

Bankers Trust Company Country Assessment

International Economics

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CHINA: ECONOMIC REFORMS IN CONTROVERSY

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1. How is reform going?

Markets
Risks

2. Phases

Confucius rural industrialism - 800's
- irreversible

Euphoric market - Deng/Zhao

1984-5 crisis

Flood of imports

Will exp. of money supply/turn over

little foreign investment

corruption

Xenophobia & banning foreign clothing

acknowledged errors; gave opponents in open forum

stepped on brake very hard

and pushing accelerator - stopped

3. Still, no support for revival of radicalism

Peasantry thoroughly committed

Global Stolypin still a love option

Stock markets, floating rate monetary & lending, bonds

4. Attitude on debt ~~still~~ has remained constant

- we're not going to become dep. on foreigners

- we're going to pay our debts (FSU at height of crisis)

- will pay a big price in policy for monetary base position

6. Emergence of serious markets

4. Institutionalization - conf. leaders

Mil

Gert/Pruby - new leaders

- reduced role in enterprises

- 3 levels of successors

DRAFT

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CHINA: ECONOMIC REFORMS IN CONTROVERSY

Throughout the 1980s, the core of China's economics and politics has been a broad program of insitutional revitalization and economic reform initiated by Deng Xiaoping in 1978.

The Recent History of Reform

During the initial period of reforms, from 1979 to early 1983, the Deng Xiaoping regime benefitted from immediate political and economic successes, with very limited costs. Politically, Deng benefitted from nearly unanimous support of China's technocrats, from nearly universal revulsion against the Cultural Revolution excesses, and from an utter lack of persuasive alternatives proposed by his opponents. Agricultural reform came first and was an immediate, almost unqualified success; farmers' incomes are now two and a half times greater than in 1978. Urban reforms were limited, slowly implemented, and balanced among sectors; despite reforms, the urban policy was a cautious bureaucratic Stalinism. Inflation was negligible, foreign reserves were high, and the trade balance was favorable.

The year 1983 saw the political ascent of Premier Zhao Ziyang and his group of much more ambitious market-oriented reformers. Early 1984 brought accelerated market reforms, and the autumn saw the announcement of price reforms, wage reforms, and increased delegation of managerial responsibility. In each of these areas, reforms were seriously needed. Previously, prices bore no reasonable resemblance to market values, and this caused serious distortion of the economy. Previously, wages bore little relationship to enterprise profitability or to the level of responsibility of the workers, and the enterprise was forced to retain every worker regardless of misbehavior or incompetence. Zhao's team pressed for prices closer to market values, wages closer to productivity, more decisions by managers close to concrete market conditions, substitution of taxes for the old practice of state confiscation of all profits, and privatization of small scale enterprises.

However desperately these reforms were needed, they nonetheless had major unintended consequences in the context of an economy which for 35 years had lacked market disciplines. By late 1984, China's economy was drunk with reforms. As tens of thousands of managers and entrepreneurs, inexperienced and unfamiliar with the demands of the market, launched new projects, China's economy spiraled out of control.

Loans, investments, growth, and wages reached unsustainable levels. In the first seven months of 1985, the economy grew at a 23 percent annual rate, construction grew at a 44.9 percent annual rate, and the trade balance suffered a massive \$7.9 billion deficit, sharply cutting China's foreign reserves.

Because the government announced that 1985 wages would be based on 1984, enterprises accelerated wage increases and wages grew 40 percent in the fourth quarter of 1984. For similar reasons, bank lending exploded in that quarter. Impending price reforms led to panic buying and severe shortages of major commodities.

Many celebrated projects and policies created at least some disillusionment in this atmosphere of economic explosion. Hainan Island, given freedom from most import restrictions in an effort to lift it out of terrible poverty, went massively into the business of circumventing the import restrictions that were still supposed to apply to other provinces. The result was a multi-billion dollar scandal in which the province actually acquired loans that vastly exceeded the value of the island's total agricultural and industrial production. Throughout China, corruption blossomed. Entrepreneurs committed huge sums to improbable investments. Rural "banks" found it more profitable (in the short term) to engage in Ponzi schemes than to invest deposits in the productive enterprises.

Beijing slammed on the brakes and in key cases reversed. Old import controls were reimposed. A foreign exchange squeeze was applied to staunch the hemorrhaging of foreign reserves, and a credit squeeze to stop the explosion of credit. Strict central supervision of many kinds of investment and credit decisions reappeared. The drive to open fourteen coastal cities for foreign investment has effectively been cut back to only four: Shanghai, Tianjin, Dalian, and Canton. (However, income taxes remain at 15 percent, rather than the 35 percent imposed elsewhere, even in the remaining ten cities.) Much of the managerial decentralization, and much of the urban price reform program, were reversed.

The leadership admitted to serious errors. But they also announced that reform would continue, and in 1986 Beijing once again stepped on the accelerator -- but very cautiously.

China in 1985 experienced an overall growth of output of about 15 percent, and a growth of income of 10 percent in industry and 9.5 percent in agriculture. Despite a rising inflation rate, this was conducive to political stability.

Assessment of the Economic Reform

China's Sixth Five Year Plan, which ended in 1985, is the first five year plan conducted under Deng Xiaoping's reform program. It aimed for a four percent rate of economic growth of output and income and achieved about ten percent. During this period, China's overt inflation stayed under 10 percent. (One Japanese estimate puts overall inflation, overt and suppressed, at 12.8 percent for 1979-84; it would be higher in 1985). It accomplished this while implementing far-reaching rural reforms that put China far ahead of the Soviet Union and Eastern Europe in creating a successful, decentralized, market-oriented agriculture, along with foreign trade liberalizations that have

vastly expanded China's exports and imports, and enterprise reforms that have begun to improve incentives for productivity and efficiency.

The rural reforms have given families responsibility for production and rewards for producing. In the past three years, China's rural areas have experienced real income growth of 14.7 percent, 14.7 percent, and 9.5 percent respectively. The rural areas have further benefitted from a tremendous diversification of sources of income: they now earn only about half their income from crop cultivation. These successes give farmers a commitment to the system, and they make reversal of the major rural reforms a political impossibility.

The openness and Western orientation of China's economy, compared with the past, are no longer in doubt. The growth of China's trade has been spectacular. Except for a list of essential commodities, China gives top priority to exports rather than domestic consumption, and China has decentralized the right to export in order to encourage localities and enterprises to take the initiative in exporting. Despite huge new trade agreements with the Soviet Union [see "East-East"], China conducts less than 10 percent of its trade with other communist countries.

There is increasing acceptance of the concept that competition is acceptable and can lead to gains in efficiency. For instance, China's textile firms compete vigorously against one another. Several Chinese shipping companies compete on the routes between Hong Kong and Chinese cities to the north. Beijing has fostered competition among banks in key markets. In an economy as sheltered as China's has been, even a limited introduction of competition has a major long-term impact on efficiency.

At the same time, the urban, trade, and foreign investment reforms have run into difficulties and the overheating of the economy since in 1984-5 has heightened controversy over the direction of reform. Rapid growth has overtaxed available transport, energy, and raw materials. Incentive systems have created relatively rich groups for the first time since 1949, and price liberalization has hurt some groups, such as retirees; the resulting inequality has caused considerable resentment. Scandals have occurred, and there has been some xenophobic reaction to foreign influence. These problems have forced sharp curtailment of important urban reforms and have increased controversies and political struggles among different groups of reformers.

Problems have occurred in China's showcase special economic zones. Shenzhen, in recent years the most important of the zones, and the premier exhibit of China's opening to the outside world, has now been severely criticized for earning its way by exploiting its special privileges to sell things to the rest of China, rather than exporting, and for channeling large amounts of government funds into construction rather than getting profitable enterprises to pay for the construction. In short, Shenzhen is

being accused of abused its privileges as Hainan Island officials did earlier, albeit in a more legal and subtle way. These criticisms may or may not be correct, since Shenzhen officials retort that they have used very little central government money for construction and that the exporters back into China are not foreigners but domestic Chinese firms that have established operations in Shenzhen. But, regardless of the merits of the arguments, the political controversy is an important indicator of leadership differences.

China continues to have problems moving to market prices. Unless prices have some reasonable relationship to supply and demand, the move to a more market-oriented economy makes no sense: the profitability of an enterprise will reflect only its good or bad luck in getting low input prices and high product prices. In China, primary products are priced low and highly processed products generally priced high. Government offices decide which products to export, and subsidize those products to whatever level is necessary to sell them. State firms are expected to export some items, with prices deliberately set below cost, at a loss, and to make up the loss by selling other products at artificially high prices. Product prices have not been allowed to change with international market prices (e.g., oil) or with changes in the cost of production (rising for coal, falling for synthetic textiles).

There have been some successes in the price reform program. The government now buys only a fixed amount of grain, letting the rest be sold on the free market. This limits the amount of grain that receives a state subsidy, easing China's greatest fiscal drain (about 30 percent of the total budget). Prices of certain non-staple foods such as pork and vegetables have been successfully floated, along with those of many minor industrial goods and of an important freely traded margin of key industrial inputs. Transportation prices have been somewhat rationalized. But staple (food grains, edible oils) prices remain fixed, and most fuel, raw materials, and production goods are still sold by the government at fixed prices.

Wage reform is a necessary complement of price reform. In the rural areas, the system of family plots and widespread free markets means that income now depends on productivity. Industry has been gradually pressured to introduce a system of bonuses and penalties tying income to productive work. A 1985 reform of pay for teachers and civil servants sought to link pay more closely to specific work; it was politically acceptable in part because it granted substantial raises. According to China Daily, (May 9, 1986), 15 percent of workers in State enterprises have been covered by a similar reform. But urban wage reforms are very gradual, and their implementation in practice greatly lags behind their official endorsement.

China's efforts to attract foreign investment and foreign technology, and to enter foreign markets, have also met with disappointments. Despite impressive reforms designed to attract

foreign investment, China's infrastructure remains weak, its workers' productivity low, its red tape costs high, and its wage costs too high to compete with neighbors like Taiwan in most areas and most industries. Its efforts to acquire foreign technology have had limited success, in part because they have coincided with Reagan administration efforts to curtail the flow abroad of militarily useful technology. Its drive to capture foreign markets has coincided with a period of economic stagnation and protectionism in Western markets.

China is making steady progress in establishing a base of rules of the game for domestic and foreign business. It has recently established basic accounting rules. Foreign investors still find many laws vague, however, and most Chinese enterprises will take some time before implementing sound accounting. In 1986, Beijing has sought to make important joint ventures far more attractive by liberalizing foreign exchange requirements, granting more access to the domestic market, and allowing 30 to 50 year joint ventures when China needs the technology or for some other reason feels these privileges are appropriate. But it severely tightened the financial rules for smaller firms. Thus a few big investors will find investment easier and many small ones will find it even harder.

After spending the second half of 1985 taking emergency measures to control inflation, investment, the trade deficit, and xenophobic reactions, Beijing's planners decided in 1986 that the economy was under control again. The new Seventh Five year Plan emphasizes continued reform, but reform with sobriety. It aims for industry to grow 7.5 percent per year and agriculture 4 percent. The industrial target is twice that of the previous Five Year Plan, but considerably below what was actually accomplished. Most observers consider the plan conservative.

The Politics of Continued Reform

By 1985 expectations had been raised unsustainably high, and the problems of late 1984 and early 1985 were very dramatic. Moreover, political reaction against economic disappointments has been supplemented by deepseated Chinese cultural reactions against the intrusion of foreigners and foreign ways. China's press has recently made much of the danger that foreigners might spread AIDS in China. The medical community has launched a program to educate doctors about venereal diseases which, although nearly eliminated by China's post-revolutionary puritanism, are expected to be reintroduced by foreigners. And there has been mass burning of clothing from abroad on the grounds that it may be contaminated by foreign diseases.

China's leadership has responded to these setbacks by publicly admitting errors, retreating where necessary, and expressing renewed determination to move forward with a reform program. Meanwhile, Deng Xiaoping has pressed forward with political and military reform. The military is being successfully reduced from

four million soldiers to three million. China's eleven military regions have been reorganized into eight, giving Deng the ability to reshuffle commands and leaders. The role of the military in the Politburo is being reduced by eliminating seven out of eight positions formerly held by military officers. The slimming, modernizing, and professionalizing of the army will strengthen civilians and increase the number and influence of military officers sympathetic to the reform program.

Deng has succeeded at installing numerous powerful figures throughout China's governmental and Party leadership. To an extent that was never true of his Maoist predecessors, he has been an organization man who put institution-building above self-promotion. In three years, more than half of the Central Committee of the Communist Party has been replaced, 950 out of 1350 senior provincial leaders have been retired, including almost all governors and party secretaries, and thirteen central government ministers have been replaced. In connection with the Central Committee meeting in September, 131 senior government officials resigned. This record implies broad success for Deng in reorganizing the government to support his reform program.

At lower levels, too, Deng has been seeking to institutionalize support for his reforms. He has reduced the role of local Party officials in economic enterprises. He is gradually carrying out a great purge of radical members of the Communist Party, and he has an ambitious program to retrain a large proportion of the rest. He has retired over half of the government officials who took office before 1949 -- more than a million individuals. In the process, he has streamlined decision-making units and given authority to younger and better educated officials.

Deng has also been planning for the succession. Unlike Mao in 1976, and unlike Chiang Ching-kuo in Taiwan today, Deng has actively replaced much of the aged leadership, so that his own death will not likely be accompanied in a short period of time by the demise of much of the senior leadership. He is instituting a mandatory retirement system. He has groomed potential successors to himself, notably Party leader Hu Yao-bang and government head Zhao Ziyang, and also potential successors to them. In the process of putting his kind of people in place, he has treated most opponents with respect, accepting the risk that they would continue to influence policy in return for avoidance of the formation of a totally alienated clique that would one day assert itself in disruptive ways.

Deng has remained flexible enough so far to limit unintended economic and social consequences of the reform that might produce an effective reaction against it. He has vigorously retrenched when inflation or debt seemed on the verge of becoming excessive; China will not be a Brazil. He has shown considerable flexibility in dealing with xenophobia, corruption, and resentment of emergent social inequality. His reforms have made China a more relaxed and comfortable place to live. They have brought the strong to the support of the new system, while

incurring some resentment on the part of the weak.

In the meantime there has been no revival of radical Maoist enthusiasm; that period of Chinese history is gone forever, because no social group sees benefits in ultra-radical policies.

Nonetheless, the future of China's reforms remains in question. At the September Central Committee meeting, Chen Yun, First Secretary of the Central Commission for Discipline Inspection and Zhao Ziyang's more conservative predecessor as economic czar, openly confronted Deng Xiaoping and demanded a return to greater bureaucratic control of the economy. China's urban economy could become much more market-oriented, following the example of the successful rural reforms. But it could also evolve into industrial Stalinism -- a Chinese equivalent of the way Moscow runs the industrial economy.

A very large and influential group of leaders favors such an approach, on economic grounds (avoiding problems like those of 1985), ideological grounds (not abandoning socialism), cultural grounds (avoidance of foreign influence, disease, and corruption), and political grounds (firm control of industry and finance facilitate firm control of politics). Victory of the industrial Stalinists would not create a crisis, but it would slow progress.

The Banking Environment

Because China's growth rate is high and its potential financial needs great, and because much of the rest of the world is beset with slow growth or lack of creditworthiness, China has been a focus of extraordinary interest for international banks.

China remains extremely conservative in managing its foreign exchange. Its sovereign credit record is impeccable. While there are frequent changes of the range of entities allowed to give guarantees, and some ambiguity in the extent to which higher level government organizations guarantee subordinate levels' financial commitments, there has never, even in China's most radical periods, been any question of China's willingness to honor a sovereign obligation. China's willingness to pay, in short, is as strong as that of any country in the world.

Its ability to pay raises more initial questions. China wants to import a great deal. There is a huge pent up social demand for imports, and China's leaders want to import technology for rapid modernization. Moreover, China's expansion of imports has been a good deal more successful than its expansion of exports, and the decline of oil prices will drastically reduce the value of its exports. But China's fear of acquiring excessive debt remains strong enough to be called a phobia. It can postpone imports of equipment, and it can cut off imports of consumer goods completely, and the government is willing to do so if necessary to maintain its foreign exchange position. The severe crackdown

of 1985 was just the latest example of China's willingness to do this. In contrast with India, China is strengthening the institutional structures that implement such policies. Thus, its ability to pay is also high, because of its self-sufficiency and its communist ability to crack down on imports.

China remains a difficult banking market. As in Taiwan, there are too many banks chasing too little need for funds. Of the eighty commercial banks with offices in China, probably no more than four make money in any given year. As in Taiwan, the absence of modern accounting makes credit assessment of enterprises difficult. Title to property is in many cases legally ambiguous, a problem for leasing deals. The Chinese concept of force majeure is extremely broad, a potential problem for guarantees. None of these problems raises issues of sovereign risk, but they do create major issues for profitability and credit risk.

China's market therefore is inherently unattractive to an incremental traditional commercial lender. It offers many large and profitable niches, however, from project financing to acquisitions to trading. While Chinese financial markets can only be termed primitive, the Chinese financial system is evolving at a rate unparalleled elsewhere in the world. This will create major opportunities. It is noteworthy that China is experimenting with highly liberalized capital markets: China Daily of May 22 reports that a city in Zhejiang is experimenting successfully with floating rate borrowing and lending by rural credit coops and that the city government has been issuing bonds and using the proceeds to fund promising industries. There are signs that nascent stock markets will be allowed to develop; investors in five cities are being allowed to buy shares in government enterprises, and there are articles in the press advocating the opening of stock markets. (A very limited number of private enterprises has long sold shares, but there is as yet no public trading of shares.) Some enterprises, including a bicycle factory, are being allowed to issue bonds. Any bank that finds a way to shape such markets, or to sequester a share of them, will be riding a very long wave.