutely aware that the privilege of having their input requirements incorporated into the state plans may prove to be a disastrous trap, in that supplies will not be forthcoming at the right time and in the amount required or promised (Kueh 1987).

Third, wide-ranging inter-industrial differentials in profitability, resulting from the severely distorted cost-price relationships, often call for highly differentiated and discretionary treatments of foreign investment proposals. The rationale is to forestall joint ventures shifting profits offshore. What inevitably ensues is endless bureaucratic interferences, accompanied with endless, frustrating bargaining between prospective foreign investors and their Chinese partners.

In short, due to the established Chinese strategy of maximizing heavy-industrial growth, foreign investors in China are subject to the same constraints as those which limit the manoeuvrability of domestic industrial enterprises - physical and administrative restrictions, and policy relaxations *vis-à-vis* foreign investors, notably in the Special Economic Zones. They include extended autonomy in labour management, preferential land allocation, controlled tax and tariff concessions and the like. It is questionable, however, whether the experiment with the SEZs will proliferate throughout China in the foreseeable future.

Summary and conclusion: what next after retrenchment?

Our foregoing discussions show that the conventional Soviet-style development strategy of maximizing savings and investment in priority sectors, notably heavy industries, continues to impose limits on the Chinese search for an optimum decentralization of the economic system. This is clearly manifested in the economic reforms of the agricultural and industrial sectors, especially in respect of the large and medium scale industries which constitute the linchpin of China's massive industrialization sector program. The same urge to maximize the pace of industrialization also constrains the country's external economic relations. Thus, foreign exchange earnings remain subject to centralized control and allocation to ensure sufficient financing for priority inputs to fill the critical gaps in the input demand.

In fact, the entire open-door policy for courting foreign capital is mainly directed towards the generation of foreign exchange earnings to serve the same purpose of maximizing industrial growth. Sino-foreign joint ventures are normally requested to market their products abroad, instead of aiming at the domestic Chinese market. This represents an ambitious encouragement of export-oriented foreign investment, which stands in sharp contrast to the practice of most industrializing nations in Asia, where foreign investment is initially part of a policy of import substitution. China's approach is certainly one unwelcome to many western investors, whose purpose in investing is to get a foothold in the vast Chinese market itself and not to create Chinese competition that will undermine investors in the markets of third world countries.

The prospect of a system of economic control in China that is decentralized to such an extent that it can be more or less fully integrated with the free trade system of the west, still seems quite remote. Against this background, the reform measures taken so far, no matter how sensational some of them may appear, seem to be of marginal significance.

Take the rapid proliferation of rural industries for example, which are basically not subject to centralized planning and control. The output of these small-scale industries has increased dramatically since 1979. Yet together with the more conventional urban collective industries, they make up no more than 35 per cent of the nation's gross value of industrial output (Kueh 1989b). Already, however, there has been mounting pressure exerted on the planners to wind up or reduce the scope of rural industrial operation. The pressure is not only for reasons associated with obvious diseconomies of scale, but probably more importantly, because these wasteful small enterprises tend to increasingly help undermine the centralized industrial planning core by intercepting important local raw

materials which are earmarked for the large state industries in the major urban centres.

The same goes with the double-track system of planning, i.e. the bifurcation of state industries themselves into planned and market sectors. State enterprises tend to undermine the planned sectors by concealing their output capacities in relation to the plan assignments in order to maximize output which can be marketed on their own account at more favourable market prices than the officially fixed prices for planned output.

More seriously indeed, against the background of chronic supply shortages, their enhanced self-marketing power enables state industries to take advantage of their monopolistic positions. Coupled with lack of monetary discipline on the part of the banking system and pent-up demand left over from years of consumption and price control, the inevitable outcome has been rampant inflationary pressures, as witnessed since mid 1988.

What will come out of the ongoing retrenchment policy measures is of course a matter subject to speculation. Perhaps the more important question is whether there will be a reorientation of the established economic development strategy towards a dismantling of the Stalinist model which emphasizes heavy industries and maximizes growth. Undoubtedly any move in this direction would involve major industrial-structural readjustments which for political or economic reasons seem untenable. However, any *ad hoc* readjustment, by way of 'lopping the tree', (suspending or scrapping investment projects in the relatively low priority sectors) will certainly bring about a lingering host of both long-term and short-term problems. There has already been increasing concern about the possible unemployment effects of any further credit squeezes to rural industries which in the past ten years or so have affected tens of millions of labourers.

Also seriously affected are the urban centres where the elite industrial workers are likely to face a situation of stagflation in the years to come. The situation is particularly acute, if not explosive, in view of the fact that urban workers in the past few years have been lured into a spiral of rising expectations in conjunction with the economic reform and open-door policies.

With respect to industrial management reforms, the current fight-inflation campaign not only implies increased austerity in terms of input control, but more importantly, increased application of administrative fiat, which has effectively halted the decentralization drive. With the ambitious price reform program having been shelved, it is difficult to envisage any concrete policy measures will be adopted in the foreseeable future to facilitate the transition from the 'double-track planning' system to a

'socialist market economy'. The moratorium could indeed be long-lasting, given the depth of the current inflation crisis and the absence of any prospective solution to the perennial problems of lax monetary control, or more specifically 'soft budget constraints' which are common to all socialist economies.

However, the impact of the ongoing economic readjustment policy on China's external economic relations is likely to be less drastic than the impact on the domestic sector. Many of the Sino-foreign joint ventures already have financial difficulties as a result of tightening credit. Nevertheless, from a longer-term perspective the massive government-sponsored modernization drive will continue to generate demand for foreign capital and technology. In the readjustment process some low priority imports, especially consumer goods, are bound to be curtailed from time to time. Also, despite Sino-Soviet rapprochement, it is hard to imagine any substantial reorientation towards the Soviet Union as an alternative source of supplies. The reason for this is imply that it will always prove to be more beneficial for the Chinese to shop around in the highly competitive and technologically more advanced western markets, rather than to resort once again to the state monopolies of the East-European countries.

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