

CHINA:

COPING WITH DENG'S LAST FLING

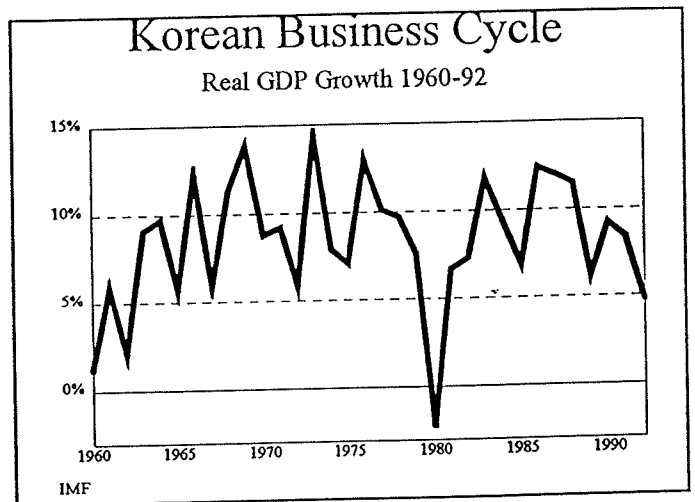
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COPING WITH DENG'S LAST FLING

In early 1992, following several years of austerity for China's economy, Deng Xiaoping decided to revivify China's reform movement and to accelerate its economic growth. Conservative Premier Li Peng submitted a plan for five years of 6 percent growth and reform at a similarly moderate pace. Deng's allies forced dozens of modifications to Li's program. Then Deng made a triumphal tour of southern China, where reform has progressed farthest, and called on the Chinese people to seize the opportunity for another great push forward. There ensued a year of phenomenal growth--12.8 percent--and, not surprisingly, the revival of serious inflationary pressures.

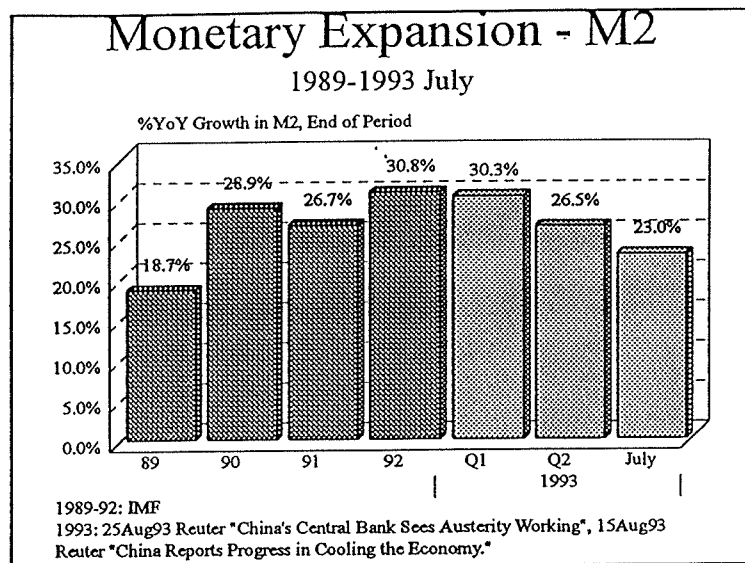
The Asian takeoffs have tended to have steep business cycles in the early phases of the takeoffs. An economy growing ten percent annually is a very spirited horse, and in the early takeoff phases the monetary reins available to guide the horse are primitive and poorly attached. The basic commands available are "Whoa" and "Gallop." The economic model closest to what China is doing is the South Korean takeoff from 1960 to 1988. As the charts show, the Chinese and South Korean business cycles have both been quite steep. (Caution: the Korean chart covers 30 years, the China chart half that period since China's reform began only in 1980.)



The Korean cycle went a little bit higher (to 15 percent rather than 13) and, in 1980, much lower (minus 6 percent at the bottom, rather than plus 4 percent for China so far), because South Korea was far less cautious in managing its inflation and debt than China has been. The Western press treated the disinflation of 1990, which bottomed out at a 4 percent growth rate, as if the Chinese economy had collapsed in depression, and the steep drop from 11 percent in 1988 did create considerable pain, but in fact 4 percent

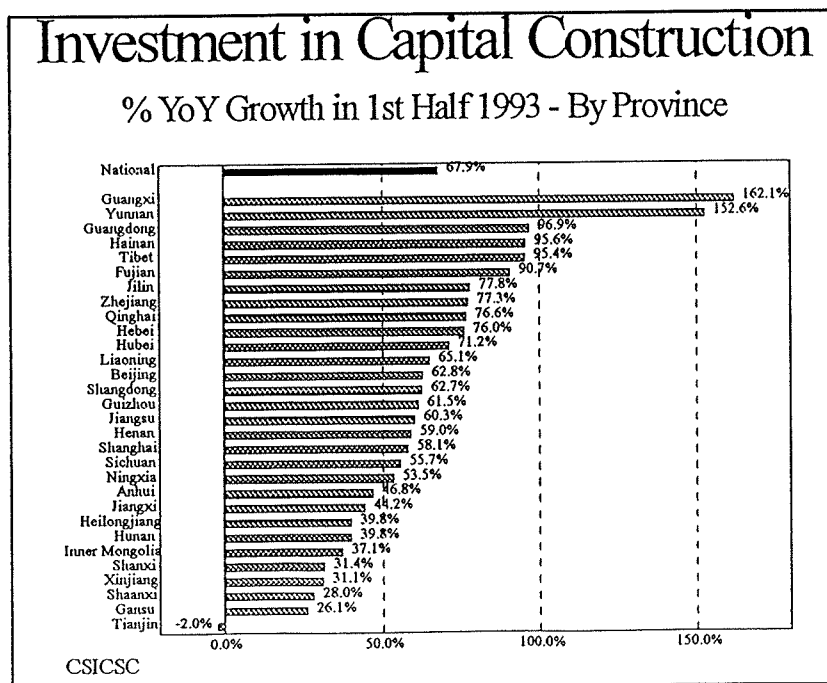
remained a performance that most economies would have envied.

Following its disinflation in 1988-'89, China experienced three years of money (M2) growth at around 30 percent. Given this rate, what is surprising is that inflation did not ignite earlier. Aside from the lags between money growth and the real economic consequences, at least part of what was happening was the emergence of a new kind of inflation for China, inflation of financial assets rather than real assets. In the early phases of reform, inflationary money



growth resulted primarily in shortages of goods while prices were controlled. During the 1988 inflation, prices zoomed upward and panic buying removed goods from the shelves; people preferred rice, bicycles, and televisions to money. During 1992-'93, however, there were gluts of most basic consumer goods; few people needed more rice, bicycles, or televisions, and in consequence inflationary pressures were funneled into financial assets. This was a rough analogue of what happened in Japan during the 1980s: consumer prices remained relatively stable, but financial assets such as stocks and real estate reached outrageous price levels.

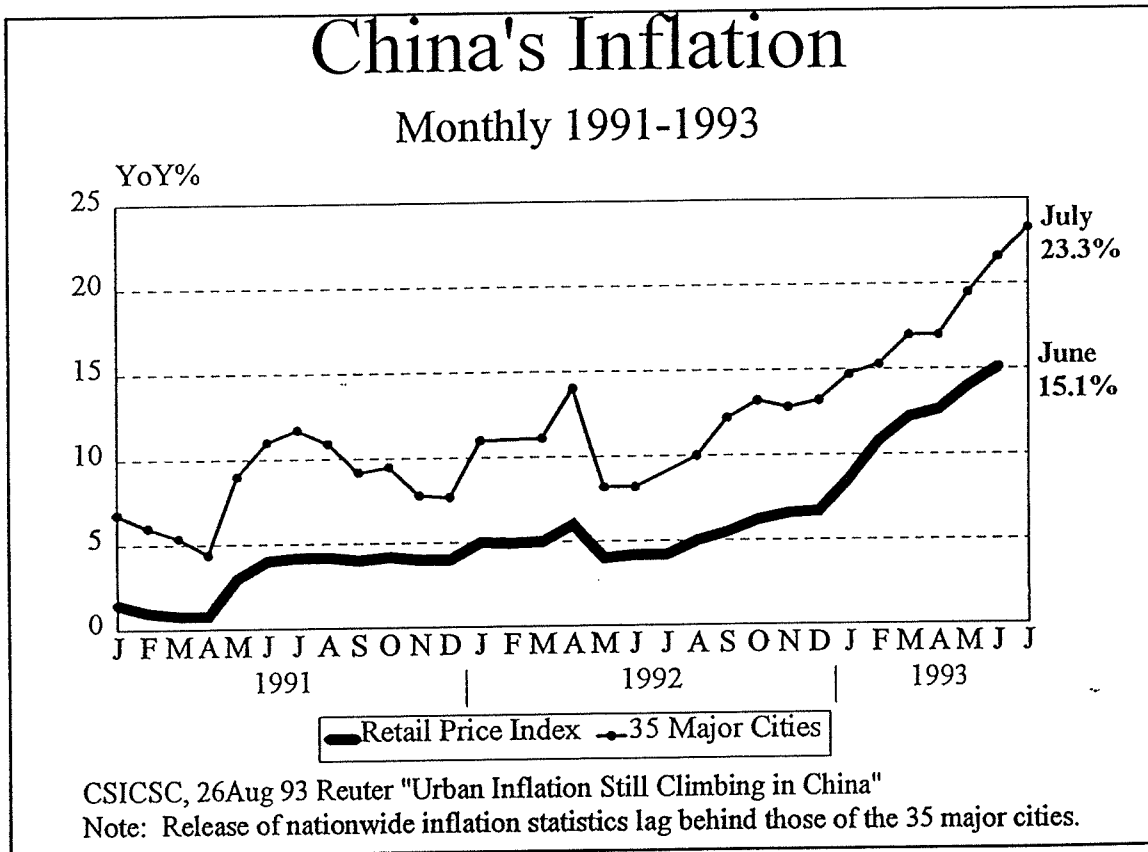
What happened in China was far less dramatic than what happened in Japan, but stock



markets soared, real estate prices and construction went wild, and vast investments poured into gold, foreign exchange, Hong Kong stocks, and Hong Kong real estate.

The most striking non-financial aspect of this inflation has been extraordinary capital spending, much of it by state enterprises, and associated with this was wild real estate speculation.

As the chart of investment in capital construction shows, this form of investment catapulted upward almost 70 percent in the first half of 1993. And such acceleration of investment was also typical of the previous two years. Such investment growth is completely unsustainable and of course led to massive shortages of construction materials, inflating the prices of steel and cement and causing imports to rise excessively. This caused prices of goods to take off dramatically from the second half of 1992.

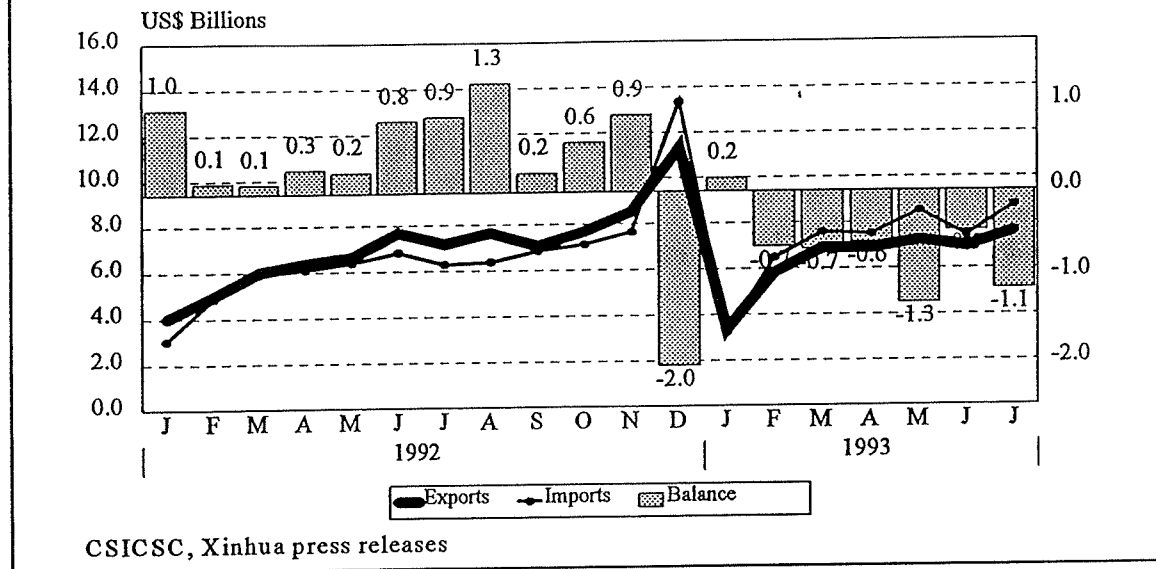


Most of the banks (all of which are state owned) formed wholly owned subsidiaries for real estate speculation and poured loans into them. Local governments did the same, often diverting money intended for infrastructure and for payments owed to farmers into real estate speculation. Associated with this was a spread of world-class corruption; in China's transition from socialism to the market the development of norms regarding conflicts of interest has barely begun. While China's top leaders remain honest (nobody has ever accused Deng Xiaoping or Zhu Rongji of pecuniary ambitions), middle and lower level figures, and often the children of senior leaders, have really enjoyed the last few years. Party and government officials still have so much control over access to housing, labor, and raw materials, and over licenses and tax privileges, that they can creatively combine regulatory authority and market license to extract huge bribes and monopoly rents.

China's trade balance plunged from very large surpluses to substantial deficits.

China's Trade Balance

Monthly 1992-1993



The government's budget deficit also increased substantially as revenues dried up due to a tax structure that abrogated the most important sources of revenue in favor of the provinces and to the government's obligation to bail out its banks and state enterprises from the consequences of their excesses.

Through the first quarter of 1993, strong political inhibitions blocked any effective anti-inflation policies. Deng Xiaoping had waged a great political struggle against Premier Li Peng's plan for low 6 percent growth. Cutbacks were associated with political opposition to Deng's desire for a faster pace of reforms. By the second quarter, however, the scale of the problem was undeniable. As inflation neared the levels associated with Tiananmen Square in 1989 (18 percent in the country as a whole, twice that level in major cities), Party and government leaders were forced to recognize that uncontrolled inflation could threaten all their plans, political as well as economic.

Executive Vice Premier Zhu Rongzhi, a tough technocratic manager, elbowed aside those who refused to deal with the inflation threat. In the process, he also elbowed aside the ailing Premier Li Peng. Zhu took over the governorship of the Central Bank and used that platform to impose austerity measures and banking reforms. In doing so, he displaced one of Li Peng's key allies. This turned the political tables: instead of the conservatives coming in to clean up a problem caused by the liberals, a relative liberal, Zhu Rongji, took charge of cleaning up the mess by discharging an important conservative. Thus the reformers carried the day, if Zhu Rongji could control inflation, but they also took full and undeniable responsibility for fixing the problems they had created.

Zhu Rongji imposed a sixteen-point austerity program designed to control inflation without crippling vital infrastructure construction.

**Zhu's 16 Point Solution:
"Document No. 6" - July 2, 1993**

Interbank lending strictly forbidden.

Increased interest rates.

Unauthorized fund-raising strictly prohibited. Interest rates not to exceed those offered by banks.

Macro-level controls enforced on money supply and credit.

All specialized banks to ensure full payment of savings deposits.

Subsidiary enterprises of banks to be severed by specific deadlines.

Monetary and investment reforms to be implemented simultaneously.

State Treasury Bond issuance to be completed within a short period of time. Issuance of stocks and bonds to adhere strictly to regulations. Enterprises strictly forbidden from issuing internal stocks.

Efforts to be made to improve foreign exchange management

Macro-level controls over real estate to be reinforced. Nationwide inspection to be conducted to recover unauthorized development zones for agriculture.

20% cut imposed on government spending. Approval not to be granted for new imports of cars in the latter half of the year.

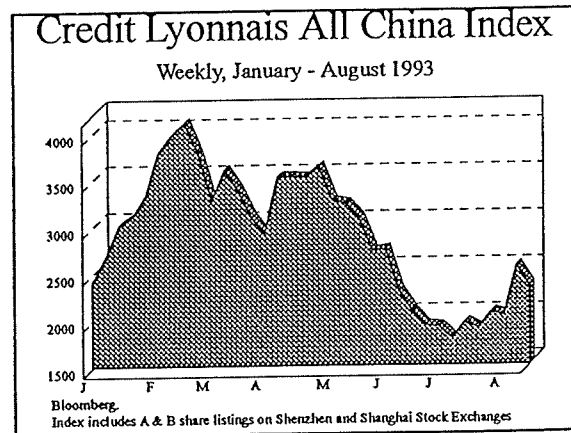
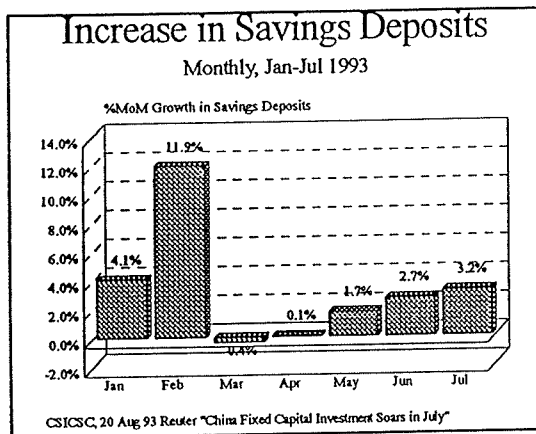
New price reform measures to be suspended. (Those already enacted are exempt.)

Banks forbidden from issuing IOUs to farmers. Banks to ensure sufficient funds are available for summer grain purchases and spring ploughing.

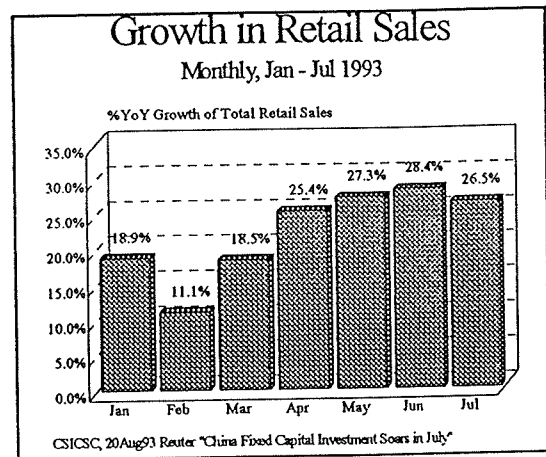
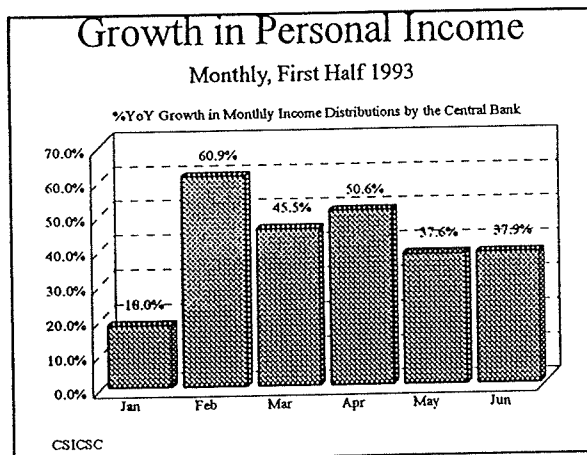
The scale of infrastructure projects to be reduced.

Central authorities to send inspection groups to all localities to ensure that the monetary situation is put in order.

These measures, and milder ones implemented earlier, appear to be having considerable effect. Illegal interbank lending was checked, and a considerable volume of unauthorized loans for capital construction was retrieved. Irregular fund raising, mainly by government bonds and company bonds, was largely terminated. Issuance of IOUs rather than money payment to farmers was terminated. Savings rates rose, particularly noteworthy in light of the earlier slippage of deposits. The currency, which had slipped badly to about 11 to one U.S. dollar, rebounded to the range of 8.6 to 8.8. (There is regular intervention on the order of \$10 or \$20 million, but such intervention would have little effect if tried on a currency, such as the rouble, which was far from equilibrium.)



Negative indicators also showed that the austerity program was biting. The stock market indices dropped sharply, and real estate prices soon followed. Interest rates on the black market rose to about 25 percent--as compared with around 9 percent charged by Chinese banks.



Personal income growth and retail sales growth topped out. All this showed that Zhu's program was making serious progress. But success will depend on continued firmness. As this was written, the trade balance and the overall inflation rate still have not topped out.

The government is attempting a soft landing. Last time around, in 1988-'89, the government stepped on the brakes with both feet, bankrupting millions of small enterprises and causing enormous political tension. On that occasion, growth declined precipitately from around 12 percent to around 4. This time, the government seeks to make the 1993 growth rate decline from the over-13 percent rate of the first half and in subsequent years to sustain an average real GNP growth rate of eight to nine percent. In doing this, the government seeks to squeeze out speculative activity but to maintain investment in all important infrastructure projects--by the simple expedient of telling the banks to continue lending to specified infrastructure projects but not to real estate speculation.

Such a soft landing would be a neat trick. Given the records of other Asian takeoffs, probably too neat. Something more precipitous, but far short of disastrous, is much more likely. The real risk is on the side of the government softening up too soon and failing to get the inflation rate down before it gets substantially worse. Then the austerity program would have to get really tough and the collateral damage could become serious. It would be particularly damaging if a premature loosening of austerity policies were to coincide with the death of Deng Xiaoping; in the ensuing power struggle it could become more difficult to gain consensus on tough austerity measures.

This raises the issue of political stability. The inflation of 1988-'89 was one of several causes of Tiananmen Square. This time, the dynamics are different. In 1989, people were obsessed with politics; this time they are obsessed with making money. In 1989 urban residents were on relatively fixed incomes and were unaccustomed to coping with the market; now they are staying ahead of inflation and are familiar with market adjustments. In 1989 panic buying and bank runs became frequent; now panic buying is rare and savings deposits are rising.

The key social problem this time around is rural rather than urban, and the key political problem is the center's ability to impose its austerity programs on the provinces. So far, the center seems clearly capable of imposing austerity on the provinces. But its ability to ensure that the farmers are paid what they are owed remains to be demonstrated. In the short run, the farmers see the central government as their allies in the fight against corrupt mayors who are not paying them. This gives the central government several years to solve the problem. But it must solve the rural problem within several years, else the farmers will begin seeing the whole system as their enemy.

On balance, it appears that China is just passing the top of the third major inflation cycle since reform began. Its success in containing inflation during the two previous cycles, and the improvement of its anti-inflation tools since then, justify substantial optimism about its ability to control inflation this time. The tenacity of the anti-inflation program at the time of Tiananmen Square, a time when Western politicians would have loosened up, provides some assurance that the political will to contain inflation will remain firm. But China is unlikely to manage the super-soft landing that its leaders are seeking. The principal alternative scenario is a premature relaxation of austerity measures followed by a much more severe downturn.

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