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# FRBSF WEEKLY LETTER

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## Economic Reform in China

Future historians will no doubt say that one of the most momentous world developments during the last quarter of the twentieth century was the near total collapse of socialist economies in the fall of 1989. They will likely also note that the events were preceded by ten years of bold economic reform in China, with remarkable successes as well as failures.

Today, it is striking to see that the serious difficulties China encountered in its efforts to reform have significantly slowed down the reform's forward momentum. The future of that vast country, with one-fourth of the world's population, will depend critically on whether it can successfully overcome these difficulties and resume reform. At the same time, as the Soviet Union and Eastern Europe move toward reform, there is serious concern that they not fall into the same traps that China encountered. For China and for the rest of the world, therefore, it is important to gain a sound assessment of China's economic reform experience of the last ten years.

The topic is obviously too large to be adequately covered in this *Letter*; moreover, much research yet remains to be done. This *Letter* can present no more than a short preliminary survey. It begins with a review of China's economic reform in the 1980s, assesses its present status, and then speculates on its likely course in the future.

### Past Experience

Overall, China's economic reform was a tremendous success. It opened up a huge reservoir of productive energy and enterprising spirit which had been dammed up by rigid economic planning. During the ten years from 1979 to 1989, the national output grew at an average rate of 9.5 percent a year, which compares favorably with the growth record of any country in the world. The result was a very substantial rise in the standard of living of the population, especially those living in the cities and in the countryside of the booming coastal provinces.

Problems began to crop up by 1986. The most obvious was inflation, which accelerated rapidly

to culminate in a nationwide run on banks and panic buying in the summer of 1988. The situation was obviously untenable. Something drastic had to be done. In September 1988, the reform was suspended, and a nationwide austerity program was imposed.

What went wrong? In hindsight, many things went wrong, even before their symptoms became obvious by 1988.

In the first place, the root of inflation lay in an abrupt shift from a centrally planned economy to a semi-market economy without first installing institutions and instruments that are essential for effective implementation of macroeconomic policy. Reform conferred considerable autonomy on enterprises in their production and spending decisions, supposedly in simulation of decision-making in a market economy. However, what was overlooked was that in market economies business decisions are tempered by national monetary and fiscal policies. In China, banks had only limited experience and authority to carry out effective monetary policy for influencing business decisions. Effective fiscal policy was hampered by the lack of an operational modern taxation system and by the heavy burden of government subsidies to maintain urban standards of living.

Under these circumstances, once given autonomy, enterprises went on spending sprees, fueled by excessive bank lending in the name of stimulating and sustaining economic growth. Although wage rates were still centrally regulated, generous bonuses were given out, whether justified by productivity increases or not. Supported by accommodative bankers, enterprises raced to expand factory facilities and build apartments for workers in an overcrowded nation long suffering from severe housing shortages.

The ensuing explosion of aggregate demand was like the fabled uncorking of the bottle that released the genie. As the genie demonstrated great magic power, the people, the government, and the entire outside world were enthralled.

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Then, it was discovered that there were no strings to keep the genie in check. As price increases accelerated, the people panicked.

Second, the ten years of reform did not fundamentally alter the nation's industrial structure. To this day, state enterprises still account for 60 percent of the nation's total industrial product, urban collectives 17 percent, rural enterprises another 17 percent, with the remaining 6 percent accounted for by joint ventures and private enterprises. Despite the reforms, urban collectives remain subject to tight controls by local governments. Thus, over three-fourths of the nation's industrial output is still in the hands of managers who have limited incentives and accountability in their job performance. Whatever economic dynamism there was in the last ten years arose mainly from agriculture—which was essentially freed from government controls as early as 1980—as well as from the rapidly expanding rural- and private-enterprise industrial sectors. In contrast, the state enterprises and urban collectives have remained heavy drags on the economy.

Third, because of concerns over inflation, the authorities were hesitant to lift price controls altogether. Instead, they installed a two-tiered price system, with output within quota to be sold at regulated, below-market prices and output above quota at free-market prices. The intention was to provide a transitional period to gradually phase out the quotas and allow enterprises time to adjust to the expanding free-market prices. However, because of inflation fears, the intended phasing-out was not fully carried out. In the meantime, the system created vast opportunities for business managers and local government officials to arbitrage between the quota prices and market prices, and make handsome profits for themselves. Corruption was rampant. It stirred up seething social discontent and eroded popular enthusiasm for reform.

Fourth, decentralization of economic decision-making degenerated into regional fragmentation. Ostensibly, decentralization was meant to shift power to local governments, which are closer than the central government to the localities they serve. In fact, however, the local governments soon became entrenched in regional economic interests to the extent of practicing regional economic protectionism. In order to foster regional

economic growth and protect local jobs, vast subsidies were extended to inefficient industries. Barriers to inter-regional movement of goods and services were erected, especially on materials and energy that were in stringent supply, and on skilled labor and highly valued technical or managerial personnel. At times, even inter-regional clearance of bank funds was hampered. The result was waste and inefficiency on a grand scale, as well as obstruction of the implementation of national monetary and fiscal policies.

## **Present status**

In September 1988 an austerity program was imposed in order to gain control over a runaway inflation. The program consisted of tight reins on bank credit, drastic cutbacks on business investment and on government spending, reinstatement of price controls, and restrictions on foreign trade. However, not all aspects were strictly enforced until after the summer of 1989.

The result of the austerity program has been dramatic. The retail price inflation rate dropped from 27 percent in the first half of 1989 to 6 percent by the year's end and 0.6 percent in the third quarter of 1990. The success in controlling inflation, however, was purchased at a high economic cost. The nation's industrial growth rate fell from 18 percent a year in the fourth quarter of 1988 to nearly zero a year later. Unemployment soared, and enterprises were laden with huge stocks of unsold goods. Particularly hard hit was the dynamic rural enterprise sector, which was denied access to bank credit and essential industrial materials, in order to sustain the inefficient, loss-incurring state enterprises. Widespread unemployment created serious social problems, with which the government was ill-equipped to cope, for lack of an operative unemployment compensation system.

Toward the end of 1989, as pressure mounted, the authorities began to release massive amounts of bank credit to enterprises in an effort to revive the economy. Total bank loans to enterprises rose 40 percent at an annual rate during the fourth quarter of 1989, compared to an average 14 percent a year during the preceding four quarters. Bank lending continued to grow at a rapid rate in 1990. In addition, the authorities relented on their policy of suppressing rural enterprises and allowed them increased access to credit and materials.

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Industrial output revived with a considerable lag. Its annual growth rate stayed near zero in the first quarter of 1990, rising to 5 percent by the third quarter, but jumped to 14 percent in the fourth quarter. At the same time, however, signs of renewed inflationary pressures have appeared, as the retail price inflation rate leaped to an estimated 10 percent in the fourth quarter of 1990.

All in all, the authorities must be given credit for having brought inflation under control. The cost to the economy was high, but probably inevitable and obviously manageable. However, the task was accomplished not through the working of the market mechanism, but through returning to mandatory controls. Past experience has clearly demonstrated that such controls were clumsy and fraught with problems, including repeatedly throwing the economy into short cycles of inflationary growth and sharp economic slowdowns. Nevertheless, without an institutional framework for effective macroeconomic adjustments, the authorities probably had little choice but to resort to mandatory controls.

In the meantime, reform has slowed markedly. A number of fundamental problems remain unresolved. The banking system has yet to be reformed, taxation has become more restrictive and distortive as a result of a series of inappropriate patchwork measures, and rapidly rising government subsidies have added an increasingly unbearable burden to the budget. Although rural industries and private enterprises have been allowed more room to operate, the problems of handling the large, inefficient state enterprises and urban collectives remain baffling. Open corruption has abated, but the two-tiered price system is still in place. Finally, economic fragmentation continues to rank among the nation's topmost problems, as regional economic interests remain deeply and firmly entrenched.

### **Future prospects**

Because so little progress has been made in economic reform since September 1988, suspicion is widespread that the authorities are anti-reform. The suspicion, however, is ill-founded. The benefits of the reform of the 1980s are too obvious to be denied by even the most rabid "conservatives." There is today general agreement in China, among the public as well as within the government, that the country cannot possibly return to the rigid planning controls that prevailed prior to 1979. As stated, the purpose of

the partial restoration of mandatory control in September 1988 was to curb inflation. Now that inflation appears to be under control—gnawing signs of its recent resurgence notwithstanding—the next step should be to resume reform.

The question is how: how to transform a centrally planned economy into a market-oriented economy without generating unacceptably high inflation and social dislocation? This is the same question confronting many socialist countries today. Despite China's ten years of reform experience, a successful transformation remains an elusive goal. Once burned, twice shy. China appears to be sitting out the current reform movement in the Soviet Union and Eastern Europe and watching on the sidelines to see how it will turn out. In the meantime, it will continue to make relatively minor adjustments in its existing half-reformed economic structure, in pursuit of "reform with stability."

Bold economic reform in China was a hallmark of the 1980s. As the 1990s opened, a more cautious mood has set in, which is probably just as well in view of the lessons that have been learned from the experience of the preceding decade. A headlong move from a rigid, centrally planned economy toward a more market-oriented economy without first putting in place effective safeguards and check-and-balance mechanisms is likely to cause painful stumbles, at great cost to a nation. History does not provide sufficient evidence to tell whether or not the reward at the end of such a move would be worth the cost. One can understand, even sympathize with, a desire for caution.

There is, however, only a thin line separating caution and timidity. The litmus test lies in whether or not caution is combined with an active search for effective ways to deal with the pitfalls that caused past economic reform to stumble. Indications are encouraging. Researchers in China, obviously under the direction of the authorities, are hard at work attempting to unravel the complex problems that have ensnared China's economic reform. Their success or failure will affect not only the lives of the more than one billion people in China, but those in other socialist countries as well.

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