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### PEIXIN YANG'S ECONOMIC THOUGHT AND ITS OUTCOMES IN THE 1980s, EARLY IN CHINA'S REFORM, AND CHINA'S REFORM MIRACLE

*Bin Yang*



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Bin Yang is Research Fellow at the Academy of Marxism, Chinese Academy of Social Sciences. His research areas include political economics, enterprise economics, and economic and financial security issues. Email: yangriver@sina.com



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**Abstract:** During the initial period of reform, China's prudent handling of the money-price relationship while simultaneously bringing inflation and unemployment under control had a far-reaching influence on economic theory as well as practical significance. The country's successful experience constituted a miracle beyond the dreams of authoritative international financial authorities and experts. The famous American Nobel Prize winner, the economist Milton Friedman, once said that anyone who could explain China's success could win the Nobel Prize. In today's complex world, with its recurrent financial turmoil and intensified threat of war, China's successful experience in the early phases of reform has important significance for developing socialism with Chinese characteristics and maintaining the country's economic and financial security and the interests of the great mass of the people. We should sum up this experience to strengthen confidence in our institutions, our path, and our theory.

**Key words:** market economy; resource allocation; economic security; financial crisis

#### A Short Introduction to Mr Peixin Yang

Peixin Yang was born in the small town of Baihou in Guangdong Province. He joined the Communist Party of China (CPC) in 1938 when studying in Wuchang's Zhonghua University. In 1943, he worked as a progressive journalist for the

*Shangwu Ribao* (*Business Daily*) in Chongqing, later becoming director of its interview department. He availed himself of this position to expose the inflation, soaring prices, and flagrant exploitation of the working class and the peasants under the Kuomintang (KMT), the corruption of KMT officialdom, and the plight of native industry and commerce. After the outbreak of the Civil War, he worked as Chief Economics Editor for the *Wen Hui Bao* (*Shanghai Mercury*), during which time he published his *New Treatise on Money* and *On Inflation in China*. In Hong Kong, he published his *Analysis of the Crony Capital of the CC Club*, *Analysis of the Crony Capital of T.V. Soong*, and *The Robber Baron Chiang Kai-Shek*. After the *Wen Hui Bao* was closed down in Shanghai, he went to Hong Kong and reestablished the newspaper there.

In 1949, he became Secretary to the first President of the People's Bank of China, Nan Hanchen, and simultaneously worked as Director of the Bank's Propaganda Section. He started the academic journal *Chinese Finance* and was its chief editor. After the Third Plenum in 1978, he became Deputy Director of the Institute of Finance Research of the People's Bank of China and undertook the empirical research necessary to the impending financial and economic reforms, presenting reform proposals to the Party Central Committee and the State Council. From 1982, he was Research Fellow at the Development Research Centre of the State Council, and thereafter held concurrent positions as Research Fellow at the Institute of Economics of the Chinese Academy of Social Sciences, Professor at Renmin University, Administrative Director of the Finance Association of China, and Consultant to the Capital Steel Group. He is the author of numerous books: *Inflation in Old China*, *The Economic Achievements of China's Five-year Plans since 1949*, *Finance in China*, *Bank Reform in China*, *China's Socialist Bank*, *China's Monetary Policy*, *The Russo-Chinese Bank*, *New Approaches to Economic Reform in China*, *The Contract System: A Necessary Route to Enterprise Development*, *Inflation: A Disaster for the People*, etc.

### **Honored with the Prize for Lifetime Achievement in Financial Studies in 2014**

On April 19, 2014, an award ceremony for the Prize for Lifetime Achievement in Financial Studies took place at the PBC School of Finance, Tsinghua University. The award for 2014 was conferred on three economists preeminent in their fields: Yongming Yang, Peixin Yang, and Haikuan Zhao. This prize is the highest honor in the field of finance and carries great authority. The ceremony was cosponsored by the Hongru Liu Financial Education Fund, the PBC School of Finance at Tsinghua University, and the Finance Association of China. The Vice President of the People's Bank of China, Hu Xiaolian, presided over the ceremony.

As Deputy Head of the Prize Committee, the President of the Central University of Finance and Economics, Guangqian Wang, delivered the following presentation speech for Mr Yang's award:

Mr. Peixin Yang was born in Dapu County, Guangdong, in 1922. A celebrated Chinese economist, financial expert and educationalist, he made a great contribution to the foundation and development of the financial system and financial studies in China after 1949. For over 70 years, he has dedicated himself to research on economic and financial theory, to institution-building and to establishing finance as an academic discipline. He has encouraged economic and financial theoretical research, economic and financial reform, finance education and the cultivation of talent.

At a very early age, he determined to devote his life to the great mission of strengthening the country and enriching the people. His initial exploration of economics and finance was bound up with the historic task of saving China and his fellow countrymen. During the Anti-Japanese War, he made a thorough study of the underlying causes of the severe inflation and sky-rocketing prices, economic monopolies and chaotic financial markets prevailing under the KMT. In the 1940s, he published numerous influential works on economics and finance. For instance, *A New Treatise on Money*, published in 1947, was reprinted in larger numbers only a year later; it became basic reading for financial cadres in the liberated areas.

After 1949, Yang became Secretary to the first President of the PBC, and simultaneously worked as Director of the Bank's propaganda branch, where he made a great contribution to rapidly gaining control of inflation, stabilizing prices, reforming monetary value and establishing a new monetary and banking system.

After reform and opening up in 1978, he became the Deputy Director of the Institute of Finance Research of the People's Bank of China and later Research Fellow at the Development Research Centre of the State Council. Devoting all his time and energy to Chinese economic and financial reform, he became a standard-bearer in theoretical circles. As early as 1978, he put forward policy proposals for the reform of the Chinese banking system, urging the introduction of market mechanisms into the system and the use of banking reform to support economic reform as a whole. With regard to financial reform, he proposed "first giving greater discretion to the grass roots branches, then establishing a diversified system of financial structures and markets and completing and perfecting macroeconomic control mechanisms, and finally establishing a modern market economy and financial system."

In the 1980s, Yang wrote numerous articles, monographs and policy proposals setting out his views on monetary policy, price reform and comprehensive financial reform. These proposals, adopted by the Party Central Committee and the State Council, helped smooth the implementation of the reform process, and proved particularly effective in bringing inflation and unemployment under control at the same time. This showed that

the "dual paradox," under which only one of the two can be controlled at any one time, is untenable, and thus steered China away from the "shock therapy" which disrupted Russian society.

With regard to economic reform in China, Yang advocated starting with simplifying government and decentralizing power, to be followed by bestowing more autonomy on enterprises via contract operations and then by the establishment of a modern enterprise system. The Party Central Committee and the State Council adopted his proposals, which were implemented to good effect. Thereafter, his colleagues in the field of theory nicknamed him "Contractor Yang." His reform proposals in the fields of monetary policy, prices, finance, enterprises and the fiscal system not only provided an impetus to the overall reform and development of the Chinese economy and finance system, but also had great theoretical and practical significance for the building of a socialist market economy with Chinese characteristics, enabling China to avoid the costs imposed by the market in the course of transition to a market system. His work still repays study today, enabling us to develop new theories that go beyond those of the West and which are suited to Chinese realities.

Peixin Yang's contribution is not confined to the field of economic and financial theory or to the impetus his work gave to practical reform. He also played a major role in finance education and in cultivating talent. He participated in the creation of the Graduate School of the People's Bank of China (now the PBC School of Finance, Tsinghua University) and Jiaying University in Guangdong Province, and became first President of the latter. He held concurrent professorial chairs in several universities and many of his students became financial experts.

Despite his advanced age (92), Mr Yang is still concerned with economic and financial reform as well as with the development of financial education in China. He lived through the rise and fall of different economic and financial systems under different social systems, took part in establishing the monetary and banking system after 1949 and encouraged the reform and opening up process. From an early age, he dedicated himself to strengthening the country and enriching the people; he sought truth from facts; was guided by real life, not only by textbooks; did not follow the crowd; and did not seek personal gain, but rather gave his all for the country and the people. The spirit with which he pursued these beliefs throughout his life has moved successive generations of Chinese economists and finance specialists. (Wang 2014)

## **Western Scholars Acknowledge the Far-Reaching Significance of the Explanation for China's Success**

One important reason for Yang's receipt of the award was the proposals he put forward in the 1980s on monetary policy, price reform, and financial reform. These smoothed the reform process, especially with regard to handling inflation

and unemployment. This success proved that “dual paradox” theory, which says both cannot be managed at once, was untenable, thus steering China away from the “shock therapy” which proved so disruptive in Russia. Yang first met Milton Friedman in the 1980s. As authorities on monetary policy and inflation in their respective countries, they engaged in an exchange of views over many years. Despite their different academic standpoints, their policies on controlling inflation were not dissimilar. In the course of their dialogue, Professor Friedman expressed his admiration for China’s success in controlling inflation and unemployment and even said that anyone who could explain China’s success could win the Nobel Prize.

This assessment from the most obdurate upholder of the free market among Western scholars was certainly not intended to curry favor; rather, it implied that he had encountered an inexplicable objective fact: China’s success transcended the free market economic policies he had regarded as ideal. The fact that the West’s preeminent monetary authority heaped such praise on China means that China should not make light of or denigrate its own successful experience, but rather should make a thorough study of these successes, with a view to refining a set of market and monetary theories superior to those of the West. We will never procure the genuine appreciation of Western economists and the Western academic community by blindly following and idolizing Western economic theory. It is only by setting out from Chinese realities and daring to uphold China’s unique characteristics that we can really succeed in our market economy reforms and win the respect of Western scholars who castigate Russia, which stuck blindly to the “Washington Consensus” but praised China, which successfully pursued its “Beijing Consensus.” These examples, plus the international praise for the “China Model” of recent years, demonstrate this point.

Friedman holds that the key to the effective functioning of a market economy is freeing up the price mechanism, with no government intervention, regardless of the cost in human suffering. The sole area in which government can intervene is the money supply. Friedman proposed a policy of price deregulation and giving full play to the market while tightly controlling the money supply and curbing inflation. In the 1970s and 1980s, Brazil, Chile, and other Latin American countries paid a high price for implementing his recommendations. At the time, Chile’s inflation was the worst in the world and its unemployment went up 10-fold. The mass of the people fell into dire straits, unable even to pay their transport costs, and average expenditure on food rose sharply from 17% of family income to 80%. Even Friedman’s disciples wrote articles stating that children were fainting in school simply because of undernourishment (Klein 2008). Even in advanced market economies such as the USA, these policies had serious consequences, leading to the bankruptcy of many firms in the real economy and serious unemployment.

The former Soviet Union and the Eastern European countries in transition paid a particularly heavy price, in hyperinflation, recession, unemployment, and the disappearance of people's savings. What is of concern is that Friedman's theories of markets, price, and money hold sway across the world.

The initial stage of China's reform and opening up witnessed the conquest of severe shortages and latent inflation. Not only did this not produce unemployment; it also solved the problem of finding jobs for tens of millions of "intellectual youth" returning from the countryside. This meant that China had successfully tackled the "Friedman Paradox," which stated that inflation and unemployment could not be solved simultaneously. At the same time, it indicated that China's market would be better able to function during the transition period, thus avoiding the heavy price paid by Latin America, the former Soviet Union, and Eastern Europe, as well as the USA and other developed countries. Friedman's comment that anyone who could explain China's success could win a Nobel Prize indicates not only its far-reaching significance for the development of economic theory but also, more importantly, its immediate significance for the resolution of real-life difficulties. It can easily be seen that for one reason or another, all countries, including China, must at some time confront the problems repeatedly found in the mature market economies of the USA, Latin America, etc., with their centuries of history. These include the worldwide import of inflation triggered by the massive printing of US dollars, the soaring price of crude oil, or the outbreak of war. Only by continuing to draw on its successful experience of controlling inflation and unemployment in the early stages of nation-building and reform can China avoid paying the heavy price of frequent bankruptcies, high unemployment, and the erosion of the incomes and savings of the masses.

### **The Miracle of Chinese Reform Goes beyond the Purview of Western Economic Theory**

As early as 1978, Yang proposed introducing the market adjustment mechanism into economic reform and reforming the banks by giving them discretion to make loans that would help state-owned enterprises step up production to meet market demand (Yang 1983). Some noted economists who later made their names as proponents of the market economy had not then changed their ideas and still upheld the planned economy as an indispensable part of socialism. Only after they visited the West in the 1980s and were influenced by the reform project hyped by the USA did they begin to endorse the policy of deregulating the price system, boosting market mechanisms, controlling the money supply, and curbing inflation. They thought total deregulation of prices posed no great danger because price rises would be controlled if the state kept a tight grip on the money supply. But

Yang felt the Western economic textbooks of the time were misleading; in the real world, the operation of market mechanisms was a lot more complex than it looked in the textbooks. He had lived through the consequences of the policies recommended by American advisors before 1949: during the transition from the wartime economy after the Anti-Japanese War, China had adopted the policy of “deregulating prices and tightly controlling the money supply,” but given the big gap between demand and supply, deregulation meant that prices shot up, while the time lag involved in the policy of keeping a tight rein on the money supply undermined its effectiveness. At the same time, the credit squeeze on commerce and industry suppressed production and discouraged absorption of the excess money. Consequently, many firms went bankrupt, workers lost their jobs, and effective social demand fell sharply. Only after enterprises and ordinary people had no money left were rising prices curbed, as inflation became deflation in a further blow to business, industry, and the general populace (Yang 1946).

In practice, the policy proposals Yang made in the initial stages of reform on the handling of the relationship between money and prices got better results than Friedman’s monetary theory. The crucial point was that Yang discerned and dealt with significant market failures which had long been ignored by Western economists. Practice proved that, compared with Western economic theory, Yang’s approach was better able to bring out the advantages of market mechanisms; he made a unique contribution to the development of a market economy theory with Chinese characteristics. He held that where the gap between demand and supply is too great, price deregulation will trigger a price explosion and damage consumer interests. At such times, the market’s role in regulating prices cannot operate effectively and equilibrium cannot be restored. Because enterprises are constrained by their fixed assets, the economic stimulus provided by the sharp rise in prices has very little effect, while the policy of keeping a tight rein on the money supply further undermines banks’ ability to support the expansion of supply. Furthermore, the soaring prices often result in speculative activity that seriously distorts demand, thus further widening the gap between supply and demand and exacerbating steep price rises and market imbalances (Yang 1987). The demand/supply curve of Western economics looks very scientific and appealing, but in fact it is only applicable where prices are close to the equilibrium point and the gap between demand and supply is not too large. When, for various reasons, there is too great a gap between supply and demand and they are not close to the equilibrium point, the upper part of the supply curve changes to a vertical straight line. This is because the continued expansion of production is restricted by firms’ plant and equipment. Soaring prices are often followed by a large inflow of speculative capital seeking windfall profits, leading to severe distortion of the normal demand curve as the downward curve turns upward. Attracted by high profits, producers

may then join the ranks of the speculators and cut their sales or hoard their stores. This is reflected in a reversal of the supply curve, which implies the stagnation of supply and soaring demand and leads to sharp price rises that may get completely out of control. This represents a failure of the market's pricing mechanism, which is unable to restore equilibrium.

Yang holds that the situation described above does not arise by chance but occurs repeatedly in many circumstances: inflation, war, capital manipulation, excessive speculation, the transition from a wartime command economy or a planned economy to a market economy, etc. All of these may lead to an overlarge gap between supply and demand and the failure of the price mechanism, triggering market failures arising from excessive speculation, inflation, a wartime or transition economy, etc. These various forms of market failure tend to interact and strengthen each other. At such a time, the government should not just stand by but should react flexibly, with due regard to the specific causes of market failure. It should take effective measures to facilitate the normal functioning of the market mechanism, allowing it to determine the allocation of resources. Prior to 1949, Yang had made a thorough study of the operation of commodity and finance markets; he had had repeated experience of market failures such as hyperinflation and excessive speculation. At the time, the KMT government and its US economic advisors stood by and did nothing about the suffering of the masses. Nominally, they were following a policy of "laissez-faire," but in fact they were giving free rein to the extortion of foreign capital and Chinese robber barons. The "Four Big KMT Families" seized the opportunity to manipulate commodity and finance markets and made huge profits through illicit speculation, greatly to the detriment of the interests of the mass of the people and the national bourgeoisie.

Yang believed that the key to giving full play to the market mechanism was not deregulation of the price system but giving producers the freedom to arrange production in accord with market demand and consumers the freedom to buy the goods they needed. With a moderate demand–supply gap, prices could be allowed to float freely, allowing for a more precise adjustment of supply and demand without harming consumers. But with an excessive gap, the price mechanism fails, and the market may reward speculative profiteers by diverting large amounts of resources to them; at the same time, volatile prices will pose a grave threat to the interests of consumers and producers. Damage to the interests of the main actors in the marketplace—consumers and producers—rules out the normal operation of market allocation of resources. Especially where major commodities that affect the entire economy are concerned, inflation or deflation may endanger the economy (Yang 1988). In cases of a large demand–supply gap, excessive speculation, or inflation, the key to allowing the market to determine resource allocation is not price deregulation; rather, the government should give the highest priority to



the interests of society and the people and take flexible measures ranging from price controls and stabilization funds to coordinated measures with state-owned enterprises to keep price fluctuation in a range acceptable to both consumers and producers. At the same time, it should adopt a combination of fiscal, financial, and industrial policies to speed up structural adjustment, narrow the demand–supply gap, and stabilize the market. Only after this has been done is price deregulation an option.

Yang observes that although price controls existed at the initial stage of Chinese reform and the prices were not set by the market, the great majority of prices fell within an acceptable range for consumers and producers. The fact that the ex-factory price was higher than the cost of production allowed enterprises a modest profit, while the relatively low retail prices took into account the interests of ordinary people with low incomes. The main reasons for shortages and lack of variety were that planning was excessively rigid. If state-owned enterprises were allowed more discretion to expand production to meet market demand and banks were granted more discretion to make loans according to market conditions, production of scarce consumer goods could be swiftly ramped up and the demand–supply gap reduced. This option, of restoring equilibrium by expanding production, was better than price deregulation; it was better able to protect consumer interests and maintain overall social stability. It avoided any obstacle to the steady progress of reform that might have arisen from the deleterious effect on ordinary people of rising prices. Although curbing price rises may have a short-term effect on producers' interests, in the long run, it leaves more room for the further expansion of market capacity. Enterprises will have better long-term development prospects if they increase efficiency and expand investment. The producer stimulus provided by rising prices involves a low-level equilibrium reached by upward movement along the supply curve, whereas with the same prices, expansion of investment expansion, moving horizontally along the supply curve, will reach a higher level equilibrium. In appropriate circumstances, the restriction of price fluctuations facilitates the market's function of allocating resources (Yang 1998).

## **Developing the Marxist Law of Value and Market Economic Theory**

Yang's proposals, early in the reform era, for monetary policy and price reform also contributed to the development of Marxist economics. Marx believed that the law of value functioned to regulate socialized production. He held that prices were affected by supply and demand and fluctuated around value, regulating the allocation of resources. Capitalists' pursuit of maximum surplus value prevents the income of the working class from rising, while the limitless expansion of production and the contradictions in effective demand lead to overproduction.

When a crisis erupts, the value of the surplus products cannot be realized and substantial resources will have been squandered, leading to an excessive gap between supply and demand and the failure of the market's regulatory function. Marx incisively revealed the underlying cause of the crisis of capitalism, giving an important stimulus to Western attempts to conquer or at least moderate market failure of this kind. After the Second World War, the Western world took measures to rein in the rapacity of capital, including improving income distribution, reducing class conflict, nationalization, and financial controls. The controls placed upon exchange rates, interest rates, and the capital account and the strict suppression of financial speculation were in fact involuntary measures taken when the pressures of the Cold War necessitated a recourse to Marxism rather than Keynesianism. This has been frankly acknowledged by the West's financial elites and think tanks. Since 2008, the West has striven to recover from the financial crisis by lavish use of the Keynesian approach, but has only sunk deeper into the red, inflating the national debt and recklessly printing money, etc., creating problems that will tie it down indefinitely. Conversely, this shows that the West's postwar economic growth occurred because it drew on Marxism.

Yang considers that when it occurs in conjunction with an excessive gap between supply and demand, inflation affects the law of value and the market's normal function of allocating resources. At such times, price deregulation results in soaring prices, to the grave detriment of consumers, and distorts the relative prices of different products, hindering the allocation of resources to different areas. This means that substantial resources are diverted from production to overheated market speculation. The fact that speculators who do not create value gain possession of substantial resources begets market failure, impeding the normal processes of production, circulation, consumption, and investment. At this point, the national economy will be affected by prolonged stagnation rather than the "short-term pain of market adjustment." He holds that the "price deregulation and monetary controls" pushed by the West are unable to curb inflation and restore the law of value and the regulatory function of the market. A socialist market economy should give the highest priority to the interests of the people and not toe the line of Western "laissez-faire" economic dogma, with its defense of the interests of capital, and should take effective measures to keep price fluctuation within a range that is acceptable to consumers, especially with regard to staple commodities, exchange rates, interest rates, and other important items. Controlling prices, not deregulating them, facilitates the normal functioning of the market. At the same time, the adoption of positive financial, monetary, and industrial policies will expedite economic restructuring, which will assist the speedy elimination of shortages and inflation, thus bringing the law of value and the market mechanism into play and restoring equilibrium between supply and demand.

Yang believed that protecting the interests of the common people was crucial to allowing the market economy to play its role. This was the law of the market economy revealed by Karl Marx in relation to the era of large-scale socialized production. The market economy unites production, consumption, and circulation in an organic unity. Only by following this objective law can we enable the market economy to serve the people in its allocation of resources; if we go against it and damage their interests, this will set off a chain reaction and an economic crisis. When the KMT government and its US economic advisors faced soaring prices, a speculative frenzy, and market chaos, they disregarded the interests of the mass of the people and were guided by the “laissez-faire” doctrine, with the aim of having the market economy allocate resources in the interests of the rich and powerful families and foreign capital. The unbearable suffering of the mass of the people made them rise in resistance and overthrow the KMT regime. Yang’s proposals on bringing the functions of the market economy into play and pursuing reform not only adhere to the “three facilitates” criterion adopted by the CPC in the initial stages of reform (the criterion for assessing whether a reform measure is correct is not whether it adheres to some theoretical dogma but whether it facilitates the development of social production; facilitates the raising of the people’s standard of living; and facilitates maintenance of social stability). At the same time, his ideas also accord with the later programs and lines put forward by the Party leadership, such as the “Three Represents” and the Scientific Outlook on Development, as well as the spirit of “reform must serve the interests of the people” emphasized in President Xi Jinping’s speech.

Yang’s proposals on gradual price reform and monetary policy were adopted by the Chinese government, enabling them to steer China safely through the dangerous transitional period for an economy of scarcity and into a prosperous buyer’s market without incurring the high price paid by the Eastern European countries and the former USSR. However, the possibility of a gap arising between supply and demand cannot be completely ruled out for various reasons, such as excessive speculation, natural disasters, war, or a currency that is out of control. The West today has entered a new stage of virtual financial capitalism, in which enormous economic resources are flowing from value-creating primary industry and manufacturing and the parts of tertiary industry that serve the real economy, such as education, scientific research, and health care, to the non-value-creating areas of virtual finance and speculation. International capital pressures countries to abandon their controls and open their capital accounts, allowing international speculative hot money to be moved anywhere in the world. This creates and exacerbates an artificial demand–supply gap in which market prices are manipulated so that they fluctuate wildly. In particular, international capital manipulates sharp fluctuations in the prices of staple commodities, exchange

rates, and interest rates, expropriating the value created by the real economy and making huge speculative profits. Under cover of the free market, violating the law of value and the regulatory function of the market, international capitalists concoct repeated financial crises to attack their international competitors or plunder global assets that belong to the people.

American and European finance capital took Egypt, Tunisia, and other Middle Eastern countries down the wrong path: these countries deregulated prices and revoked subsidies, then took the opportunity of a good harvest to speculate in the international grain market. When the skyrocketing price of grain threw the Middle East into turmoil, the West harnessed popular indignation to incite riots and export color revolutions and regime change. Western financiers also pressed the Japanese government to free up exchange rates and interest rates, creating a bubble economy and dragging the country into a financial crisis and 20 years of economic stagnation. International finance capital also profits from natural disasters, wars, etc. If in these circumstances governments still stick to *laissez-faire* dogma, prices will rise dramatically. During the First World War, runaway prices left the Western world in turmoil. Forced to learn the error of their ways, Western countries adopted widespread price controls during the Second World War. History demonstrates there is no such thing as an objective law of market adjustment that inflicts short-term pain on ordinary people but ultimately improves the market's ability to allocate resources. This is nothing but a myth concocted by the West to defend the interests of big capital and lead other countries astray. The true lesson of history is that any attempt to undermine the interests of the common people will violate the laws of socialized production revealed by Marx, destroying the law of value and the market's normal role in the allocation of resources. These errors will multiply in a chain reaction leading to economic crisis and widespread turmoil. The world today is beset by repeated financial turbulence and the intensified threat of war, so Peixin Yang's theoretical perspectives and policy proposals on coping with market failure brought about by a wide gap between supply and demand and on controlling the threat of excessive speculation and inflation is of considerable significance for us as we seek to safeguard the interests of the people, to maintain social stability, and to preserve economic and financial security.

Yang believes that Chinese economic reform should not be a matter of wholesale importation of the market doctrines in Western textbooks; instead, we should uphold practice as the sole criterion of truth, seeking truth from the facts, and should uphold the Communist Party's mass line of giving the interests of the people the topmost priority. In this way, socialism is better able to activate the potential of the market economy than capitalism. Before 1949, Yang had already made a lengthy study of the functions of various commodity and finance markets and had personally witnessed the hyperinflation and excessive speculation resulting from

the dogmatic market theory urged on the KMT by its American advisors. This had allowed Western capital and the “Four Big KMT Families” to manipulate soaring prices and extract windfall profits while causing great suffering and hardship for the masses and the national bourgeoisie, a situation that led to popular resistance and ended in the fall of the KMT regime. Yang was thus familiar with the market’s positive functions of adjusting supply and demand and allocating resources, but he also had personal experience of complex market failures such as inflation and deflation. He is well aware that the interests of the people must be given priority and that effective measures have to be taken to correct different forms of market failure; only in this way can the market’s positive function of allocating resources be made to serve the people. He likewise believes that people must be placed first in the socialist market economy; this will enable us to develop better theories than the West with regard to markets, prices, and money.

The celebrated economist Liu Guoguang had already begun his research career before 1949. He too was familiar with both the positive side of the market economy and its manifest evils, and, with Yang, was among the first to propose that reform should look toward the market. At the same time, he upheld the socialist path and opposed wholesale transfer of the West’s market dogma. In contrast, many well-known Chinese scholars established their reputation as economists only after 1949, and, as the famous economist Wu Jinglian admitted, they had a blind belief in the doctrine of the planned economy. Once reform started, Wu said that “some of us, including myself, naïvely thought that all we had to do was build a market economy. Any kind of market economy would do; they could all guarantee economic prosperity and the welfare of the people” (Wu 2002, 234).

Only afterward did he realize that “That’s not how it really is, there are good market economies and bad market economies” (Wu 2002, 234). Professor Wu made his name as a supporter of the market economy in China, so much so that he was branded “Market Wu” and has been awarded the China Economics Prize. However, he began to study the market economy decades after Yang, and his post-1978 proposals for market reform also came some years after Yang’s.

Some of the most famous economists in China, deeply influenced by the dogma of the planned economy, rejected the law of value and market regulation. But after trips to the West in the 1980s expanded their horizons, they became blind devotees of Western economic theory, taking the neoliberal “Washington Consensus” America was urging on China as a normative goal and model for systematic economic reform and overall deepening of reform. They proposed “one step price reform” and “no gain without pain.” Despite resistance and dissatisfaction on the part of the masses with the rising prices of the early period of reform, these radical proposals for price reform won the upper hand at one stage. However, dissenting voices arose from the older generation of economists, including Yang, who had

personal experience of the market economy and had more authority with the policymakers. Therefore, China did not accept the program of the World Bank as Russia was to do; instead, it adhered to the reform line of giving first place to the interests of the people and social stability, avoiding the devastation of the “shock therapy” implemented in Russia. Practice proves that this approach was better able to activate the positive resource allocation function of the market economy than taking the great risks entailed in adoption of the American model of transition to a market economy.

### **Wise Handling of the Relationship between the Money Supply and Price Levels: Simultaneously Controlling Inflation and Unemployment**

In the 1980s, the USA urged on the Chinese government the policy combination of “deregulating prices and tightly controlling the money supply,” which it called a normative reform package. Yang had encountered this sort of policy proposal before in interchanges with international finance institutions. However, he had had personal experience of the consequences of similar American proposals before 1949; therefore, he made it clear that this policy combination was unwise. He endorsed an extremely cautious approach to monetary and price reform; any increase in the money supply should be appropriately and frequently adjusted according to changing economic conditions. The one-size-fits-all approach was to be avoided in favor of differentiated handling, and price reform should proceed incrementally to avoid damaging the interest of the common people. In the 1980s, he published numerous articles, monographs, and policy proposals setting out his monetary policy and price reform proposals. Their adoption by the central leadership helped to smooth the reform process and was significant in simultaneously bringing inflation and unemployment under control. *China's Monetary Policy* and *A New Approach to Chinese Economic Reform* collected dozens of Yang's research reports from the 1980s, expounding his position on monetary policy and price reform.

In a sense, Yang's proposals represent precisely the opposite approach to that of the USA; he believes that when shortages put upward pressure on prices, reforms involving hasty price deregulation are equivalent to giving prices free rein, to the detriment of consumers. In addition, the rising prices do not deliver an immediate stimulus to supply due to the constraints imposed by fixed assets. If tight controls are placed on the money supply at this point, enterprises will get no support for expanding production. In such cases, it is better to proceed cautiously with incremental price reform to lessen the upward pressure on prices while relaxing credit so as to facilitate economic restructuring and support enterprise investment aimed at improving and expanding production of the goods in shortage. Once the

supply and demand of scarce goods have been brought into equilibrium, prices can be deregulated. In its early stages, Chinese reform was faced with a grave shortage of material goods and with tens of millions of jobless “intellectual youth” returning from the countryside. This situation was much more serious than that confronted by the former Soviet Union in the early stages of its reforms. China opted for a course of action exactly opposite to the normative prescription of the West. On one hand, it carried out a cautious incremental reform of the price system; on the other hand, it loosened credit to support light industry and the textile industry to accelerate industry restructuring and upgrade technology. Consequently, supply expanded and inflation was curbed, and, at the same time, employment was provided for the “intellectual youth.” The former Soviet Union, on the other hand, which adopted the policy pushed by the West of “deregulating prices and tightly controlling the money supply,” suffered hyperinflation, recession, and an unemployment crisis. From 1979 to 1984, consumer goods in China went from scarcity to plenty, lessening latent inflationary pressure. In 1983, Beijing presented a scene of unparalleled prosperity hardly seen since 1949; the streets around the Forbidden City were crowded with new stalls and booths stretching away into the distance, all sparkling with the products of light industry. By expanding production, China employed an extra 46 million people, of whom 50.38% entered state-owned enterprises and 49.6% entered collective enterprises. The 1979 unemployment rate of 5.9% was the highest since 1959. But by 1984, there had been a marked improvement, and unemployment was down to 1.9% (Yang 1996). The Nobel Prize winner Milton Friedman and his monetarist disciples thought that one couldn’t lower unemployment and fight inflation at the same time; when he found, through exchanges with Chinese economists, that China had been successful at both he expressed his admiration, going so far as to say that anyone who could explain China’s success could win the Nobel Prize.

As early as 1978, Yang saw that banking reform would support China’s overall economic reform: banks, he said, should issue short- and mid-term loans for equipment to expand production of scarce items. In the winter of 1980, too many major infrastructure projects were launched as part of the “Foreign-style Great Leap Forward.” The national economy was under pressure from shortages and price rises, and society faced a number of sources of instability. The Party Central Committee made the decision to further adjust and curb the advance of basic infrastructure, as a result of which the national economy entered a period of readjustment and reform slowed down. At the time, some economists believed that the first step in this policy should be a restriction on the short- and mid-term equipment loans offered by the banks, because such credit was “a manifestation of credit inflation which was an important cause of the prolongation of basic infrastructure work.” In response, Yang wrote “Some Views on Short- and Mid-Term Credit,” which was

delivered to the State Council and the Party Central Committee. In these policy proposals, he pointed out that experience showed that the billion Yuan and more issued as short- and mid-term loans for plant and equipment had been used to tap the potential of state-owned enterprises, enabling them to reform and upgrade. The investment was relatively small, the local construction projects were modest, and they went into operation quickly. This meant that they could rapidly expand the production of goods in short supply and check price fluctuations while increasing employment through the expanded production, encouraging structural adjustment, and absorbing the machine and electrical goods rendered surplus by the curbs on infrastructure projects. His proposals were adopted by the central leadership. In the readjustment period, it not only refrained from preventing the banks from issuing short- and mid-term loans but explicitly called for more such loans (Yang 1983).

Yang believes that as control of inflation is a precondition for price reform, deregulating prices before inflation has been eliminated is equivalent to standing by while prices soar, to the detriment of the interests of the mass of the people. In the 1980s, some people claimed that as some Western countries had managed to achieve a certain success in social and economic development under the spur of moderate inflation, there could be no harm in giving this approach a try. Yang thought this was wrong, because at the time, capitalist overproduction did not exist in China; on the contrary, our purchasing power often outran the supply of commodities. Furthermore, our infrastructure projects were indeed overextended, and Chinese living standards needed to keep going up. Objectively, the phenomenon of spontaneous inflation already existed; without macro-controls, it might explode and destroy our political security and unity.

Several of China's most famous economists were for instant price reform. West Germany's postwar reforms, which were responsible for the high speed economic growth known as "Erhard's economic miracle," were supposed to have been based on this approach. But Yang, with his years of research into banking and inflation, had his doubts about Germany's successes and their American promoters. He undertook a study tour of West Germany and came to the opposite conclusion. In 1986, he made a special call on Hans Karl Schneider, then Chairman of the German Council of Economic Experts. The latter told him that the postwar German price reforms had adopted a cautious approach. The price of steel, coal, and electric power, sectors that influenced the rest of the economy, had remained regulated because of insufficient supply. They had relied on the funds provided by the Marshall Plan to expand production in these areas and implemented price deregulation only after a basic equilibrium between supply and demand had been reached. After the war, housing shortages meant that house prices and rents were also not deregulated. Twenty years later, rents had been freed up but the price of housing was still rather closely controlled to ward off speculation (Yang 1988).



In 1986, the relevant economic government departments had adopted the policy of “crash through or crash” with regard to price reform, implementing “instant price reform” for some major items that were in short supply. For instance, the price of a ton of steel was set to double or more. After Yang returned from his study tour of Germany, he reported on his visit to the Party Central Committee and the State Council, expressing dissenting views. He proposed that adjustment to the prices of important commodities such as steel should proceed with caution, because their effect would be felt throughout the national economy and could trigger an overall price rise through a complex economic chain reaction. The central leadership called a meeting to examine his report, explaining that this course of action had been decided by the 1986 Beidaihe Central Economic Working Conference and was scheduled to be implemented on January 1 of the following year. The plan had already gone through the Central Committee Secretariat and only awaited the Politburo’s assent. However, after considering Yang’s proposals, the leadership told him it was suspending the plan’s implementation (Li 2000, 229).

In the 1980s, scholars had widely varying assessments of how China’s initial reforms were going. However, when, in the 1990s, Russia took over the reform schemes touted by the West wholesale, it was possible to see “deregulating prices and tightly controlling the money supply” in action in the real world. The former Russian Prime Minister Gaidar was called “the father of the market economy,” but all he knew came out of books and he had never worked in the real economy. The West deliberately selected a number of scholars of this sort for training in neoliberal economics and then introduced them to the Yeltsin government as market economy specialists to be entrusted with the heavy burden of reform. Gaidar was misled by ostensibly scientific but in fact simplistic Western price and supply and demand theories, and so adopted the policy of “deregulating prices to allow the market to do its work and tightly controlling the money supply to curb inflation” that America had been pushing. This led to the hyperinflation Yang had foreseen. Price deregulation was supposed to have freed the market to regulate the economy effectively. But in reality, the main actors in the market, producers and consumers, suffered badly, and the market shrank to less than half its former size in a severe recession. This was not “short-term pain” but a chronic disaster that lasted more than a decade. Only when neoliberal policies were forsaken under the Putin government did the economy begin to recover.

The policy of “deregulating prices and tightly controlling the money supply” trumpeted by the Americans was supposed to stimulate production while curbing prices, but in reality it had an exactly opposite effect. Deregulation sent prices soaring and undermined producer supply and demand. On the supply side, rising prices led to the depreciation of enterprise capital, making it difficult to purchase costly raw materials and equipment. Tighter control of the money supply added to

firms' woes, making it impossible for them to get the equipment loans they needed for structural adjustment or even the operating capital they needed for survival. On the demand side, soaring prices led to hyperinflation, which vaporized the savings accumulated by residents over decades. The lack of effective social demand plunged the market into a depression, and enterprises had trouble maintaining production, let alone expanding investment. The supply of scarce items, such as color TVs and refrigerators, not only failed to improve but went downhill rapidly. The Russian people were hoping for an "economic miracle," but what they actually got was hyperinflation of 2,000% and a recession worse than the Great Depression of the 1930s (Yang 2000).

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*Translated by Sicheng Zhou, Central Compilation & Translation Bureau*