CHINA'S REFORMS: 
THE NEXT WAVE

During a visit of 15 Hong Kong-based economic analysts to Beijing, Chinese officials outlined plans for sweeping further reforms during China’s eighth five-year plan.

The most important reforms center around a new push for price reform. Officials indicated a determination to rely on market prices for most products, raise basic commodity prices, and end dual-track pricing. Most consumer prices will be freed completely. Prices of vital necessities such as grain will be controlled but pushed far closer to market levels. Guangdong and Fukien have already increased grain prices 30 percent, and people have accepted this. Key industrial inputs such as glass, concrete, and steel will fluctuate within a band.

Currently, many basic commodities, including coal and oil, are priced at a fraction of market value. This encourages waste and precludes insistence that state firms make a profit. Therefore raising these prices to market levels is seen as essential not just for conservation but also as a prerequisite to instituting a bankruptcy system.

Many commodities currently have two prices: a low price for a quota that a farmer or firm must provide to the state and a much higher market price for the remainder. Market prices for grain were triple the quota prices last year, double this year. Planners, acknowledging that this not only created inefficiencies but also stimulated widespread corruption, said the quota price will gradually be brought in line with market prices until the two are unified.

The plan will call for housing prices to be raised gradually and for private home ownership to be expanded. Today, it is not unusual for family payments on a middle class home to be only 2 renminbi (US$0.42) per month. Even including larger payments by the enterprise, rents do not even cover maintenance, much less the 20-30 billion renminbi annual cost of building new houses for an expanding population. The result has been a desperate housing shortage and a huge financial burden for the state. Officials indicated that the long-run goal is to encourage private home ownership by raising rents to a level that will create an incentive for home purchases. They characterized this as a financial necessity, not just a visionary plan. The shift to private housing is clearly a very long-range goal, but if fully implemented would by itself revolutionize Chinese society.
Expansion of bond markets

China will rapidly expand its financial markets. Bond markets are expanding explosively, with bonds valued at 45 billion renminbi slated for issue this year as compared with 100 billion for the entire past decade. Stock markets are still very limited, but officials expressed a consensus on the importance of stock markets to China’s future. The current tiny stock markets in Shenzhen and Shanghai will expand very cautiously, and a centralized trading system has been developed in Beijing. More stock markets are to be opened soon in interior cities. Officials indicated that an early opening to foreigners is possible.

New futures market

In September, a futures market for agricultural products will open in Henan. This will be experimental and confined entirely to domestic participation. Given the scale of agricultural production in China, and the vital importance of stabilizing domestic grain prices, the advent of futures markets could prove crucial to China’s economic future.

Labor mobility

China has also moved to enhance labor mobility. Most importantly, university graduates now have the right to choose between having the state assign them jobs or finding jobs themselves. If they find jobs themselves, the government has to certify that the jobs are appropriate, but recent graduates said that this simply involves the university’s certifying that they have training appropriate to the job in order to prevent corrupt appointments to inappropriately high positions. The universities, graduates said, are easygoing about this certification.

The content of education has also been changed. Recipients of masters degrees in international finance from the central bank said that all of their textbooks were British and American financial texts. Recent graduates’ opinions were as market-oriented as those of an American MBA.

New social security

China will introduce a social security system. Today, assured employment in their state enterprise makes unemployment insurance unnecessary, and each enterprise is responsible for its own retired workers. Hence a social security system to provide unemployment and retirement benefits is a prerequisite of using a bankruptcy system to reform enterprises.

Near-market foreign exchange system

Foreign exchange is being put on a market basis. China has repeatedly devalued the renminbi in order to move the currency closer to market rates. An increasing proportion of China’s foreign exchange transactions goes through foreign exchange adjustment centers, now available in every major city, which operate on a purely market basis. Almost 50 percent of all foreign exchange transactions are conducted through the centers. This will eventually create a market renminbi.
China's economic reform program can be described without excessive oversimplification as following a sequence of overlapping phases: market incentives for production, opening to foreign investment, then price reforms, then enterprise reforms. The first phase freed farmers and some enterprises to receive market benefits from producing a margin of goods for sale at market prices; in support of this, they were allowed to reorganize within limits and to use foreign capital within narrow limits. Market incentives for farmers, enterprises and workers succeeded beyond dreams in the 1980s, but price reforms self-destructed in a bout of inflation that reached 25.2% nationwide.

While the inflation was blamed on price reforms, it was a combination of price reforms, over-investment, transformation of old scarcities into new demand, and lack of tools to manage aggregate demand. The rising role of bond markets, and rising use of bank loans rather than grants to finance investments, has dramatically increased the role of China's banking system. Top central bank officials said they now intend to control inflation by controlling the money supply even while prices are being simultaneously liberalized. This shift from dictated prices to market methods revolutionizes China's financial management and yields the first hope for price reform without hyper-inflation. (Of course, whether they will have the discipline to use the new tools firmly remains to be seen.)

Chinese planners also plan a vast tax reform. The current tax system has allowed the provinces to give broad exemptions to enterprises and to raise their own revenues while causing the center's to decline.

Enterprise reforms, including bankruptcy and privatization, are lagging behind price reforms. Partly the delays are ideological, but officials argue persuasively that price reforms and social security must precede wide-ranging enterprise reforms. It would make little sense to force a coal company into bankruptcy when the price of coals is fixed by the state at a fraction of the market price. An immediate bankruptcy system would bring down the entire banking system, which has funded the deficits of all these firms with loans. And it would create widespread hardship in the absence of a social safety net. So, for the time being, China handles moribund companies the way the U.S. handles moribund banks: by merging them with more efficient firms. As the U.S. problem with savings and loan institutions shows, this approach has inherent limitations.
The use of bankruptcy to eliminate inefficient firms logically requires widespread private ownership to be effective. (If the state is the owner, how can the enterprise go bankrupt? One Chinese economist said that if we could help him to make bankruptcy consistent with socialist theory, he would be sure to win the Nobel Prize in economics.) Likewise, the use of stock markets to raise capital will only be efficient in a context of widespread private ownership, because only if ownership is private can stockholders pressure or change management in order to increase profits. Eventually the Chinese economic reform will have to confront these issues of enterprise reform. Deferring them makes sense; avoiding them will never work. Chinese planners seem to understand this.

Although important differences on speed and sequence of reforms remain, Beijing has achieved consensus that reform should move forward. Contrary to widespread impression, the principal risks to reform no longer come from orthodox ideology. The orthodox few are old and are losing their grip on the major institutions. They have no credible theory of victory over China’s economic problems. The real risks are: long delays caused by struggles among ministries and banks for control of key sectors; a potential renewed bout of inflation if the center should fail to impose firm priorities; and as part of the latter a possible inability to control the military budget. In sum, the real risk is lack of firm leadership.

The bad news is that this puts the short-term burden of coherent reform squarely on the back of one man, Deng Xiaoping, who just passed his 86th birthday. The good news is that the younger generation has largely abandoned the illusions of the past, is set with desire to lead the economy in more promising directions; and does now possess a credible theory of victory.

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