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Inflation and Economic Instability in China

Children love the thrill of roller-coaster rides. For a national economy, however, the precipitous ups and downs can wreak havoc. To a large extent, economic growth in China during the 1980s was like a roller-coaster ride. Bold economic reform brought about impressive increases in economic productivity and improvements in living standards; but, in the process, China also experienced no fewer than three episodes of rising inflation followed by sharp economic slowdowns and business distress.

As the West watches Eastern Europe lurch toward economic reform, it is well to keep in mind the lessons of the Chinese experience. How a socialist planned economy can move toward a more market-oriented economy without unleashing devastating inflation and economic instability is a question of utmost importance not only to China, but to other socialist planned economies as well. China's experience indicates that in the short run inflation can be avoided, or its severity lessened, by judicious monetary policy. In the longer run, however, effective monetary policy would necessitate fundamental changes in the social and economic structure.

The first cycle: 1979-83

In 1979 China began to implement its economic reform, focusing on the rural sector. Almost immediately, prices began to rise: 2 percent in 1979, then 6 percent in 1980.

The sources of the inflationary pressures during that episode are not hard to find. In both 1979 and 1980 government budget deficits were large, amounting respectively to 5.2 percent and 3.3 percent of the value of the national product, compared to a small surplus in 1978. The deficit arose because in 1979 the government raised its procurement prices of farm products and absorbed the cost increase in its budget rather than passing it to consumers. It financed the resultant huge deficit by borrowing from the central bank, which in turn printed money to finance the deficit. As a result, money grew at an average rate of

28 percent a year in 1979 and 1980, compared to 8.5 percent in 1978. The continuing rise in the money supply increased the public's demand for goods and services, and pushed up prices.

To shut off the source of inflation, in 1981 the government stopped borrowing from the central bank and, by drastically reducing its spending on enterprise investments, reduced the budget deficit by two-thirds. It financed the rest of the deficit by forced purchase of government bonds, and even used part of the proceeds to retire its past borrowings from the central bank. As a result, the money growth rate was halved from 29 percent in 1980 to 14.5 percent in 1981. The market response was equally quick: the inflation rate dropped from 6.0 percent in 1980 to 2.4 percent in 1981.

With the tightened fiscal and monetary policies, signs of widespread business distress developed. The total demand for goods declined, unsold goods piled up, and enterprises were holding mounting unpaid bills. Industrial production increased only 1.7 percent in 1981, compared to an 11 percent growth in 1980.

In the next three years, the government kept up the conservative fiscal-monetary policy stance. The budget deficit declined from 5.2 percent of the value of the national output in 1979 to only an average of 1.4 percent in 1981-83; the money growth rate dropped from 29 percent in 1980 to an annual average of 15 percent in the following three years. As a result, inflation fell precipitously from 6 percent in 1980 to an average of 1.9 percent a year in 1981-83. Apparently, low inflation was compatible with high economic growth, as the output growth rate soon picked up from 4.9 percent in 1981 to 8.3 percent in 1982 and 9.8 percent in 1983.

The second cycle: 1984-1985

In 1984, encouraged by the success of rural reform, the authorities turned to urban reform. The scope of mandatory planning on production

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and prices was substantially reduced. Enterprises were given a wide berth in managing their own affairs, and were told to look to banks, instead of the government, for financing. Banks were separated from the central bank and instructed to operate as independent "profit-seeking" institutions. In addition, decentralization transferred much of the economic supervisory and regulatory power to the provincial and municipal governments.

The 1984 reform unleashed a nationwide spending spree. Given autonomy, enterprises provided generous wage increases, bonuses, and all sorts of amenities to workers, and invested as much funds as they could lay their hands on in plants and equipment. The provincial officials were equally eager to promote regional industrial development, and ordered the provincial branches of the banks, which the reform had placed under their control, to extend credit as requested by the enterprises.

The result was an explosive increase in total demand. In 1984, wages rose 20 percent, compared with an average increase of 2.5 percent during the preceding three years; bank credit increased 31 percent, compared with an annual average increase of 14 percent in 1981-83; the money supply grew 49 percent, compared to an average of 15 percent during the preceding three years. As a result, the national output growth rate leaped to 13.5 percent in 1984, greatly straining the economy's productive capacities, compared to an average annual rate of 8 percent in 1981-83. The inflation rate lagged slightly behind, rising from an annual average of 2.0 percent in 1981-83 to 2.8 percent in 1984, and accelerating to 8.8 percent in 1985.

The central authorities responded promptly in 1985 to the rising inflation by slashing government expenditures, raising interest rates, enforcing credit controls on provincial and municipal branches of banks, and ordering reductions in unbudgeted investments. To a large extent, the belt-tightening policy was effective: as total bank credit growth fell to 22 percent in 1985 from 31 percent in 1984, and money growth to 25 percent from 49 percent, the inflation rate declined from 8.8 percent in 1985 to 6.0 percent in 1986. As in 1981, the measures exacted an economic cost in terms of a sharp decline in industrial output growth from 20 percent in the first half of 1985 to 5 percent a year later, rapidly rising

unsold goods, and a steep increase in enterprise losses. As in 1981, the pressures on the central government to ease the austerity measures mounted.

The third cycle: 1986-1990

Unlike the years that followed the 1981 slowdown, the central government this time relented. In 1986, the restrictive policy was reversed. Credit was eased. Monetary growth accelerated from an average annual rate of 14 percent during the year that ended in the first quarter of 1986 to 28 percent during the six quarters from 1986Q2 to 1987Q3. Then, after a brief respite in 1987Q4, monetary growth leaped to an annual average rate of 49 percent a year during the first three quarters of 1988. Under this strong and steady stimulation, national output grew at an unsustainable rate of 11 percent a year in both 1987 and 1988, while inflation accelerated to 9 percent in 1987 and 27 percent in 1988. In the midst of this rising inflation, the authorities announced in mid-1988 a decision to lift all price controls in 1989. The public reacted by rushing to the banks to withdraw their savings and on to the stores to strip their shelves bare. The pro-inflation policy crashed.

Again, the authorities responded in September 1988 by tightening credit control, raising interest rates, ordering drastic cutbacks in investment expenditures, and also re-imposing price controls. In line with the severity of the inflation that preceded them, these measures were much stronger this time than previously and were carried out with greater tenacity. Again, the same plot unfolded, but with stronger intensity: inflation dropped from 27 percent in 1988 to 0.6 percent in 1990Q3, and industrial growth from 18 percent in 1988Q4 to zero percent a year later. Unemployment was widespread. Hundreds of thousands of urban workers returned to the countryside, where they could find little work to do. Those who stayed on their jobs turned out goods that could not be sold. In 1990, China suffered the severest economic recession in recent decades.

Assessment

From this quick preliminary survey of China's inflation and economic instability in the 1980s, obviously it would be premature to draw firm conclusions. Nevertheless, some tentative impressions might be useful for further studies.

First, China's experience in the 1980s does not warrant the pessimistic view that inflation and economic instability are endemic of socialist economic reform. Misguided policy was the primary, if not the only, cause of China's roller-

coaster economic growth during the decade. The inflation in 1980 can be attributed to monetizing the fiscal deficit, and the inflation during 1985 and 1987-89 to unrestrained enterprise spending on capital investment and wage increases, financed by unrestrained extension of bank credit.

The experiences in all three episodes demonstrate the familiar proposition that inflation is basically a monetary phenomenon, which means that it could be avoided, or at least its severity reduced, by appropriate monetary policy. Indeed, the corrective measures adopted in 1981 provide convincing evidence that inflation could be quickly brought under control without prolonged economic dislocations, once monetizing the fiscal deficit ceased.

Second, China's experience also shows that monetary policy alone cannot prevent or fight inflation, because it is by necessity conducted in a politically charged environment. Inflation resurged in 1987 because during the preceding year the authorities were unwilling or unable to bear the cost of temporary dislocations and prematurely resumed monetary stimulation. To bear with the pains of temporary dislocations is basically a political decision which no monetary authorities in the world can make without staunch political support.

In China, and perhaps also in other socialist economies, political support for a strong and unwavering anti-inflationary monetary policy is hindered by the nation's social and economic structure. Because each enterprise is responsible for the welfare—including housing, health, children's education, recreation, retirement pension; in short, almost all aspects of life—of its workers and their families, allowing enterprises, especially large enterprises, to fail would cause serious social dislocations. Moreover, the same paternalism permeates the political structure: provincial and municipal authorities are held responsible for the welfare of all the people within their jurisdictions to an extent unimaginable in market economies. Since the people's livelihoods depend on the enterprises, the local authorities often are inclined to place the interests of the enterprises in their territories ahead of the national interest.

Economic reform conferred autonomy to enterprises and elevated the role of the banks, without

making basic changes to this social and economic structure. Prior to reform, the government budget subsidized the unprofitable enterprises; reform merely shifted the burden to the banks. Indirect financing of enterprises gave the false impression of the market mechanism at work, when in fact there was none. Concealed deficit financing has substituted open deficit financing. The lack of transparency has clouded discussions on inflation and hindered inflation control.

Remedies

In the short run, given the unchanged economic and social structure, monetary policy can be made more effective by gearing it primarily towards achieving and maintaining price stability, and by assuring it a high degree of political support from both the central and the provincial authorities. Decentralization of power since 1984 has weakened the political basis for monetary policy, but not inflicted irreparable damage to it. The vigor and rigor with which monetary policy was tightened, and inflation stamped out, in 1989-90 provides strong evidence that where there is a will, there can still be an effective anti-inflationary monetary policy.

In the longer run, however, a change in the nation's economic and social structure may be needed. So long as the structure is unchanged, enterprises may continue to rely on either the government or the banks to bail them out of the results of their overspending; and, given autonomy, it is likely that they will always overspend. Since government budgets are nearly always hard-pressed, the temptation to pass the buck to the banks may be irresistible.

To change the present economic and social structure does not mean to abandon people's welfare to the vagaries of the marketplace. The government can be as paternalistic towards social welfare as it wants to, without being tied down to the existing economic and social structure, which is probably the least efficient way of delivering social welfare services. To search for an alternative system that will best fit the Chinese conditions requires careful study. But, that is another story.

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